Goals-Based Asset Allocation

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Defining Your Goals With More Than Just Numbers

You may feel overwhelmed, defeated, or lost when it comes to saving. You know you need to do it, you just do not know how to start. To add to that, it is difficult to put away a chunk of your money when you cannot exactly visualize the long-term goal. “Because I should” is rarely enough motivation to accomplish anything.

Goals-Based Asset Allocation is a technique that allows you to better conceptualize your savings by assigning them to your financial goals. It also provides framework for you to prioritize your goals, quantify how much should be allocated to each goal, and decide how much risk each goal can afford.

Goals-Based Allocation & Mental Accounting

Goals-Based Asset Allocation (GBAA) falls within the realm of behavioural finance and is used as an adaptation tool for dealing with mental accounting.

Mental accounting is the process where people categorize, compartmentalize, and treat money differently depending on where it comes from, where it is kept, or how it is spent. In the simplest form, mental accounting considers how individuals and households organize their finances into mental “buckets” of money.

For example, if you won $100 on a scratch ticket, you may feel inclined to spend it on a night out, a new pair of jeans, or even more lottery tickets (a “fun bucket”, we might call it). However, if we received a tax refund for the same amount, we would be more likely to save it (into a “not-so-fun bucket”).

It is true that mental accounting is classified as a cognitive error. Not to worry, however—everyone has cognitive errors. You can read more about these behavioural quirks here. They are often found in old rules of thumb or exploited by magicians to make you think you witnessed magic. Acknowledging and accepting mental accounting as human nature can enable individuals to not only feel more comfortable with their finances, but also allow them to save more.

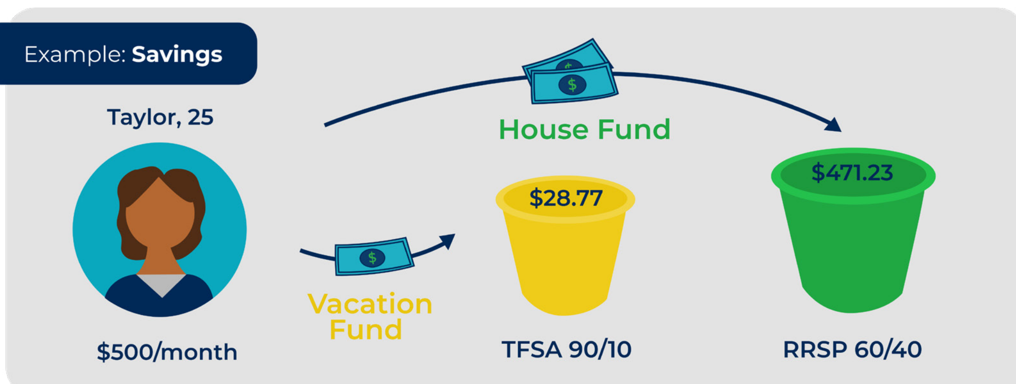
In order to ensure that this error does not end up having a detrimental effect on your finances, it is essential for us to show you how the proper use of mental accounting can actually benefit you.

How Does it Work?

The first step in GBAA is to clearly visualize and define your objectives. Take a step back for a moment and consider how you organize your money and your sentiment in doing so. Are you motivated, overwhelmed, or even resentful? Perhaps you may have recently opened a separate savings account to fund the purchase of a new home, a child's education, or your retirement. Each one of these goals can be classified into investment buckets. This process is a tool to strategically plan and organize your objectives.

A higher risk bucket has a greater proportion of equities, which can result in greater fluctuation in expected returns from year to year. On the other hand, lower risk buckets contain more fixed income (like bonds), and you can expect less fluctuation with these. Higher risk buckets provide lower confidence that the goal will be reached, so they are best assigned to aspirational goals, like a vacation, over core goals, like making certain you can maintain your quality of life in retirement.

