



mind fields

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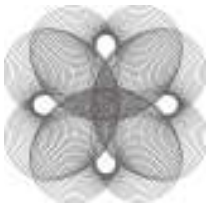
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Introduction

introduction

Mind Fields is produced by the Research team at Advantage Asset Managers.

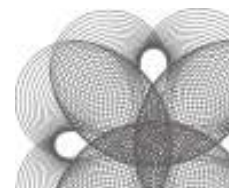
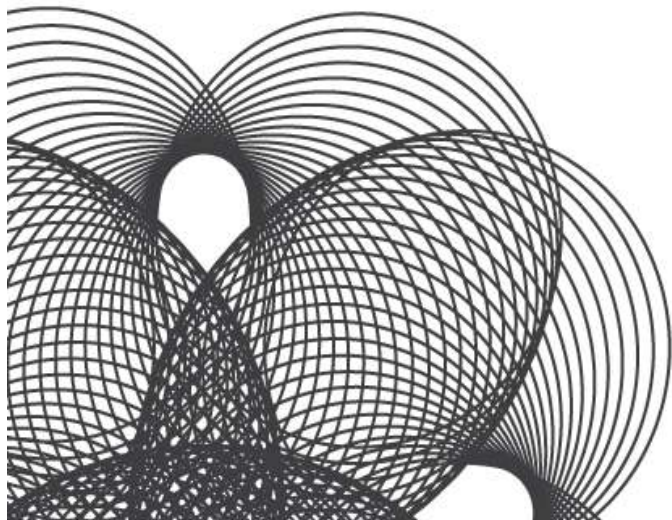
Mind Fields provides a platform for introducing and debating the more controversial and complex issues that face our industry. We aim to share the insights of our Research team, and provide ongoing output on a wide range of research initiatives that should have particular significance to investors and trustees.

Mind Fields will provide readers with simple, high-level overview of each of the topics under discussion. We envisage a format, though, that directs readers to more substantive, technical documents on our website.

Most importantly, Mind Fields provides a critical communication link that allows readers to feed back commentary and questions.

We welcome suggestions of specific topics that you would like to see the Research team address, so please feel free to contact us directly at sonjas@advantage.am

complexity simplified



Why the best laid plans are failing members



Anne Cabot-Allet-Hauser

Anne is the Chief Investment Officer of Advantage Asset Managers

When asked to make a decision about anything as complicated as determining a twenty year investment strategy that can assure that the value of your growth in savings keeps pace with the cost of living, most people freeze up, and make decisions that better reflect a “path of least resistance” than a carefully calibrated decision.

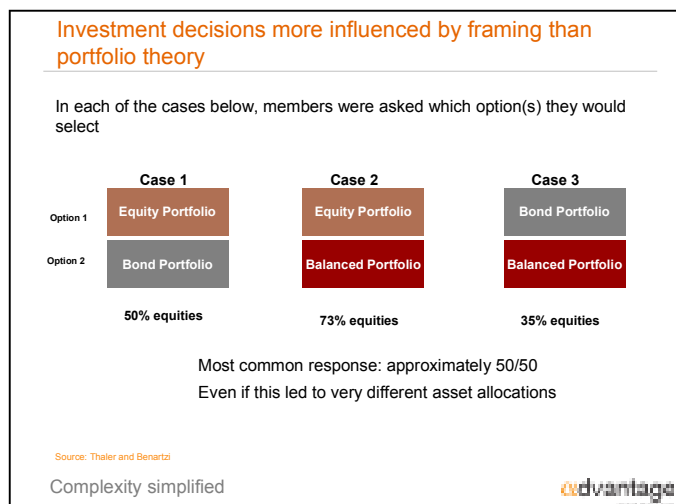
There’s a wonderful story I always make a point of telling whenever trustees are debating the issue of member choice in their retirement funds. The story involves Harry Markowitz, the esteemed academic who won the Nobel Prize in Finance for his Modern Portfolio Theory – the same theory that underpins the principle that members can change their risk profile on their portfolio by changing its asset mix towards less risky assets. Anyway, as the press reported it, Professor Markowitz was asked what asset mix he would select for his own retirement fund. Without a blink, his pithy reply was...“How do I know what’s going to happen? I guess I’d invest 50% in equities and 50% in bonds!”

What makes his response particularly significant is that research shows that this is pretty much the answer that most of us mortals give...Nobel prize holder or not. When asked to make a decision about anything as complicated as determining a twenty year investment strategy that can assure that the value of your growth in savings keeps pace with the cost of living, most people freeze up, and make decisions that better reflect a “path of least resistance” than a carefully calibrated decision. This means that, more often than not, they’ll simply divide their investment choice between all the options on offer. So...give a member two options to choose from for their retirement strategy, and they divide their allocations 50/50. Give them three options, and they’ll typically divide it 33/33/33, give them four options and...you see the drift.

What’s amazing about this reflex reaction is that it seems to defy rational insight. For example, when Thaler and Benartzi were testing the phenomenon, they gave three groups of pension fund members the following options to choose from:¹

- Group A could elect to choose between a 100% equity portfolio, a 100% bond portfolio, or some combination of the two.
- Group B was given the choice of a 100% equity portfolio, a 100% balanced portfolio, or some combination of the two.
- Group C was given the choice of a 100% bond portfolio, a 100% balanced portfolio, or some combination of the two.

True to form, the almost universal response was 50:50 in all three groups – no matter what the equity exposure translated into given these allocations. So, in the case of Group A, their 50/50 split left them with 50% in equities. In Group B, they had an exposure of 73% in equities, and Group C’s split decision netted them a mere 35% in equities! (see Graph 1 below).



