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Cost-Income Ratios and Robo-Advisory

Why Wealth Managers Need to Engage with Robo-Advisors

Robo-Advisors and their impact on Wealth Managers

In this third edition of Deloitte's series on Robo-Advisory in Wealth Management, we at Deloitte would like to look in more detail at the impact of Robo-Advisors' cost structures on the Wealth Management segment and to examine the options Wealth Managers have to make use of recent developments in the market to achieve cost benefits. Improving the cost-income ratio (CIR) and at the same time rejuvenating the product offering is the Holy Grail that all financial institutions are looking for. Robo-Advisory firms demonstrate that it is possible to build a bridge between offering innovative and good services while taking a low-cost approach. This is how investments starting as low as 1,000 EUR can be managed successfully while charging less than 1 % in management fees.

In general terms, Robo-Advisors are increasingly being looked at by traditional advisors, established Wealth Managers and banks owing to the rapid growth of more than 9 % p.a. in Assets under Management (AuM) in Europe over the past few years.[1] This growth also means that there are many players with a comparable service offering on the market, making the Robo-Advisory market a crowded space. Thus, it is essential for Robo-Advisors to find their unique selling proposition (USP) in order to set themselves apart from the mass. In the near future it can be expected that one key player with the potential to disrupt the Wealth Management industry will emerge, rather like *Uber* in the passenger transportation industry or *Airbnb* in the hotel industry. Today, Robo-Advisors are already providing an array of alternative solutions that were previously almost exclusively the business of traditional Wealth Managers such as *UBS* or *Morgan Stanley*. That means that

[1] Source: EFAMA Asset Management Report 2015.

Robo-Advisors such as *Vaamo* or *Nutmeg* are capable of profiling their clients' risk appetite and can offer diversified investment portfolios that match this risk appetite in a fully automated manner. They are highly advanced, comprehensive, easy to use, and yet secure – a circumstance that may change the industry landscape in the long term and render existing products and traditional investment management processes obsolete much sooner than might be expected.

Furthermore, all this is offered at considerably lower prices – since Robo-Advisors have lower expenses, they still can generate attractive margins at fairly low prices. This is an additional challenge that traditional industry players should plan to overcome if they want to play a significant role in the foreseeable future. The very low price level of Robo-Advisors is one of the main selling points, complemented among other things by considerable transparency, comparability, availability, and an automated investment taxonomy free from investment decisions biased by emotion.

This abstract therefore essentially covers the massive impact of Robo-Advisors on cost-effectiveness which is also reflected in the enormous cost pressure which banks and Wealth Managers are struggling with. This epitomizes the generally miserable situation in which the majority of players in the sector are currently operating, with cost-income ratios that have skyrocketed to beyond the 90 % level – and irritatingly enough, the trend is expected to continue. In broad terms, costs are being pushed up by exceptional regulatory measures and the complexity and costs associated therewith, under which the entire industry is at present suffering.

In addition, we conducted a comprehensive comparison, demonstrating that by means of a successful integration or partnership-based collaboration, Robo-Advisors can play a decisive role in identifying and exploiting cost optimization opportunities. We then present three options for reducing costs by means of the integration of (scalable) Robo-Advisory solutions. The first two possibilities to profit from the cost advantages are to cooperate with an established player or to build and incorporate a Robo-Advisor into the existing product offering. The third option is to leverage a platform, which is defined as buying or building a Robo-Advisor but at the same time opening up the Robo-Advisory platform to other market participants such as other Wealth Managers or family offices.

The abstract concludes with an outlook on the future of Robo-Advisory and the traditional Wealth Management industry. What can be expected from Wealth Managers? Most of them are aware of the progressive expansion of Robo-Advisors, but so far only a few players have engaged actively in this field. Nonetheless it is becoming obvious that there is also increased competition among Robo-Advisors with a particular focus on Wealth Management. Many risk and venture capital companies are investing in various Robo-Advisors, which is why more and more Robo-Advisors are entering the market to jump on the bandwagon. This in turn increases the probability that one Robo-Advisor will emerge which will one day be able to acquire a Wealth Manager.

