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Robo advisors emerge to challenge tradition

Forty years ago, **Charles Schwab** capitalized on regulatory reforms to commence a revolution in retail investing by opening a discount brokerage office in Sacramento. In a little over a decade, that lone outpost had blossomed into a network of 100 offices throughout the U.S. Today, the discount model is ubiquitous, with large financial firms playing "how low can you go" as they compete for clients and assets.

In March, Schwab capitalized on technology to enter another potentially revolutionary movement targeting retail investors who want help managing their assets — but don't need human intervention and the related fees. This time around, however, the San Francisco-based firm is following in the footsteps of some of the original "robo advising" pioneers such as **Wealthfront** and **Betterment**. "We know there are three controllable variables that have an impact on the long-term success of investors," said Schwab Executive Vice President Naureen Hassan in launching the Schwab Intelligent Portfolios service. "Being and staying invested. Having access to quality investment advice and money management. And keeping costs low."

Robo advisors are just the thin edge of a wedge of algorithm-based services that will remake the 21st-century economy. Dozens of job categories from accountants to X-ray technicians — and, yes, computer programmers — are vulnerable to displacement. The financial advisor and wealth manager — notwithstanding his or her ability to hold a client's hand in a market crisis, provide face-to-face advice about complex investing, retirement and tax matters, and even assist with everyday chores if the client is rich enough — is hardly immune to the revolution. In a reference to Wealthfront CEO Adam Nash, a fellow panelist at a financial advisory conference in January, **Edelman Financial Services** Chairman and CEO Ric Edelman dramatically warned attendees: "Adam is going to put most of you out of business. It's as simple as that. And if he doesn't put you out of business, someone like him will."

Robo advisors tend to share a number of characteristics:

- Their websites are easy to understand and navigate.
- Questionnaires assessing goals and risk tolerance are simple. "If you have time for a cup of coffee, you have time to start investing with Schwab Intelligent Portfolios," Schwab's dedicated Website says as part of its client-friendly pitch.
- The firms are quite democratic, offering their services to clients with as little as $5,000 to invest. Accordingly, client assets tend to be in the five figures, falling far short of the threshold required by wealth managers. At Betterment, one of the larger such firms, the average client account is around $24,000.
- Fees are low, ranging in the area of 25 basis points, depending upon assets.
- The product line comprises low-cost exchange traded funds,

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and portfolios are automatically rebalanced based on individual preferences. The product line can also be limited. For example, **WiseBanyan**, one of the newer and smaller robo advisors, offers just eight ETFs spanning equities, bonds and real estate in the U.S. and globally, with **Vanguard** the predominant provider.

- The services incorporate such value-added features as tax-loss harvesting, with that particular benefit usually reserved for clients with a minimum asset base.

The primary market for robos is the millennial generation born between 1980 and 2000, given its comfort interacting with technology over human beings and openness to cutting edge trends. A survey this year by Spectrem Group indicated that 17% of millennials use automated managers, or three times the level of all "affluent investors." Spectrem notes that robo users "are more likely" to consider themselves dependent on advice and counsel than investors who do not use technology-driven advisors — a somewhat counterintuitive finding that might be due to the relative youth and investing inexperience of many robo clients. Adam Nash told *CNBC* last year that millennials are seeking three characteristics in their advisor: an automated solution; low fees; and passive investments. After two market corrections in 2000 and 2008, Nash said, "They are very cynical about this idea that anyone can reliably beat the markets."

In the three-plus years since its emergence as a robo advisor, Nash's Silicon Valley-based Wealthfront business has already accumulated $2 billion in assets by delivering in all three areas, including fees of 25 basis points (taxable client accounts above $100,000 also have access to tax-loss harvesting) and asset allocation models built from exchange traded funds. Wealthfront says client portfolios range from $5,000 to $10 million but average $90,000. The company has stacked its investment committee with such high-profile market analysts as Charles Ellis and Princeton University economics Prof. Burton Malkiel, who serves as chief investment officer.

Betterment is another early and independent entrant in the robo advising arena. Based in New York, it was founded in 2008 and has $1.8 billion in assets spread around 75,000 clients — or three times the number of clients at Wealthfront. According to the company, the average customer is 36 years old, has an income of $150,000, and a net worth of $250,000. Betterment offers a similar menu of services as its competitors, with fees ranging from 15 to 35 basis points depending upon account size. The firm counts just 25% of its customers in the 50-plus age range compared with 10% at Wealthfront.

Recently, Betterment completed a new $60 million round of fundraising that valued the firm at $400 million to $500 million, or around 40 times revenue, according to *The Wall Street Journal*. Investors include **Bessemer Venture Partners**, **Francisco Partners**, **Menlo Ventures** and **Northwestern Mutual**. **Motif Investing**, based in the San Francisco Bay Area, counts **Goldman Sachs** and **JPMorgan Chase** among its backers. In 2014, the robo industry raised $290 million, or nearly twice the amount in 2013 and eight times the level in 2012, according to venture capital tracker CB Insights.