1 Benartzi and Thaler, 2001, “Naive Diversification Strategies in Retirement Savings Plans,” American Economic Review, March 91(1): 79 - 98.

The industry is still failing at the most basic step in the process: getting the member into the right solution in the first place – and then getting them to where they need to go over time to address a lifetime of savings requirements and investment concerns.

The dominant factor dictating investor decision-making in retirement fund investing appears to be *inertia* – not a rational process of weighing up the options.

Nor does the decision seem to be predicated on members' assessments of their risk profile. Thaler and Benartzi discovered that when they gave workers an opportunity to choose between their own age/risk appropriate portfolio and the portfolio of the median participant, 8 out of 10 participants preferred the median portfolio to their own. The implication here is that members have little clear insight or commitment to the investment rationale of their own portfolio. As such, when confronted with the reality that the average member of the fund has a very different portfolio, the preference was clearly to go along with what the rest of the members did – whether this is an appropriate solution or not.²

But we are describing only one of a half dozen behavioural phenomena that are contributing to the most important reality our industry has yet to properly face. In spite of the extensive amount of intellectual capital being applied by investment professionals to identifying the “optimal investment strategy” for accommodating every possible attitude for risk, every possible funding requirement, over every imaginable time-frame, it appears as though the industry is still failing at the most basic step in the process: getting the member into the right solution in the first place – and then getting them to where they need to go over time to address a lifetime of savings requirements and investment concerns.

As Olivia Mitchell and Stephen Utkus summarised the problem in their excellent working paper “Lessons from Behavioural Finance for Retirement Plan Design”: “Behavioural research...challenges some of the most central assumptions of decision-making: that workers are rational, autonomous, microcalculators who exercise independent and unbiased judgment when it comes to their retirement plans.”³

We are only just beginning to appreciate how powerful this force is. Consider this conclusion of the authors, for example. In their estimation, the dominant factor dictating investor decision-making in retirement fund investing appears to be *inertia* – not a rational process of weighing up the options. Inertia is what keeps members from signing up for plans in the first place (unless plans are compulsory); it's what keeps members from increasing their savings rate when failure to do so will clearly create a drag on achieving their replacement ratio targets; it's what accounts for the fact that once investment programmes are set, only 10% of members make any further changes in their portfolio asset allocation (unless a Lifestage portfolio forces the appropriate change over time)⁴; and, most disturbingly, it's what accounts for the fact that even when pension plans set up elaborate member education programmes, these too fail to get members any closer to their optimal investment strategy over the course of their membership.⁵

Why is inertia such a dominant force? To begin with, we probably grossly underestimate how difficult and complex a job retirement plan investing really is. As Mitchell and Utkus state the problem:

“Being good at retirement savings requires accurate estimates of uncertain future processes including lifetime earnings, asset returns, tax rates, family and health status and longevity. In order to solve this problem, the human brain as a calculating machine would need to have the capacity to solve many decades long time value of money problems, with massive uncertainties as to stochastic cash flows and their timing.”⁶

So inertia is really just one way our brain tells us that it simply doesn't know how to resolve all the complexity.

But, there are a number of other equally dysfunctional behaviours that our brains revert to during the complex member decision-making process and these also demand our attention.

Consider this example:

Can't make a decision about the optimal path to retirement investing? Then the “path of least resistance” heuristic (short cut) leads members to either:

- Just go with the crowd – pick the median portfolio selected by all the members of your Fund (regardless of their ages or years to retirement).
- Buy a solution that has an equal exposure to all of South Africa's top fund managers – regardless as to whether this solution meets your own funding retirements and time frame.

2 Benartzi, Shlomo and Richard Thaler 2002 : “How Much Is Investor Autonomy Worth?” Journal of Finance ((57) 4: 1593-1616.

3 Mitchell, Olivia and Utkus, Stephen, 2003, “Lessons from Behavioral Finance for Retirement Plan Design” Wharton Business School Working Paper, p.30.

4 Madrian, Brigitte C. and Dennis F. Shea, 2001 “The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior.” Quarterly Journal of Economics. 116 (4) 1149-1187.

5 In a study by Choi, Laibson, Madrian and Metrick, they discovered that immediately following one of their educational seminars, they could elicit a 100% commitment to “action” from members attending their seminars. “In fact, however, over the next 6 months, only 14% did so”. Disheartening news to say the least.

6 Mitchell and Utkus, *ibid*, p.3.

- Let an expert do it for you. Fall back on the default selected for you by the trustees of the Fund. Perhaps they know a thing or two that you don't.

The examples go on and on. We will come back to a few more. Bottom line is that unless our industry gets serious about understanding and addressing these types of behavioural issues, and works collaboratively to develop ways to mitigate against these sub-optimal decisions, then the best laid investment plans will continue to fail the members – and not because the investments have gone sour.

What Behavioural Finance can teach us

What behavioural finance is beginning to teach us is that we need to re-examine a number of conventional practices if we are going to get it right. What follows is a discussion of where these practices are failing the process, why they're failing the process, and what we, the broad group of fiduciaries responsible for these assets, can do to ensure a better outcome. We grant that these suggestions may prove to be quite provocative at first – but, in light of the findings of our authors – they may actually redress some of the problems we all grapple with.

Risk profiling in isolation should be banned!

Point 1: Risk profiling in isolation should be banned!

Just how do we structure investment options to members of pension funds?

