Goals-Based Wealth Management in Practice

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Wealth management processes have not always been responsive to individual clients' priorities and modes of thinking. A model is presented and evaluated that uses goals-based wealth management concepts to generate module-built portfolios, each of which is driven by a client's expressed goals. This model allows for a high degree of flexibility and responsiveness to client needs with a practical level of standardization.

My thinking about goals-based wealth management has evolved out of an "Editor's Letter" I wrote for the *Journal of Wealth Management* in 2002.[1] It was clear to me at the time, and has grown only clearer since then, that the traditional asset/liability analysis and mean–variance solutions typically used in wealth management were not responding to clients' needs. They were not, in particular, addressing the financial goals that clients express in nonfinancial terms. Less clear, however, were the factors that needed to change.

During the ensuing decade, I continued to study this area of concern while often swimming against the current of the status quo. Nonetheless, I have found other financial thinkers—Daniel Nevins,[2] Ashvin B. Chhabra,[3] and Michael M. Pompian[4]—who have produced valuable work along similar lines.

To discuss my current thoughts about goals-based wealth management, I have organized this presentation into three sections:

1. The changed investment environment since 2008,
2. The goals-based process architecture, and
3. A case study of GenSpring's goals-based management.

A Changed Environment

The financial crisis of 2008 led many of our clients to think that 2008 was not just another cycle. They worried that it might lead to a rerun of Japan's painful decline that began in 1989. They came to realize that their return expectations, based on the previous 10 years, would probably be unrealistic in the future. Furthermore, they found that investments that were supposed to be liquid were—in extreme conditions—not as liquid as they had expected and that their diversification strategies worked only under normal market conditions. Absolute return strategies, which were never supposed to post a negative return, posted –20 percent

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[1]Jean L.P. Brunel, "Editor's Letter," *Journal of Wealth Management*, vol. 5, no. 1 (Winter 2002): 1–2.

[2]Daniel Nevins, "Goals-Based Investing: Integrating Traditional and Behavioral Finance," *Journal of Wealth Management*, vol. 6, no. 4 (Spring 2004):8–23.

[3]Ashvin B. Chhabra, "Beyond Markowitz: A Comprehensive Wealth Allocation Framework for Individual Investors," *Journal of Wealth Management*, vol. 7, no. 4 (Spring 2005):8–34.

[4]Michael M. Pompian, *Behavioral Finance and Wealth Management: How to Build Optimal Portfolios that Account for Investor Biases* (Hoboken, NJ: John Wiley & Sons, 2006) and *Advising Ultra-Affluent Clients and Family Offices* (Hoboken, NJ: John Wiley & Sons, 2009).

returns. Investors were living through a six-standard-deviation event, and many of our clients were now asking for something different.

The dislocation of 2008 was not the only factor indicating a need for change in wealth management thinking. In 2010, Meir Statman, Sanjiv Das, Harry Markowitz, and Jonathan Scheid published an influential article that argued that mental account processes (their term for goals-based processes) are just as efficient as what they call "mean–variance processes," provided that clients and wealth managers change their definition of risk.[5] Risk, they asserted, should not be defined mathematically as a standard deviation of return but as the probability of not achieving goals, which is the way that most people intuitively define risk. After all, although the volatility of returns is a matter of concern, it is not the same thing as failing to meet goals altogether.

Thus, the changed environment has created an opportunity for those who think that focusing on clients' goals is a better way of dealing with their concerns than are methods of the past.

Goals-Based Process Architecture

The architecture of the goals-based process consists of the following:

- Integrated wealth planning,
- Goals-based asset allocation, and
- A practical, iterative model.

Integrated Wealth Planning. Our industry was created by institutional investors who tended to have one goal: to meet their liability stream. All institutions—whether pension funds, foundations, endowments, or insurance companies—use their assets to defease a particular liability. But individuals are different. Individuals have assets for a variety of purposes, and managing their financial wealth is only one of those purposes.

