How are Robo-Advisors Changing the Finance Industry?

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The Terminator. Blade Runner. Transformers. The sci-fi genre is replete with the notion that robots will "take over the world". But that's just in the movies of course, it could never happen in real life…or could it? Well, although the chance of mechanised lumps of metal becoming our masters is slim, the *investment* world is undoubtedly experiencing the rise of a rather distinct type of robot.

And although this robot is not in any position at present to take over the industry, it continues to attract growing worldwide attention and debate. As we observe FinTech relentlessly disrupting traditional models of finance, the robo-advisor is arguably one of the biggest of all disruptors in the space.

Questions now persist over whether these robo-advisors will replace human advisors whilst seamlessly continuing to deliver the highest standards of financial advice. But before we address this in more detail, a quick reminder of some of the basics is in order…

What is a robo-advisor?

While there does not appear to be one over-arching definition, a robo-advisor can simply be described as an automated method to allocate investments. Typically, this automation is manifested in online wealth managers who use algorithms to construct, diversify and periodically rebalance an investor's portfolio, largely through exchange-traded funds (ETFs). The term was first applied to digital start-ups in the US, with Betterment, Personal Capital and Wealthfront emerging as three of the biggest names in the industry, managing assets worth around $10 billion,

$4.9 billion and $4.65 billion respectively.

What changes are they bringing?

They aim to make the investment process more straightforward and affordable. Indeed, one of their signature features is that they plug a gap for those who are unable to meet the minimum investment balance threshold for traditional advisors, which tends to be upwards of $200,000 if not more. In contrast, robo-advisors can apply a professional service to a portfolio valued for as little as $5,000 – and often even less. And the associated management fees are also substantially lower. Firms generally charge under 1.0% of assets per year, while some like WiseBanyan don't even charge an expense ratio.

The UK Treasury and Financial Conduct Authority call this gap the "advice gap". In the words of Treasury Committee member Mark Garnier, "As we move into an increasingly digital age, it is inevitable that the traditional financial advisor will be available in a robotic form. This is not a bad thing as it will make standardised advice available to everyone cheaply." This explains why robos are proving especially popular among the younger, less affluent and less experienced investment crowd at present.

But robo-advice should not merely be perceived as a brief stopover on the path towards accessing full-scale human advice. On the contrary, such companies have distinct advantages of their own that can make them undeniably attractive. For instance, an automated service removes the 'human error' associated with financial advisors. Even the most experienced of professionals can fall prey to mistakes that may lead to sub-optimal asset allocation decisions, such as cognitive and emotional biases. The detached objectivity of algorithms, on the other hand, leaves little room for such biases to emerge.

But will the robots replace humans?

