Lifeworks

The Future of Advice

Dynamic hyper-personalized investment strategies optimized for the right benchmark—achieving your financial plan

BY RON BULLIS

The traditional approach to planning and investing is broken and fails to deliver the results you, the investor, need.

Every firm claims to offer personalized financial planning and investments. Yet, regardless of what they say, whether they are a robo-advisor, a large national firm, or an independent registered investment advisor, they all follow the same flawed and functionally obsolete investment framework—where all roads lead back to risk scores and model portfolios.

We see three major flaws with the industry's traditional investment framework: risk scores, model portfolios, and a focus on the wrong objective.

Risk scores

The first and perhaps most significant flaw in the traditional investment framework is the common use of risk scores. There are many reasons to be critical of risk scores and risk tolerance assessments. I will highlight a few of the most important ones here.

1. Falsely equates risk with the volatility of returns

Consider the following excerpt from our article dedicated to the topic, Going Beyond Risk Scores to Reinvent Retail Investing:

> *"Risk surveys are a norm when it comes to investment advice. They may vary in content and length, but their common purpose is to distill an investor's complex profile into a single measure of how much risk their portfolio should assume. Inputs include age, wealth, income, investment horizon, and investor behavior. The resulting measure, either qualitative ('conservative,' 'aggressive') or quantitative ('6 out of 10'), is meant to be reductive enough so as to be interpreted by the person or the algorithm building the portfolio. It ultimately determines the target volatility constraint inputted in a portfolio optimizer function."*[1]

2. Entirely subjective and unscientific

Qualitative investor classifications like "conservative, balanced, aggressive" are completely arbitrary and convey a false sense of alignment between the investor and their investment strategy. What could be risky to you might easily be considered safe for another investor.

3. Fail to provide meaningful information

Risk assessment questionnaires and risk scores are based on ever-changing emotions and fail to provide meaningful information to investors.

What do I mean by "meaningful information?" Let me use an analogy to demonstrate this point.

Imagine, if you will, that you have not been feeling well for some time now. You schedule an appointment with your doctor to see if they can help figure out what might be causing you to not feel well. Your doctor meets with you, asks you a bunch of questions, explains that they will need to run several tests, and then have a follow up meeting with you when the tests are back. A week goes by and your doctor calls you and asks you to come back to their office so they can share the results with you. When you arrive, they sit you down and say, "I have bad news. You have cancer." After the shock of the news wears off enough for you to start thinking,

[1] Mathé-Cathala, Alex. "Going Beyond Risk Scores." Lifeworks Advisors, 2020.

Ron Bullis

CO-FOUNDER & CEO

@RonBullis

A lifetime builder turned into an ambitious FinTech innovator, Ron founded Lifeworks in 2015 as he realized that the wealth management industry was broken—both for advisors and clients . At Lifeworks, he leads a team of wealth advisors, quant strategists, and software engineers, together developing the first liability-driven wealth management system to fix the flawed traditional approach to financial planning and investing.

Ron is passionate about providing hyper-personalized planning and investment strategies to everyone. Lifeworks has built one of the first subscription-based financial planning services for clients that has no minimum investment or net worth requirements.

you start asking questions to try and understand your current situation better. "How bad is my situation? What course of action should we take? Am I going to be ok? What are my best options? Have you successfully beat this cancer before in other patients? What should I expect going forward?"

Now, imagine how you would feel and what you would think if your doctor instead of answering those questions were to ask you, "On a scale of 1 to 10, how do you feel about chemotherapy and radiation and how much of it would you like to have?"

The most logical answer would likely be, "The least amount of poison needed to kill the disease."

But I think it is safe to assume that the doctor would never ask you that question. Instead, they would focus on informing you of what they believe is best course of action that has the highest probability of success with the least risk to your body. They would tell you the pros and cons of the treatment options so that you could make an informed decision. You would be provided with "meaningful information" that would allow you to make an informed decision.

When you go to an advisor for help with your financial planning and investments and that advisor asks you to take a risk tolerance questionnaire or complete a risk score tool, they are essentially asking you, "How much chemotherapy and radiation would you like to have?" Unfortunately, this does not give you meaningful information about what you need to do to achieve your goals and empower you to make an informed decision. Instead, they ask you to let your emotions and preferences for the volatility of returns dictate your investment strategy and, in turn, the success or failure of your financial plan.

