Robo Advisors: Can an Algorithm Replace your Wealth Manager?

Automated, algorithm-based portfolio management services, or "robo advisors" offer low-cost, high quality financial advice for investors. As these services become mainstream, traditional broker-dealers and registered investment advisors will face stiffening competition from these automated digital competitors.

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1. What is a Robo Advisor?

Robo advisory is an automated, algorithm-based portfolio management service provided by wealth management firms. By virtue of its automated nature, a robo advisor significantly reduces underlying management costs, enabling wealth management firms to offer this as a low-cost service for their customers. Also, robo advisors often have no minimum investment requirements, which make them attractive to the tech-savvy "Millennial" generation of investors.

Low cost pricing and transparency in portfolio construction are two additional benefits associated with robo advisory services. These factors differentiate its investment style from the traditional method of asset servicing and wealth management. It is vital for providers of this service to invest heavily in creating awareness among the various investor demographics described below, especially the "Pioneers" and the "Enthusiasts."

POTENTIAL CONSUMER SEGMENTS FOR ROBO ADVISORY

Pioneer	▪ Younger consumers ▪ Highly employed ▪ Sophisticated and risk taking investors
Enthusiasts	▪ Slightly older than Pioneers ▪ Highly employed ▪ Less sophisticated and more cautious investors
Potential Late Adopters	▪ Slightly older than Enthusiasts ▪ Limited investment experience
Unlikely Adopters	▪ Older consumers ▪ High incidence of retirees ▪ Non-risk takers

2. Key Features and Benefits of Robo Advisory Services

Do-it-yourself investing requires a great deal of research about various financial products or money making avenues, primarily through coverage in financial media and research on internet. Investing through a robo advisor not only provides access to top quality investment advice, but also offers low fees, regular rebalancing of portfolio, tax-efficient investing and low minimum investment requirements.

NO HUMAN INTERVENTION

Automated portfolio construction eliminates bias in investment advice, improves customer trust and increases transparency in the services being provided to customers. Since the investment advice is algorithm-based, there is never a question of impartiality on the part of the advisor.

LOW-COST INVESTING

Eliminating human intervention also reduces the cost of advice. For example, Wealthfront, a leading robo advisor, charges a management fee of just 0.25% of the assets under management (AUM) and the first $10,000 is managed absolutely free[1]. In contrast, the average fee charged by traditional wealth managers is as high as 1.18%. The management fee can also be reduced further as more funds are managed.

PORTFOLIO REBALANCING

With the volatility of today's market, a well-allocated portfolio can become imbalanced in just a day or a week's time, and regular portfolio monitoring and rebalancing is not easy. With a robo advisor, the portfolio is created, tracked and automatically rebalanced based on the customer's expected return, financial goals and risk appetite.

ACCESSIBLE TO LOW NET WORTH INDIVIDUALS

Cost reduction in advising and managing portfolios has resulted in robo advisors accepting clients with minimum investments as low as $500. This feature has attracted many new investors to the market, including individuals who might have been excluded earlier because of prohibitive minimum investment requirements.

TAX LOSS HARVESTING

Maximizing customer profit is at the core of any asset manager's strategy, and taxes can have a major impact on investment returns. Many robo advisors offer tax loss harvesting – an intelligent way to offset capital gains taxes by selling investments that have experienced a loss – which has been shown to optimize the total investment performance by at least 1% annually.

ANYTIME / ANYWHERE SERVICING

Most robo advisors offer 24/7 financial advice to their customers on a variety of platforms and devices. This is a very attractive feature for people whose daily schedules don't allow them to meet with an investment professional during normal business hours, or for those who prefer to manage and track their finances more frequently.

ZERO DISTANCE FROM CUSTOMER

Process automation leads to faster, hassle-free client onboarding as well as easy, anywhere/anytime reporting, giving the customer a feeling of extreme proximity.