It is the rare investment tender or beauty parade of manager skills that doesn't request that an asset manager provide trustees with their very best (house view) recommendation for an "aggressive", "moderate" and "conservative" investment option. What comes across as a perfectly straightforward request actually masks a minefield of potential problems.

Here's the crux of it. What exactly is meant by "aggressive", "moderate", "conservative"? Do the consultants, the trustees, the members, and the investment managers/multi-managers even begin to share the same understanding of these adjectives and, more importantly, do they have the same expectations as to how these different solutions should:

- Be structured?
- Behave under different market conditions?

Any tool provided to members that helps them make investment choices should include at a minimum the individual member's financial status as well.

Not likely.

Even more problematic is whether members can meaningfully assess their own risk profile. Chances are that a 28 year old mother who is the sole provider for two children is going to view her current situation as precarious and readily tick the "conservative" risk profile box. But is a cash or the low risk portfolio the right long term retirement funding strategy for someone who will undoubtedly be required to work for most of her life to provide the required family support?

Similarly, is it the right strategy for a senior member of the fund, who has the bulk of their external wealth tied up in market-related assets, to compound their bet on the markets so close to retirement by selecting a high risk, high performing single manager portfolio for their "asset holding of last resort"?

These are complex questions. But two things are clear:

Risk profiling questionnaires as the only decision-making tool are unlikely to get us any closer to the right answer. With such thought provoking questions such as "do you like bungee-jumping?", it's little wonder that research is now suggesting that risk aversion questionnaires do little more than help members identify what their attitude towards risk is **at that specific moment in time** – an insight that may bear little relationship at all to what their attitude would be should their pension fund replacement ratio fail to hit its mark twenty years from now. Any tool provided to members that helps them make investment choices should include at a minimum the individual member's financial status as well.

To begin with, we are up against an all-too-human tendency known as "hyperbolic discounting".⁷ This is the mental sleight of hand that leads individuals to undervalue (under-prioritise) future long term benefits and overvalue the nearer dated opportunities. It's the same behavioural phenomenon that results in many members of provi-

Menu design may have a greater impact on decision-making than option design.

dent funds simply opting to take as large a lump sum payout as they possibly can at retirement, in spite of all the well-meaning advice to invest that cash in some form of annuity. And it's the same phenomenon that results in risk profiles merely capturing the risk attitudes of individuals to the environment that surrounds them in their present circumstances, and not the environment that might meet them 20 years from now if they failed to meet their funding requirements. No questionnaire would be likely to elicit that emotional response.

Point 2: Menu design may have a greater impact on decision-making than option design.

For most trustees, consultants, and service providers such as ourselves, the primary focus is typically on the extremely complex problem of making sure that the investment strategy or range of investment strategies selected have the highest probability of delivering what is promised to members. The irony is that much of this good work may be completely undone by – of all innocuous-seeming things – how we present these options on the decision forms we give members!

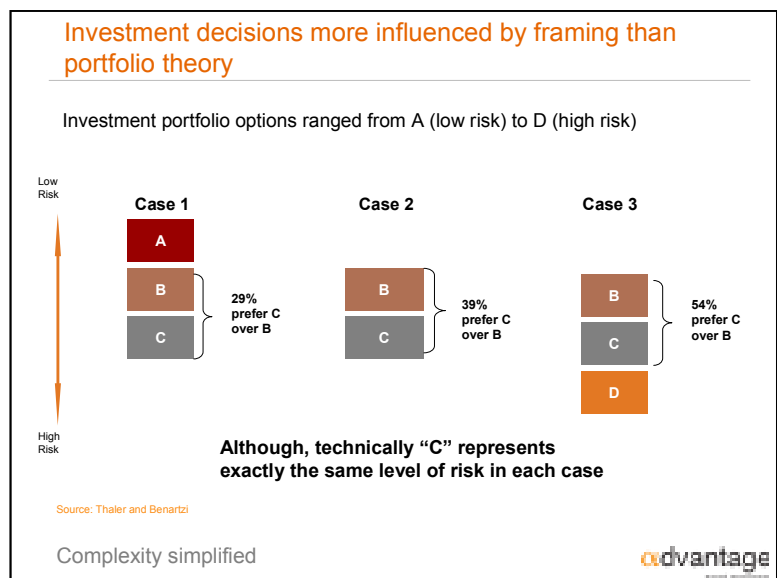
To start with, “the path of least resistance” phenomenon stacks the odds heavily in favour of whatever gets listed first. Even when a default option is made available, if it is listed last, as they often are, the very members who should be opting for the default may not be reading far enough into the document to actually select it.

But the behavioural phenomenon known as “framing” also plays an important role. Here the issue refers to how the layout of the options may end up inadvertently leading the decision-makers to the wrong decision simply because of the way the decision was “framed”.

Consider that most option sheets typically list available choices in order of their riskiness. List the least risky portfolio first and this will become the dominant choice. List the most risky portfolio first and this too will get selected more times than our calculated distribution would suggest. For many individuals, listing something first subliminally suggests that it may well be best.

Behavioural research is suggesting that better education does not necessarily lead to better investment decisions.

A better example of framing is perhaps illustrated in another fascinating study by Benartzi and Thaler. In this study they developed four portfolios ranging from portfolio A to D that each reflected a different risk profile ranging from most aggressive to least aggressive. Different groupings of these portfolios were presented to three different groups of members to determine their preferences. Astonishingly, although portfolio C reflected the same risk profile in each grouping, how it was positioned relative to other options being offered to members impacted their preference for the portfolio. For example, if the C portfolio was positioned last – indicating that it had the most extreme risk profile, it would garner the lowest number of preferences. If C was one of two options available (although still the last listed option) the preferences increased – but still didn't exceed the first option. And if C was sandwiched in between two other options, this is when it would attract the highest number of votes (this is when the “select the median” heuristic clearly kicked in). (see Graph 2^o below).



