THE RISE OF THE ROBOS:
A NEW MODEL FOR U.S. WEALTH MANAGEMENT
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ROBOS AMONG US
Anyone who has perused a financial industry news app or attended an industry conference over the past year knows: the robos are among us. Automated financial advisors, or robo-advisors as they are affectionately known, exploded onto the scene with great fanfare and substantial VC funding, and with a vast and profitable industry segment in their sights: personal wealth management. While robos have enjoyed a brilliant start off the blocks, the outcome of the race is far from certain.

There are two ways to look at Robos. First, they have pulled together some $19B worth of assets as of Q4 2014, on the back of an impressive 2013-2014 asset growth of 64%. Second, their assets under management comprise a miniscule .38% – barely a rounding – error on the $5 trillion retail market for financial advice.

And there are two ways to look at the eye-popping $427 million in VC funding that the as-yet unprofitable new robos attracted in 2014: either harbinger of an imminent revolution in financial services or a dotcom-worthy example of supercharged burn rates and imminent insolvency. It might also be worth putting this investment into perspective, given that the asset management industry generates $215 billion in annual sales.

There are 30 dedicated robo-advisory firms today, contrasted with 31,000 traditional wealth management firms employing 300,000 professional advisors. Their appeal is obvious: robos provide basic financial advisory and asset allocation for 25-30 basis points in fees, plus some 15-30 basis points for underlying funds – a 50% discount on the typical 100 basis points charged by traditional advisors.

What’s more, most robos offer to manage as little as $5,000-10,000, where many traditional advisors cannot afford to service portfolios of less than $250,000 or more. Seen in this way, the robos commenced their initial industry foray by astutely identifying an underserved, but growing, market.

AN UNDERSERVED MARKET
Private banks serve ultra high net worth (UHNW) investors with $25 million or more; traditional “wirehouse” advisors and fee-based registered investment advisors (RIAs) find their sweet spot in high net worth (HNW) investors with $1-25 million to invest. As might be expected, these markets represent a distinct minority of investors but a very substantial proportion of total advisory asset under management. These services are hands-on and highly customized, oriented to managing the complex financial lives of wealthy investors, many of whom are retired or pre-retirement boomers.

But just under this level is the vast mass affluent market with between $100,000 - $1 million. These investors tend to be mid-to-late career workers investing through workplace savings plans. Depending on their personal inclination, mass affluent investors might seek advice through a junior advisor at a major global firm, “regional” advisors or an independent advisor, or go it alone as a self-directed online investor. Robos have aimed their services precisely into this space, offering basic liability assessment and financial planning, portfolio analytics and asset allocation/rebalancing to investors that have never before had access to these services.

Mass affluent investors are in a tricky spot (this has not gone unnoticed by the robos). For the most part, they can’t afford to hire fee-based RIAs or purchase managed accounts. If they opt to pursue alpha through actively managed mutual funds, they must accept rather steep fees and dedicate hours that they do not have to portfolio monitoring and rebalancing, lest they fall afoul of wealth-eroding “style drift” and sub-optimality. What’s more, do-it-yourself investors are exposed to endemic trading risk, as was the case when tens of millions of US investors hit the “sell” button at the bottom of the financial crisis, locking in losses on billions worth of hard-earned investments.

Mass affluent investors mostly invest through workplace savings plans, and in those plans, they are increasingly choosing target date funds (TDFs), investment vehicles that automatically rebalance over time, investing in higher risk equities while investors are young and volatility-tolerant, incrementally shifting across to fixed income instruments during the pre-retirement years. According to Vanguard, some 88% of workplace savings plans offer TDFs and fully two-thirds of workplace savers purchase them. US TDFs comprise just over $700 billion in assets under management with variable pricing, ranging from an average asset-weighted expense ratio of 78 basis points (36% more than the average robo) to a rock bottom 17 basis for Vanguard passive index TDFs.

But TDFs are almost entirely allocated to long-only stock and bond investments, which may foretell unwanted risk concentration. While stocks and bonds have historically moved counter to one another, in recent years they have exhibited heightened correlation during periods of high volatility, notably during the 2008-2009 financial crisis. Robos offer individually customized allocations for a fraction of the price of managed accounts. The heterogeneity of their allocations makes clear that they resemble active management or “smart beta” more than passive, even though their portfolio “building blocks” are often simple indexed ETFs.

AUTOMATED ADVISORS BY THE NUMBERS

| 6 YEARS | $20B | 5K |
| Around but popularised in last 2 years | Estimated managed assets in 2014 | Minimum investment, Wealthfront |
| 25-30 BPS | 70% | 30 |
| Versus 100bps full service brokers charge | YoY growth in managed assets | Average number of staff in 2014 from top 5 firms |

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For example, in a recent survey of robo allocations for moderate risk investors, leading robo-advisor Wealthfront was found to have allocated fully 41% to U.S. equities, zero to international bonds and only 5% to “other” – cash and alternatives. Motif Horizon, by contrast, allocated 29% to international bonds, while Schwab Intelligent Portfolios allocated 19% to “other” (principally to cash, a practice that has been met with some controversy). Betterment deployed 36% to international stocks, nearly three times the levels of Motif. While Schwab allocated only 12% to US bonds, TradeKing Core allocated nearly triple that level.

Seen this way, robos are something new: actively managed, fee-based, tech-enabled RIAs for the mass affluent.

