'Robo-advisor' growth hits Wall Street money managers

March 22 2015

When it comes to investment advice, would you trust a financial professional or a robot?

A growing number of people are choosing the latter, on the belief that algorithms can provide rational and dispassionate advice at a cost well below that of traditional advisors.

A handful of automated investment startups created in the past few years now have more than $4 billion in assets under management, according to Forrester Research.

It's a small segment of a trillion-dollar wealth management industry but growing at a red-hot pace, Forrester analyst Bill Doyle said.

"This is a more meaningful crop of disruptors than we've seen for many years, really since the Internet brokerages emerged," he told AFP.

Doyle said the digital investment services appeal to young adults who lack the minimum—often $100,000 to $1 million—for traditional wealth managers, but who want advice or management of their investments.

Robo-advisor firms often allow customers to set their preferences and let the algorithm do the rest—trading, rebalancing and minimizing taxes.

Costs are often far less than a traditional advisory firm, which may charge one percent or more of a customer's assets.

"These upstarts have simple uncomplicated offers, often for markets that are not being served effectively by incumbent firms," Doyle said.

On the Bogleheads investment forum, one contributor claimed to be happy with the "low fees with a lot of added value" at one firm and the "Silicon Valley viewpoint on investing."

Jumping to $2 billion

Wealthfront, the largest of the new breed, announced this month it had reach $2 billion in assets under management in just over three years.

The California startup has an investment team led by Burton Malkiel, an emeritus professor of economics at Princeton University and author of a 1973 book that championed "passive" investing in low-cost indexes for stocks, bonds and other assets.

The strategy is based on the idea that "active" managers rarely outperform over the long term a broad index such as the Standard & Poor's 500, especially when manager fees are included.

These firms mainly recommend exchange-traded funds (ETFs) that offer these blends of assets.

"Investors are sick of the lack of transparency from traditional financial services," Wealthfront chief executive Adam Nash said in a blog post.

"For too long, this industry has made too much of its revenue on the backs of those who can least afford it."

Other startups including Betterment and FutureAdvisor use a similar formula—turning over daily portfolio management to an automated algorithm that selects investments based on a customer's risk profile, age and other factors, in an effort replicate broad market returns.

"More people are searching for a technology-first automated solution," said Betterment's Joe Ziemer.

The New York startup launched in 2010 now has 73,000 customers and $1.6 billion under management.

Betterment's average customer is 36 years old but its fastest growing segment is people over 50.

The mainstream financial industry has taken notice.

The large investment firm Charles Schwab this month launched its "Intelligent Portfolios," using a similar method, without any fees beyond the underlying investment fund costs.

Schwab is likely to quickly overtake the "pure play" automated firms but won't put them out of business, according to Doyle.

"Schwab's entry will raise this whole market. It brings credibility to this model," Doyle said.

But Doyle said the large investment firms have done little to appeal to young adults with relatively small amounts to invest.

Talking people off bridge

Some financial advisors argue that an algorithm can never replace the personal recommendations and hand-holding a live person can provide.

"Our conversations are deeper. We talk with people about their goals, about saving for retirement, for that home they want to buy." says Juli McNeely, a financial planner and president of the National Association of Insurance and Financial Advisors.

"Sometimes my biggest job is to talk people off the bridge. When there is a market panic, they want to jump. We need to talk it through so they understand what's happening. It's a comfort to have someone to talk to."

Some robo-firms seek to automate the effort to calm frayed nerves.

"We can tell from the number of log-ins if someone's temperature is getting warm, and we can do some additional messaging to educate them," explained Betterment's Ziemer.

Lowering financial advice costs

Robo-advisory firms raised some $290 million in venture funding last year, according to CB Insights, naming the best-funded ones as Wealthfront, Motif Investing, Personal Capital, Betterment and LearnVest.

Doyle said these startups will lower the cost of financial advice and hurt traditional financial firms such as Morgan Stanley and Fidelity, if they fail to adapt.

Wealthfront manages the first $10,000 for free, and then charges 0.25 percent of assets.

Betterment, which includes an investment team with Columbia University faculty and former executives at JP Morgan and Deutsche Bank, charges between 0.15 percent and 0.35 percent of assets it manages.

Others charge a similar percentage or flat monthly fee.

Some traditional money managers argue that robo-advisers will expand the overall market, and that investors will see the value of personal advice in the long term.

Financial planner and blogger Ben Carlson called the trend a "great thing for financial advisors that can differentiate themselves from robo-advisors."