3. The Relevance of Robo Advisor to Financial Institutions

The coming years will be challenging and exciting for Wealth and Asset Managers. As the Baby Boomer generation continues to age and their wealth passes on to younger generations, significant shifts will be observed in client behavior, investment patterns and financial expectations.

Having experienced the recession of 2008-09, their investment patterns may be driven more by a survival mentality, and their risk tolerance may be much lower as compared to preceding generations. In fact, a recent survey conducted by MFS Investment Management found that nearly half of Millennials are uncomfortable investing in the stock market[2]. The survey also indicated that Millennials maintain most of their assets in cash, making it potentially the most financially conservative generation since those that experienced the Great Depression.

- **Baby Boomers: Born 1946 – 1964**
- **Generation X: Born 1965 – 1981**
- **Millennials: Born 1982 – 2003**

One of the key challenges for wealth managers is to stay involved with the management of assets as they pass on from Boomers to younger generations. A research report by Accenture Consulting claims that in North America, $30 trillion in financial and non-financial assets are expected to shift from Baby Boomers to their heirs in over the next 30-40 years[3]. The report also reveals the challenges that Wealth Management firms face in maintaining loyalty of Boomers while appealing to Millennials.

To accomplish this difficult task, businesses need to rely on and harness the benefits of digital technology as an essential part of their core business — a fundamental shift from their usual method of working. Now, nearly every business is incorporating automation into their workflow to eliminate manual work, and harnessing digital technology to deliver superior customer experience and drive operational efficiency.

Robo advisors can reduce the cost of operation, enhance the customer experience, attract Millennial customers, and free up valueable staff time to focus on higher value areas like financial planning and wealth management.

4. How The Market is Preparing for this Paradigm Shift

With the benefits of offering robo advisory services well established, wealth management firms have taken a few different approaches to capitalize on this trend. Some wealth management firms have developed their own in-house robo capability, while others have integrated a standalone robo advisor solution.

Vanguard Personal Advisor Services, a leading wealth management firm, has built a hybrid advisory service that offers automated investments combined with human financial advice[4]. The human advisor provides financial planning and ongoing support, while the automated platform handles asset allocation for the client — combining a personal touch with robust web accessibility that enables clients to track their portfolio and visualize progress towards their investment goals.

Robo advisory is also enabling other financial institutions like **asset managers, independent financial advisors** and **insurance companies** to expand their customer base and distribution channels with cost-effective financial planning services.

5. The Technology Behind Robo Advisors

The primary computing techniques that enable robo advisors to provide effective, unbiased financial advice are **artificial intelligence** and **process automation**, along with other related technologies.

- **Artificial intelligence** is used to create a client's investment profile and construct their portfolio. The client interacts with a system to capture data like their age, financial status, risk appetite, financial goals, and investment horizon. This information is analyzed in order to segment the client according to these characteristics and create the client's investment profile. This profile is used to create a portfolio by proportionally allocating financial instruments that are mapped to the client's investment horizon, financial goals and risk appetite. Artificial intelligence is also used to trigger a portfolio rebalancing if and when needed, based on market movements or a change in the client's financial goals.

- **Algorithmic trading** is utilized to purchase financial instruments. This service is triggered upon construction of the portfolio, or when an alternative rebalanced portfolio needs to be built.

- An automated interactive **query answering system** is usually employed to answer any questions that clients might have. It not only helps clients understand their current portfolio performance, but also encourages increased financial literacy by guiding clients to supplemental information within the system. The technology that enables this feature includes natural language processing, machine learning, reasoning, and information analysis, retrieval and presentation.

- **Predictive analytics** are used to analyze structured and unstructured data from various data sources and social media to create a more accurate, personalized client profile — as well as to predict market movements. This is an automated process that helps capture changes in client interests, and also enables the system to anticipate market movements in order to improve investment returns.