Point 3: Members who may be more investment-savvy do not necessarily make better retirement fund decisions.

There is an accepted wisdom that members of pension funds who are well-informed about the nature of investments will make better decisions about long term retirement investments. Ironically, these are often the very members or trustees who lobby hard to have more aggressive or exotic options represented on the member choice platform. But again, behavioural research is suggesting that better education does not necessarily lead to better investment decisions.

In addition to the issues of hyperbolic discounting and framing that afflict all of us, we add to the list the “anchoring heuristic”. Anchoring simply tells us that the starting point of your investment experience can often have a greater influence on what you invest in and how, than where your end point should dictate.

Mitchell and Utkus investigated 2.3 million participants in the Vanguard Group’s pension plans:

- “Participants who enrolled in their plans near the top of the bull market in 1999 allocated more than 70% to equities in their member choice options, notwithstanding the huge market drop sustained over the preceding three-year period.
- Meanwhile participants who newly enrolled during the first months of 2003 after a three year fall in US equity prices, allocated only 48% of new monies to equities.”

This not only illustrates how sensitive participant investment decisions are to then-current market conditions but how these conditions can “colour” future decisions for some time.

Interestingly enough, the same phenomenon persists among investment professionals – who should theoretically know better. The rule of thumb is never to pick a fund manager who has never experienced a bear market. But, in fact, the issue might be more subtly complex. Select a manager who began their career when certain conditions persisted and those conditions have a more dominant impact on their thinking than lay people would like to imagine.

What Mitchell and Utkis conclude is that no matter how well educated the investor (remember our Harry Markowitz story), their investment decisions are typically formed by both the current market conditions and some element of their “anchoring” experience.

Point 4: More choice = more confusion = more inertia.

Again, trustees genuinely believe they are serving their members well if they provide for more member preferences. But Sethi-Lynegar et al. caution that the reverse is actually true.⁹ Offering more choice actually triggers the “inertia” shutdown response that members experience when decision-making becomes too complex. In fact, the optimal number of choices for effective decision-making is probably significantly lower than most trustees imagine – with five options possibly stretching the human decision-making mechanism to near sub-optimality.

Point 5: Reverting to peer group assessments and survey rankings really is value destroying to long term solutions.

A better heading here would probably be: “You actually *can* get members/trustees to stop using surveys and peer group rankings as crutches for their decision-making.”

But perhaps we first need to understand why it is that there is such an extraordinary weighting given to past performance and rankings.

Mitchell and Utkus argue that this specific behaviour owes much to two phenomena:

- the pervasiveness of the “representativeness” heuristic, and
- the seduction of the “availability” heuristic.

As cryptic as these two phenomena sound – they are really quite straightforward.

The representativeness heuristic simply refers to the tendency of human beings to see patterns in a series of numbers or results when, statistically speaking, there is

The representativeness heuristic simply refers to the tendency of human beings to see patterns in a series of numbers or results when, statistically speaking, there is really only randomness.

By contrast, the “availability” heuristic kicks in when there is simply so much information to process to develop a meaningful insight, that any distillation of this complex data to provide a readily available assessment (through, say, an oversimplified ranking of manager performances) becomes a welcome crutch in the decision-making process.

9 Sethi-Iyenjar, Sheena, Gur Huberman, and Wei Jang. “How much choice is too much? Contributions to 401 (d) retirement plans.

10 This last point is a massively complex issue in itself, but for readers interested in exploring the point a bit further, please feel free to contact the author for further background information on the subject.

11 Watson Wyatt, “Hiring and Firing Managers” What If? April 2006.

really only randomness. Give a manager three straight, five straight, and even ten straight years of top performance and invariably they will be regarded as superstars – in spite of the fact that odds are still high that such an outcome is well within the range of a random distribution of outcomes.

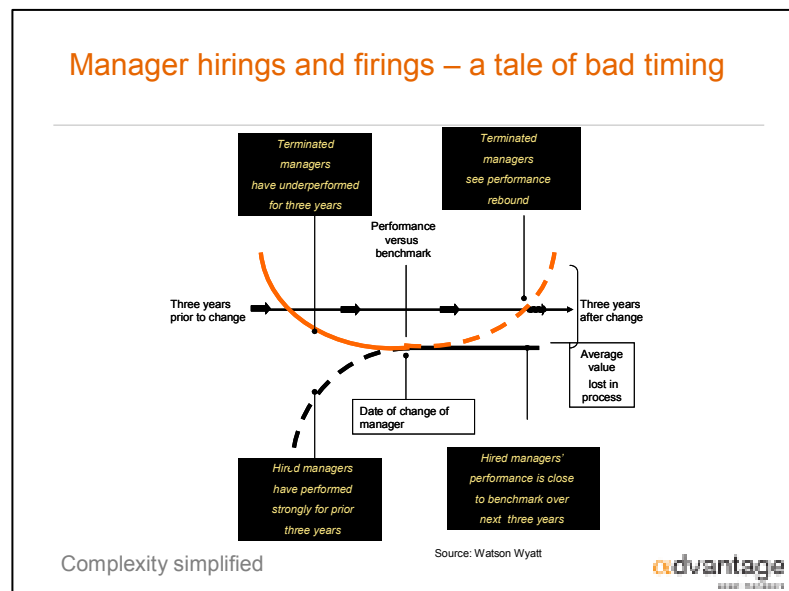
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So when trustees are presented with performance surveys, the double whammy of the “representativeness” heuristic and the “availability heuristic” kick in to ensure that trustees and members (and even consultants) mistakenly leap to the conclusion that top quartile performance must be a powerful indicator of manager skill – although nothing could be further from the truth.¹⁰

In summary, the value-destroying behaviour that’s triggered is that investors will typically abandon a perfectly viable long term investment strategy in the belief that short – or even medium term - underperformance is somehow indicative that the underlying manager responsible for performance delivery is somehow devoid of skill.