Although the industry's assets ($20 billion) are just a fraction of what traditional wealth managers and brokerages handle, the major asset managers — mindful of the dangers of ignoring technological disruptions — have been quick to respond. **Vanguard** has joined Schwab in introducing a robo business, Personal Advisor Services, that incorporates the benefit of some human interaction; it has already garnered more than $4 billion in assets. The service requires a minimum investment of $100,000 — far in excess of dedicated robo firm minimums — and charges an annual fee of 30 basis points. Vanguard says it will ultimately lower the investment minimum to $50,000. In a March 2015 interview with *The Wall Street Journal*, Karen Risi, principal, Advice Services, referred to the service as a "hybrid" between old and new, saying: "We certainly have the dedicated advisor who works on a continuing basis with a client and does dedicated financial planning, but it's powered by a technology platform."

Schwab's Intelligent Portfolios is open to investors with as little as $5,000 and offers portfolios that can draw on dozens of ETFs across 20 asset classes. These include Schwab ETFs, which wrap in the more expensive smart-beta Fundamental Index products, as well as those from competitors such as **iShares**, **PowerShares** and Vanguard. Fees range between 4 basis points and 48 basis points. In launching the service, Schwab was criticized for a requirement that investors maintain a cash balance of between 6% and 30% of assets "to manage volatility and risk" (Schwab takes a percentage of the interest in those cash accounts). That stipulation led Adam Nash to run to his blog attacking the impact of those large cash holdings on potential returns, calling it "almost criminal." Schwab was quick to rebut Nash in its own blog: "Adam wishes he could build a moat around Wealthfront and protect it against competition. But misrepresenting facts isn't the way to do that."

Fidelity Investments is opting for collaboration for the moment, having reached agreements last year with Betterment and financial education advisor **LearnVest** to provide tech-related services to its external industry clients. The LearnVest agreement is managed via Fidelity Institutional, which delivers clearing, custody and investment services to registered investment advisors (RIAs), broker-dealers, family offices and banks. The goal: help advisors and others digitize their practices and meet the demand for online advice. The initiative is in line with Fidelity research indicating that 56% of RIAs and broker-dealers "plan to embrace digital platforms by incorporating them into their existing businesses or partnering with one." A similar agreement with Betterment is run through Fidelity Institutional Wealth Services, a platform for 3,000 RIA firms.

In March of this year, **Northwestern Mutual** became the first major player to acquire a robo advisor when it bought LearnVest, gaining 10,000 "premium" clients, an additional

25,000 clients through the "LearnVest at Work" employer-based program, and 1.5 million users. "There's been a gap between what consumers want and what the financial industry has been able to offer," said John Schlifske, Northwestern chairman and CEO. "Northwestern will fill that gap by redefining how financial security is delivered." The Milwaukee-based insurer, which led a $28 million investment in LearnVest in 2014, cited three "critical [LearnVest] assets that make the acquisition attractive: easy-to-use financial planning technology; a complete financial education; and the entrepreneurial passion of LearnVest's employees." (Northwestern also led a $32 million 2014 fundraising for Betterment.) While LearnVest provides computer-generated financial advice, unlike its peers it does not manage assets. For its part, Northwestern can wrap LearnVest's technology into an infrastructure that includes 4.2 million clients and 16,000 field representatives. Fortune reported the acquisition price at $250 million, although Northwestern did not divulge pricing.

The emergence of robo advisors is a predictable outgrowth of both the technological revolution and the shift among retail investors toward fee-consciousness and passive investing. And while robos are a veritable minnow compared with the whale-like wealth and financial advisory industries, the long-term competitive threat could ultimately prove as formidable as that posed by Schwab to full-service brokers 40 years ago. "The revolutionary change that the little robo advisor firms have provoked is that they challenge the price of advice," Alois Pirker, research director at financial consultant Aite Group, recently told *Bloomberg Businessweek*. "Now the big firms have to justify their costs or lose the client." Additionally, for an ascendant millennial generation, the traditional appeal of interacting with an advisor in a wood-paneled office may prove no more compelling than reviewing a computer-driven portfolio from a laptop or phone.

As evidenced by Fidelity's tie-ups with Betterment and LearnVest for its industry clients, there could be a benefit for traditional asset managers and advisors who embrace the robo revolution: capitalizing on the technology to manage portfolios (which could help lower costs) while they focus attention on value-added touchpoints designed to strengthen relationships. Some small advisory firms are already trying to get ahead of the curve. Brian Murphy, president of **Pathways Financial Partners**, an Arizona firm with $100 million in assets, added a robo platform in January, hiring two advisors to work with online clients. "Advisors fear that they're going to be replaced by technology," he told *Investment News*. "What we're doing is offering a service that is that technology."

Still, many traditional advisors and wealth managers are taking a wait-and-see attitude regarding just how successful the robo advisors will prove to be, particularly with high net worth clients. "An investor with $2 [million] or $3 million doesn't want to just deal with a website," Carl Domino, president and chief investment officer of Florida's **Carl Domino, Inc.**, told *CNBC* last year. "They hire someone else to worry about their money so they can sleep at night." In a sentiment expressed by many traditional advisors, Michael Kitces, a certified financial planner at Maryland's **Pinnacle Advisory Group** (AUM: $1.4 billion), told the *New York Times* last year: "Ultimately, the biggest challenge for these services will be the next bear market. Will their investors bail without anyone to talk to, blowing up their business model?" ▲