

Investing with Profile

This paper provides a detailed outline of Profile's investment philosophy and implementation strategies for clients.

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**INVESTING
WITH
PROFILE**

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IMPORTANT INFORMATION

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THE TRADITIONAL APPROACH TO INVESTING IS FLAWED

What is the traditional approach?

A majority of the financial planning industry at present relies three key assumptions when designing investment strategies for clients:

- The first assumption is that “risk” is measured by volatility – that is, a risky asset is one which has highly variable short and medium-term returns.
- The second key assumption is that each investor has a consistent personal approach to risk which can be determined, and which provides a reasonable basis for investment strategy.
- Thirdly, it is assumed that an appropriate investment portfolio can be constructed by mixing different proportions of five major asset classes, which have consistent and predictable return and volatility characteristics, to deliver a portfolio to the client with a volatility level that’s consistent with their risk profile.

The role of the planner in this model is to select underlying investment managers or direct investments within each asset class, and to rebalance the client’s investments each year in line with a pre-defined strategic asset allocation and changes in the investor’s circumstances.

The definition of risk

Defining risk as volatility assumes that each asset class has a typical or expected return over a particular time period, that can be understood and used for planning purposes. Some asset classes’ returns are more predictable than others. Generally, the more predictable returns are over the short term, the lower they also tend to be. More volatile asset classes tend to have a narrower range of expected returns if held for longer periods.

Risk profiling

A client’s “risk profile” is usually built using a written questionnaire. Clients answer questions which aim to determine their knowledge of markets, and their emotional risk tolerance – that is, how much volatility can they tolerate?

Investors then are grouped into one of five categories of risk tolerance based on their answers: Conservative, Moderately Conservative, Balanced, Moderately Aggressive or Aggressive.

Strategic asset allocation

Each of these five profiles has a pre-determined Strategic Asset Allocation (SAA). Each profile has a mix of the different major asset classes, which aims to deliver the maximum potential investment return within the different volatility constraints of each risk profile. By mixing asset classes, the theory of diversification suggests that for a given rate of return, volatility can be reduced because different asset classes perform well at different times – that is, they are not perfectly correlated.

Recommended strategic asset allocations

The following table shows a typical asset allocation for the specified risk profiles. Investors who are 'emotionally profiled' as conservative, tend to have a higher proportion of their portfolio in 'defensive' assets, while investors who are emotionally profiled as aggressive, tend to have a larger part of their portfolio in more volatile or 'risky' assets. Each risk profile also has its own recommended investment timeframe. The target return is a function of static forecasted asset class returns.

ASSET CLASS	% OF TOTAL PORTFOLIO TYPICALLY ALLOCATED TO EACH ASSET CLASS				
	CONSERVATIVE	MODERATELY CONSERVATIVE	BALANCED	MODERATELY AGGRESSIVE	AGGRESSIVE
Defensive					
Cash and cash equivalents	23.0	15.0	6.0	2.0	0.0
Fixed income	45.0	33.0	21.0	10.0	0.0
Growth					
Property	5.0	8.0	10.0	14.0	17.0
Australian equities	12.0	21.0	27.0	34.0	42.0
International equities	7.0	12.0	16.0	20.0	25.0
Alternatives					
	8.0	11.0	20.0	20.0	16.0
Target return (X+ years)	CPI+2%	CPI+2.5%	CPI+3%	CPI+3.5%	CPI+4%
Recommended investment timeframe	3+ years	4+ years	5+ years	6+ years	7+ years

Source: van Eyk Research (Software Inputs & Asset Allocation Strategy, 2010)

The role of the planner

Financial planning firms then choose fund managers (and, in some cases, direct assets such as shares) which they believe will do a good job over the recommended investment time period.

They also regularly review the portfolio allocations and rebalance them in accordance with the investor's pre-determined risk profile.

What are the problems with this approach?

The definition of risk

The reality is, for most investors "risk" means different things at different times – and very rarely (if ever) does it mean "volatility".

- In down markets, for most people it is the risk of losing money, not having sufficient cash-flow to meet living expenses, or the risk that they will outlive their investment portfolio.
- In up markets, for many people it is the risk of underperforming – feeling a fool for missing out on higher returns, or doing less well than others in their peer group.

As a result, typical investment risk management strategies are inconsistent with the client's goals – with portfolios being managed primarily to reduce volatility risk instead of reducing the actual risks to the client outlined above.

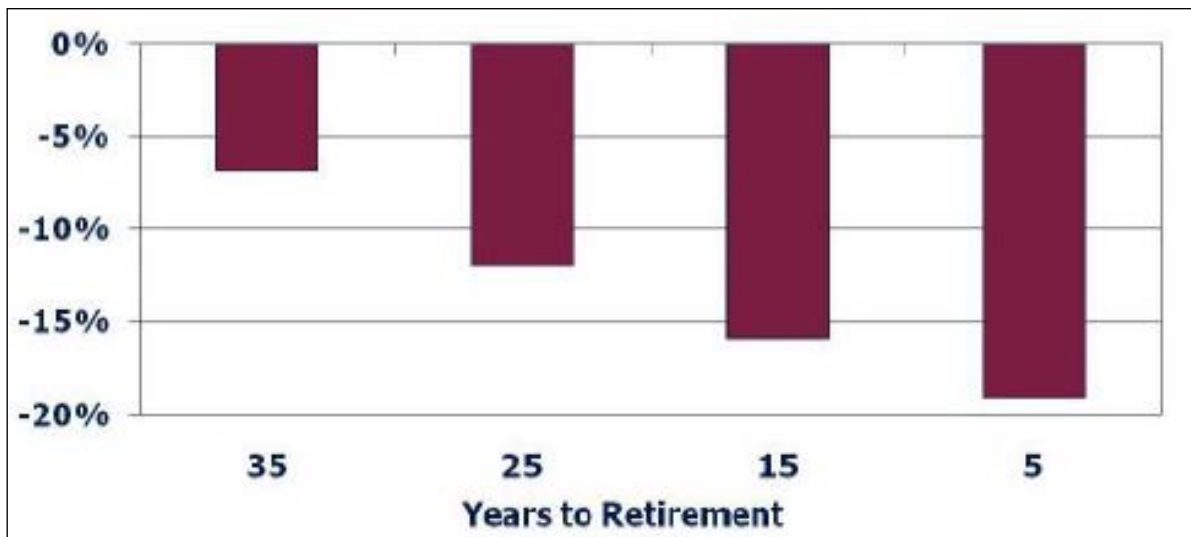
Risk profiling

As noted above, investors are not consistent in their attitudes to risk. Most people are conservative in bear markets and aggressive in bull markets. Therefore it is not possible to assign investors to a single risk profile and expect them to be consistently happy with their investments throughout the investment cycle. However it is not advisable to chop and change investments using the rear vision mirror – this almost guarantees that clients would buy high and sell low! (This effect is so well known that fear-greed indices are now commonly available around the market place.)

