CNL Securities

PRACTICE MANAGEMENT

The Robo-Advisor: Opportunity or Threat

New automated investment-management tools offer basic functions like asset allocation at low costs. For traditional financial advisors, these "robo-advisors" present both a threat and an opportunity.

Robo-advisors have become more popular in the past several years. These online tools use algorithms to help investors handle basic investment management services such as asset allocation, primarily using exchange-traded funds or other passive investments.[1] They also can handle advanced functions, like automatic rebalancing and tax-loss harvesting, as well as tailor their asset mix to an investor's risk tolerance.[2]

Robo-advisors charge fees that are far lower than traditional financial advisors, typically 25 to 50 basis points less. Others may charge more, but offer periodic access to a live financial advisor, and some of the newer ones might be free.[2] The latest wave of consumer-oriented robo-advisors includes firms with approximately $18.7 billion in assets under management, an amount projected to grow to $489 billion by 2020, reflecting a more than 2,500 percent growth.[3]

For the most part, robo-advisors provide a low-fee approach for investors who have small accounts, prefer a more passive approach to investing or have the potential of turning into larger fee-paying clients later in life. Regardless of the investor's interest in these automated tools, financial advisors need to understand both the opportunities and threats robo-advisors present.

NOT JUST STARTUPS

Although startup robo-advisors have generated significant coverage in the business press, major retail brokerage firms and mutual fund companies also have begun offering automated, online tools at lower costs by either partnering with existing robo-advisors or rolling out their own proprietary offerings.

As of late 2015, Vanguard's hybrid online offering (which includes some access to a live advisor) had $26 billion in assets under management. Schwab has a similar offering, which now has $4.1 billion under management. Bank of America, Wells Fargo and Merrill Lynch plan to follow suit.[4]

Among pure-play, online robo-advisors, some experts expect consolidation and a reduction in the number of firms. Many are still funded by venture capital, which could run dry as investors seek to cash out on their initial investment.[5] For example, one of the original startup robo-advisors was recently acquired by BlackRock.[5]

THE BENEFITS AND RISKS OF ROBO-ADVISORS

BENEFITS

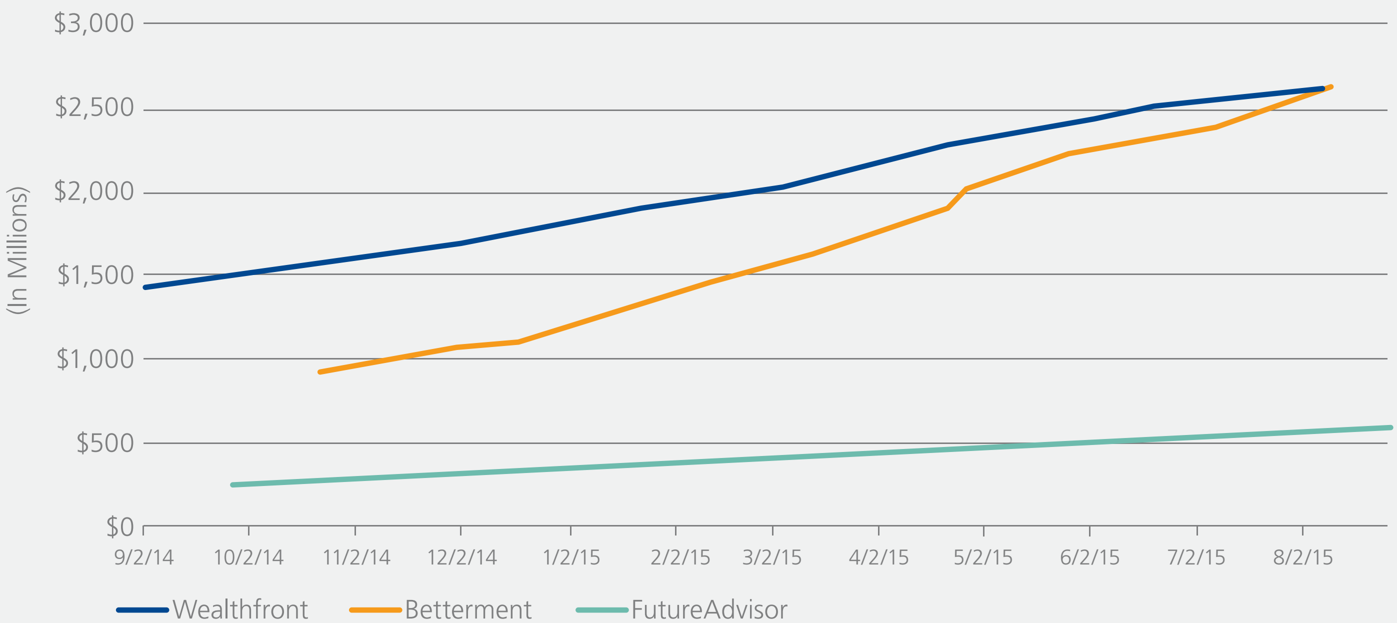
- Robo-advisors provide solid investment management tools at low costs for passive investors who don't have complex investment needs.
- They have low minimum account sizes, allowing advisors to work with a wider range of clients (many of whom may need more advanced financial planning services and advice later on).
- They give clients 24/7 access to their portfolio, through websites and apps that are generally extremely easy to use.

