The Foundation of Every Proper Investment Plan

Quantifying and prioritizing financial goals moves them from dream status to "you got this."

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“Goals-based what?”

That was my response when I when I first heard the now-ubiquitous term “goals-based investing” several years ago. Isn’t all investing “goals-based”? And if people aren’t investing with goals in mind, what are they doing?

It’s obvious that goals should underpin all of the investing we do. That’s the reason I made “having a goal” as the very base of my investment pyramid, well before jobs like setting your asset allocation and miles ahead of selecting securities.

But too often, investors operate with an amorphous goal of "amassing wealth" rather than thinking through the specifics of what they'd like to accomplish. Without clearly articulated goals, it's impossible to know how much you should be saving and investing, or how long you’ll need to do so. Nor can you know whether a specific goal is even achievable alongside other goals you might set. While buying a vacation house might be part of your vision for a financially well-off you, saving for it should necessarily play second fiddle to make-or-break goals like building an emergency fund or building up your retirement nest egg.

Yet as crucial as it is to investment success or failure, goal-setting is one of those financial jobs, like saving and investing enough, that seem almost too obvious to discuss. A lot of the investing materials you encounter in books or online breeze right by goal-setting and figuring out how much to save. Instead, they go straight to more sophisticated subjects like how to set your asset allocation, taking advantage of tax-sheltered vehicles, and so on.

To help turn your financial dreams into something that you may actually be able to achieve, it's crucial to quantify them, set a timeline for them, and prioritize them, assuming you’ve articulated more goals than you can reasonably invest for at the moment. Armed with that information, you can then custom-craft your investment plan for each goal. And once you've set your baseline goals and started investing toward them, checking your progress can serve as the ultimate financial dashboard; monitoring specific investments is secondary.

Even if you already have an investment program up and running--and if you’re reading Morningstar.com, you probably do--it’s also valuable to make sure that your plan fully reflects your current goals. Financial objectives have a way of sloshing around. Perhaps you gave your retirement savings short shrift while you powered toward a home down payment; now that you've signed the mortgage papers, it's time to get back on the stick with retirement investing. Or maybe you're doing so well on the road to retirement readiness that you can reasonably start saving for a goal that you had previously put on the back burner, such as setting aside a college fund for grandkids.

Take the following steps to get your arms around your goals.

Step 1: Articulate Your Goals and Segment by Time Horizon
The first step in the goal-setting process is to think through all of the financial goals you'd like to achieve, big and small, short-term and very long-term. Don't forget to include debt paydown in your goal queue. Morningstar's Goal-Planning Worksheet can help you document your various goals; it's one of several worksheets available on Morningstar.com.

Next, group your goals into one of three bands: those you'd like to achieve quite soon (say, fewer than five years), intermediate-term goals with a time horizon of five to 15 years, and long-term goals (more than 15 years into the future).

Specify the date by which you hope to achieve them as well as the duration for multiyear goals--30 years for retirement, for example, or four years for college (if you're lucky). Of course, the length of your retirement will depend entirely on your life expectancy. But most people would rather be safe than sorry when setting aside funds for retirement. Retirement-planning experts typically recommend planning for a 25- to 30-year horizon, but if you're planning an early retirement, you'll want to set the duration even longer than that.

Step 2: Quantify Your Goals
Next, determine how much each of those goals will cost. You may know some of these figures to the dollar, especially if the goals are close at hand or already in progress. For example, your mortgage statement will depict, to the penny, how much principal you still owe on your loan. And if you've been pricing colleges that your 16-year-old is interested in, you probably have a good idea of how much that will run, too. Ditto for prospective purchases of properties, vehicles, and the like.

The big wild card in longer-term goal planning is inflation: While inflation is currently quite low by historical standards, it's reasonable to assume at least a 2% to 3% inflation rate for longer-term goals, and an even higher rate for college. This calculator will help you quantify how much college will cost based on your child's matriculation date.

Retirement is by far the trickiest goal to quantify. As noted above, retirement is a multiyear proposition of uncertain duration. Further complicating matters is that the percentage of salary spent in retirement varies substantially by retiree; for each retiree, spending may also vary meaningfully from year to year. (Morningstar Investment Management's head of retirement research, David Blanchett, discusses the complicated business of calculating retirement costs in this paper.) Because retirement funding is so complicated, I'd recommend that you employ a good retirement savings calculator to help assist you. I've long been a fan of T. Rowe Price's Retirement Income Calculator; Vanguard's Retirement Nest Egg Calculator is also solid and easy to use.

Step 3: Assess Funding Status
Armed with an estimate of what your goals will cost you, you can turn your attention to how much progress you've made so far and what steps you need to take to make them a reality. A retirement-savings calculator can make quick work of figuring out how you're doing on the road to having enough for retirement. If you're attempting to gauge the state of your college fund, this calculator from College Board can help. If you're saving for other goals, a good general savings calculator such as this one from Bankrate.com will help.

In all of these cases, note that there are two main ways to move the needle on getting to your goal: bumping up your own contributions as well as any investment returns you expect to earn. Remember that you have much more control over the former than the latter. And given that most market return forecasts for the next decade are pretty muted, be cautious when plugging in return expectations for goals you hope to achieve within the next decade; a 4% return estimate, at the high end, is reasonable.

Step 4: Prioritize Them
Finally, prioritize your goals by numbering them in the left-hand column on the Goal-Planning Worksheet. Of course, you want to let your own wishes inform your priorities, but you'll also want to factor in which goals allow for more flexibility in funding. For example, your child may be able to rely on external sources such as loans to pay for college, but you'll have no such options for your own retirement. For that reason, it usually makes sense to move retirement funding above college funding.

If some of your goals end up on the cutting-room floor, don't despair, especially if you're early in your investing career. Even if you're de-prioritizing them for now, you may be able to reconsider them down the line. If you're part of a married couple, be sure to bring your spouse into the discussion.

The following hierarchy will make sense in many different situations:

1. High-interest-debt paydown/emergency fund (tie)
2. Retirement savings
3. College savings
4. Other short- and intermediate-term goals (within reason)

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