But, as the study by Watson Wyatt¹¹ in the UK suggests, the real outcome is that trustees and their consultants simply end up firing managers just as their fortunes begin to turn. Investment philosophies and styles do have a nasty habit of working for certain parts of a market’s cycle and not in others – so when the cycle turns against the strategy, the mistaken view is that the manager’s skill has somehow vanished.

The ultimate performance of the solution owes far less to individual manager performance and far more to the integrity of the long term structure of the asset management solution than trustees remotely imagine.



How much does this bad timing cost a fund? The timing problem alone suggests that fund managers who may have outperformed by as much as 4.4% p.a. before being hired go on to underperform the fired manager, whose performance has now recovered. In fact, the stronger the pre-hiring performance, the weaker the post-hiring delivery. Conversely the stronger the underperformance of the fired manager before being fired, the stronger their outperformance after being fired. But timing isn’t the only factor that destroys value. Changing managers on a fund incurs costs that research suggests aren’t necessarily recouped.

Clearly, then, finding the mechanism that can curtail this reflexive churning has significant implications for meeting, if not preserving, long term returns.

There is nothing new in these findings. So a rather provocative question comes to mind: Is our inability to curb these practices a function of the incredibly powerful behavioural influence at work with boards of trustees, or is it a function of the fact that it may not be in the industry’s interest to encourage such a change in behaviour?

In truth, the ultimate performance of the solution owes far less to individual manager performance and far more to the integrity of the long term structure of the asset management solution than trustees remotely imagine. This is exactly what Brinson, et al, proved.¹²

The good news is that the pattern of reliance on performance histories and performance surveys *can* be broken. What's required, however, are three critical factors that may not always be forthcoming.

- The first is a commitment from all parties involved to break with the dependency – performance surveys have become the be-all-and-end-all of investment choice, whereas they should only be used as a tool when comparing like-for-like.
- The second factor – more readily available - is through the creation of an assessment framework that simply determines how effectively a given strategy is at meeting the specific funding requirement of each individual member. This is a massive shift of focus. But it suggests that what's really meaningful is not whether the portfolio the member was invested in achieved top quartile performance that year (that outcome will always be shifting over time), but whether they are likely, given the portfolio's performance trajectory, to meet their ultimate retirement replacement ratio. **(The next paper in our series here delves into this concept which we call Goals Based-Investing.)**
- The third factor is an assessment tool that can be placed in the hands of members to help them map their progress on their goals-based path. Our tool, alpha-lab, will be described in detail in our next issue of Mind Fields.

The most important decision that trustees will make is determining the optimal default portfolio.

Point 6: The most important decision that trustees will make is determining the optimal default portfolio.

What these sub-optimal decisions of members make clear is that the choice of the default portfolio for any member choice fund is absolutely critical. This will be the portfolio that inertia forces most members into selecting. The problem though, is that for many trustees who are genuinely interested in ensuring there is no potential come-back from members should the portfolio be deemed "unsuitable", the default portfolio typically turns out to be the "least risk" portfolio. Unless more than 60% of the fund's members are within five years of retirement this would clearly be the *wrong* portfolio choice for the bulk of the fund's membership. It's a widespread phenomenon that reflects the most prevalent abuse in retirement fund investing: reckless conservatism.

Bottom line, though, the default portfolio must reflect the optimal investment strategy for the *most* members – not the least risk option.

For many trustees, arriving at a meaningful insight for the default option demands the kind of "management" information that trustees rarely have access to. What's really required is:

- A demographic distribution of members,
- An assessment of their general tendencies as employees (average years on the job, average contribution rate, current portfolio selection) as well as a clear picture of who among the members are likely to retire at an adequate replacement ratio and who might experience a serious shortfall and why.

We believe the answer lies in a management decision-making tool that is readily accessible to trustees and should be reviewed at the start of every trustee meeting. These are the meaningful dialogues trustees should be engaging in.

We believe that our current developments in the alpha-lab tool provides trustees with just these insights. **(Again, more on alpha-lab in the next issue of Mind Fields.)** Bottom line, though, the default portfolio must reflect the optimal investment strategy for the *most* members – not the least risk option.

Summary and conclusion

So what are the most critical lessons that Behavioural Finance has to teach us about member choice decision-making? Possibly the most important lesson is that education alone is not going to resolve the bulk of these problems. Addressing the challenge demands that the industry itself provides the much needed structures and tools. If inertia is such a prevalent problem then we need to have programmes that automatically move the bulk of members to where they need to go, when they need to go, to meet their long term funding requirements. A Lifestage structure is certainly an excellent starting point but has an inherent flaw in that it is time-to-retirement dependent, which does not deal with other factors that should be used to make the

If inertia is such a prevalent problem then we need to have programmes that automatically move the bulk of members to where they need to go, when they need to go, to meet their long term funding requirements.

