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You're Measuring Investment Risk and Success Wrong

By Coryanne Hicks

If you aren't doing goal-based investing, you're probably measuring investment risk and success wrong. Investors have long defined success by whether they're beating a market benchmark and risk by volatility.

If you outperform the market, you win. The more your portfolio value fluctuates over time, the riskier it is. It's as simple as that – unless you've been measuring investment risk and success with the wrong ruler.

"People invest so they can make specific things happen in their lives and that's the standard we should measure risk and success by," says Michael Farrell, managing director of SEI Private Wealth Management in Oaks, Pennsylvania. "If you can't buy that dream home or get the monthly check you need in retirement, what does it matter if you're beating the market?"

The real risk investors face is not market volatility and short-term fluctuations in their portfolio value; it's not achieving their goals.

"If you get that, you're right at the core of goal-based investing," Farrell says.

Goal-based investing designs an investment portfolio around specific investment goals, such as paying for college or funding retirement. In doing so, it redefines risk and success to whether or not you accomplish your goals.

Success becomes "a personal achievement rather than an investment achievement against a [market] benchmark," Farrell says. "A performance benchmark tells you how your manager is doing; it doesn't tell you how you're doing."

A market benchmark can only tell you how you're doing relative to the market, says Andy Schuler, investment managing director at PNC Wealth Management in Cleveland. That return may be sufficient to meet your goals, or it may not. The only way to know is to change your ruler to a goal-based one.

Why use goal-based investing? "Investors have goals; investments have objectives," says Jan Gunderson, a Los Angeles-based senior product management manager at American Funds. Goal-based investing aligns these two by matching what you own with what you're trying to accomplish.

When they do this, investors are more likely to stay invested because they understand how what they own is helping them reach their goals, he says.

At SEI, they saw this exemplified during the 2008 Financial Crisis. Goal-based investors were less likely to take action in the midst of the financial crisis because they were more secure in their plan, Farrell says.

How to goal-based invest. Farrell lays out four steps to goal-based investing. First, "you need to define and prioritize your goals," he says. Most of us have multiple goals and sadly are not blessed with unlimited resources to achieve them, so prioritization becomes key.

He has his clients use SEI's "Discovery Board" decision matrix to map their goals. To create your own board, draw a square on a sheet of paper and break it into four quadrants. Over the left side, write "now," and over the right, write "later." Next, along the left-hand side, put "want to" beside the top quadrant and "have to" beside the bottom quadrant.

When you're finished, you should have a quadrant for goals you want now, want later, need now and need later. By placing each of your goals into one of the four quadrants, you can quickly visualize which goals are the most pressing in terms of need and time frame.

As you're defining your goals, ask yourself what success looks like for each goal, Schuler says. Is it a finite dollar amount? A stream of future income? This will help you with step two of the goal-based investing process: establishing the risk level for each of your goals.

Measuring risk in goal-based investing. Your portfolio's risk level is defined by the return you need to achieve your goal, Schuler says. If you want to retire with $2 million in 30 years and can only save $10,000 per year, for instance, you're going to need a high return to get there. Luckily, with 30 years to go, you can afford more risk.

While taking more risk is fine in theory, it may pose a challenge in reality."You may need a [high] return to meet your goals, but if you can't stomach the volatility that comes with it, you're likely to sell out at the wrong time and put yourself in a much worse situation," Gundersen says.

Building goal-based investment strategies. You're only as likely to reach your goal as you are to stay invested. So your risk tolerance still plays a key role in goal-based investing.

"Your risk tolerance and goals should combine to inform how you invest," Gundersen says. Your risk tolerance will tell you how to allocate your portfolio among stocks, bonds and cash in your portfolio, and your goal will determine the type of stocks and bonds you use, he says.

For instance, your risk tolerance may dictate a 60/40 stock/bond portfolio. If your goal is 30 years away, you might choose to allocate that stock portion to growth stocks. Alternatively, if your goal is income in retirement, dividend stocks may better.

Always aim for the investment portfolio most likely to reach your goal for the least amount of risk, Farrell says. "Why take risk that's unnecessary?"

There's no merit in a risky strategy if it puts your goal at risk. If you know you need $1,000 per month, a strategy that promises that is more beneficial than one that may get you $1,200 per month but may also land you with only $800.

Track your progress toward your goal. The final step in goal-based investing is to regularly report on your progress toward your goals, Farrell says.

By now, you've mapped a path to achieving your goals. Use it as the benchmark against which you measure your progress.

That isn't to say your path can't change. "Very few, if anyone's, lives remain static over time," Schuler says. Any number of things could happen to cause you to alter your course and that's fine. As long as your goals remain the center of your target, you still have a better chance of achieving them than if you were blindly chasing a market benchmark.

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