PART I

ALL ABOUT YOU

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CHAPTER 1

Changing the Game

Science is a long history of learning not to fool ourselves.
—Richard Feynman

Not long ago, a woman we know came into some money. It was a substantial but not a breathtaking sum that had come quite unexpectedly from a childless aunt. Julia, as we'll call her, is a diligent, responsible person; and to her surprise and consternation, the inheritance threw her into turmoil for a long time. She had absolutely no idea what to do with the money.

Julia wanted to consult with a financial advisor, but she felt lost when it came to finding one. Although she owned her own business and considered herself financially literate, the prospect of choosing a trustworthy advisor seemed overwhelming to her. Her aunt's attorneys were no help. They were out of state and had no local names to recommend.

Julia began canvassing a few of her friends for advice. She hoped they could share insights, opinions, and with luck, some good referrals, too. She started with Sue, whom she saw often because their children were classmates. She

also spoke with Sam, another friend, who worked in her office building. Sam always seemed to be in the know about the latest new thing.

Things did not go as Julia had planned. Instead of generating some interesting but very casual conversations, she found that she'd ignited a fire.

She'd caught Sue just as Sue was trying to learn more about her family's investments. They'd lost what felt like a vast amount during the financial collapse at the end of 2008. Sue was horrified and wondered whether her husband hadn't been playing a little too fast and loose with their money. Until then, he'd assumed sole responsibility for their investments, but Sue was divorcing now and needed to take charge. Just how she would manage to do this she did not know.

Sam, too, responded with unforeseen enthusiasm. Through the accountant who did his taxes, he had just learned of a financial planner—we'll call him Paul—who was hoping to launch a guidance group. He was modeling his group on the support groups he'd been hearing about—people who got together every month or so to help one another learn more about money and investing.

Paul thought a support group could be more motivating and interesting than a classroom could ever be. The groups that had inspired him were not conventional investment clubs or counseling groups to help with budgeting and the like. Rather, what they offered was more like an amalgam of investment education, inspiration, and mutual encouragement.

Paul was peeved that many people seemed to be flying completely blind. They were subjecting themselves to all kinds of misinformation culled from a potpourri of unvetted sources in the library, the Internet, the popular press, television—you name it.

That's how Paul came to hatch a new plan. He was still in the early days of his project when he shared his thoughts with Sam's accountant, who loved the idea and promised to spread the word.

It wasn't long before Sam contacted Paul. He brought Julia and Sue to a meeting—and the three of them liked what they heard. There was a small fee, but the arrangement seemed reasonable to them all.

Paul asked them to recruit one other person, or couple, so they could broaden the experiences they'd be able to talk about. He insisted that they choose someone at a different stage of life, though. The three of them were in their thirties through their late forties, and Paul believed that it would be helpful to include someone in the group who was closer to retirement. It would give them a glimpse of themselves in 15 or 20 years. And the newcomers would benefit too. They'd get a wider view of their options along with the energy of this spirited group.

With the group's blessing, Julia approached an older friend at her health club. They'd bantered together for years at the gym, and Julia thought he, and possibly his wife, might be interested in joining their group. Julia's instinct proved right. Patrick, age 57, and his wife Marianne, 55, were immediately attracted to the proposal. They, too, had suffered big losses in 2008, wanted to get their investments back in shape, but felt vulnerable. Patrick told Julia that the idea was just the ticket he'd been looking for. He didn't know Paul, but he considered the group a low-risk way to learn a lot and to get back on track—all in a friendly, interesting setting.

At their first meeting, knowing that it would be important for their success to identify what they had in common, Paul asked each of them why they'd come. As each took the floor to answer, the others found themselves nodding in agreement as they heard the same feelings of frustration, confusion, and vulnerability repeated again and again.

Julia and Sam were the ones who considered themselves knowledgeable about money and investing, yet both felt either paralyzed or completely flummoxed. They'd both done all the "right" things: They'd saved the maximum amounts allowed in their retirement plans, they'd been disciplined

about saving as much as possible, they'd each "diversified" their investments and put 65 to 70 percent in equities as they'd been educated to do, but they had little to show for their effort.

The recent near collapse of the financial markets had paralyzed Julia. She knew she ought to be investing her inheritance, but she was too overwhelmed, intimidated, and confused to make a plan. In addition, she found herself in resistance mode quite often these days. Early on, her two brothers, who had also received shares of the bequest, had been pressuring Julia to join with them in a real estate investment. Julia had refused; it had never felt right to her, and they all now believed they had dodged some bullets. Still, she felt no closer to a solution although some time had already passed.