RISKS

- Because robo-advisors charge such low fees, advisors may need to justify higher fees for additional services to clients.
- Clients who become accustomed to investment management through robo-advisors may require education about why they need to advance to more personalized investment management or to more complex advice, such as tax and estate planning.
- Many robo-advisors have a limited range of investment options, largely consisting of index funds.

Figure 1

Robo-Advisor Asset Growth



SOURCE: Michael Kitces, "BlackRock Acquires FutureAdvisor for $150 Million as Yet Another Robo-Advisor Pivots to Become an Advisor #FinTech Solution," *Nerd's Eye View*, Aug. 27, 2015.

Yet whether the future consists of growth among new startups or online automated investment management through larger firms, it is highly likely that most financial advisors will incorporate some version of these tools in the next three to five years.[3]

A THREAT TO TRADITIONAL ADVISORS

These new services may pose a threat to traditional financial advisors and wealth managers for several reasons. First, robo-advisors are helping to commodify basic investment management, particularly for people with straightforward needs.[1]

Second, their low fee structure could ratchet expectations downward regarding the fees that some clients are willing to pay. At a minimum, these tools may require that traditional advisors become more transparent about their fees.[1]

Third, many robo-advisors feature new technology, including extremely intuitive user interfaces. Thus, clients could start to expect or demand similar technology — including 24/7 access to their accounts, mobile platforms and other tools — from traditional advisors.[1]

Lastly, because robo-advisors allow lower minimum account sizes, they are attracting younger investors who could be the wealth-management clients of tomorrow. These people may require education about why they ultimately need to switch from a basic robo-advisor to the more comprehensive services a live person offers.[1]

CREATING OPPORTUNITIES

Given that robo-advisors are likely here to stay in some form, financial advisors need to determine how they will incorporate them into their practice.

The future market for financial services will not be split between online robo-offerings and traditional, in-person services. Instead, it will likely be a hybrid of the two. Advisors that integrate robo-offerings into their existing suite of services can get ahead of this trend and turn the threat robo-advisors pose into an opportunity.[6]

"I don't see the robo-platforms as threats," says Steve Stanganelli, a financial advisor in Boston. "I see them as additional tools for advisors." In 2014, Stanganelli began researching robo-advisors for his firm Clear View Wealth Advisors. He ultimately chose Betterment, which offers an institutional platform advisors can offer their clients. "To me it's a no-brainer," he says. "These platforms offer a solution that works for a lot of clients — diversification and regular rebalancing, with online access — for a relatively low cost."

However, he adds, "What these platforms don't address are the nuances of how you deal with a client's unique situation." For example, some robo-advisors do not handle individual equities or cash, and many do not accommodate 401(k) accounts.

