Goals-Based vs Cash-Flow-Based Planning

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One of the most frequent questions I get asked when talking to Financial Advisors is, "Which planning software approach is better, cash-flow or goals-based?"

The problem with this question is that it's similar to asking a doctor, "Which is better, an X-ray or MRI?" The correct answer, of course, is an X-ray for bones (which takes 2-3 seconds) and MRI for soft tissues (which takes 30-45 minutes). In other words, the correct tool is evaluated in the context of the work you plan to do.

There are two types of software analysis available in the advisory business: goals-based and cash-flow-based. In this "one-pager," I'm going to try and help you understand the major differences between them and, more importantly, the use cases for both.

The simplest way to differentiate them is looking at their starting point. Goals-based planning begins with client goals, assets, and savings and then creates a plan based on those variables. You collaboratively adjust spending, savings, risk, timing, and legacy until you have a plan with a reasonable probability of success that the clients are willing to implement. This approach is excellent for helping clients answer the question, "Am I going to reach my goals?" If not, you must determine what trade-offs are necessary to get the plan on track. This approach is premised on the belief that life and markets change so frequently that it is better to invest client/advisor time in adjusting the plan regularly as life happens rather than investing that time in a more precise planning process upfront. Goals-based planning is perfect for providing "Wealthcare as a Service" to your top-tier clients as part of their advisory fee or to lower-tier clients for a modest upcharge.

By contrast, the cash-flow-based approach starts by accounting for a client's spending year by year. This approach obviously requires more precise data (primarily detailed budgets and tax info) from the client and upfront work for the advisor. Still, this approach is far superior for answering questions like, "When should I exercise my employee stock options?" or "How much tax will I owe on my restricted stock as it vests?" Cash-flow-based software has evolved to the point where you can even generate Pro-forma 1040 tax returns. Cash-flow-based planning is ideally suited for doing comprehensive financial planning and detailed income tax planning for clients with complicated compensation structures, business owners, etc. However, because of the complexity and time commitment, cash-flow-based planning can be better suited for a retainer or planning fee-based approach.

So, to answer the question asked at the beginning, an advisor with a diverse client base will likely need both. They will need a cash-flow-based planning tool for short-term, precise tax planning. Like an MRI machine, it will take longer and require more information. You will also need a goals-based tool for planning and ongoing monitoring with clients in simpler situations or for those already retired. Like an X-ray machine, they will need fast and frequent updates.

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