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## The Essence of Goal-Based Investing

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By Kerry Pechter    Wed, Sep 7, 2016

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*Goal-based investing is more than just mental accounting that assigns labels like “house,” “college” or “retirement” to different pots of money. It's ultimately about risk management, as we learned from Lionel Martellini, director of France's EDHEC Risk Institute.*

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It was July 15, only a day after the horrific truck attack on a crowded seaside esplanade in Nice, France. Lionel Martellini, the director of the [EDHEC Risk Institute](#) in Nice, appeared slightly uncertain as he approached the lectern in a conference room on the mezzanine of the Grand Hyatt in midtown Manhattan.

The 48-year-old Martellini admitted that he was shaken by the terroristic event in his hometown. But, after assuring the audience of two-dozen or so pension economists that his family and friends in southern France were safe, he plunged into the third session of a three-day seminar blandly called “Advances in Asset Allocation.”

*RIJ* first [reported](#) on Martellini’s work, which is far from bland, last March. Since then, he’s been campaigning for a financial services “revolution” that will make the management of individual retirement accounts more like managing pensions: More goal-based, reliant on the sophisticated risk management tools, and focused on delivering retirement income.

That revolution is necessary, he believes, because the shift from defined benefit to defined contribution plans makes middle-class people responsible for creating their own pensions. So, even though Martellini’s audience at the Grand Hyatt consisted of pension wonks, his work is relevant to investors and their advisors.

If you’re an advisor who’s familiar with the curriculum of the [Retirement Management Analyst](#) or the [Retirement Income Certified Professional](#), the following may sound familiar. If you’re a more traditional investment advisor who’s curious about goal-based investing, this report on Martellini’s recent seminar may reveal a new way to look at saving for retirement.

### What ‘goal-based’ means

Listening to Martellini, a contrast emerges between conventional and “goal-based” investing (“liability-driven” investing, in the language of pensions). Goal-based investing is more than just a form of mental accounting that assigns labels like “house,” “college” or “retirement” to different pots of money.

A switch to goal-based investing, for instance, changes the way advisors assess their clients’ risk capacity. Instead of asking new clients how far they could stand to watch the value of their accounts drop without panicking, a goal-based advisor measures a client’s risk “capacity” or risk “budget” by calculating how much of their savings clients can afford to put into risky assets without jeopardizing the achievement of their savings goals.

“Risk aversion is irrelevant,” Martellini said. “We need to understand *loss* aversion, relative to goals, not risk aversion.”

In practice, different clients will have different risk capacities. It won’t depend on their fortitude in the face a market downturn. It will depend on the differences between their savings rates, their time horizons, and the amount of savings they’ll need to fund their retirements.

“You can’t decide what the client’s essential goals will be. But with your help, the client will be able to calculate his floor. After that, your job will be to show clients the different opportunity costs”—what you might miss by being too conservative, for instance, or how much more you might have to save—“between different routes to his goals,” Martellini said.

Establishing a “floor” is central to goal-based investing. A traditional investor hopes or expects that his advisor or fund manager will outperform a market benchmark using stocks and bonds. A goal-based investor relies on his advisor to act more like a pension fund manager—using a conservative “goal-seeking” portfolio to fund an essential level of income in retirement and a “performance-seeking” portfolio of risky assets with upside potential that will finance discretionary spending in retirement.

### **A goal-based advisor’s job**

It’s the synergy between those two portfolios that makes goal-based investing interesting. Martellini likes to use automotive analogies. As he puts it, clients face different routes to their retirement savings goal—straight and smooth, uphill and down, or carved by hidden curves. Goal-based advisors apply the only three risk management techniques at their disposal—diversification, hedging or insurance—to help clients reach their goals safely, on time, and fuel-efficiently (i.e., with the least contributions).

When it comes to managing risk (i.e., volatility) during the accumulation period, traditional advisors and goal-based advisors take very different approaches. A traditional advisor might periodically rebalance a client's portfolio by selling winners and restoring the original asset allocation. Goal-based advisors (or their fund managers), are more inclined to do the opposite, with a kind of stop-loss strategy.

Using what's known as dynamic asset allocation, they might practice *daily* rebalancing between the client's goal-seeking portfolio and the performance-seeking portfolio. Instead of selling risky assets that have appreciated, they might sell losers before the losses can break through the client's pre-determined floor. Somewhat counter-intuitively, they buy back risky assets as their value recovers.

That particular type of dynamic asset allocation is called Constant Proportion Portfolio Insurance (CPPI). It protects the goal-seeking portfolio to fulfill its mission. It's more momentum-based than contrarian, and it's more defensive than aggressive. Like other forms of goal-based investing, it values accuracy over distance.

"Dynamic asset allocation reacts to changes in market conditions," Martellini said. "It lets you go faster when the road is straight and slows you down when the road is windy. You'll never reach your goals if you go too slowly. The question is, how much of the portfolio can the client afford to allocate to risky assets and still be safe?"

"The client is in the driver's seat," he added. "But advisors have to be smart about how they spend the client's risk budget. Their skill is all about implementing the efficient use of diversification, hedging, and insurance. The client makes his own decisions, the market does what it will, and the advisor tries to get the best possible outcome."

### **Putting GBI into practice**

Many advisors and investors already use products to practice goal-based investing, perhaps without being aware of it. When people buy a fixed index annuity, for instance, 95% of their money goes into a goal-seeking portfolio of bonds that preserves the principal and 5% goes into a performance-seeking portfolio of options on an equity index that will appreciate if the index goes up.

Similarly, when people buy the Even Keel managed-risk mutual funds, part of their investment pays for a Milliman short-futures strategy; the futures gain value if and when the underlying equities lose value. When people bought Prudential's variable annuity with the Highest Daily living benefit a few years ago, most didn't realize that Prudential was

practicing CPPI with their money.

In an interview, Martellini had admiring things to say about Dimensional Fund Advisors' target date funds, which emphasize the funding of an income-generating portfolio of Treasury Inflation-Protected Securities (TIPS) by the retirement date. He also likes BlackRock's CoRI Index, which shows people how much inflation-adjusted lifetime income their savings would produce starting at age 65, based on their current age, current level of savings and prevailing bond prices.

Martellini and his colleagues at the EDHEC Risk Institute, which was founded at France's School of Advanced Business Studies (EDHEC) in 2001 to do research on pension risk management, have their own [project](#) underway. They want to "encourage the adoption of cost-efficient retirement solution that would have defined benefit-like qualities," he told *RIJ*.

Their solution would involve dynamic asset allocation between two low-cost, high-liquidity exchange-traded funds (ETFs): a bond ETF leading to a bond ladder that would provide income from about age 65 to age 85, and a balanced ETF invested in EDHEC's proprietary smart-factor indices that would provide upside potential. Martellini believes that smart-beta or smart factor indices provide better risk-adjusted returns than conventional capital-weighted indices. Income after age 85 might be provided by a longevity annuity.

Ultimately, Martellini envisions the "mass-customization" of such a solution. (Within the next few days, he'll be presenting a paper on the topic at a Retirement Investing conference in Oxford, England, co-sponsored by Oxford University, EDHEC Risk Institute and the Journal of Investment Management.)

He feels strongly that millions of defined contribution participants worldwide will need customized, goal-based savings strategies in order to enjoy a secure retirement. But he knows it won't necessarily be easy. "Mass customization is made harder by the facts that people have different ages and different dates of retirement as well as different amounts of savings," he told *RIJ*. "They also have different streams of future contributions and different essential and aspirational goals. We know how to do it. We just have to make it happen."

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