Investors are also far more diverse than the five pre-set profiles would suggest. Within the single “Balanced” profile, for example, fall all sorts and stages of investors, from a young investor just starting out and cautious with their money, to a retiree drawing down on their investments to provide an income. While these two investors might have the same ‘risk tolerance’, they have very different needs from their investments. A retiree who draws income each year has very little scope to deal with an adverse market event – after selling at a loss it is less likely they will be able to get back on track, even with many years remaining until retirement. Contrast this with a young accumulator, who has many years to go before needing to draw on their investments. By remaining invested in a low risk/low return environment, they potentially cost themselves tens of thousands of dollars in missed returns – even allowing for a number of typical market ‘crises’.

Impact on lump sum at retirement of a 15% negative return

The chart below shows how a single market event – a 15% negative return – can differently impact investors at different stages of their investing lifecycle. For example, for an investor with 35 years to retirement, their final capital value would only be reduced by 7%. However an investor with only 5 years to retirement is set back much harder - their final capital value would reduce by almost 20%! This is because short term downturns not only impact an investors’ current capital, but also hinder the long-term effect of compounding returns. It is a lot harder to catch up over the very short-term, versus over a longer period where you have time up your sleeve.



Source: Schroders (Achieving Real Returns); DataStream; Chantwest, Objective is CPI +5%

Strategic asset allocation (SAA)

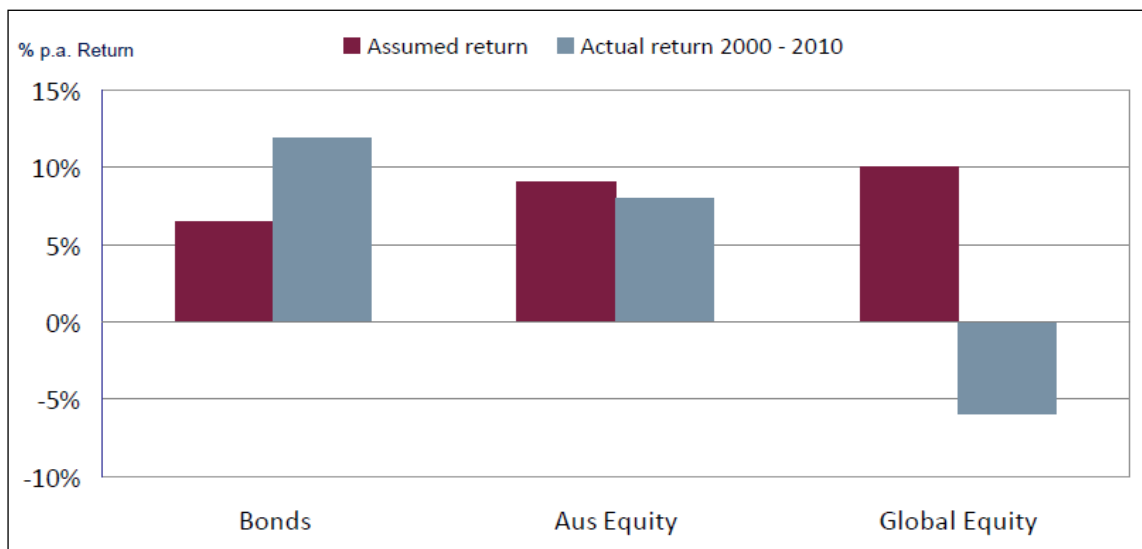
The theory of SAA assumes several things about the behaviour of the major asset classes which are not always consistent with the facts.

Predicted returns and actual returns often do not match

When actual returns differ substantially from the expected returns, then the plan fails to deliver what it was intended to.

Assumed versus actual returns

The following chart shows how forecasted returns for asset classes can diverge significantly from their actual returns. From 2000 to 2010, bond returns were significantly higher than expected, whereas global equity returns were dramatically lower than forecast.



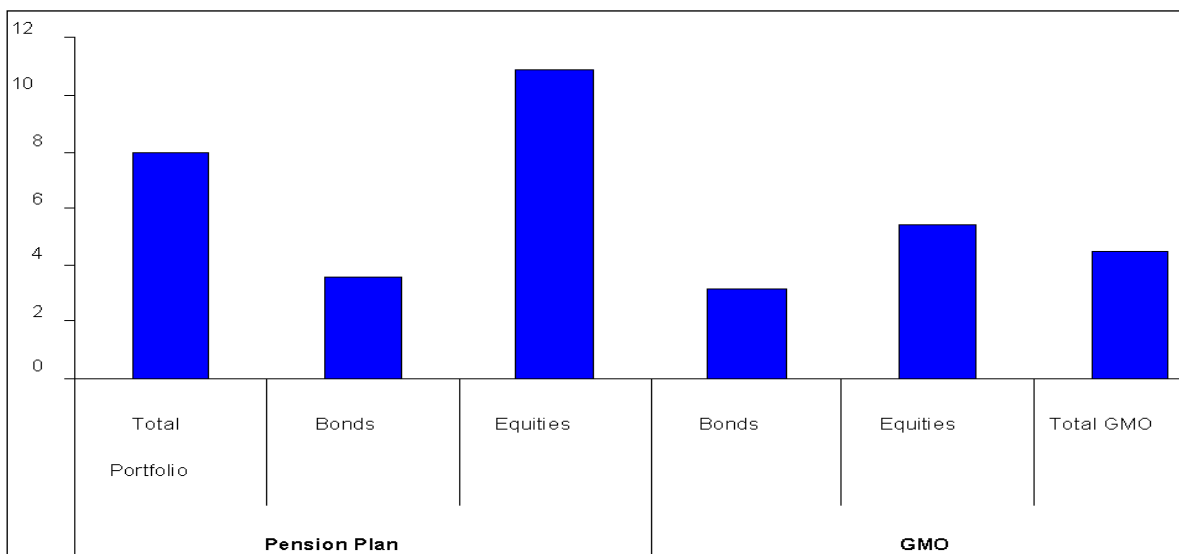
Source: Schroders (Achieving Real Returns); DataStream (Jan 2000 to May 2010 in AUD)

Predicted returns are static over time

The SAA approach tends to assume a similar pre-determined long term return for each asset class, regardless of prevailing market conditions.