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Source: PwC - http://tinyurl.com/nh6u2el

THE RISE OF THE ROBOS

THE MILLENNIALS – A VERY SPECIAL CASE
Robos are often associated with young professional HENRYs (High Earning Not Rich Yet). While most robo clients are millennials, most robo assets belong to boomers, just as they do for conventional advisors. After all, households in their late 60s and early 70s have a net worth some 22 times greater than that of investors under age 35. This may be why, according to industry surveys only 30% of financial advisors are actively pursuing clients under age 40.

Another, less quantifiable factor, may turn on investment culture. For example, many industry leaders presume that millennials are resorting to robos because they lack access to traditional advisors that they would prefer, but cannot yet afford. But according to one study, one-third of millennials with at least $100,000 in investable assets prefer online advisory – a number expected to rise as robo techniques go mainstream and gather more assets. Millennials are accustomed to managing every aspect of their lives, in real-time, over mobile devices. It is easy to understand why they might prefer cloud-centric, real-time portfolio rebalancing for 50 basis points over traditional advisory that re-balances quarterly and communicates with clients through semiannual office visits and paper-based financial statements.

Only 29% of young workers have ever sought out professional financial advice – yet another example of robos targeting an under-served market. But today’s HENRY is tomorrow’s wealthy investor and millennials will certainly constitute the wealthiest investment market in history. Millennials today control $2 trillion in investable assets, rising to $7 trillion by 2020. And millennials will be the primary recipients of a historically unprecedented boomer-to-millennial intergenerational transfer of $30 trillion.

DISCOUNT BROKERS, ETFS AND DISRUPTION
In considering the rapid rise of robos, two analogies spring to mind. In the nineteen eighties, when simple stock trades could cost up to $100 per transaction, dozens of “discount brokers”, rode the wave of commission deregulation to take on Wall Street, morphing, in the nineteen nineties, into the first internet brokers. Most are gone, but Schwab, Fidelity, TD Ameritrade, E*Trade, Interactive Brokers and Vanguard are today pillars of the industry, with diversified businesses and services, intermediated by constantly-evolving technology.

There were, in those days, hubristic notions that a new guard would knock off an old guard, but at last check, Bank of America Merrill Lynch, Morgan Stanley, Wells Fargo, UBS, Edward Jones, Stifel and other traditional wealth managers are robust and expanding, joined by growing legions of independent wealth managers aggregated into firms like LPL, Cetera and others. These two industry segments have in fact joined forces, with myriad interconnections and partnerships.

A second analogy is the rise of low cost indexed Exchange Traded Funds (ETFs). In only 25 years, US ETFs evolved, by 2014, into a $2 trillion industry segment, providing low-cost diversification, liquid trading and opportunities for arbitrage across a bewildering range of asset classes and geographies. The ETF business is growing at triple the rate of mutual funds, with assets under management growing by 24% per annum in the 10 years to Q4 2014, as compared with 7% for mutual funds. But ETFs have fallen well short of displacing the mutual fund industry. As of 2014, US mutual funds accounted for nearly $16 trillion – or eight times the assets of ETFs.

And, as with the earlier rise of discount brokers, the insurgent ETF industry and the traditional mutual fund sector have long since intertwined, co-mingled and generally gone into business together. The largest manufacturers of ETFs – Fidelity, Vanguard and State Street Global Advisors – are among the world’s largest mutual fund firms.

And passive investment – a hallmark of early ETFs – never overtook active management, though not for want of trying. On the back of the post-crisis bull market, passive investing is growing ten times faster (on an absolute basis) than active management, with net inflows of $420 billion in 2014, as compared with $44B for active funds. But active still rules the roosts, with $9.7T under management vs. $4T for passive funds.

So while robos have been greeted as conquering heroes – and have some reason for self-congratulation – they are but the latest wave of technology and innovation to wash up on the shores of U.S. wealth management. As with discount brokers and ETFs, their genius has been their identification of unmet market needs and their use of technology to oblige costs and pass savings on to investors.

ROBOS AND THE FINTECH BOOM
For all the industry enthusiasm and alarm over the rise of robos, their rapid growth may not, perhaps, be all that it appears. Robos come in two broad varieties – platforms that aggregate financial information and assist with planning and investment modeling, delivering results through interactive dashboards; and robos that use proprietary algorithms to model, allocate and trade investment portfolios.

According to industry consultant Corporate Insights, fully 78% of robo assets might best be considered under advisement rather than under management. What’s more, a substantial proportion of robo assets under management are to be found in the hybrid robos put forward by robo assets under management. As of 2014, US mutual funds accounted for nearly $16 trillion, as compared with $4T for passive funds. But active still rules the roosts, with $9.7T under management vs. $4T for passive funds.

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Different robos measure their assets and processes in different ways – a common practice in new industry sectors in which standardization has not yet found purchase. But robos have certainly raised some eyebrows. Consultancy A.T. Kearney recently predicted that competition from robos may trim the annual revenues of traditional advisors by as much as $15 billion – $8 billion from fees lost to standalone robos and $7 billion due to the re-pricing of existing products – 7% of the industry’s $215 billion in annual revenue.

And it should be recalled that robo-advisors are but one element of a vast, cloud-based, mobile-centric, socially driven transformation underway in financial technology. FinTech attracted $12 billion in new investment in 2014 – up $300% over 2013. Innovation is rampant across the ecosystem – not only in wealth management, but also in payments, peer-to-peer lending, crowd funding, institutional investing, equity financing, remittance and socially sourced investment research. Any way you cut it, robos are on their way. And, as with so many waves of transformation that have come before, the ripples of their disruption will be felt far and wide.
ENDNOTES
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