If you have worked with a financial advisor, robo-advisor, or have a retirement plan through your employer, you have more than likely experienced this very process. The simple truth is that risk tolerance questionnaires and risk scores do not provide any meaningful or relevant information that you need to make an informed decision as an investor. The only thing they do is take a snapshot of your feelings and preferences for the volatility of returns at that precise moment in time.

There are three reasons why risk scores or risk classifications are the standard practice for most advisors and firms:

1. To reduce your unique situation and needs into a single measure of risk so your advisor can match you to a one-size-fits-all model portfolio. Why? Scalability and profits. Driving everyone into the same model portfolio through a risk score means that the advisor and firm can build a model portfolio and replicate it without any additional work.
2. They provide cover for the advisor or firm when the investment recommendations fail to achieve your (the client's) objectives. When the outcome of your investment strategy is not what you need, your selected risk tolerance is often pointed to as the culprit, not the model portfolio or the advisor who is "managing" your investments.
3. Regulatory "safe harbor." Many of the largest firms and most powerful interest groups on Wall Street have lobbied against a uniform fiduciary standard for advisors. There are many reasons why large firms have fought against a fiduciary standard for their advisors. However, none of them are in your (the client's) best interest. They all come back to firm profit and being able to mass-produce products to sell to clients. What does this have to do with risk scores? Simple. Risk scores and risk classifications are not only used to map clients to mass-produced model portfolios and financial products. They are used to justify why the sale of the financial product or a model portfolio was appropriate for the client.

For a detailed analysis of the failings of risk scores, I would encourage you to read our article, Going Beyond Risk Scores to Reinvent Retail Investing.

Model portfolios

The second flaw in the traditional approach to wealth management can be found in how model portfolios are mass-produced for the retail investor. There are three main steps to the process of creating a model portfolio.

1. The first step is to group individual investments into somewhat arbitrary categories and sub-categories. This can be by asset class, company size, geography, sector, growth profile, etc.
2. The second step in the process would be for the advisor

or firm to select money managers (mutual funds and ETFs) in each category of assets. These managers are then tasked with selecting the individual investments and their primary motivation is to follow their investment mandate and outperform their respective benchmarks.

3. The third and final step would be for the advisor or firm to set some basic portfolio trading rules like rebalancing frequency, drift tolerances, etc.

The result of this process is the creation of a static model portfolio that can now be mass-produced (replicated) to many clients without any additional work or cost.

There are three critical assumptions that have to be accepted if we are to believe that model portfolios add value for investors.

1. That a person or firm can infer the correct risk loading to each asset category based on your risk score.
2. That a person or firm can select the right managers for each category.
3. That the money managers for each category can continually select the right individual securities.

To challenge the first assumption, we can look back to my point in the preceding section. What might be risky for you could easily be less risky for another investor. What might have been risky for you yesterday based on your emotions on that particular day could easily be less risky on the morrow. Measuring and quantifying risk is a complex process that should be unique to each individual investor.

The second and third assumptions do not hold up in practice either. A great deal of studies have assessed the ability of an individual investor or fund to outperform a market benchmark. While a small percentage have done it, out of luck more than skills, the vast majority have failed to deliver consistent outperformance[2,3].

In addition to the three assumptions that would thave to be falsely accepted, there are three essential questions that every investor should ask when considering the value of model portfolios:

1. Where in the process of manufacturing model portfolios does my unique financial and life goals come into consideration?
2. What incentive drives the individual advisor or firm who creates a model portfolio?
3. Is it likely that the incentives that drive the money manager (the mutual fund and ETF managers who were selected by the advisor) are aligned with my unique objectives?

I would submit that the model portfolio's official and probably true objective is to follow a specific investment mandate and outperform a specific benchmark. However, the model portfolio's unofficial true purpose is to make your unique profile fit into a predetermined and standardized category (along with thousands of other investors), so your advisor, their firm, and the industry as a whole can have a scalable business model. Scalability and profit are the real and unspoken purpose behind the industry's continued focus on creating and selling model portfolios to clients.

Focus on the wrong objectives

The third flaw in the traditional investment framework is that it focuses on the wrong objectives.

Post the dot-com crash, large companies started shifting away from defined benefit pension plans and moving their employees to defined contribution plans (401k, 403b, etc…). The move from defined benefit pension plans that provided retirees with a stable and consistent source of retirement income to defined contribution plans where the focus is on asset value maximization has laid the groundwork for a crisis in retirement planning.[4]

This shift has had significant impact on consumers. First, it transferred the investment risk from the pension plan to the individual. The consequence is that consumers are responsible for making life altering and complex financial

[2] Bu, Qiang and Lacey, Nelson. "Reexamining Fund Manager Skill From a New Angle." Managerial Finance 42, 2014, revised in 2020.