Return assumptions – US pension funds versus GMO (a global investment management firm which does not use SAA)

This chart shows how large institutional funds, such as US pension funds, often do not adapt their models to changes in market conditions when using SAA - with forecasted returns remaining fairly static over time. As at July 2010, US pension plans were still forecasting total portfolio returns of around 8%. GMO, however, taking into account current market valuations and a varying economic outlook, was forecasting a much lower overall return of closer to 4%.



Source: GMO (SAA White Paper), July 2010

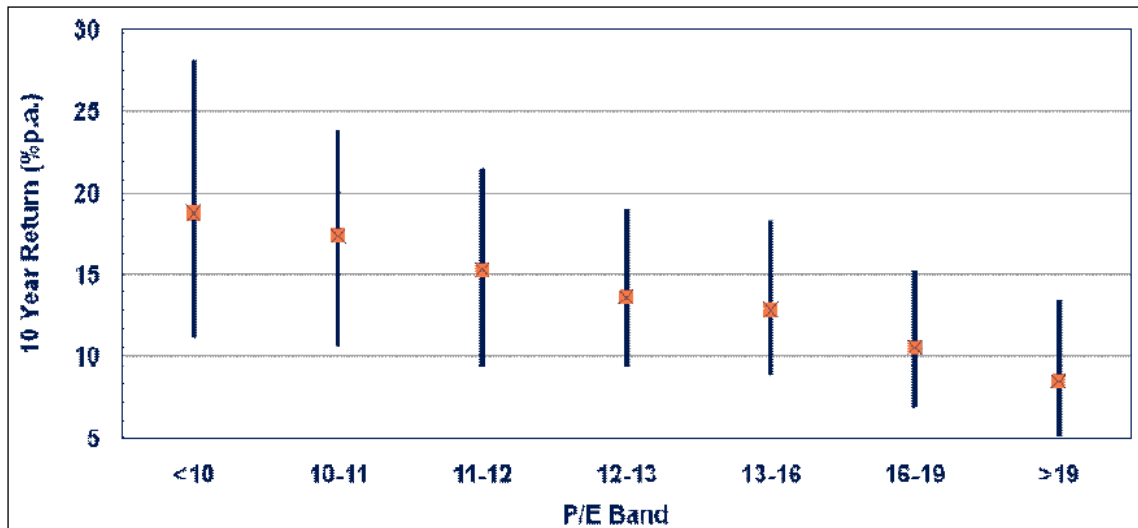
A better basis for predicting returns

Predicted returns in SAA are fairly static, and often quite different to actual experience. In our view, this is largely because the modelling used to estimate expected returns under SAA is valuation indifferent (which means that regardless of the prevailing market price for assets, the predicted future return under SAA remains similar).

In fact, subsequent returns are very strongly correlated with the price initially paid for an asset. The lower the price of the asset, relative to its earnings, the more likely it is to generate future performance in line with the economic outlook.

Distribution of 10 year Australian equity returns by P/E band at starting period

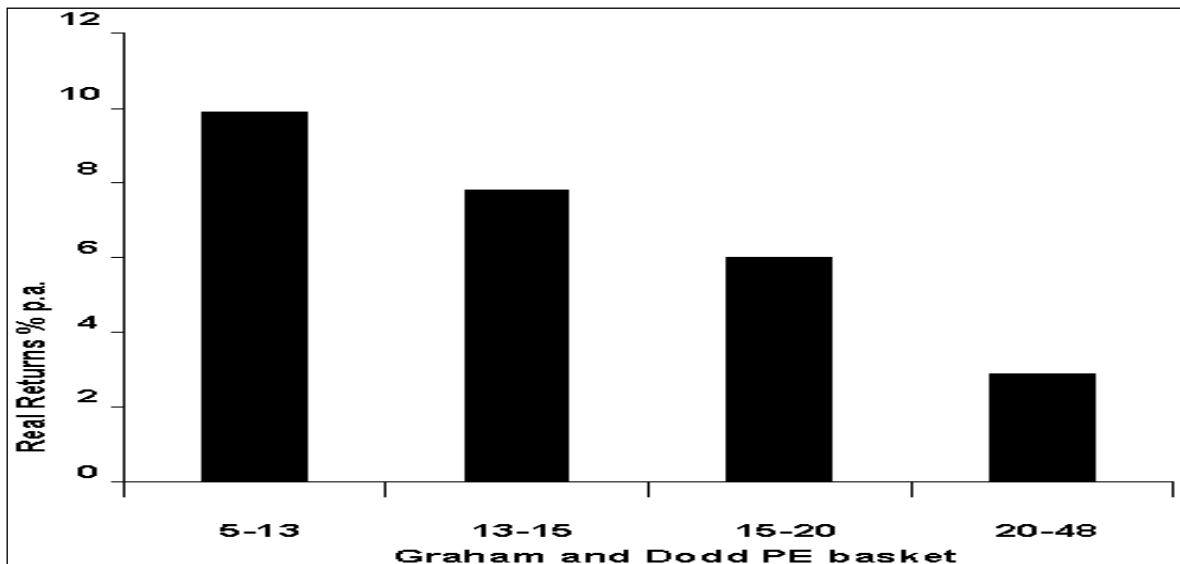
The chart below shows average 10 year returns from Australian shares, based on the price to earnings ratio at the start of the period. For example, during times when P/E ratios were between 11 and 12, subsequent 10 year returns averaged just over 15%. However, during times when P/E ratios were much higher, over 19, subsequent 10 year returns were much lower: averaging just 8%.



Source: Schroders (Achieving Real Returns); DataStream; MSCI Australia (1 Jan 1970 to 31 July 2009)