We need to provide trustees with meaningful management information on the membership profile of their funds and the decisions those members are making to help them determine an optimal default portfolio that will service the maximum numbers of members.

We need to change the whole evaluation process of the plan's success from one that simply assesses how well the performance of the fund is doing when compared to the peer group to one where members assess how well they are doing at meeting their own long term goals and funding requirements.


investment choice. But with the increasing awareness with trustees that their responsibilities actually extend to ensuring that members get into the right post-retirement vehicles as well, we believe that the Lifestage construct needs to expand right through to post-retirement.

We have also learned that members "opt out" for the default option when decision-making becomes far too complex – and that it doesn't take much to make members feel overwhelmed by the decision. As such, we need to provide trustees with meaningful management information on the membership profile of their funds and the decisions those members are making to help them determine an optimal default portfolio that will service the maximum numbers of members.

And finally, we need to change the whole evaluation process of the plan's success from one that simply assesses how well the performance of the fund is doing when compared to the peer group to one where members assess how well they are doing at meeting their own long term goals and funding requirements. This shift in focus demands a tool that can be readily and regularly available to all members whether in paper form or via a web-based means. Only by changing this mindset will we be able to keep members and trustees focused on staying the course of their optimal investment plan and curtail the constant erosion to long term performance that comes from chopping and changing managers and strategies.

What have we learned

- If the default is the portfolio of choice.....
- If inertia rules
- If members keep reverting to the peer group or median....
- We need to make sure it optimally serves the maximum members in the fund
- We need a program that automatically shifts members to where they need to go
 - Saving rate increases
 - Shift to optimal portfolio
 - Takes them into post-retirement
- We need to provide them with a meaningful way to make decisions and stick with them

Complexity simplified 

To these ends, we believe at Advantage that we have taken the critical first step forward in providing trustees, members, and their consultants with the solutions and tools they require to address these issues.

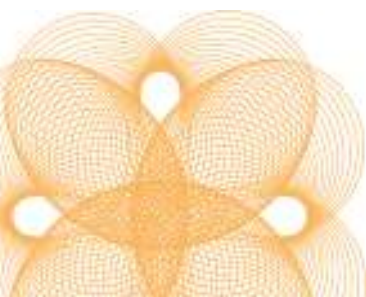
Goals based investing



Louisa Launderson
Deputy Chief Investment Officer

In March 2001, a report submitted by the Myners Commission in the UK (at the behest of the Chancellor of the Exchequer) castigated the entire retirement fund industry for promoting decision-making behaviours that clearly were not in the best interests of members.

At issue was the persistent practice by funds of hiring and firing managers based on the latest performance outcomes against their peers.



What the Myners Commission argued was simple: What possible relevance could short term peer group performance have to do with the distinctly different time frames, funding requirements, or appetites for risk that the members of a specific fund invariably had?

What was really required if retirement funds were going to get it right was for each fund to develop its *own* investment policies and guidelines to address the unique requirements of their own members. It was a cry echoed in South Africa as well when National Treasury made proposals to change Regulation 28.

But change has been particularly slow in coming. Trustees in South Africa, for the most part, remain fixated on performance surveys and continue to believe that chopping and changing managers based on performance outcomes, remains a valuable exercise (in spite of numerous research reports that suggest exactly the opposite).

At Advantage Asset Managers, we believe that the true value of multi-manager management is that, for the first time, investors now have a framework for creating solutions that are not only fund or member specific, but that can shift the long term performance focus away from “beating the Joneses” every quarter, towards meeting the very specific goals of the individual members.

What’s called for, though – and it applies to the entire investment community - is a complete change in focus away from short term performance comparisons to, what is known internationally as “goals-based investing.”

Consider that fund managers typically measure their worth based on the amount or return they achieve for every unit of risk they assume. In their world, risk is measured as volatility of returns (standard deviation of returns). But to members of pension funds, risk may have an altogether different meaning, such as loss of capital or purchasing power at the end of their working careers. More importantly, members frequently find that they actually have multiple investment objectives and therefore multiple risk concerns. Additionally, their sensitivity to these multiple objectives and their prioritisation of them, will typically change over their lifetime.

From this perspective, goals based investing allows members of funds (or investors in general) to select their asset management solutions based on the specific financial goal they are trying to achieve. On this basis then, success is gauged as a function of how well their investment option is doing in meeting the specific goal or goals that they have identified – full stop.

Goals based investing allows members of funds (or investors in general) to select their asset management solutions based on the specific financial goal they are trying to achieve. On this basis then, success is gauged as a function of how well their investment option is doing in meeting the specific goal or goals that they have identified – full stop.

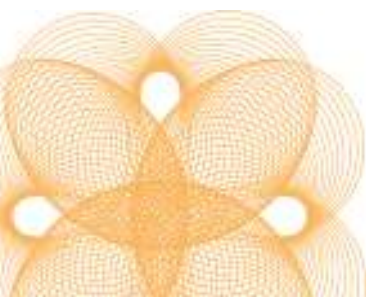
Is this not what we have been doing all along?