Whatever strategy is finally selected, advisors seeking to hold or expand their stake in the highly competitive Wealth Management sector must quickly take the initiative by cooperating with, building, or leveraging a Robo-Advisory platform.

Ultimately, traditional Wealth Managers will only survive and find their way back on track by fully accepting and recognizing the increased importance of Robo-Advisory and making use of the incredible variety of opportunities that exist for cooperation to complement each other's strengths for an increased benefit to clients.

Robo-advisors' pricing models

Robo-Advisors are financial services providers with comparatively extremely low prices. Deloitte's database of more than 100 providers related to Robo-Advisory services highlights the fact that most providers charge an annual management fee which normally ranges between 0.02 % and 1.0 % of the AuM. Traditional Wealth Managers, according to their own price lists, charge about 2.0 % to 3.0 % in fees and are not able to compete with these prices for this kind of service provided, thus more and more customers are deciding to shift larger portions of their investable assets to Robo-Advisory investment schemes.[2]

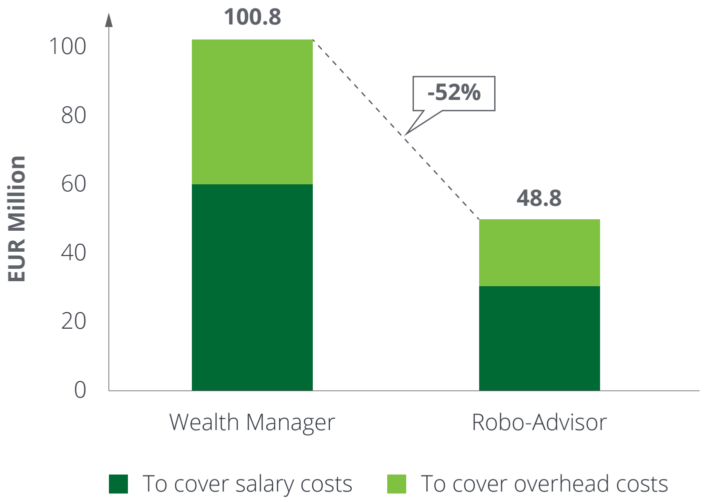
To understand why Robo-Advisors are able to offer services for a fraction of the fees of traditional Wealth Managers, it is necessary to understand the underlying costs of both of them.

Although the services offered by Wealth Managers are more comprehensive compared to pure Robo-Advisory focusing on investment management, the aim of almost all offered services is the same – the investment of funds to realize a return for a pre-defined risk appetite. However, the costs resulting from the investment process differ tremendously. Therefore the following analysis and its results focus on the costs for the investment of client assets.

Analyzing the Wealth Management departments of leading international and specialized financial institutions shows clearly that the highest cost factors for traditional Wealth Management are salaries and the connected costs of social security, pensions and other personnel-related costs. In the group of Wealth Managers analyzed, the associated costs averaged around 60 % of total costs. Overheads and depreciation and amortization complete a cost structure that can often be described as unhealthy.

[2] Source: World Wealth Report 2015.

Fig. 1 – Required Assets under Management to cover costs per advisor



Source: Deloitte Consulting GmbH

High costs for personnel are not really surprising since Wealth Management – as defined by traditional Wealth Managers – is a client relationship business. Clients must be served, representative buildings in highly expensive cities are used for regular meetings or events. Special client reports are necessary to satisfy client demands. Such an environment is not only very expensive, the way in which client advisors interact with their clients is also very time-consuming. For this reason, each client advisor is responsible for a limited number of clients.

This limitation increases the number of advisors required and subsequently increases costs. Although the client advisor ratio is usually not disclosed, recent Deloitte research indicates that one client advisor is responsible for 60–150 clients, which shows the upper limit. The small number of clients served and the resulting large number of client advisors increases the amount of AuM each client advisor must be responsible for to finance salary and overhead costs. To be able to compare Wealth Managers with Robo-Advisory firms, Deloitte introduced a key measurement – the required AuM to finance the average costs of one client advisor:

$$x = (\alpha + \beta) * \frac{\mu}{\pi}$$

α = Average salary of a client advisor[3]
β = Average overhead costs of a client advisor[4]
π = Average operating income of a client advisor
μ = Average AuM of a client advisor
x = Average AuM required to finance salary and overhead costs of a client advisor