Distribution of annualised US equity returns by P/E band at starting period

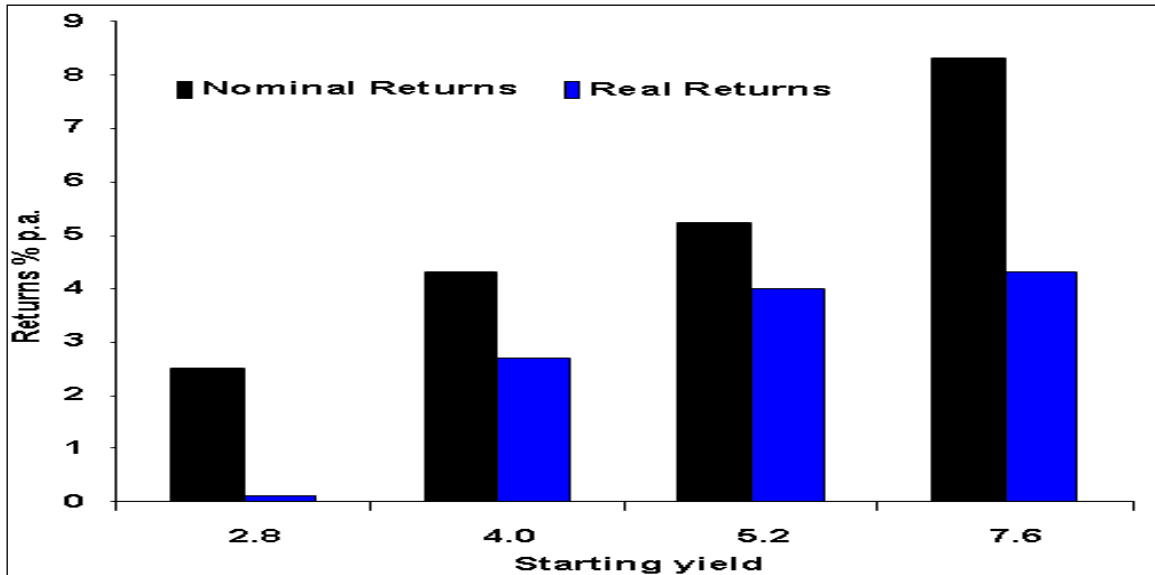
The US equity market shows a similar pattern. Shares with a P/E ratio between 5 and 13 achieved returns of close to 10%, whereas shares with a P/E ratio of 20-48 achieved closer to 3%.



Source: GMO (SAA White Paper); Data from 1871 to 2010

Distribution of annualised US government bond returns by yield at starting period

US government bonds also demonstrate the importance of valuations to future returns. In this case, the starting valuation metric applied is a function of the yield (income over price) of long-dated treasuries. A higher yield indicates a lower purchase price relative to the coupon (or interest payments).



Source: GMO (SAA White Paper); Data from 1871 to 2010

SAA underestimates downside risk

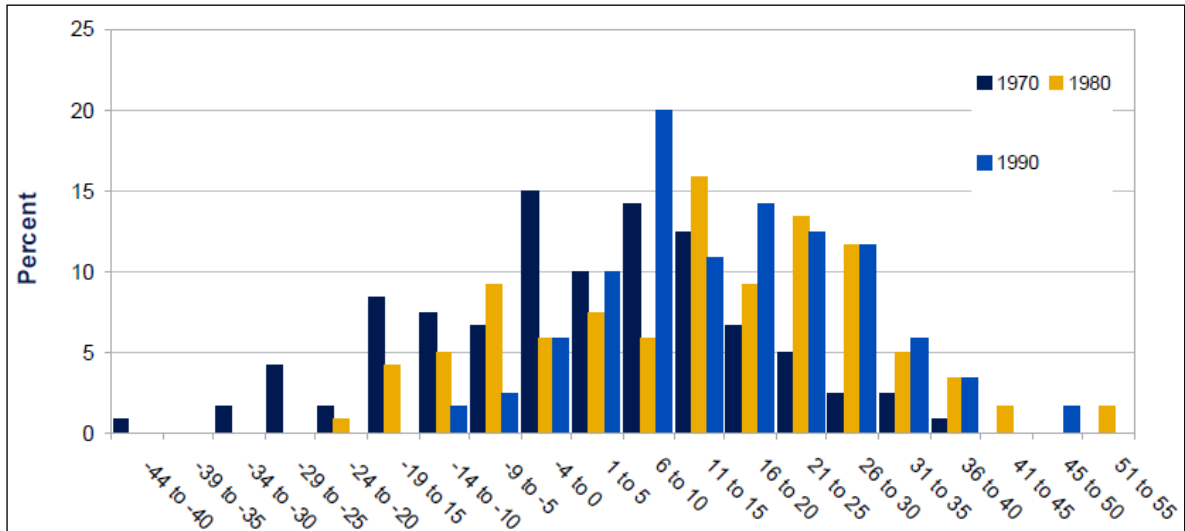
Traditional volatility assumptions tend to dramatically underestimate the real downside risks of investing. This is known as a 'fat tail', and it is this which accounts for many hedge fund failures in recent years. Trying to fit the chance of a negative return to a standard bell curve distribution significantly underestimates the real risk of a large occasional loss – that is, these events actually happen more often than the theory suggests they should.

Fact Box

According to James Xxiong (in "Nailing Downside Risk", 2010), normal distribution theory predicts a 0.13% chance of an extreme negative return from US shares (sometimes referred to as a 'one in a hundred years' event – that is, more than 3 sigmas below the mean return). In reality, between Jan-1926 and Apr-2009 the actual occurrence of these extreme events has been over 1% - still sounding low, but in fact happening almost eight times more often than the models predicted.

Distribution of real US equity rolling returns (decade by decade)

The chart below shows rolling year on year returns for the US equity market over three decades. "Fat tails" (that is, more frequent extreme returns than expected) were very pronounced during the 1970s and were still of notable significance during the 1980s and 1990s.



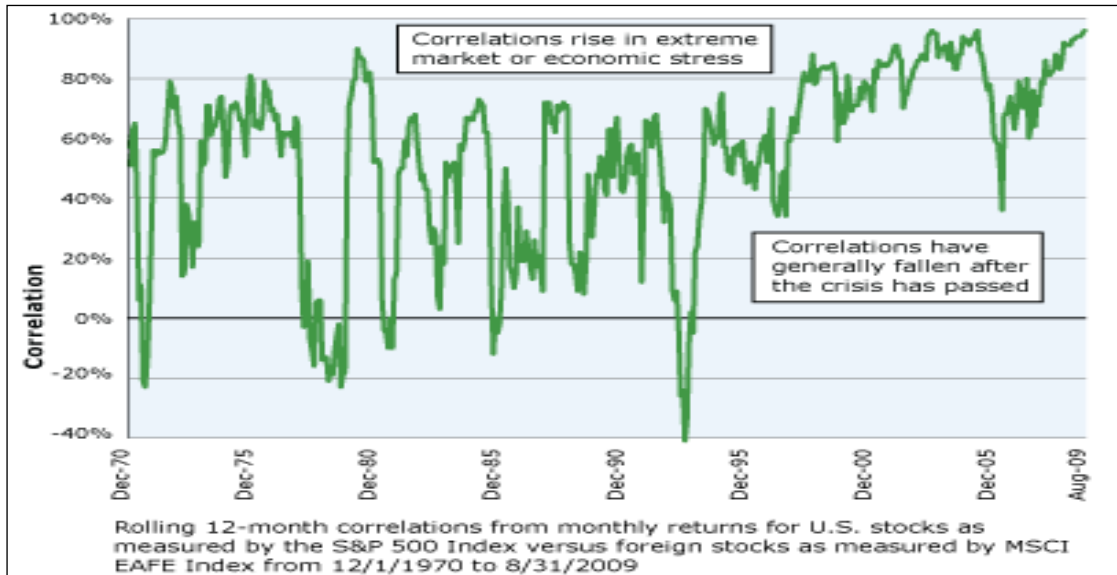
Source: Schroders (Achieving Real Returns); DataStream