	Goals based perspective	Traditional theory
Premise	<ul style="list-style-type: none"> Relies on trade-offs between reward and risk 	<ul style="list-style-type: none"> Relies on trade-offs between reward and risk
Risk and reward measure	<ul style="list-style-type: none"> Based on investor goal 	<ul style="list-style-type: none"> Traditional measures
Return goal	<ul style="list-style-type: none"> Term-based focus Relative to investment goal 	<ul style="list-style-type: none"> Long term annualised/cumulative return Relative to benchmark or peer group
Risk measure	<ul style="list-style-type: none"> Risk of loss Risk of not meeting goal 	<ul style="list-style-type: none"> Standard deviation Tracking error
Goals	<ul style="list-style-type: none"> Multiple goals and therefore risk tolerance 	<ul style="list-style-type: none"> Single risk tolerance
Strategy required	<ul style="list-style-type: none"> Typically requires more than one strategy 	<ul style="list-style-type: none"> Ascertain risk tolerance and construct single strategy

If we can get investors to ask of their investment strategy that it simply meet their specific investment goals – and not try to live up to a “pie in the sky” dream that it will always beat the rest of the herd – then perhaps we can not only get investors to stay the required course, but actually increase their probability of getting there.

Source: Adapted from SEI

As the leading US pension fund consultant, Keith Ambachtsheer, pointed out: “the biggest single threat to people meeting their investment goals is not the occasional under-performance of fund managers, but the lack of confidence by members or trustees in staying the course of an investment strategy”. Not only is chopping and changing course a costly exercise, but most people are notoriously bad at getting the timing right. If we can get investors to ask of their investment strategy that it simply



meet their specific investment goals – and not try to live up to a “pie in the sky” dream that it will always beat the rest of the herd – then perhaps we can not only get investors to stay the required course, but actually increase their probability of getting there.

The goals based value proposition

Re-defines:

- Investment principles form the viewpoint of the investor, not the practitioner;
- Portfolio efficiency in terms of client goals;
- Performance assessment from the perspective of individual requirements – not the peers;
- Risk management in terms of client goals;
- Investment strategies by matching the client’s goal with the appropriate strategy.

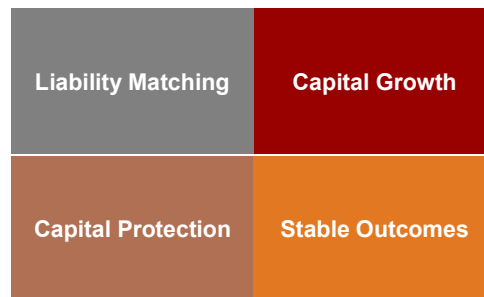
What are “goals based solutions”?

While research at international multi-manager, SEI Investments, has been promoting the concept of goals-based investing since 2003, in South Africa, building comparable solutions is only just now becoming possible.

For a multi-manager to structure differentiated goals based solutions, it demands a blending of fairly sophisticated investment strategies: low volatility, managed floors, portable alpha, and 120/20 funds to name just a few. But these investment concepts have only started to really emerge in South Africa over the last few years. Today, there are now enough viable providers in these new areas of investment thinking to enable Advantage to restructure a full range of offerings using the goals-based dynamic.

Consider how goals based solutions might be formulated, for both the pre-retirement retirement fund investor and the post-retirement investor. Already we have two different groups of investors that, quite likely, may reflect distinctly different investment objectives (goals) and priorities.

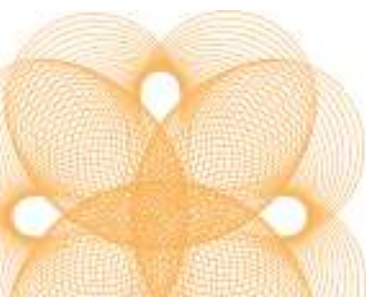
Goals based investment objectives



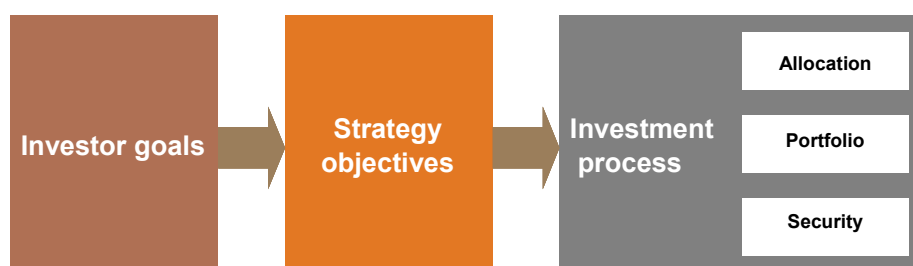
The diagram illustrates typical goals required by clients. For example, pre-retirement, liability-matching in a defined contribution context could be deemed as ensuring that the purchasing power of the member is preserved, no matter what the inflation variability might be over the specified time-frame. In the post-retirement space, though, liability matching could be deemed as maintaining a specific lifestyle by drawing a required income.

The distinctive differential of goals based investing is that investment strategy itself (and not just the asset mix) needs to be reformulated if it’s going to provide high probability delivery to specific goals. Instead of offering members a range of portfolios whose risk-profiles are tweaked through differentiated asset allocations (the higher the proportion in cash or fixed income, the lower the risk profile on the portfolio), goals based investing demands that we consider the nature of the underlying asset class strategy or investment process in addition to providing risk differentiation through the asset allocation.

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Goals based investment strategies implemented



Source: SEI

Consider these examples:

Capital growth:

If the primary goal of the investor is to obtain maximum capital growth over a long term time frame, then the key investment strategy characteristics that would be required are:

- Maximum equity exposure – maximum breadth index (FTSE/JSE all share)
- High beta (to capture the full upside potential in equities)
- Alpha sources not dependent on beta bets (i.e. no market timing or low volatility strategies, but rather, strategies such as 120/20 funds - that allow the manager to go short a small component of the fund but remain net fully invested in equities – or portable alpha that introduce sources of excess return independent of the market's return).
- High quality tracking error but not necessarily a high tracking error
- A comparable solution in the global equity portion
- Credit risk exposure in bonds that provides yield pick-up in fixed income.

