The “Mission” of Financial Planning

As an engineering manager at Intel Corp for a decade and a half, I spent a lot of time working on team goals and objectives. Designing a computer chip is a complicated effort. It requires multiple teams to coordinate their efforts in order to get the chip designed, tested, and manufactured on schedule. The design engineering effort needs to be coordinated with software, validation, systems, and several other support teams so that every piece of the project is ready to go at the right time. After spending multiple nights until 2:00 in the morning working bugs out of the design, no one wants a project to grind to a halt because there isn’t a computer board to put the chip on, or because the software engineers decided to go on a team-building excursion the week before the chips arrive (software people were always going on some kind of activity). Every person on the project needs to be crystal clear about their team’s objective, and because the projects are so large and involve so many people, the big objectives need to be broken down into smaller objectives that can be easily measured and tracked. Since everything at Intel needs to be reduced to an acronym, we called these smaller objectives “MBO’s,” for Monthly Business Objectives.

I hated doing MBO’s. They needed to be aggressive enough to motivate the team, but also realistic, unambiguous and measurable. Most team members wanted their objectives to be “soft” so that there was wiggle room if the objective wasn’t met, but the job of a manager was to come up with “hard” objectives and that’s a pain in the butt. To complicate matters, designing a computer chip is not simply a matter of moving from point A to point B. Projects are started with a ton of unknown issues that will only be discovered as the project progresses. These unknowns need to be planned for, with contingencies built in if the issues end up being bigger or taking longer than anticipated.

Col. Tom Magness (ret.) talks about this idea of mission clarity in his book “Leader Business.” Col. Magness was an Airborne Army Ranger, which (according to him) is a step above Navy seal. When a Ranger team goes out on a mission, every member of the team must be clear on the objectives. The mission objective is paramount, so when things go wrong, which they often do on any complex activity, the contingency activities must be focused on getting the mission back on track. When I play golf, I often say that it’s not how you play the game, it’s whether you look good doing it. I need to say this or I would have given up golf a long time ago. For a real mission, this couldn’t be further from the truth.

How does this relate to financial planning, investment management, and all of the other stuff that financial advisors do? In an effort to communicate what we do, we often get wrapped up in the activities and characteristics of financial planning, but miss out on the mission objective. We tend to talk about fee structures, performance, investment cost, capital preservation, fiduciary responsibilities, etc, which are all good things to talk about but are not the objectives of the mission. Every client relationship represents a new and unique mission. The objective of that mission is a clear, feasible, and measurable financial goal or goals that the client is seeking to accomplish. The first job of a financial planner is to help clients figure out exactly what they are trying to accomplish. What is the mission? When everyone is crystal clear on the mission and its objectives, we can then move forward with the work of planning how to accomplish those objectives.

MISSION OBJECTIVES

Let’s start with what I would consider to be a typical client objective: retirement. When a client asks, “What do I need to do to retire?” they are actually asking a more complicated question. The real question is “How do I create a sustainable cash flow in retirement that allows me to maintain the lifestyle I desire?” Now we’re getting somewhere, but it still needs clarification. At what age would they like retirement to begin? What type of lifestyle do they have in mind and what will it cost to achieve it and maintain it? We can get into a lot of detail here, but for the purpose of driving home the point we can keep it pretty high-level. A financial plan that is focused on a client's ability to retire has a clear objective: developing a series of cash flows that is sufficient to maintain the client's desired lifestyle throughout retirement. The specific amount and timing of the cash flows will be unique to each client.

For discussion purposes, let's assume a client wants to retire at 65 and will need a household income of $100,000. We will want to build in some level of annual income increases to offset inflation, and we may want to divide retirement spending into multiple segments to account for increased travel and "play" money in early retirement, a reduced amount in mid-retirement when the desire or ability for extended travel diminishes, and a further reduced amount in late retirement when spending patterns tend to shift again. After factoring in Social Security, pensions, and any other fixed cash flows we know about, and determining a level of investment income that can be sustained, we ultimately arrive at a "retirement number." A portfolio amount that must be achieved by age 65 to make the plan work. At this point the real planning can begin. We have a clear objective, which is the year-by-year cash flow needed to sustain the client's anticipated lifestyle and activities in retirement, and we have a defined investment goal (a specific number) that must be reached by age 65 (a specific timeframe) in order to meet that objective. Everyone involved now knows what needs to be accomplished. In other words, we have defined the mission. Notice that the mission makes no mention of beating the S&P 500, keeping investment costs to a minimum, preserving capital, etc. I can trounce the performance of the S&P 500, use nothing but Vanguard index funds, and crank the implementation through a robo-advisor to reduce fees, and still fall miserably short of the mission…because those things aren't the mission.