Applying this key measurement to a sample of Wealth Managers, Deloitte calculated that each client advisor ought to oversee AuM of €100 million in order to generate as much revenue as the costs the client advisor creates (see Figure 1). Every additional euro of AuM creates a contribution margin to finance service employees, research departments, licenses, facilities, and other expenses. In the sample, each client advisor is responsible for €250 million of AuM. Therefore, €150 million of AuM generate a contribution margin to finance these cost factors and in the best case to create a profit. However, German Wealth Managers are faced with high cost-income ratios, ranging up to 0.90, which indicates that the AuM a Wealth Manager is responsible for are still too low to generate sufficient revenue.

Although most Wealth Managers who offer tailor-made solutions do not disclose their pricing, three different types of fees can be distinguished: event-based fees, asset-based fees, and all-in fees.

Event-based fees include transaction fees, management fees, and custody fees. Asset-based fees consist of performance and advisory fees, while an all-in fee is rather exceptional, most Wealth Managers charge a mix of event-based and asset-based fees. Event- and asset-based fees vary between 1.25 % and 1.5 %. However, large discounts are the rule rather than the exception, especially for major positions of High Net Worth Individuals (HNWIs) who have a greater bargaining power.

[3] Average salary is the sum of salary, social security costs, bonuses and other direct salary expenses.
[4] Average overhead is the sum of costs associated with facilities used, licenses, and other expenses.

Although traditional Wealth Managers manage the majority of the wealth, Robo-Advisors are catching up very quickly. Especially US-based Robo-Advisors are showing significant AuM inflows. *Betterment* and *Wealthfront*, for example, each have approximately US$5 billion in AuM. This is not a lot compared to the leading Wealth Manager *UBS* with approximately US$2,000 billion AuM in 2014, but still a significant value for companies which have been existent for less than 10 years.

Compared with the fees of traditional Wealth Managers, Robo-Advisors claim to commoditize Wealth Management services and make them accessible to mass or affluent clients, by offering automated investment advice, which is much cheaper than traditional advisory services. What all Robo-Advisors have in common is their low pricing, even though pricing structures sometimes vary in their detailed configurations. However, in Deloitte's analysis of the Robo-Advisory landscape, which was described in the previous edition **"Same name, different game – a look at the German Robo-Advisor landscape"**, the results show that most fee types are very similar to classic portfolio management firms. This means that over 80 % of the Robo-Advisors charge a management fee on the AuM at a fairly reduced level compared to Wealth Managers. As a variation from the classic pricing model some Robo-Advisors charge a performance fee either in addition to a management fee, for example *Ginmon*, or a performance fee only, in the case of *Cashboard* and *United Signals*. Another possibility is an annual flat fee to access the online investment management platform. Despite the fee structure, Robo-Advisors attract new customers by innovative client interaction tools. Frontend design, customer services, and analytics as well as user experience and user interaction are far ahead of the classic Wealth Management industry. Finally, there are scattered pricing structures in the market in combination with innovative and up-to-date design strategies, but it can be expected that in future only the most promising pricing strategies will survive.

To answer the question of why Robo-Advisors are able to build an economically viable business while charging much lower fees on AuM for their services, one has to take a closer look at the cost-structure of Robo-Advisors compared to existing Wealth Managers.

Robo-Advisors have second-to-none cost advantages over traditional Wealth Managers, thanks to their digitalized online investment approach, which becomes particularly evident in three areas of business: personnel, operating expenses, and cost savings through digitalization.