Sam believed he had a newly clean slate. He was a marketing professional who'd just moved into town from another state after 9 months of unemployment. After working for many years in a much larger firm, he had taken a position in a small technology company. Sam felt chastened about the way he'd handled his money—he'd either spent or lost a big share of his portfolio during his job search. He told the group that he was motivated to do it right this time around, but he still did not know what "right" was.

Sue, a physician with three children, told them how frightening she had found the market's descent and said she wanted to learn more about how to manage risk. But she agreed with the others about how hard it was for her to gain any sense of mastery or control. This she found enormously frustrating. She had developed a pattern of letting herself grow discouraged.

Patrick enjoyed watching the financial news on cable TV and had spent a lot of time researching and trading stocks. But now he was motivated by fear. Both he and his wife Marianne felt lucky to be employed, though the retirement clock preoccupied them and made them both uneasy.

The evening flew by. Paul was excited by what he had started, and they were all surprised by how alike they sounded despite their different circumstances. They enthusiastically scheduled a series of monthly meetings. As an antidote to their shared state of inadequacy and confusion, Paul decided to assign them some things to read, including a few of the best investment web sites geared for people like them.

New Rules

This book has been written as a kind of syllabus for Paul to follow. It's been designed with Julia and her friends in mind—and for all of you who want to make sense of investing, even if you've tried before only to give up, feeling confused, overwhelmed, defeated, or bored. Or if you once believed you understood what to do only to be proven wrong.

As a remedy, we offer a few simple principles to help guide you to investment success. Throughout, we put you, the individual, at the center of the pursuit: you, your resources, your plans and, above all, your financial goals. These are the elements that should be driving your investment plan; and on these subjects *you* are the world's best expert.

At first blush, this may not sound terribly new or different. It's common practice, after all, for financial advisors to ask you all about your financial goals when they're preparing an investment plan for you.

But the goal-based investment paradigm is a game changer. It redefines the mission of personal finance. Your goals and your biography are not simply the stepping-off point for a plan. They are both driver and destination. They help determine the vehicle as well as the path. They dictate how high or low you can fly, how black-and-white your plan should be, and how much color or wiggle room you can add.

In contrast, conventional financial practices often take note of your goals but then seem to sideline them. In the conventional school, the route to goal achievement is indirect

and often circuitous. Instead of goals, the objective is maximizing wealth. And the focus tends to be on the separate moving parts—as in selecting stocks and bonds, then aiming to beat each market benchmark.

This menu of choices can feel a little like building your own home computer system out of an array of separate components that may not serve your particular needs once they are assembled. Too often, making sure that your investments will meet your future needs has become your charge alone. In both cases, you are the one who will have to grapple with the pieces in order to impose the functionality you require. It's small wonder that frustrations can mount.

For most non-aficionados, separate computer components are too hard to orchestrate. It's easier to opt for the integrated desktop, or iPad, for that matter. Anything but plug-and-play feels difficult, because all we really care about is the applications—whether it's movies or spreadsheets.

The story is much the same when it comes to choosing goal-based investing over outdoing any given benchmark's return: What we ultimately care about is meeting our goals. You can't eat rate of return.

Paul subscribes to a goal-based investment philosophy. He believes that investing—and all financial planning—must be tailored to each individual's goals, resources, and opportunities. He's been influenced by life-cycle economics, and he considers lifestyle preservation at all stages of life to be of topmost importance.

At the group's next meeting, Paul introduces them to the core principles of goal-based investing. Right away, his framework brings their discussions down to earth. At once, they begin by looking at their own singularities, not their seemingly limitless investment possibilities.

Patrick is encouraged by the topic of conversation to move beyond his recent losses and to start talking about his personal financial goals. Soon, his friends press him to get more specific. When will he and Marianne be retiring? Where do they plan to live? How much might that cost? And so on.

Julia can see that she's now expected to stop grousing about her brothers and to put her questions about her recent inheritance on hold while she takes a closer look at her own bigger picture. She has to talk out loud now about how—and when—she plans to spend her money. When her turn to speak comes, she too feels pressed by the others to get realistic about attaching a price tag to her dreams, together with a timetable.

As Julia and Patrick ponder these questions, Sam points out how hard it is to put a price tag on goals like retirement that require resources over a long period. Up until his recent layoff, he admits, retirement seemed so far off to him that it was hard to make it a serious goal. If it hadn't been for the tax deferrals offered by his employer's retirement plan, he might never have started to set money aside. But unemployment changed that: As his job search stretched longer, he began to doubt whether he'd ever find work again.

Now that he's working again, Sam is still asking questions—but now he's wondering whether he'll ever be able to afford to retire. He has been reflecting quite a bit about how to protect his investments. He has a hard time, though, guessing how much money he'll need for retirement.

Sue agrees, and adds that even the cost of college has been hard to estimate as one future number. The idea that there is some elusive, magical number, she says, seems a little crazy. "All I want," she tells them, "is to be able to live the way I live now after I retire." There is a lot of agreement on this, but not a lot of discussion.