[3] Clare, Andrew. "The Performance of Long-Serving Fund Managers." Available at SSRN: https://ssrn.com/abstract=2836434, 2016.

[4] Merton, Robert C. "The Crisis in Retirement Planning." Harvard Business Review, vol. 1401, 2014.

and investment decisions without the educational background or tools necessary to make informed decisions.[5] To add insult to injury, financial literacy is still mostly ignored by academia and government regulators. Individuals went from being employees who could focus on their jobs to being both an employee and an investor.

Consider this quote from Robert C. Merton, a Nobel laureate and professor at the MIT Sloan School of Management:

> *"Investment value and asset volatility are simply the wrong measures if your goal is to obtain a particular future income."*[6]

The overwhelming majority of firms focus on arbitrary benchmarks and historical returns.

For most investors, their objective should be to have a dynamic investment strategy focused on their most meaningful goal, achieving their financial plan and living the life they want. It should not be outperforming an arbitrary benchmark or focusing on asset value maximization, as these objectives often conflict with your (the client's) primary goal.

The apparent reality is that traditional investment methodologies are obsolete and fail to deliver the results that you, the investor, need.

The Lifeworks innovation

Knowing that the traditional approach fails to deliver what clients really need, we built the future of advice: a framework that provides dynamic hyper-personalized investment strategies optimized for the right benchmark—achieving your financial plan.

Our revolutionary investment framework is built on three key pillars:

1. The first is a liability-driven investment methodology. For years, pension funds, corporations, and insurance companies have been using liability-driven investment methodologies. The core function of a liability-driven investment methodology is to map the future cash flow needs ("liabilities") directly to the investment assets held in the portfolio.

For a pension fund, this would mean calculating the amount of pension benefits they would need to pay each year and then investing in the right assets to provide the highest probability of paying out those benefits when needed. Again, the objective is to effectively hedge against risks that would negatively impact their ability to pay the income when required.

Your liabilities are the future cash flows needed to support your financial plan. Our liability-driven investment methodology uses your financial plan to construct your investment portfolio and dictates the risk management in the portfolio. We match the right investment assets to your specific cash flow needs (liabilities) with the proper risk loading and hedging.

Our investment framework is dynamic and adjusts to changes in your financial plan and the market. For a more detailed description of our methodology, I would encourage you to read our article, From Investment Products to Investment Solutions.

2. The second pillar is efficient and disciplined factor investment strategies. Factor-based investing allows us to:

- Deliver hyper-personalized investment portfolios that allocate investments based on scientific risk factors instead of arbitrary asset classes.
- Eliminate the unnecessary expenses of active management (fund fees and manager fees) and provide superior liquidity.
- Provide total customization of the investment portfolio to align with your values and financial goals.
- Allow complete control of taxes and tax-planning opportunities.

3. The third pillar is Smart Beta techniques which provide true diversification, superior to market-cap-weighted portfolios and indexes.

---

[6] Merton, Robert C. "The Crisis in Retirement Planning." Harvard Business Review, vol. 1401, 2014.

[5] Martellini, Lionel. "Mass Customization Versus Mass Production — How An Industrial Revolution Is About To Take Place In Money Management And Why It Involves A Shift From Investment Proucts To Investment Solutions." Journal of Investment Mangement, vol. 14, No. 3, 2016.

Our innovative liability-driven investment system relegates risk scores and model portfolios to the ash heap of history.

The overwhelming majority of firms use flawed risk scores and functionally obsolete model portfolios that focus on arbitrary benchmarks and historical returns instead of the right benchmark—achieving your financial plan.

Consider one last quote from Robert C. Merton:

> *"Risk surveys are a norm when it comes to investment advice. They may vary in content and length, but their common purpose is to distill an investor's complex profile into a single measure of how much risk their portfolio should assume. Inputs include age, wealth, income, investment horizon, and investor behavior. The resulting measure, either qualitative ('conservative,' 'aggressive') or quantitative ('6 out of 10'), is meant to be reductive enough so as to be interpreted by the person or the algorithm building the portfolio. It ultimately determines the target volatility constraint inputted in a portfolio optimizer function."*[7]

Lifeworks focuses on the right benchmark—your life.

---

[7] Merton, Robert C. "The Crisis in Retirement Planning." Harvard Business Review, vol. 1401, 2014.