Wealth management clients expect their financial managers to think beyond simple dollars and cents. I have met few wealthy people who say, "Get me the highest possible return with the lowest possible risk, and everything will be fine." For most of my clients, the effect of wealth on family issues is powerful. For example, several years ago, I was visiting with a 67-year-old client who was CEO and owner of one-third of the stock of an NYSE-listed company worth billions of dollars. I asked him, "Five years from now, what would indicate failure for you?" Suddenly, tears welled up in the eyes of this tough businessman, and he said, "If I ruined my grandchildren by giving them too much money too easily." Family issues matter, and wealth managers must be attuned to those issues.

Therefore, during the last several years, GenSpring has been talking with clients not in terms of risk and return but in terms of dreams and nightmares. Integrated wealth planning allows us to understand more fully what our clients hope to accomplish with their wealth. What are their priorities and their most cherished dreams? These are the goals they want to achieve with the greatest degree of intensity, and their failure to achieve them will be felt with the deepest pain.

Goals-Based Asset Allocation. Wealth management clients' goals typically fall into three categories: personal, dynastic, and philanthropic. Even before personal goals come the basic needs for food and shelter. But these are not typically a concern for our clients, and once they are satisfied, then the three categories of goals can be addressed.

In their personal goals, clients hope to meet current lifestyle requirements and unanticipated financial needs. They also hope to maintain future flexibility. In their dynastic goals, they consider what their children should get and how the generation beyond their children should be provided for. Most clients do not want to spoil their descendants but merely want to help them on their way. Philanthropy typically arises out of and reflects clients' personal values, and these values can be addressed through both active and passive philanthropy.

This tiered system of goals is well illustrated by the behavioral finance portfolio pyramid first proposed by Meir Statman and shown in **Exhibit 1.**[6] Applying the concepts of behavioral finance, Statman indicated that each investor has not only a variety of goals but also different risk profiles to accompany each of those goals. Some of these risk profiles may seem almost contradictory, yet they are not exclusionary. They merely reflect normal human behavior. For example, the same person who stops at the local convenience store and buys a lottery ticket that offers only the slimmest possibility of unexpected profit may also be prudent enough to buy insurance for protection against the possibility of unexpected loss. Thus, wealth management advisers must develop investment strategies to match their clients' different goals and risk profiles.

[5]Sanjiv Das, Harry Markowitz, Jonathan Scheid, and Meir Statman, "Portfolio Optimization with Mental Accounts," *Journal of Financial and Quantitative Analysis*, vol. 45, no. 2 (April 2010):311–334.

[6]Meir Statman, "What Do Investors Want?" *Journal of Portfolio Management*, vol. 30, no. 5 (30th anniversary 2004):153–161.

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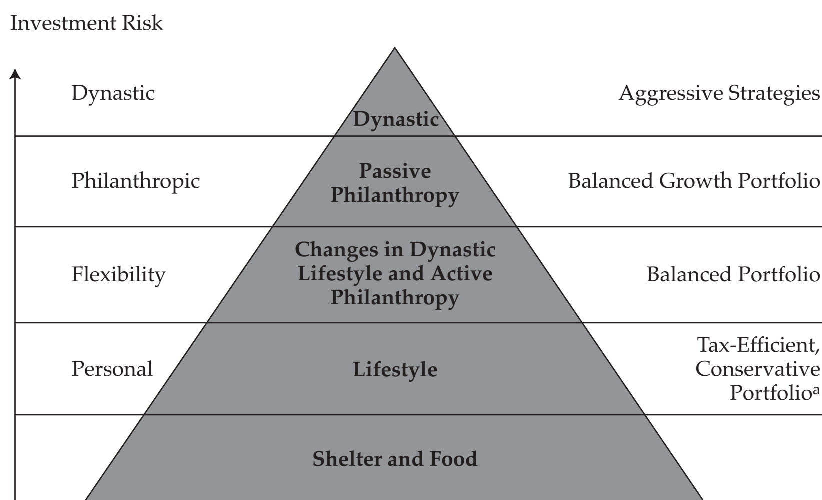
Exhibit 1. The Behavioral Finance Portfolio Pyramid



[a]Risk taken only to preserve long-term purchasing power.

