The Next Generation of Goal-Based Investing

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In 2013, Robert Merton made the following notable statement: *"One thing that I think is going to be very important – that remarkably is missing now – is the notion of goal-based investing. This probably won't be for twenty years, but I hope it isn't twenty years*." As Merton hoped, twenty years it is not. The notion of goal-based investing is upon us.

While the term "goal-based investing" is not new, several attempts to develop goal-based investing have failed to impress practitioners and academics alike. In recent years, however, this concept has begun to shape up as a disciplined economic theory. Recent developments in simulation-free stochastic analysis have produced new concepts and analytical tools. This powerful and flexible toolbox makes possible direct optimizations of the key components of funding problems – glide paths, contributions, payouts, risk tolerance and its evolution.

The next generation of goal-based investing is applicable to the major segments of institutional and individual investors – DC and DB plans, foundations and endowments, sovereign funds and government agencies, as well as many others. In particular, DC plan participants would maximize the payouts from their retirement accounts; DB plans would minimize the contributions required to fund their financial commitments; all retirement plans would minimize their riskiness. In all cases, the new approach produces Nash equilibrium optimal glide paths designed to take care of the best interests of the major stakeholders of investment programs.

"Diversification is the only free lunch" is one of the most renowned maxims in finance. Yet, the next generation of goal-based investing produces two new types of "free lunches." In addition to the classic Modern Portfolio Theory based "free lunch" (*"Free Lunch" 1.0*), investors get glide path design "free lunch" (*"Free Lunch" 2.0*), and funding problem optimization "free lunch" (*"Free Lunch" 3.0*).

This author is optimistic that the next generation of goal-based investing will become a broadly accepted concept in finance.

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