RELATIONSHIPS WITH NEW CLIENTS

Robo-advisors also accommodate small accounts, allowing some advisors to take on clients they might not have been able to in the past, particularly younger investors. David Hunter, a financial advisor with Horizons Wealth Management in Asheville, North Carolina, started using a robo-advisor known as Motif in mid-2015.

"It was born out of necessity," he says. "We had people who didn't fit our traditional wealth-management model, with smaller account sizes from $5,000 to $20,000. In the past, we would possibly have taken them on pro bono, just to establish a relationship, or tried some other approach. But for clients that size — or up to a few hundred thousand dollars — it's more efficient from a cost standpoint to use the robo-model."

As with Stanganelli, Hunter says that the long-term objective is to transfer the clients currently on robo-platforms to more custom financial advice as their assets grow and their needs become more complex. In this approach, the robo-advice component becomes an "on-ramp" to more advanced services later on, such as retirement planning, estate planning, insurance considerations and other aspects that cannot be addressed with a computer algorithm.[6]

TIERED SERVICES AND FEES

Because robo-advisors are relatively limited in their functionality, some advisors may benefit from offering tiered service levels, with correspondingly tiered fees. Advisors can lower the fees they are charging for straightforward investment management services through online tools, and increase their fees for more specialized services such as tax advice and estate planning.[6]

For example, Andrew McFadden, a financial advisor in Fresno, California, charges a monthly retainer to help clients with smaller account sizes (typically less than $25,000) get set up on the Betterment platform. After they exceed $25,000, he offers more sophisticated portfolio management and charges a percentage of their assets under management (though clients can stay with Betterment if they want). And for clients with accounts of more than $250,000, he drops the monthly retainer and only charges a percentage of assets. "At all levels, I break the fees apart and make sure that clients understand what they're getting for what they're paying," he says.

"For clients who just need basic diversification and reallocation, the robos are the best places to go," McFadden says. "But they're not going to guide a client when the market drops sharply or when they're scared. For all those emotional pain points, the algorithm isn't going to help. When people are in those situations, they want someone who can advise them and have some empathy."

IN BRIEF

For some financial professionals, new tools such as robo-advisors may pose an apparent threat to established ways of working. Yet robo-advisors also offer a means to better interact with certain clients, particularly people with smaller account sizes. As a result, advisors can tap into a wider client base, potentially developing relationships that evolve to more traditional services as the clients' needs become more complex. However, robo-advisors are no replacement for more traditional services. Smart advisors will treat these tools as an addition to — instead of a replacement for — the advisory and planning services they already offer.

KEY CONSIDERATIONS FOR FINANCIAL ADVISORS

- Robo-advisors are growing fast, but they don't represent a significant threat to most financial advisors.
- Instead, they are a complementary offering that some advisors may want to provide for their clients who only need basic investment management (e.g., a primarily passively managed portfolio made up of index funds) at a low cost.
- Many robo-advisors offer an institutional platform. Because this requires an additional level of compliance and training, advisors need to understand all their features and explain them to clients.
- The client base for robo-advisors goes beyond tech-savvy millennials. Some new robo-advisors generate a significant portion of their business from clients who are in their 50s or older.
- Advisors say it is extremely easy to get new clients set up with robo-advisors for investment management. Transferring existing clients requires a bit more paperwork, and advisors usually do this in conjunction with visits for other purposes.

[1] "How to Build a Robo-Shield for Your Financial Advisory Firm," *Fox Financial Planning Network*, 2014.
[2] Rob Berger, "7 Robo Advisors That Make Investing Effortless," *Forbes*, Feb. 15, 2015.
[3] Alessandra Malito, "2,500% Asset Growth Projected for Robo-Advice Platforms," *InvestmentNews*, Nov. 4, 2015.
[4] Alessandra Malito, "Look Out for These Robos in 2016," *InvestmentNews*, Nov. 11, 2015.
[5] Samantha Sharf, "BlackRock to Buy FutureAdvisor, Signaling Robo-Advice Is Here to Stay," *Forbes*, Aug. 26, 2015.
[6] Leslie Kramer, "How Financial Advisors Can Adjust to Robo-Advisors," *Investopedia*, Dec. 17, 2015.

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