PLANNING FOR MISTAKES

For a financial plan that will span multiple decades, it would be extremely rare for even a majority of the assumptions to be close to the predictions, much less all of the assumptions. Things will go wrong. A disability may affect the assumed savings rate while the client is still working. Inflation could rear its head. Long-term care needs may be higher than expected. And we know before starting the plan that investments do not return an "average" rate year after year. In fact, there are no guarantees the stock market will give us any particular return in the timeframe we need it to, even if we convince ourselves that the timeframe is "long-term." Given all this uncertainty, we need to plan for contingencies. In other words, we need to play defense. To protect the mission we need to protect capital, so defensive planning may take the form of Long-Term Care insurance, or life insurance, or inflation hedging. All of these things cost money, so optimizing a plan for the lowest possible cost could very well end up putting the mission in danger. Playing defense is not the exciting part of financial planning, which is why so much emphasis is put on investment performance, and yet an improper defense can make it almost impossible to accomplish the mission if one of these risks ends up coming to fruition.

RISK-MANAGED OFFENSE

If protecting capital in the face of "life event" risk is playing defense, then investing can be considered the offense. However, risk management still needs to be taken into consideration during the offensive part of a plan. To shift to a football analogy, not every offensive play a football team runs is necessarily targeting the end zone. Sometimes, in fact most times, the main objective of the play is to get a first down. If, in the course of trying to advance the ball to the next incremental milestone (a first down) there is an opportunity to score a touchdown, the players will take it, but most of the plays are designed to advance the ball and simply get closer to the ultimate objective of scoring a touchdown. One of the worst things that can happen is to lose yardage and move further away from the goal.

All of this holds true when it comes to investing. If we have properly quantified the financial objectives, which for the purpose of this discussion is retirement, then we can derive the average annual rate of return required to accomplish the objective. From an accumulation standpoint, we know where we need to be and when we need to be there, so it's very straightforward to calculate the required average rate of return that is necessary to accomplish the objective. This is the goal of financial planning and investment management. We tend to get caught up too often in things that are not the actual objective. Beating the performance of the S&P 500, or finding the lowest-cost investment products. These can be made to sound compelling, and they may even be part of the mission, but they are not the mission. The mission is to meet or beat the required average rate of return with the highest probability of success. To do this, we need to ignore the competitive aspects of investing. We need to take appropriate risks while being careful to never give up too much "yardage." And we need to focus on high-value investments as opposed to just low-cost investments.

OUR APPROACH

There are many investment strategies to choose from, and advisors can argue all day long about which one is best. When debating different investment styles, most people tend to use past performance, often with carefully-chosen starting and ending points, as a "proof" for their argument. The weakness in looking at past results is that it doesn't take risk into account. Risk is only forward-looking. It deals with events and situations that haven't happened yet. When looking backward at results, we only see the circumstances that did happen and we don't see the risk it took to get those results. There are plenty of studies available "proving" that low-cost index investing is the best approach, but low-cost investments also tend to be the least risk-managed investments. Likewise, there is always a discussion going on about whether this or that investment can "beat the S&P 500," but this implies a competition. For a retirement objective, the mission is not to outperform the S&P 500 or hold the cheapest investments possible. It's to achieve the required average rate of return with the least risk possible.

This mission-focus has led us to adopt a "personal endowment" strategy. A typical endowment strategy (think of Yale or Harvard or Stanford) is designed to accomplish the mission of meeting scholarship obligations each year. The personal endowment strategy is designed to accomplish the mission of meeting or beating the required rate of return to arrive at your retirement number, and then to provide a cash flow to meet your living expenses. Whether it's personal or institutional, the endowment's goal is a defined, measurable objective that needs to be met whether the stock or bond market cooperates or not. The stock market doesn't care about your mission and certainly not about your timeframe.

What differentiates an endowment model from a more typical portfolio is the number of diverse asset classes. The Harvard endowment does not run a 60/40 portfolio of Vanguard funds. A typical endowment uses stocks and bonds as individual sleeves of the portfolio, in addition to absolute return, private equity, natural resources, emerging market or private debt, real estate, etc. Within these diverse asset classes are investments that hedge the downside and reduce risk beyond just non-correlation. The same is true for the personal endowment. Is it more complex than a 60/40 mix of index funds and investment-grade bonds? Absolutely. But if we consider ourselves to be "investment professionals" it would seem reasonable that we can handle some complexity. This is where a high-value orientation comes into play. Complexity for complexity's sake doesn't help anything, but if I get a high value from an investment with downside protection, or perhaps leveraged upside, then the added complexity and associated cost is worth it.

There is a downside to every strategy, and that is no different for a personal endowment. The downside is that an endowment portfolio will always under-perform its best-performing asset class. That's not a big deal if the best asset class is private debt or some other obscure investment. But when the best asset class is U.S equities, suddenly the ability of the portfolio to reliability accomplish its mission takes a back seat to investment competition. Some investors will become worried that they aren't "keeping up with the market," and for these investors, perhaps an endowment model is not the best choice. An index fund that goes up and down with the daily movements of the market may actually be more comfortable for them. When the market is up everything is wonderful. When it falls, there are plenty of people to share the misery with. We've chosen to be solely-focused on accomplishing each client's mission, and that means a commitment to asset class diversification and risk-management. The Yale endowment has a track record of 13%+ returns for the last 30 years, and yet whenever U.S. equities are the best asset class, the endowment gets criticized for not keeping up with the S&P 500. We're willing to live with that risk, and we think it's in our client's best interests as well. Hooah!