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Intro

Risk management is a tricky thing. The general assumption is that the older we get, the less risk we should take — but that's not always the case. If your retirement is fully funded and you have a good amount of cash, why not be more aggressive in funding your legacy and philanthropic goals?

Financial planning is all about managing risk to help clients work toward their goals successfully. That means gathering data, determining clients' goals, running simulations, and presenting it all in a clear, concise way. To put it differently, financial planning is equally as much an art as it is a science.

Not All Strategies are Created Equally

There seem to be as many approaches to financial planning as there are wealth management firms. At Gatewood Wealth Solutions, we choose to employ goals-based planning, a strategy pioneered by the Chartered Financial Analyst (CFA) Institute. Goals-based planning involves segmenting out "risk buckets" and then matching asset allocations accordingly.

A goals-based planning approach gives you a clear view of exactly where your assets stand, where they're projected to go, and what options exist for funding them in the future.

Risk vs. Reward: Managing Highly Concentrated Assets

The beauty of a goals-based approach is that it can be easily personalized and scaled to address any client's needs. But the strategy tends to resonate especially well with clients who have concentrated risk in a closely held business or company stock.

What is specifically challenging about a highly concentrated asset? Most people simply just don't know how to handle it — so they don't. They file their position away in the backs of their minds. "I know I have this asset," they think, "for when I really need it." They find reassurance in holding onto it for a rainy day, without considering that it may not even exist when that rainy day comes.

What if their business eventually goes south or their company becomes obsolete? In that case, their ownership or shares would be completely void of value. That would be a shame, especially if some of the assets could have funded a child's education, the client's retirement, or even legacy goals. Plus, no one should ever cash out on any asset without considering tax implications. Otherwise, it could end up costing them thousands that could have gone towards their goals, had they taken a broader perspective and considered other financial vehicles.

The Power of a Good Visual

Like any nuanced or complicated topic, financial planning is much more easily understood when presented in a visual way. One way to think about goals-based planning is to envision three buckets. It helps you visualize your assets, how they break down into each "risk bucket," and determine how you should allocate your assets.

Together, these considerations make up the three main risk buckets we'll discuss: 1) personal risk, 2) market risk, and 3) aspirational risk.

Keeps enough cash on hand to weather economic storms.

Bucket #1: Personal Risk

Source: CFA Institute

The first bucket is our liquidity bucket or “cash bucket.” It helps us make sure we have enough cash — usually two to four years’ worth — to make sure we can weather any economic storms.

As Aaron Tuttle, our chief investment officer, likes to remind our team, “Bull markets are measured in years, while bear markets are measured in months.” It’s vital we keep enough cash in this bucket to maintain the liquidity necessary to weather those bear months while remaining opportunistic.

Covers the cash flow you'll need in retirement.

Bucket #2: Market Risk

Source: CFA Institute

The market risk bucket is essentially your "core retirement bucket." It's the net present value of all the cash flow you'll need in retirement. To get to this number, we run a financial planning simulation to determine how much capital you'll be spending in retirement, and then we work backwards.

The goal is not to protect against principal loss; after all, your principal will always be at risk as the market fluctuates. Rather, this bucket's main job is to seek to protect against purchasing power risk (essentially, the risk that your "eggs" become more expensive than you can afford) . Inflation is best hedged with a diversified portfolio, so we just aim to keep up with benchmarks rather than try to drastically outperform the market – in this bucket, at least. This way, as clients navigate through retirement, education, and other life goals, their capital account can keep up with the growth of those expenses.

Helps you reach your legacy goals.

Bucket #3: Aspirational Risk

Source: CFA Institute

Anything in excess of our first two buckets we consider aspirational. This includes legacy planning for clients' children, grandchildren, or a cause that's important to them.

This bucket often warrants more concentrated risks. This would include the closely held businesses or public company stock mentioned earlier. Our expectation for assets in this bucket is that they will significantly exceed their benchmarks.

To tie all this together, let's use an example and say you work for a large pharmaceutical company, and a significant portion of your compensation is in company stock. That means you have many proverbial "eggs in one basket" — so you had better be getting some incredible returns for all of that risk. If you're only getting 4 or 5%, something needs to change.

What This Means for You

The visual aspect of these "buckets" makes goals-based planning simple to understand, but it's quite complicated to execute and usually warrants the assistance of a third party. Part of the challenge is having the right technical and financial knowledge to create a plan, but the other part comes from fighting our own human natures. Our innate "fight or flight" instincts cause us to run at the first sign of trouble — including market uncertainty. That's when the behavior coaching of a professional third party becomes invaluable. According to research by Vanguard, it can add about 3% to clients' returns.

Therefore behavior coaching is such a major aspect of wealth management — and why it's a company pillar here at Gatewood Wealth Solutions. It's vital to your financial success that you have someone holding you accountable to your goals and managing your risk buckets. Plus, you'll have confidence that you have suitable planning to address your goals.

As John Gatewood, our founder, president, and CEO is fond of saying, "Wealth is made in concentration and preserved through diversification." To properly create and preserve wealth, you have to maintain the strategy and perspective necessary to win the game.

Disclosures

The opinions expressed are those of Brian McGeehon as of the date stated on this material and are subject to change. There is no guarantee that any forecasts made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment or security.

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Investors should be aware of the risks of investments in foreign securities, particularly investments in securities of companies in developing nations. These include the risks of currency fluctuation of political and economic instability and of less well-developed government supervision and regulation of business and industry practices, as well as differences in accounting standards.

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