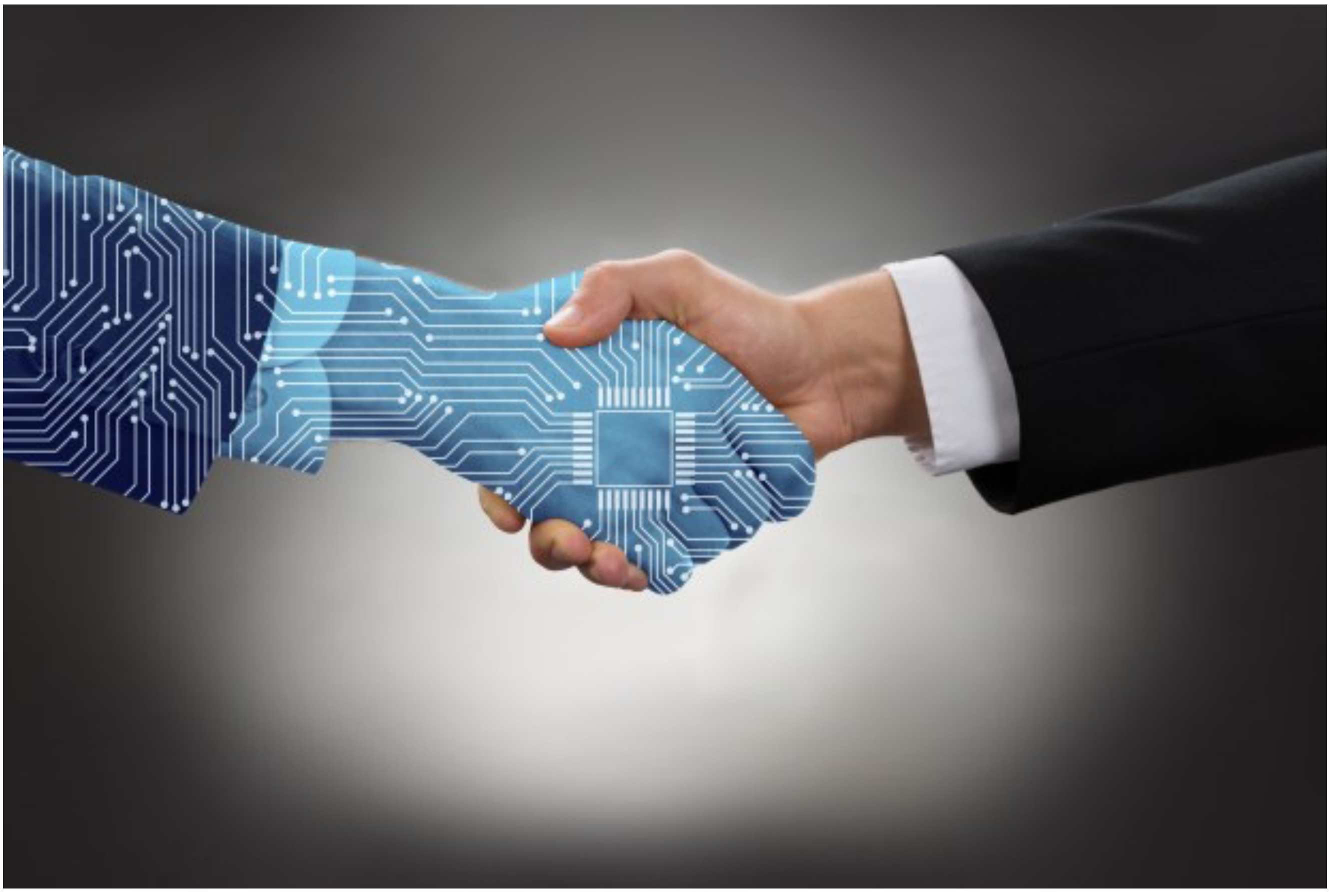
It seems unlikely. The human component within the overall investment process remains of paramount importance – and in fact, it seems more the case that robos fail to provide *enough* expertise from seasoned professionals. The most basic of robo-advisory models may be more susceptible to this failing, whereby little more is required from investors than to visit a company website, fill out a questionnaire pertaining to their investment goals and risk preferences, and then let the algorithms work their magic in accordance with the investor's profile. The degree of automation may also extend to processing applications, which helps to lower costs and improve efficiency for customers; as well as to allowing services to be accessed from various devices including laptops, tablets and smartphones. So, for those who intentionally prefer less in the way of regular contact with their financial advisors, this basic model is bound to have distinct appeal.

But few firms these days consider the job finished at letting the machines do all the work. Customers are now increasingly demanding a hybrid model – one that involves the efficiency of big data with the personalised appeal of the human touch. According to Accenture research, 68% of North America's emerging wealthy and high-net-worth investors want a hybrid over both the pure robo-advisor and the dedicated finance professional. And roughly the same proportion say they get better financial planning advice through hybrid offerings – surprisingly, this even extends to the traditionally human-centric services such as estate and tax planning.

And there is also solid evidence to validate the crucial role played by financial advisors. Asset manager Royal London found that those who received financial advice between 2001 and 2007 managed to accumulate significantly more liquid financial assets and pension wealth during the 2012-14 period than those who did not receive any advice. This result also held true for those on more modest incomes, implying that financial advice is not solely the preserve of the wealthy, but also has a positive impact on the lower income cohorts. In the words of Steve Webb, Royal London's Director of Policy, the research shows for the first time "the very real return to obtaining expert financial advice".

What's more, financial advisors themselves are keen to join the robo revolution in what seems to be a comprehensive turnaround in attitudes to the burgeoning industry – from one of fear, to one of opportunity. A recent survey by Panacea Adviser found that around 20% of financial advisors are either in the process of integrating robo advice into their offerings, or are at least considering such an option. And yet it was only a year ago that a survey by the same company found that almost 9 in 10 advisors considered robos to be a threat to their business (although it should be noted that 66% of respondents still remain undecided as to whether robo-advice is a net good for their existence).

The evidence is there for all to see, moreover, with some of the industry's most dominant asset managers getting aboard the robo train over the last few years, through creating standalone robo-advisors, partnerships, discount broker robo-advice or full-service e-advisor offerings. Charles Schwab, for example, launched its robo platform Schwab Intelligent Portfolios in 2014; while Vanguard released Personal Advisor Services a year later. And let's not forgot the top dog itself – Blackrock – which purchased robo firm FutureAdvisor a couple of years ago. Indeed, Blackrock's ETF and Index Sales chief Michael Gruener expects digital services to soon be the norm; "I really believe that we're only 1 per cent done," he opined earlier this year.