6. Adoption Models

There are a number of different models available for financial advisory and investment management firms to deploy robo advisory services. Among these, the most prevalent are:

- In-house development
- "White label" offering from a robo advisory service provider
- Customized or un-customized API from a robo advisory provider

IN-HOUSE DEVELOPMENT

In this case, the wealth manager would develop a custom product in-house, which could be integrated with their existing system to provide automated advice and investment management services. Developing such a system helps improve the efficiency and productivity of the services they provide to customers, but requires not just functional expertise but also a high degree of technological expertise.

WHITE LABEL OFFERING

This refers to a pre-packaged offering from a robo advisory service provider which is licensed to the business without the service provider's branding. The product can be labelled and customized by the wealth manager according to their requirements, and appears to users to be their own product. There may be a one-time implementation fee, or it may be structured as a price-per-transaction model.

API

Most robo advisory service providers have the ability to bundle a few high-touch services like execution, advisory and discretionary portfolio management as a scalable, cloud-based digital platform. Such services can be integrated into the wealth manager's ecosystem through an application program interface, or API, provided by the robo service provider. In such a case, each individual service would be adopted through an API and integrated with business systems according to their functional and system requirements.

7. Business Benefits

In coming years, the client base served by robo advisors will continue to grow, especially among young investors who are more comfortable using online services as compared to human interactions. Some features, like easy onboarding procedures, low minimum investments and online access to information will be big differentiators for wealth management firms with robo advisory capabilities.

Robo advice also offers distinct benefits to insurance companies, enabling them to allocate their resources effectively to manage wealth, and letting agents concentrate on insurance sales. Discount brokers can also provide robo advice by leveraging their traditional direct customer engagement model. Similarly, full-service advisors are also looking to robo advice as an accelerator to manage smaller accounts and improve advisor productivity.

Since their debut in U.S. market, several robo advisors have become established and are growing stronger by the day. A few of these front runners include **Betterment, Wealthfront, Personal Capital, Future Advisor, Rebalance IRA** and **Acorns**. Recent research conducted by A. T. Kearney states that the total assets managed by robo advisors are estimated to grow to approximately $2.2 trillion by 2020 in the United States i.e. about 5.6% of the total investible assets[5].

8. The B2B Model

A handful of automated investment advisory firms are partnering with financial firms to up-sell their dashboards for investment analytics, information on existing products and instruments, and risk assessment. An easy signup process grants investors access to free analytics and financial information on their existing portfolios. Wealth managers are providing these services as value add in order to retain existing customers and attract new ones. In this case, the B2B robo advisor is paid some percentage of the advisory fees by their partners.

However, a few B2B robo advisors are aggressively shifting from purely aggregating and supplying online financial information to asset managers, and beginning to offer portfolio analytics software to banks and other financial institutions in the investment management domain.

Other advisory firms are envisioning future customers that are not limited to financial firms, but also telecommunication, technology and media companies who wish to offer investing and saving options to their growing customer base via their devices.

POPULAR B2B ROBO ADVISORY MODELS

Digital Investment Manager	▪ Online investing ▪ Automated rebalancing ▪ Portfolios using ETFs
Digital Advisory Manager	▪ Automated advice ▪ Simplified guidance on asset selection ▪ Various asset classes
Hybrid Digital Wealth Manager	▪ Digital plus video/web chart ▪ Online investing ▪ Automated advice
Other Innovative Models	▪ Model portfolios ▪ Preference-based investing ▪ Socially responsible investing

9. Conclusion

As robo advisory services become mainstream over the next decade, traditional broker-dealer advisory firms and registered investment advisors will face uphill competition from robo advisors or digitized wealth management firms.

Many in this new generation of tech-savvy investors will gravitate to digital wealth management services rather than engaging a human advisor, because of attractive features such as their convenience, low cost, and ease of use — not to mention the inherent familiarity that Millennials have with the online / mobile / social model.

It is imperative that investment and wealth management firms invest in technology and robo advisory platforms, but at the present time, investors are yet to give a clear indication about the robo advisory model that will add maximum value to them. For the time being, robo advisory may be more of an exploratory exercise, but it will be exciting to observe if and how long it takes automated investment advisors to overtake their human counterparts.

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