Source: Meir Statman, "What Do Investors Want?" *Journal of Portfolio Management*, vol. 30, no. 5 (30th anniversary 2004):153–161.

The goals that hold the highest importance for me are those in which failure is least acceptable. Thus, personal lifestyle goals are typically addressed first and with the lowest level of risk. Moving up the pyramid, the goals become less crucial, so certain degrees of failure are acceptable and risk can increase.

From a purely financial standpoint, the least important goal will always bear the highest amount of residual risk. For example, if I have $100, I may decide that I need $50 to maintain my personal lifestyle, $30 to provide for my children or dynastic goals, and $20 for my philanthropic goals. Most clients will want to apply the most protection to their lifestyle goals. They may seek more growth (and thus accept higher risk) for their dynastic goals and even more risk and growth for their philanthropic goals. Thus, if the markets turn down, the client's losses will come out of investments with the highest risk—the $20 at the top of the pyramid.

Clients can, of course, order their risks differently. If philanthropic goals are their highest priority, then they will accept the least risk on those goals and take losses out of other portions of their portfolios.

Iterative Model. Goals-based wealth management uses an iterative model consisting of four steps that generate a full iterative cycle. The first step is for the manager to identify and describe the client's main goals. Second, the manager dollar weights and prioritizes those goals, thus assigning to each goal the amount of money that the manager believes will be necessary to achieve that goal. Third, the manager structures a subportfolio for each goal. In particular, the manager decides which assets or strategies are most likely to help the client achieve each goal. For instance, if the goal is to maintain the client's lifestyle, then the manager will certainly not invest in private equity, which may offer potentially high long-term returns but will not provide for regular distributions to cover living expenses. Finally, the manager optimizes the subportfolios throughout the client's entire portfolio.

Another thing to keep in mind is that clients do not usually come to wealth managers with their decisions already made. Most of them have never really managed their money. They may have owned a business, but they did not think of running that business as managing money. As time passes, though, and as clients adjust to the idea of wealth management, they discover what is important to them. They learn how to rank their priorities, and they gain a better understanding of what is possible.

One of my favorite stories concerns a client whose ambition was to amass an estate worth $20 million. But when he and his partner sold their business, they realized not $20 million but $250 million each, far more than either had ever expected to have. When the client asked me to manage the family wealth, he had one simple request: Do not lose money.

He continued to live a relatively modest lifestyle, and after about five years, when the portfolio was well diversified, he became less concerned about losing what he had and more concerned about long-term goals. His thinking was at last evolving beyond his initial goal of not losing money.

Variation on the Iterative Model. A variation of the iterative process that applies specifically to family assets is one that recognizes that families have two kinds of assets: internal assets, which the family members control and manage themselves, and external assets, for which the family hires managers to control and manage.

- *Internal and external assets.* Internal assets are typically divided into capital preservation assets, which are low risk and income producing, and growth assets, which have a higher degree of risk. An example of a capital preservation asset might be timberland that is harvested regularly to produce nonessential income flows. If the prices offered for timber drop, the family can choose not to harvest until the prices rise, thus preserving the asset and regaining its income flows on the family's terms. An example of a growth asset might be a family-operated business, such as a venture capital firm, that seeks long-term growth in what the family perceives as the next big idea.

- *Lifestyle assets.* Externally managed assets can typically be divided into lifestyle and non-lifestyle assets, which is a more important division than it might seem at first. In my experience, however, the biggest nightmare any of my clients face is a change to their lifestyle. Maintaining lifestyle is a core issue, and it is one that I address on two time lines. First, short- and medium-term assets address immediate lifestyle needs for a three- to five-year period. Second, long-term assets address lifestyle needs for a period of 6–15 years.