SAA overestimates diversification benefits

The idea that mixing asset classes gives diversification benefits depends on the asset classes performing differently to each other, in a consistent and predictable way. That is, their returns need to have a low and predictable correlation, otherwise there is no net benefit from mixing asset classes - you might as well just pick the one you think will perform the best. This theory has played a big role in the rise in popularity of 'alternative' investment assets such as hedge funds - which are supposed to have no correlation to share market returns. In reality over many years correlations have changed significantly, and assets which are supposed to deliver diversification benefits often fail to live up to expectations. For example, US shares and other developed share markets have had a very variable correlation, which has generally been higher during times of economic stress - meaning there was no consistent benefit from holding both asset classes.

Correlation between global equities

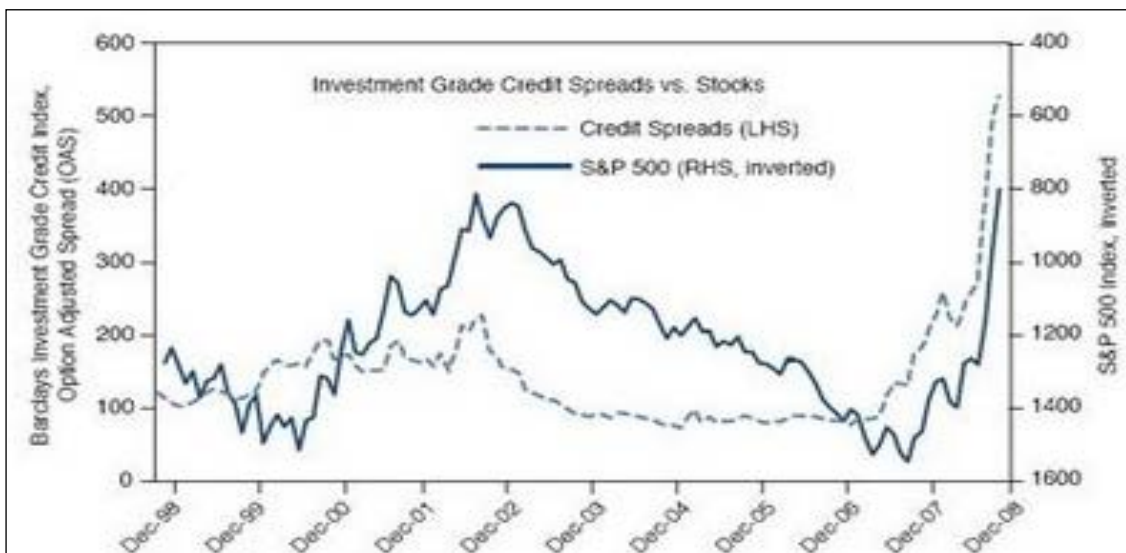
The chart below shows how correlations between US equities and other developed nation equities have tended to rise during periods of extreme market or economic stress. Although correlations often fell somewhat after a crisis passed, this shows that correlations are far from constant - and at the times when you most need correlations to be low, they are most likely to rise! As the saying goes, the only thing that goes up in a falling market is correlation.



Source: Ibbotson; Fidelity Investments; Seeking Alpha (David Hunkar)

Correlation between equities and corporate bonds

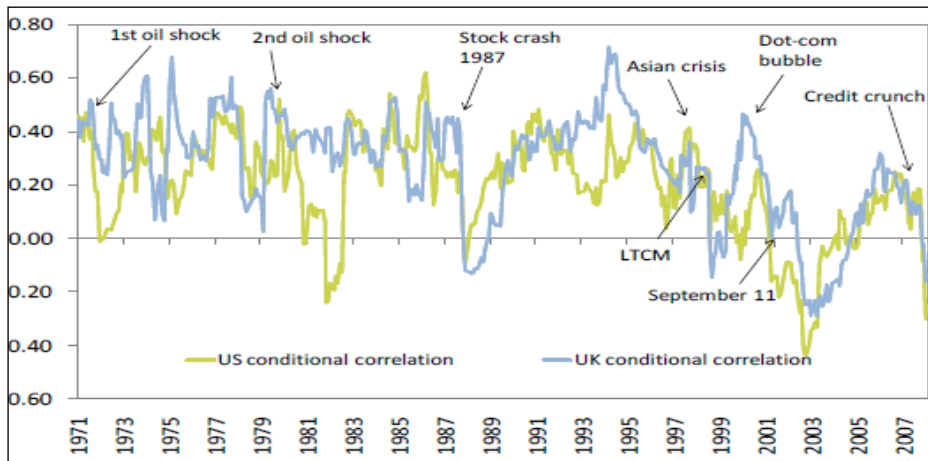
The chart below shows the relationship in performance between US equity markets and investment grade credit (BBB+ and above). Since the capital performance of credit investments is inverse to the spread, the chart below has inverted the S&P500 index and has charted it against the Barclays investment grade credit spread. The result is that the two assets in fact have performed in a similar pattern - when equity markets turned down, investment credit followed suit and hence there were minimal diversification benefits.



Source: Barclays; Bloomberg; Seeking Alpha

Correlation between equities and government bonds

The chart below shows the correlation of US equities with US treasuries (in green), and the correlation of UK equities with UK gilts (in blue). It demonstrates that both equity markets have unpredictable correlations with their respective government bonds.