Stable outcomes:

Now the primary goals of the investor are to capture inflation-beating returns but maintaining as much stability in that outcome as possible. As such the key characteristics to the strategy would include:

- Lower equity exposure – lower volatility benchmark (FTSE/JSE SWIX)
- Low beta (to dampen the portfolio's long term volatility) (can result in higher tracking error, but this does not necessarily translate into higher risk – just more differentiated from the index)
- Equity selection based on downside protection
- Global blend of equities and bonds also incorporate low volatility strategies and are hedged to eliminate volatility from currency fluctuations
- Lower risk, value-based bond strategies.

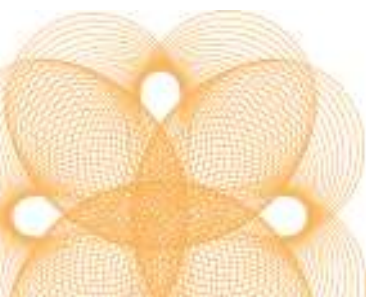
Capital protection:

With the primary goals of the investor being capital protection for the specified time-frame the key characteristics to the strategy would include:

- Benchmark is now either inflation or cash – depending on the liability to be matched
- Portfolio blends an array of differentiated absolute return strategies inclusive of a managed floor, where downside risk is underpinned by a dynamic derivatives strategy
- Equity selection based on downside protection
- Global blend of equities and bonds also incorporate low volatility strategies and are hedged to eliminate volatility from currency fluctuations
- Lower risk, value-based bond strategies.

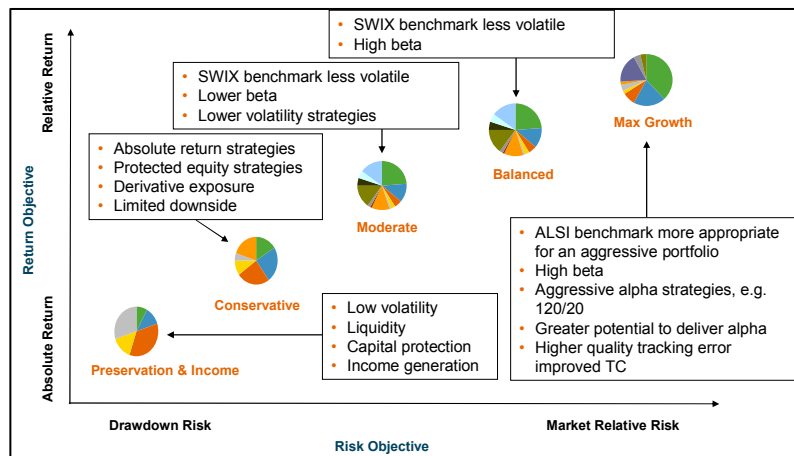
Liability matching – where income is required:

Providing a liability matching strategy which ensures a regular inflow of pre-specified income drawdowns to the member demands:



- A flexible blend of income generating asset classes and strategies – inclusive of money market instruments, bonds, inflation linked bonds, infrastructure bonds and property
- Strategy blend a function of liability
- Benchmark is now either inflation or cash – depending on the liability to be matched
- Portfolio blends an array of differentiated absolute return strategies inclusive of a managed floor, where downside performances are underpinned by a dynamic derivatives strategy
- Equity selection based on downside protection
- Global blend of equities and bonds also incorporate low volatility strategies and are hedged to eliminate volatility from currency fluctuations
- Lower risk, value-based bond strategies.

Goals based strategy funds



Perhaps the most powerful contribution that goals based solutions make to retirement fund investing is that they effectively shift the evaluation focus away from whether one fund manager is beating another fund manager over a specific period in time to whether the individual member is likely to meet their specific investment objective, over the specified time frame.

Evaluating goals based solutions

Perhaps the most powerful contribution that goals based solutions make to retirement fund investing is that they effectively shift the evaluation focus away from whether one fund manager is beating another fund manager over a specific period in time to whether the individual member is likely to meet their specific investment objective, over the specified time frame.

To achieve this, effective goals based investment programmes need to be partnered with trustee and member management tools that allow them to provide these assessments at any point in time. More importantly, these tools need to provide enough flexibility to both trustees and members to allow them to explore the consequences of other options or other actions should they find that conditions are providing an impediment to achieving their goals.

To this end we encourage trustees and their consultants to review the companion piece to this paper, “Advantage alpha-lab – A Trustee and Member Decision-Making Tool” in our next issue of Mind fields.

Goals based investing: Summary

At Advantage Asset Managers, we believe that if the goals based investment concept could take hold, it could be a powerful force in changing destructive investment behaviour and in aligning the interests of the investor and their investment managers.

Investors would be starting with far more realistic expectations, have a higher probability of achieving them and, as such, be more inclined to “stick with the programme”. And from the fund manager’s perspective, what a win for them to be focusing on meeting specific client objectives in the time frame required and not have to worry whether next quarter’s underperformance will see them to the door. Just how good can an industry really be at servicing the very specific requirements of investors if their primary focus is monitoring every trade their competitors are making?

The information in this document was compiled by the Advantage Asset Managers Research team. Contributors to this issue include Anne Cabot-Alletzhäuser and Sonja Saunderson.