One way to address lifestyle needs is to create an endowment portfolio from which the family draws a regular income, which leaves no concerns about having to sell any assets. But because of estate taxes, this approach is sometimes not an efficient solution, and a declining-balance portfolio may make more sense. But a declining-balance portfolio has limitations, particularly if markets fall and the declining-balance portfolio must be replenished sooner than expected from the non-lifestyle portfolio. In that case, a random fluctuation in asset values can be turned into a permanent loss of capital.

At GenSpring, we focus our attention on a 15-year time span because 15 years offers the highest probability of achieving positive returns. Japan, unfortunately, has proven itself the exception to the rule. Japanese equities have had negative returns for the past 22 years, which makes it an outlier. I fear that the United States may join that club because it has had very low returns for an extended period of time, and it would not take much more of a decline for a 20-year compound negative return to occur.

To provide for immediate lifestyle needs (within the next three to five years), we build a portfolio composed principally of fixed-income securities. Only in the longer-term segment (6–15 years) do we focus on combating inflation.

- *Non-lifestyle assets.* Depending on a family's needs and inclinations, non-lifestyle external assets can be designed for either capital preservation or capital growth, depending on the degree to which the wealth is discretionary or nondiscretionary. Jarrod Wilcox wrote an article in 2003 that explored this dichotomy with great insight.[7]

According to Wilcox, nondiscretionary wealth is that portion of a client's wealth for which there is a specified purpose. Whatever wealth remains is discretionary. Wilcox postulated that the risk in a portfolio should be proportional to the ratio of discretionary to nondiscretionary wealth. But some clients perceive their discretionary wealth as money that they do not really need. And if they do not need it, they assume that they can take risks with it or that they can apply it to growth simply because everyone assumes they need growth in their portfolios. But that is not necessarily a rational choice, especially if the risk taking represents a risk that is either unnecessary or out of character for a particular client. Clients can regret the loss of discretionary wealth just as much as they can regret the loss of any other wealth.

Therefore, before assuming that growth is the only proper use of discretionary wealth, clients should consider potential challenges—such as unexpected inflation, lifestyle changes, and generational fragmentation—that a growth portfolio may not address. Capital preservation can play a role even in a discretionary wealth portfolio. Among capital preservation assets, GenSpring tends to differentiate in terms of real and nominal risk; among growth assets, we distinguish between liquid and less liquid assets, such as private equity.

- *Financial advisers as goal translators.* Financial advisers play two related roles. First and most obviously, they help clients manage their portfolios. But before that, advisers act as translators. They need to ask clients to express their goals in the nontechnical language that is most comfortable to them. Then the advisers translate those goals into the language of finance and investment so that clients' goals can be achieved.

When discussing our wealth management model with clients at GenSpring, we try to delineate the model's capabilities and limitations because our

[7] Jarrod W. Wilcox, "Harry Markowitz and the Discretionary Wealth Hypothesis," *Journal of Portfolio Management*, vol. 29, no. 3 (Spring 2003):58–65.

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clients need to understand that a perfect model has not yet been invented. Our model incorporates certain assumptions, but it is not a deterministic exercise. We do not assume that if certain actions are taken, certain results will follow. The market does not work that way. Every investment choice carries with it a variety of trade-offs, and we encourage clients to join us in discussing these trade-offs. Such discussions generate an ongoing feedback loop that helps reduce misunderstandings. We conduct our discussions in plain language, and we try to stay humble and flexible.

Case Study of Goals-Based Wealth Management

Implementing GenSpring's wealth management model begins with crucial inputs that combine generic and personal family data. These inputs include capital market assumptions, financial asset totals, current lifestyle needs, anticipated lifestyle inflation, life expectancy of the principals, and asset-holding structures. To gain a more precise insight into the model, consider the following case study.

Translating Family Goals. Assume that a family has $35 million in assets with annual spending needs of $1 million. The first generation (G1) is about 50 years of age, inflation is expected to run at about 3 percent per year, and the family does not have any income outside of the portfolio.