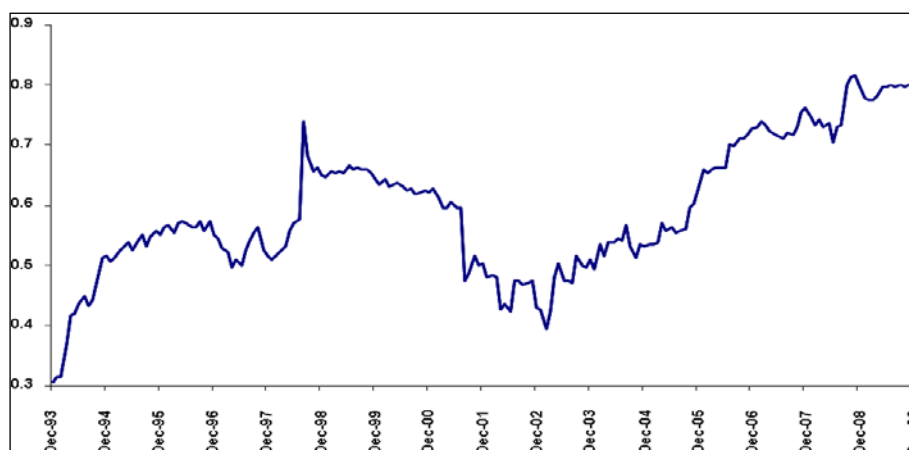
Source: Barrie & Hibbert (Steffen Sorensen); Federal Reserve; Bank of England; FTSE World

Hedge funds have not been effective diversifiers

Hedge funds – an asset type which is intended to be uncorrelated with the broader market - have in many cases actually performed similarly to markets. On occasion they have smoothed some of the peaks and troughs, but have generally mirrored each others' performance, and that of the overall share market, during periods of market stress.

Correlation between hedge funds

The chart below shows that at some points in history (1993 and 2002-03), hedge funds were largely uncorrelated in their performance, and therefore diversification benefits could be found within the asset class. As time progressed however (1998 and 2008-09), hedge fund returns tended to converge as too much money chased too few strategies, eventually marginalising the alpha available. Excess gearing was then often employed to improve their alpha opportunities - but leverage, as investors have discovered through the GFC, was a two edged sword!



Source: GMO (SAA White Paper)

Strategic asset allocation has not consistently delivered the results it promises

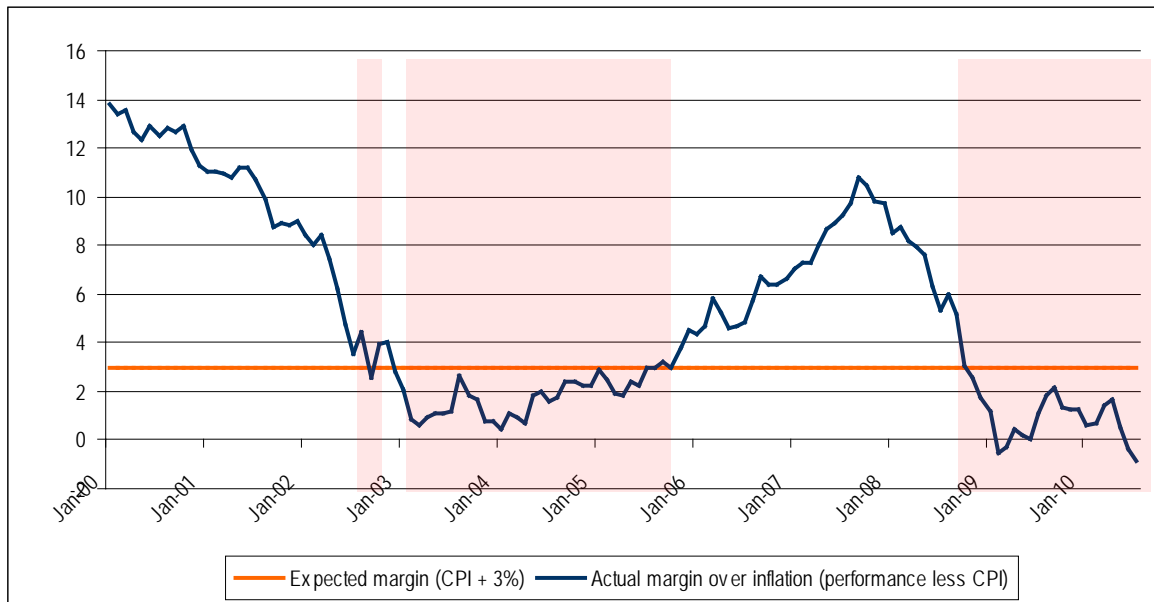
In the first part of this paper, we discussed the theory behind strategic asset allocation, and the results it purports to deliver. What have the results been?

Strategic asset allocation outcomes

The following table compares the actual returns of different risk profiles over time, and contrasts them to their expected outcomes being a function of forecasted asset class returns, and inter-asset class correlations.

ASSET CLASS	CONSERVATIVE	MODERATELY CONSERVATIVE	BALANCED	MODERATELY AGGRESSIVE	AGGRESSIVE
Target return (X+ years)	CPI+2%	CPI+2.5%	CPI+3%	CPI+3.5%	CPI+4%
Recommended investment timeframe	3+ years	4+ years	5+ years	6+ years	7+ years
Forecast range of returns (over 5 years)	0.7 to 5.6	-0.6 to 8.0	-1.7 to 10.0	-2.8 to 11.7	-4.5 to 13.2
Best* ever return over any 12 months (actual)	+26.9%	+32.5%	+37.8%	+45.4%	+52.4%
Worst ² ever return over any 12 months (actual)	-7.7%	-16.4%	-23.4%	-29.7%	-35.2%

The chart below compares the targeted return for a Balanced portfolio over rolling 5 year periods with the actual return generated by the median Growth Managers. When the blue line is above the orange line, the objective was met, but when it falls below the orange line, the objective was not delivered. Over the last fifteen years, there have been two extended periods where, the median growth manager did not meet its long-term investment objective.



Source: Profile Financial Services; van Eyk Research (Software Inputs & Asset Allocation Strategy); Reserve Bank of Australia – CPI Index; Morningstar Median Multi-Sector Growth Manager *period January 1995 to July 2010

A NEW APPROACH – OBJECTIVES-BASED INVESTING

Objectives based investing is an alternative approach to risk profiling and Strategic Asset Allocation (SAA). It starts with the unique objectives of the investor, and constructs an investment portfolio that has a high probability of meeting their needs, based on what is known about the way investors and investment assets behave in the real world. It is flexible enough to cope with changing circumstances, and reduces the impact of short-term market volatility on investors’ plans – after all, investors cannot live off relative returns, only real ones!

Objectives come first

The essential first step in any investment plan is to clearly understand the individual investor’s needs and goals. While they are different for everyone, they can generally be grouped under four headings:



Liquidity – “Foundation” bucket

This includes an ‘emergency’ cash reserve to cover contingencies such as the car blowing up or an unexpected bill, as well as any income needed from investments in the short term to support or supplement lifestyle spending.



Wealth preservation – “Preservation” bucket

Another need is to protect the purchasing power of assets from erosion by inflation and capital depreciation over the medium term. For this goal, it is more important to avoid a loss, than to chase a potential gain.



Growth – “Accumulation” bucket

While preservation is important to a portfolio, often a higher return needs to be targeted for at least some of the portfolio, in order to meet an investor’s goals. This may be needed to provide protection against longevity risk (outliving capital), or the investor simply has an appetite for higher returns over the longer-term.