Paul jumps into the breach. He points out that there is room for more clarity and detail here, and proposes that they return to the subject in greater depth next time.

For now, he suggests, an overview is in order.

He points out that goals need to be feasible. He asks the group what makes the difference between a feasible goal and an unrealistic one.

The talk turns immediately to money. Not just money, but earnings and income. It's Julia's inheritance that has

pointed the discussion in this direction; but, inevitably, the conversation soon turns to their pay. They're asked to consider how much they are earning, and also what they expect to earn over their lifetimes. Where are they in their careers? How predictable is their income? How flexible do they think they can be if faced with economic challenges?

Sue starts. As a physician, she expects a high degree of income security, but she feels that her savings so far are too small in comparison with her lifestyle and her goals. Still, she realizes that it has taken her until recently to pay off her debt from medical school and to save enough for her son's college tuition, so she expects to be able to have more money to invest in the future. She has yet to get a good grasp on what it will be like to be a divorced single mother.

Sam has a different take. He questions whether his old income expectations are ever going to pan out, even once the economy improves. He is toying with the idea of a career change. He reminds people of how decimated all his accounts still are, and concludes pessimistically that he plans to work for a long, long time.

Julia knows that her ability to save and invest is going to vary considerably from year to year. As the owner of a very small landscaping consultancy, she is hoping to grow but knows she can't count on it. That's the reason she has wanted to avoid risk when investing her inheritance. She's been troubled by feedback she's had that she needs to take risk if she wants to net enough money to pay for education and retirement.

Julia's husband, a tenured high school teacher, has a stable and predictable income. But it has amounted to less than half their joint income and Julia, ever uneasy, worries they may be living beyond their means.

Patrick feels as though time is not on his side because he has fewer years left in the workforce than the others in the group. He acknowledges how much pain the collapse of 2008 caused him and Marianne. He wants to map out different ways he might be able to reach his goals over a 10-year

time horizon. Although his income is stable and relatively secure, the brevity of his time frame worries him.

In these conversations, Julia and her friends have reframed their investment projects in simple, clear, and personally meaningful terms. Taking a goal-based view has led them to consider both their desired outcomes and their expected inputs. Their thinking about investment has turned immediate and concrete.

Reframing Risk

So far, we've introduced you to the starting point of goal-based investing, showing how a twin focus on an individual's desired outcomes and expected income leads to a clear, concrete agenda. But this is just the beginning. When you take stock of your goals in terms of the annual cash distributions they will require, as Sam and Sue have proposed, you're also well on your way toward solving the hardest part of the investment puzzle—deciding how much risk is right for you.

That's because goal-based investing encourages matching your investments today to your future needs. And the matching structure reframes risk in a new way.

Now that you are focusing on required yearly spending instead of a more abstract notion of target asset value, it's a quick intuitive jump to envision just how much a given shortfall will hurt. Changing the yardstick for measuring risk in this way also shines a spotlight on it. Loss has a context. Your grasp of potential shortfalls is tighter than it seemed before.

For instance, if you experience serious portfolio losses, that nice check you've been planning to cash from your retirement fund—the one that's meant to cover living expenses over and above Social Security each year in retirement—could be reduced to a much smaller amount.

For perspective, in this past decade of two collapsed stock market bubbles, stock market losses in the trusty S&P

index, when adjusted for inflation, averaged just over a nickel on every dollar each and every year. If you had accumulated a nice balance in an S&P index fund at the start of the decade, more than half of it, in buying-power terms, would have vanished.

Of course, if you had needed to spend that money, your living-expense budget would have had to shrink by the same measure. You get the picture. The process of weighing investments against specific goals can concentrate the mind wonderfully.

The conventional answer to managing potential losses is to bet the odds, diversify, stay invested for the long term, and hope for the best.

But you're a person, not an institution; you plan on spending what you need when you need it. And there's the rub. Even if you have some flexibility to postpone your goals, your time horizon is not terribly elastic. Your child needs