When analyzing the family's external versus internal assets, we find that the internal capital preservation portfolio consists entirely of an apartment complex that generates rental income and is worth about $2 million. Because the rental income is used principally to maintain and upgrade the complex, we must define the asset from the point of view of capital preservation only and not income generation. The family has also invested $1 million in a venture capital start-up that is managed by a member of the second generation (G2) and that we define as an internal growth asset.

Assuming that the family agrees that a declining-balance portfolio is the right strategy to provide for their short-term lifestyle needs and that a 4 percent return assumption seems reasonable, a portfolio is funded with $4.7 million to cover the family's annual spending needs of $1 million for a five-year period. For years 6–15, we will raise the return assumption to 6 percent because we can take a little more risk for the longer-term portion of their lifestyle needs. That portfolio is funded with another $7.2 million, which provides a total of $11.9 million to cover a 15-year cycle of lifestyle needs. We then verify with the family that this meets with their approval, thus engaging the feedback loop.

Because G1 is about 50 years of age, the 15-year cycle will carry that generation to age 65, which leaves a life expectancy greater than zero, so we know we will need to replenish. Investing another $7.7 million now should be adequate to fund the second 15-year cycle and take G1 to the age of 80.

At this point, $19.6 million has been allocated to provide for two 15-year cycles of lifestyle needs, which leaves $15.4 million in the portfolio. The family also wants to reserve 10 percent of their total wealth ($3.5 million) for what they call "opportunistic goals." After also allocating $3 million to internal investments (the apartment complex and the venture capital start-up), the family still has $8.9 million for capital growth.

The family's personal goals have now been translated into financial goals as shown with more detail in **Table 1.** Note that the family has zero tolerance for losses, which is reflected in the table, and that what they call "opportunistic goals," we call "thematic needs." This personal goal summary does not assign amounts to bonds, cash, equities, or other types of investments because we are still describing the portfolio according to the language of the family's goals.

Table 1. Summary of Financial Goals in the Case Study

Goals	Amount (thousands)	Share of Total
Short-term lifestyle	$4,716	13.5%
Long-term lifestyle	7,206	20.6
Lifestyle refills	7,653	21.9
Subtotal	$19,575	56.0%
Low tolerance for losses	$0	0.0%
Capital growth	8,925	25.5
Internal investments	3,000	8.6
Thematic needs	3,500	10.0
Totals	$35,000	100.0%

Creating the Policy Portfolio. The creation of the policy portfolio and its subportfolios is driven solely by the goals of the client. We provide guidance regarding only the trade-offs between risk and return, the implications those trade-offs hold for the client's goals, and the likely impact on the structure of the subportfolios. For example, we may advise the client that projecting 5–6 percent returns for the family's lifestyle portfolios rather than 3–4 percent returns will reduce the amount of assets needed to fund those portfolios. But such projections will be accompanied by an increased risk that actual

returns will be lower than hoped for and the family is thus left short of their lifestyle goals. The family must then decide on their risk comfort level, after which we will size and structure the lifestyle portfolios according to the family's risk preferences. Every portfolio we construct is a unique combination suited to the needs of the individual family.

Each subportfolio is constructed of modules that are driven by the risk–return profiles of specific assets and matched to individual goals, with client preferences being integrated into the process.

Tables 2 and 3 show the resulting policy portfolio's individual modules; Table 2 is based on the dollar amounts, and Table 3 is based on the percentage share. Note, for example, that the low-risk requirements of the short-term lifestyle module limit the number of eligible asset types and strategies. In fact, we are currently debating at GenSpring whether it is still appropriate to include nondirectional hedges in such a module. This model probably applies best to individuals who are comfortable with and seek exposure to relative value hedge funds. It is being used here to provide the widest possible range of assets and strategies. Perhaps it works for very wealthy families but not for the less wealthy.

Managing the Process

GenSpring uses four sets of goals-focused modules in creating portfolios:

1. Tax aware with nontraditional strategies,
2. Tax agnostic with nontraditional strategies,
3. Tax aware with only traditional strategies, and
4. Tax agnostic with only traditional strategies.