High involvement – “Acceleration” bucket

This category is for sophisticated investors with significant assets already, or with high levels of understanding about asset markets, and a desire to be personally involved with adding value to their investments, or to access unique opportunities not available to most investors.

The role of the planner

Although goal types can be broadly grouped, every investor is unique. The crucial role of the planner is to understand their clients’ investment goals, psychology and behaviour, then construct, maintain and make the necessary adjustments to an investment plan over time that delivers the client’s goals.

Investors will generally have several goals and needs at any one time, which change over time. Each goal will have a different timeframe and different priority for the investor, and so often a different asset mix is appropriate for separate goals. There is no one appropriate 'risk profile' that will meet all the goals.

Psychology is crucial, and the way an investor feels about their plan will be strongly influenced by the recent performance of markets. Coming out of a financial crisis, investors will often express a preference for more certainty in investment returns and willingness to give up the chance of high returns for the greater certainty of no loss. However when markets recover, people often feel very differently!

The amount regularly contributed (for accumulators) or withdrawn (for retirees) from investments is a crucial element of any investment plan. Often the actual amounts and timing do not match the original plan! A planner must monitor this aspect tightly and will often need to adjust the investment strategy accordingly. This is another aspect of psychology planners must deal with – some people are natural savers, and others natural spenders, and it is very hard to change such a basic aspect of personality. However the trend can and should be recognised and the plan adjusted to cope.

A new definition of risk

In objectives based investing, risk is no longer about volatility. Risk is the chance that an investor's objectives may not be met.

As a result, managing risk is not about reducing the volatility of a portfolio. Instead, the focus changes to providing a higher degree of certainty that the investment objectives will be met.

So it is very important to set appropriate investment benchmarks for each objective, and to select investments for that objective that have a high likelihood of delivering the outcome.

Building the investments

Meeting these goals requires a different approach to investing. Rather than mixing all the major asset classes to deliver the highest net expected return for a given volatility tolerance, investments are instead managed to deliver a specific outcome within a given timeframe.

Up to three years - the "foundation" bucket (identifying opportunities in the yield curve)

Because liquidity is important, the investment manager only invests in assets that are liquid (cash, bank bills), or investments that have pre-defined liquidity constraints (term deposits), with essentially zero chance of capital loss. Because a full three years of liquidity is not required in the first year, some part of the allocation can be invested in securities with a longer duration, taking advantage of higher interest rates which may be offered down the curve.

Three to six years - the "preservation" bucket (identifying the most appropriately valued asset classes over a medium term horizon - underpinned by income yield and capital risk awareness).

Because expected return is important, the investment manager chooses the assets with the greatest likelihood of delivering the required outcome over the specified time period. These assets might change significantly depending on the state of the market.

For example, as noted above the biggest driver of future returns is a function of the initial price paid. So if Australian shares are currently deemed to be over-valued, a manager may hold no, or few,

Australian shares in the portfolio. Alternatively if shares are deemed to be under-valued, then this asset class would form a high proportion of the portfolio.

The focus is on delivering the objective of the fund instead of beating a volatility-based benchmark, and the investment manager requires broad discretion over how they manage investments in order to deliver the objective. As a result, investors must be comfortable with the potential for their mix of assets to change substantially. This is another reason why strategic asset allocation cannot work with objectives-based investing: an investor might hold mostly fixed income in one year, and international equities in another, without changing funds or their ultimate objective.

Six years and over – the “accumulation” bucket (identifying the most appropriately valued asset classes over a longer-term horizon - underpinned by macro-economic and thematic insights).

The overall approach is aligned with that for the preservation bucket. However, because the timeframe is longer, the investment manager can acquire assets at higher prices – taking higher-risk entry points on assets. Typically this bucket would have a higher allocation to traditionally ‘risky’ asset classes such as equities.

In this bucket the investment manager targets a higher return over inflation than the wealth preservation bucket, with a longer timeframe for producing returns. Individual investors can also use this strategy in different ways - for example, by adding gearing, sacrificing partial returns to buy downside protection (insurance), or dollar cost averaging.

The “acceleration” bucket (identifying investment opportunities beyond the traditional).

Some investors have a desire to participate more actively in the performance of their portfolio, or higher levels of personal funds that allow access to a broader investment set once their lifestyle needs have been met. For this bucket, the investment manager recommends investments with unique access points into investment markets. These investments have unique characteristics that diminish their ability to be actively managed within a broader model portfolio. The investor must be comfortable with the typically higher risks of these investments, and therefore would make the final selection based on their personal preferences in consultation with their planner.

The table below summarises the 4 objective groups and considerations for building their investment exposures:

CLIENT OBJECTIVE	INVESTMENT OBJECTIVE	BENCHMARK	TIMEFRAME	EXPECTED AVERAGE ANNUAL RETURN*	TOOLS
Liquidity – “Foundation”	Provide cash flow CASH FLOW RISK	Cash rates (prevailing market)	Daily to 3 years	3.5%*	Term deposits (generally up to 12 months) Bank bills CMA / CMT / cash fund
Wealth preservation – “preservation”	Preserve real purchasing power of assets CASH FLOW RISK & LONGEVITY RISK	Inflation + 4%	3-6 years	7%*	Multi-asset classes Managed funds Structured products Direct securities Derivatives (hedging)
Growth – “accumulation”	Increase real value of assets LONGEVITY RISK	Inflation + 6%	6+ years	9%*	As above Gearing (optional)
High involvement – “Acceleration”	Increase real value of assets Higher direct involvement with investments LONGEVITY RISK	Various (depending on asset)	Various (depending on asset)	Various (depending on asset)	Sophisticated investments and strategies, ie: Private equity Structured deals / infrastructure IPOs Investment property Hedge funds ... etc

* The “expected average annual return” figures outlined above are notional only. They are subject to change based on changing market states and the managers’ view on the most likely returns from each asset over the investment timeframe.

BUILDING AN INVESTOR’S PORTFOLIO

This section summarises the steps to constructing an investor’s portfolio using the objectives based investing approach.

Accumulators

- Determine and quantify the investor’s goals:
 - Liquidity: What cash reserve is needed, and what annual income (if any) is required from investments? (for example, to fund investment / advice fees and costs). Are any other expenses likely within the next three years?
 - Medium term goals: Does the investor have any financial requirements in the 3-6 year timeframe?
 - Financial independence: What asset base is required for the investor to live from their investments, and when?
- Determine the current investable assets
- Determine the amount the investor can regularly contribute towards their investment strategy

4. Discuss the investor's attitudes and behaviour with regards to money.

5. Model the strategy (using Profile's Pathways software)

- Of investable assets, the cash reserve required, plus the amount needed to fund three times annual income needed from investments, plus any amount needed to meet short-term goals, is allocated to the "Foundation" bucket (assuming the assets return the expected average annual return).