What concerns does robo-advisory raise?

There's a trade-off to all this cheerleading for simplicity, however. With the overwhelming majority of robo-advisors trading almost exclusively in ETFs, they are somewhat justifiably considered to be following a narrow portfolio concept. Indeed, it's far from an overstatement to assert that robo-advisory has become *synonymous* with passive investing. And although such strategies offer a cheap way for investors to achieve portfolio diversification, market scenarios can easily transpire that show them up to be far from ideal – an issue we have recently discussed in some detail.

Is there much diversity in robo-land? Well it seems to be growing. A handful of robo-advisors do offer funds that ostensibly aim to exploit market anomalies. Since 1926, for instance, US small cap stocks have beaten large caps by a yearly average of 2.7% – robo-advisors such as Tradekings Advisors offer a handful of opportunities to gain exposure to ETFs focusing on such small caps. But are robo-advisors meeting the needs of those investors seeking to go *beyond* the universe of stock and total bond market / government bond ETFs? It is usually desirable for a portfolio – and in particular, its fixed income component – to possess safe haven qualities in the event of a market shock. But liquidity providers are not necessarily guaranteed to continue supporting ETFs during such events. In turn, this could lead to underperformance at a time when the relative safety of fixed income should be *protecting* investors.

With that in mind, robo-advisors soon need to move beyond the relatively limited ETF environment; in fact, some of the more forward-thinking ones are already making this transition. Take RiskSave Technologies as an example; this new London-based advisor employs fixed-income algorithms and analytics that extend further than ETFs to identify suitable assets among the significantly more diverse universe of individual securities, in order to facilitate a more granular level of algorithmic trading. Such an approach, RiskSave CEO Daniel Tammas-Hastings hopes, will not only hedge against observable Black Swan events, but also "generate tailored risk profiles similar to those available to the largest pension funds". But the likes of RiskSave and True Link Financial in the US remain exceptions, rather than the rule, to date.

Another pertinent issue plaguing the robo-advisory industry is the lack of profitability for most incumbents. The majority of the US' 200-odd robo-advisors operate in the "direct-to-consumer (D2C)" space, a model from which it is proving notoriously difficult to generate profits thanks to the costly process of acquiring customers. A recent study estimates that customer acquisition for a US robo-advisor costs an average of $389, but that the average account size of $27,000 only generates $90 in revenue. So, it seems that many of the smaller players could struggle to survive, especially in the face of likely consolidation in the industry, as bigger companies continue to launch their own robo offerings.

And this trend could be worse for the rest of the world. The UK is just one example – a rather sobering analysis from IRN Consultants suggests that robo-advisors could take up to a decade to make a profit from their clients, with each new robo-advice customer losing the company £162.50 on average in the first year before making a paltry £17.50 in subsequent years. Indeed, despite being named "Best Robo Advisor Europe 2016" recently, the UK's – and evidently, Europe's – best robo-advisor Nutmeg continues to generate losses. Its 2015 figures, released last October, showed that for the third consecutive year, the company has failed to reach profitability, posting a pre-tax loss of £9 million on a turnover of £1.7 million; to compound matters, this was worse than the £5.3m pre-tax loss posted in 2014. Clearly, the industry still has to make considerable efficiency gains before it can be considered sustainable.

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It should be emphasised just how early on we are in the evolutionary process of robo-advisory, as we seemingly are with many of the most profound innovations in the FinTech space. Despite the flurry of headlines and attention they continue to generate, the impact of robos on the wealth management industry today remains minimal – the assets of US–registered investment companies exceeded $19 trillion in 2016, whereas US robo-advisors managed less than $0.2 trillion.

That said, robo-advisory is expected to continue growing at a healthy pace to possibly $2.2 trillion AUM worldwide by 2020, or perhaps even $8 trillion if the more optimistic BI Intelligence is to be believed. Overall, this expanding presence is a good thing – it keeps the costs of Wall Street fees in check; it stretches the participant universe to include beginner investors who would have otherwise been largely precluded from the traditional channels; and it offers greater competition, which in turn promotes financial innovation.

But algorithm-based trading is not for everyone, and sophisticated investors with more complicated portfolios are likely to continue relying predominantly on financial advisors – or at the very least, hybrids – for the time being. But even those financial advisors will now be increasingly triggered to find ways to boost performance and lower costs to maintain their customer bases. And as robo-advisors begin to move beyond the simplistic world of passive strategies, it may prove increasingly difficult for traditional advisors to differentiate their service. As such, the robots may not end up taking over, but they will certainly become a force to be reckoned with.

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