Goals-Focused Modules. Each of the four sets consists of nine modules that address all the categories of a client family's needs. The modules are contiguous, but each module must be sufficiently different to distinguish it from the others. Each module must also be optimal within the constraints created by inevitable trade-offs while leaving room for flexibility.

The nine modules represent the essential building blocks needed to create our product. I like to use the analogy of constructing a bicycle to help explain how we create our products. A bicycle is made up of a certain number of pipes, wheels, and gears. The bicycle for one client may require a horizontal pipe of 30 inches, whereas the bicycle for another client may require a horizontal pipe of 32 inches. But every client's bicycle will need a horizontal pipe.

The model creates a superficially complex process. The portfolio created for each client is unique to match that client's goals, which means that the potential exists for having as many benchmarks as we have clients. Yet, the process is simpler than it appears because the goals-based modules are common across the platform and thus leave room for a standardization that essentially amounts to mass customization. Complexity exists where it belongs, and leverage exists across investment management.

Limits of the Process. Although we have created a model process that can encompass a great deal of flexibility and complexity, it does have limitations.

We must be prepared to deal with client preferences and deviations from normal, such as certain asset classes or strategies that the model might show as contraindicated. The model must sometimes be adapted to accommodate a client's preexisting portfolio or concentrated positions that the model does not normally include. Finally, because certain strategies may appear in more than one module and because of the demands of proper benchmark use, the model can lead to complexity in investment reporting.

Conclusion

The financial crisis of 2008 led to a new environment that includes changes in client needs and market opportunities that goals-based wealth management responds to quite effectively. The architecture of GenSpring's wealth management model builds on existing concepts and is based on a three-step process of (1) integrated wealth planning, (2) goals-based asset allocation, and (3) a practical, iterative model. The process itself allows for a flexible form of mass customization that we believe works to the greatest benefit of our clients.

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Table 2. Resulting Portfolio for Case Study Based on Dollar Amounts

	Lifestyle		Non-Lifestyle					Internal		
	Short Term	Long Term	Medium-Term Capital Preservation	Long-Term Capital Preservation	Liquid Growth	Long-Term Growth	Opportunistic	Capital Preservation	Growth	Policy Total
Cash										
U.S. municipal bonds, investment grade	$2,806	$2,450	$1,026	$390						$6,672
EAFE fixed income, hedged	495	432	181	69						1,177
U.S. municipal fixed income, high yield	424	519	633	230	$53					1,859
Emerging market debt										
Nondirectional hedge	990	1,211	1,478	536	123					4,337
U.S. equities			193	233	532	$825				1,782
EAFE equities			193	233	532	825				1,782
Emerging market equities			97	116	266	412				891
Directional hedge equities, long/short			422	643	1,470	2,278				4,814
Private equity						814				814
MLPs		692	543	92						1,327
REITs		461	362	61						884
Commodities										
Global macro			452	230	263	136				1,080
Managed futures			452	230	263	136				1,080
Opportunistic themes							3,500			3,500
Internal capital preservation								2,000		2,000
Internal growth									1,000	1,000
Total	$4,716	$5,765	$6,033	$3,061	$3,500	$5,425	$3,500	$2,000	$1,000	$35,000

Notes: All amounts are thousands. EAFE is the Europe, Australasia, and Far East Index. MLPs are master limited partnerships.