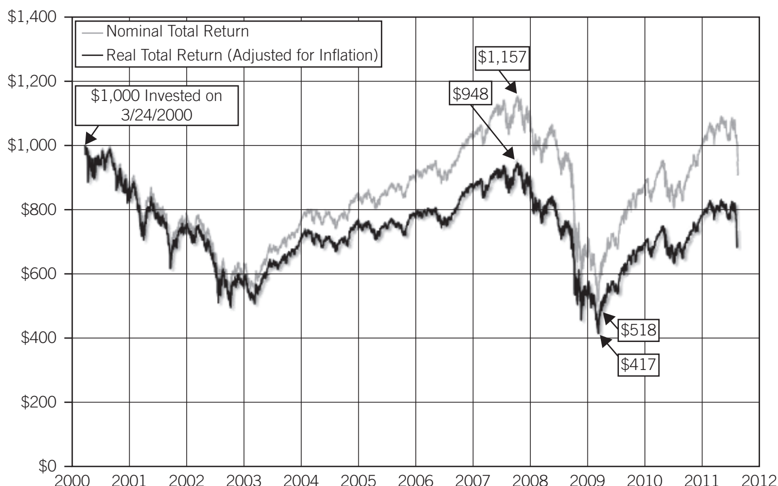

Figure 1.1 S&P Total Return and Real Total Return on $1,000 Invested on March 24, 2000

Returns Include Reinvested Dividends

Source: Doug Short, Advisor Perspectives. Used with permission.

to attend college within a narrow window of time; you may postpone retirement, to be sure, but not indefinitely.

Instead of taking the conventional approach, try flipping the risk question on its head and think about what you *cannot* afford to lose. This may equate to the amounts you have targeted for your goals; but most likely you can reimagine your destinations in their most essential terms, separating wants from basic needs.

How low can you turn down the jets? Is a state or community college a viable alternative to a private university? Can you find frills and extras you may be able to do without during retirement if you must? Perhaps your bare essential living expense budget can go lower. It may help to subject your goals to a series of virtual crash tests to find your own bright line between "must-haves" and "nice-to-haves."

This sharp edge is your line of defense. It's the part of your investment portfolio that belongs in safer instruments. We'll talk at greater length about what constitutes a safer investment, and we'll show you how best to acquire them. For now, the critical point is that you can build a self-made hedging plan that's sure to cover your most basic goals.

A hedge is a tradeoff. To protect your basic needs, you can cut your exposure to loss by investing in safer instruments. When you hedge in this way, you don't pay anything, but you give up possible extra gains beyond the yield of your safe investments.

How much you allocate to safe instruments will be one of your most important decisions. It's important not to decide in a vacuum, but to tie your safe investments to the essential needs you must protect.

Before we leave the subject of risk reframing, let's return for a moment to our starting point, as Julia and her group are taking turns specifying both their goals and their funding sources. You'll recall that everyone recognized how closely their earnings power defined the amounts they could invest. No surprise there, because income from work is where most people get the bulk of their resources.

But here's an added point that's easy to overlook: Your earning power—its stability and flexibility in particular—also sheds light on your ability to take risk. Again, this is intuitive, yet it's an observation that's commonly ignored. That is a real shame, because it is so easy to build your earnings expectations into your personal risk prescription.

Try comparing yourself to the friends in the support group, for example. Sam realizes that the unpredictability of working in a smaller company probably means that he already has added risk to his plate. Spooked by a long period of unemployment, he has already incorporated his intuition into his personal risk profile.

Patrick had once felt secure as a seasoned human-resources manager with a great deal of seniority in the drug company that employs him. But he no longer does. He's concerned that he and his wife Marianne no longer have enough working years ahead of them to replenish their diminished savings. But his anxiety may be leading him in the wrong direction. While his risk-taking habits in the past might have made sense in light of his secure income and his younger age, circumstances have changed. Paul is trying to show Patrick that he is playing with fire.

Sue, on the other hand, recognizes that as a pediatrician her income is relatively stable, substantial, and predictable. From that perspective, she may once have had a fair amount of unused risk capacity. On the other hand, she is about to be newly divorced. Her ex-husband will be making cash contributions toward her children's education needs, but he'll only partially cover them. And for her retirement, Sue is now relying exclusively on her own earning power, so she does not have extra risk capacity after all.

That may be the case for Julia, too, despite her inheritance. As a small-business owner, Julia's earning expectations are neither stable nor predictable. Still, as a successful entrepreneur with professional skills, she has a career path that is flexible and probably resilient. And her husband's income,

while lower than hers, is relatively secure. So Julia's case is not cut-and-dried.

The younger members of the group are in their thirties or forties and can look forward to a long working life ahead of them. As time passes, though, the future income they can expect over their lifetime horizons will naturally start to shrink, and this will reduce their ability to take investment risks. This is what Patrick and Marianne need to understand, too.

Our starting focus on outcomes and incomes has turned into a powerful springboard to reconsider risk on a very personal basis. It can facilitate matching on two fronts, between future goals and planned investments and also between earnings power and recommended risk. We'll have much more to say about ways to recalibrate risk as we proceed.

Let's join Julia and her group as they learn how to put their investments on a firmer footing. They'll be building on the central premise that personal finance is about you—your goals, your values, your family, and your career path. The rest is secondary. And that's where we'll turn next: your self-assessment, starting with your goals in all their distinctive detail.