On the flip side, with lower risk comes a lower expected rate of return—meaning you will need to save more for core goals than aspirational goals. It makes sense intuitively; if you want to have high confidence that you will achieve your financial goal (as you should with retirement), you will want to fund it more and be less dependent on investment returns.



For example, we have Taylor who is 25 and looking to purchase a home in 5 years. Taylor would like to take advantage of the Home Buyer's Plan that is offered through their RRSP and wants to have $35,000 saved by the time they are ready to purchase the home.

Because Taylor wants to have a high level of confidence that the goal will be achieved, and has a relatively short investment horizon before the funds will be withdrawn, they will have a low risk allocation for the RRSP. In this example, the RRSP is invested in a 60% equity and 40% fixed income allocation. We can calculate that Taylor will need to contribute $471.23 a month for the "house bucket."

If Taylor was able to save a total of $500 a month, $471.23 would go towards the RRSP and the rest could go towards a "fun bucket" TFSA with a 90/10 allocation. This fun bucket could be used to save for a vacation, aspirational purchase, or other goal that Taylor deems a non-necessity.

The risk of each investment bucket should be chosen by degree of necessity. Core needs, such as retirement savings, should be in lower risk buckets. Fun lifestyle goals, such as saving for a family holiday, should be in higher risk buckets.

Keep in mind that once you have selected your risk strategy/asset allocation, your returns are not guaranteed. The general rule of thumb in the investment industry is that annual expected return for equities and bonds are 10% and 3%, respectively. However, rules of thumb are never the most optimal. Finding a wealth manager to assist with these expected returns by analyzing macro trends in the market or running Monte Carlo simulations, will help build more confidence around the expected returns.

A **Monte Carlo simulation** is a complex quantitative analysis tool used by professionals in many industries to determine probabilities of future events with pre-determined levels of confidence.

Individuals should be aware that when they invest, they must allow for enough time for their investments to grow to their true value— preferably a minimum of 5 years. If you plan for your goals to come to fruition before that amount of time, choosing a highly liquid, lower risk ETF (exchange-traded fund), or high-interest savings account will help to protect your money from any short-term fluctuations in the market. Volatility protection is important when your funds do not have enough time in the market to rebound from any drops.

What is the alternative to using risk buckets in GBAA? You could look at your wealth as a whole without dividing funds into buckets. Although it may be more difficult to provide context when using this technique, this allows for optimization of your total portfolio. If you have three buckets with three different risk tolerances, you will still have, as a whole, an overarching risk allocation.

In Conclusion...

Utilizing the GBAA planning tool allows investors to reap a number of benefits in regard to their financial planning. Throughout the process, individuals are able to not only clearly visualize and define their goals, but to also understand their strategy behind meeting those goals. This could mean allocating different automatic contributions to different buckets and knowing, based on necessity, which ones can afford to be missed for a few months if life demands the funds elsewhere. It could also be used to help "put away" a lump sum of money in a lower risk bucket to never think of again until retirement, while the rest is put in buckets for nearer team goals.

By organizing goals into investment buckets, investors are able to ensure that they are capable of meeting their long-term goals—core needs—without negatively affecting their fun short-term goals. This confidence, not only in the risk allocation but also in your own personal understanding of your financial plan, will allow for better decision-making when markets undergo fluctuations. If you have full confidence that your core needs will have the time to stay invested until they rebound, you are less likely to make rushed or misguided decisions, like liquidating and locking in those losses permanently, for example.

When contemplating the implementation of a GBAA strategy or any other financial planning tactic, investors will benefit from the services of a Portfolio Manager. Unencumbered by alternative motivations, your Portfolio Manager will work with you to delve deep into your personal circumstances. Your Portfolio Manager will be help you consider which buckets you deem long-term core needs and which buckets you would aspire to have for the fun of it.

Our team at Qube is committed to providing you with a holistic investment experience tailored to your unique financial hopes and obligations. If you would like to learn more about financial planning, reach out to us by email or call (780) 463-2688.

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