Table 3. Resulting Portfolio: Percent Share

	Lifestyle		Non-Lifestyle					Internal		
	Short Term	Long Term	Medium-Term Capital Preservation	Long-Term Capital Preservation	Liquid Growth	Long-Term Growth	Opportunistic	Capital Preservation	Growth	Policy Total
Fixed income and related	**100.0%**	**80.0%**	**55.0%**	**40.0%**	**5.0%**					**40.1%**
U.S. municipal bonds, investment grade	59.5	42.5	17.0	12.8						19.1
EAFE fixed-income, hedged	10.5	7.5	3.0	2.3						3.4
U.S. municipal fixed income, high yield	9.0	9.0	10.5	7.5	1.5					5.3
Emerging market debt										
Nondirectional hedge	21.0	21.0	24.5	17.5	3.5					12.4
Public equity and related			**15.0%**	**40.0%**	**80.0%**	**80.0%**				**26.5%**
U.S. equities			3.2	7.6	15.2	15.2				5.1
EAFE equities			3.2	7.6	15.2	15.2				5.1
Emerging market equities			1.6	3.8	7.6	7.6				2.5
Directional hedge equities, long/short			7.0	21.0	42.0	42.0				13.8
Private equity						15.0				2.3
Total equity and related			**15.0%**	**40.0%**	**80.0%**	**95.0%**				**28.8%**
Real assets and related		**20.0%**	**30.0%**	**20.0%**	**15.0%**	**5.0%**				**12.5%**
MLPs		12.0	9.0	3.0						3.8
REITs		8.0	6.0	2.0						2.5
Commodities										
Global macro			7.5	7.5	7.5	2.5				3.1
Managed futures			7.5	7.5	7.5	2.5				3.1
Opportunistic							**100.0%**			**10.0%**
Opportunistic themes							100.0			10.0
Internal assets								**100.0%**	**100.0%**	**8.6%**
Internal capital preservation								100.0		5.7
Internal growth									100.0	2.9
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Notes: This model applies best to individuals who are comfortable with and seek exposure to relative value hedge funds. It is being used here to provide the widest possible range of assets and strategies.

Question and Answer Session

Jean L.P. Brunel, CFA

Question: How do you manage performance reviews that encompass circumstances that may have changed over time?

Brunel: An important aspect of the goals-based environment is for us to help clients feel that they have been successful. The performance review is conducted in relation to individual goals and has two dimensions. First, have we met the goals in an absolute sense? Obviously, the shorter the time horizon of a particular goal, the easier it is to evaluate. For instance, one year into the process, it is fairly easy to evaluate whether the short-term lifestyle portfolio has provided the client with sufficient income.

The second dimension addresses slightly longer-term goals, which tend to be benchmark driven. How successful has portfolio performance been with respect to results expectations?

I like the analogy of the flight plan of an airplane, which is not necessarily a straight line. The pilot and I have exactly the same goal: to get to the destination on time. But once I am in the cabin, I do not worry about exactly how we meet that goal. I leave it to the pilot to evaluate altitude, speed, and other issues needed to achieve the goal of arriving at the destination on time. That is what a benchmark does. I can tell the client, "I cannot prove to you that the capital preservation module is doing what it is going to do, but I can tell you that it is doing what it is supposed to do."

Question: How frequently do you rebalance a goals-based portfolio?

Brunel: When markets are behaving normally, in the sense of meeting the expected returns, we tend to rebalance annually, which in our experience offers the right balance between short and long term. When markets are volatile, we might rebalance more frequently. But rebalancing too frequently undermines the process.

Question: What are your expected returns for fixed income and equities?

Brunel: For me, this aspect is the weakest point in the whole process. My personal view is that we are probably at a major inflection point. I fear that the returns on average over the next 15 years will not be a good predictor of subperiods. I would expect that 7 percent returns are likely for equities and that 4 percent returns are likely for bonds. But I think that such a number will tend to be wildly inaccurate over specific subperiods.

I believe that at some point over the next five years, we will go through a period of a substantial change in inflation levels. Equities have in the past been a good protector against inflation. But when inflation leaps from 2 percent to 10 percent, markets will likely suffer a sharp pullback because as inflation rises, bond rates also rise, which means lower bond prices. This outcome usually leads to lower price-to-earnings ratios, which equates to declining equity prices.

We deal with this issue through our capital market forecast, which encapsulates our best guess. Right now, in the modeling process for families, we tend to apply discounts to these rates of return. For example, I am currently using a 3 percent estimate for expected returns from bonds of all subcategories. I am using close to 5 percent for expected equity returns, but I think it is going to be lower than that rather than higher.