- Next, any investment goals to be met in the 3-6 year timeframe are ascertained and the amount needed to fund them allocated to the "Preservation" bucket (assuming the assets return the expected average annual return).

- Lastly, the required return on any remaining assets plus regular contributions is calculated, and the assets and contributions are split between the "Preservation" and "Accumulation" buckets to give the required return in order to meet the investor's goals.

The resulting asset allocation is discussed with the client to ensure they understand the level of risk they will need to take on in order to generate the required return to meet their goals.

If it is not possible to meet the client's goals –for example, if the required rate of return is greater than 9%, or the client is uncomfortable with the asset allocation required - then the planner must work through the assumptions with the client, modifying the timeframes, income required and amount contributed and so on until a match is found.

Retirees

In their report on 'Securing Retirement Income Streams (2009)', Mercer consulting refers to the retirement income "trilemma". This is the requirement for a portfolio to take into account three major retiree investment objectives – 1. protection from risks, 2. access to capital and 3. good returns. Mercer discuss how although many investors in retirement automatically revert to a more conservative investment portfolio, the degree to which this is implemented should take into consideration the required longevity of the portfolio, which it often doesn't. By providing short term access to capital (liquidity), and protection from risks (wealth preservation), the portfolio can also take active long term positions with some allocation to manage this longevity risk (accumulation).

1. Determine and quantify the client's goals:

- Liquidity: What cash reserve is needed, and what annual income is required from investments? Are any other expenses likely within the next three years?
- Medium term goals: Does the investor have any financial requirements in the 3-6 year timeframe?
- Financial independence: For what time period does the investor wish to generate income from their investments, and how much of a lump sum is required to remain at the end of that period?

2. Determine the current investable assets

3. Discuss the client's attitudes and behaviour with regards to money.

4. Model the strategy (using Profile's Pathways software)

- Of investable assets, the cash reserve required, plus the amount needed to fund three times annual income needed from investments, plus any amount needed to meet short-term goals, is allocated to the "Foundation" bucket (assuming the assets return the expected average annual return).

- Next, another three years of income requirements, plus any investment goals to be met in the 3-6 year timeframe are ascertained and the amount needed to fund them allocated to the "Preservation" bucket (assuming the assets return the expected average annual return).
- Lastly, the required return on any remaining assets is calculated, and the assets and contributions are split between the "Preservation" and "Accumulation" buckets to give the required return in order to meet the client's goals.

If it is not possible to meet the client's goals –for example, if the required rate of return is greater than 9%, or the client is uncomfortable with the asset allocation required - then the planner must work through the assumptions with the client, modifying the timeframes, income required and amount contributed and so on until a match is found.

Charitable foundations, not-for-profits & other organisations

When we are investing on behalf of an organisation rather than an individual, a similar process is followed. That is, the investor's requirements from their capital are ascertained and assets allocated in such a way as to increase the probability that the goals will be met.

When an organisation is relying on its assets to generate an income or regularly fund a particular project (for example, a PAF which must pay out a defined percentage (currently 5%) of its assets each year), the process followed is similar to that for a retiree. If the organisation is raising funds in order to achieve a particular goal (for example, a church wishing to build a spire on a cathedral in 6 years' time), then a process similar to that for an accumulator is often more appropriate.

The underlying principles – ensure sufficient liquidity is available to meet defined short-term needs, and don't take on greater investment risk than that which is required to achieve goals – are the same.

The "Acceleration" bucket

Generally assets would not be allocated to this bucket until a client's lifestyle needs had been met, as outlined above. As the assets in this bucket are likely to be much more risky than those used in the other buckets, we would not want to put a client in the position where their important lifestyle goals would not be met if one of these investments failed.

In addition, as many of these investments will have unique characteristics and risks (for example, liquidity constraints, high concentration etc), it is our intention to restrict access to this bucket to 'sophisticated' or wholesale investors who have a recognised capacity to assess and maintain these more complicated investments.

We are currently developing this segment of our investment strategy and will update this paper once details have been finalised.

MAINTAINING AN INVESTOR'S PORTFOLIO

Once invested, each year the portfolio must be reviewed to ensure the strategy remains on track. The initial modelling done for the client is retained, and recalculated each year in line with changing investor circumstances and changing market conditions.

Starting with the "foundation" bucket, the planner reviews expected versus actual expenditure and modifies the calculation on this basis. Did the client spend more, or contribute less, than they

planned? Is this a one-off, or is it likely to continue? If less is remaining than the required 3 years of income plus short term cash needs, then if markets have been favourable the planner can reallocate funds from one of the other 'buckets' - taking profit from either the "preservation", or "accumulation" bucket, depending on returns and guidance provided by the Profile Investment Committee.

Next, a similar calculation is performed on the medium-term investment goals: does enough remain in the "preservation" bucket to cover the 3-6 year timeframe, plus another 3 years of income? If not, then if markets are favourable then additional funds can be reallocated from the "accumulation" bucket. As above, the Profile Investment Committee provides guidance to planners on rebalancing strategies based on market performance and expectations. However planners can override this if the client's individual circumstances warrant it.

Of course if markets have not been kind, it may be preferable not to reallocate funds to cash. This is why three years of income is allocated to the "foundation" bucket – in a bear market, the client can choose not to sell their other assets at a loss, continuing to draw on the cash reserve for up to three years in the expectation that markets will have sufficiently recovered before needing to draw on these investments. In fact, depending on the overall strategy position, the planner may suggest reallocating funds from cash or "preservation" to the "accumulation" bucket.

This reduces the client's reliance on short- and medium-term market conditions. It allows planners to realise profits in good times, and reinvest in bad times, in a structured way that makes sense for the individual client and their unique circumstances.

SUMMARY

Objectives-based investing seeks to align an investor's financial strategy with their investment portfolio. It is designed to provide greater certainty and flexibility around meeting financial and lifestyle objectives, through market cycles. While meeting financial objectives should be sufficient in theory, behavioural finance would suggest that this is only part of a truly satisfying investment strategy for clients. Objectives-based investing seeks to address non-financial investor preferences as well, in a way that is operationally efficient, satisfies investor appetite, and is complementary to the rest of the portfolio. It allows planners to focus on strategy over investment selection, provides a higher degree of certainty around client outcomes, and provides a more tailored investment model to meet the individual needs of the investor.