Personnel

First of all, Robo-Advisors do not need as much staff as Wealth Managers to run their business. As the advisory process is automated, there is no classic advisor role to be fulfilled. There are account or portfolio managers who oversee the investment process. For communication purposes they use digitalized channels such as live chats in order to support Robo-Advisory clients in their investment process. As a rule, most employees of a Robo-Advisor do not require an investment advisor license to provide classic advisory services, which saves costs given the high degree of digitalization and intelligent algorithms employed. For the most part portfolio managers provide only technical support rather than giving investment advice. The automation of investment processes allows one account manager to serve up to 20,000 clients, whereas service staff employed by Wealth Managers usually assist one to three advisors who manage 60–150 client portfolios. Newly-founded Robo-Advisors often start with a team of only three to five employees, and more established ones such as *Betterment* have now reached more than 130 employees. This is still a very small fraction of the number of staff employed at renowned Wealth Management institutes who have thousands of employees. As Robo-Advisors are young Fintech-companies, employees often earn much lower fixed salaries than in a comparable position with a Wealth Management firm: they are committed instead to the idea. Frequently, they are also involved as founders or shareholders of the company or receive performance-related compensation in order to participate in the firm's success. All in all, the two aspects lead to massive savings with regard to salary costs.

Operating Expenses

Operating expenses include rent, equipment, inventory costs, payroll, marketing, insurance, and resources allocated for research and development. Robo-Advisors are - in contrast to traditional Wealth Managers - far more flexible with regard to their offices and facilities. Targeting visionary, talented employees, most Robo-Advisors use remote work-places, or co-working spaces with other startups. This manner of working reduces costs significantly and increases work motivation. Usually, a desk with a computer is the main equipment in the daily business of a Fintech employee. As clients do not visit the facility in person, there is no need to invest in fancy office inventory. By analogy with the online investment process, marketing activities are also mainly focusing on online initiatives which are more cost-effective than traditional marketing campaigns such as TV-spots or offline advertisement placements. Moreover, most administrative processes are digitalized as well, which saves time and money for filing documents and other business-related paperwork.

Digitalization

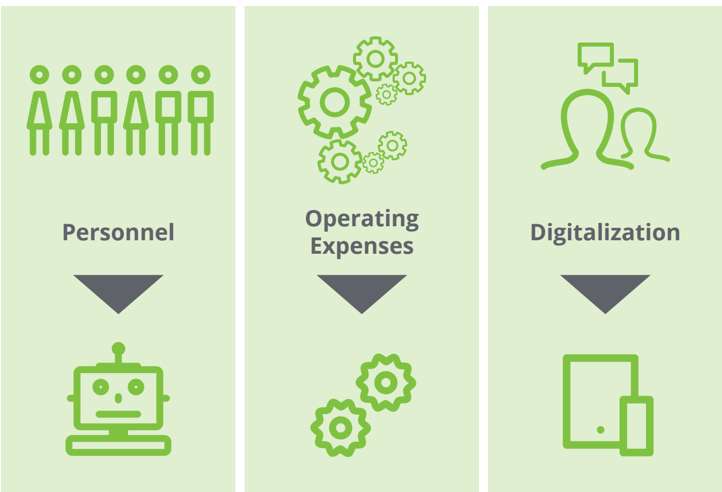
Robo-Advisory user front-ends are intuitive, user-friendly and provide beneficial customer support realized by live chats, chat-bots or direct message possibilities at very low cost, as most processes are digitalized. For instance, chat-bots offer an array of pre-defined answers for a variety of standard questions raised by clients and allow for customer support outside service hours without any human involvement. In addition, compulsory FAQ sections are provided, and classic hotlines to reach out to a service agent who is willing to solve client issues. As Wealth Management services are almost fully digitalized, account managers focus only on client satisfaction and retention and do not have to spend their time in costly client onboarding processes or risk-profiling appointments as usually required to meet regulatory demands. Thus most of the investment process is digitalized and no longer requires human interaction.

These means of digital client engagement are the first steps towards mass-customizing the advisory part by keeping up with the client in a totally different way. UK's renowned Robo-Advisor *Wealthify* already uses customized e-mails triggered by single client portfolio characteristics measured against market changes to keep up with their clients on a regular basis, with one clear goal: signaling the need for care and encouraging the client to invest more cash or shift assets within the Robo-Advisory universe. Calling the investment advisor on the phone in this case means only double checking on a proposal and not explaining the whole investment proposal from scratch, which in turn accounts for significant cost and time savings for Robo-Advisory firms. On top of that, it ensures intuitive and guided self-direction and on the support side with 24/7 web-based support for handling issues.

Taking all these aspects together, even though Robo-Advisors charge much lower fees for their AuM, one account manager would only need to manage an average of € 48.8 million in order to cover the costs and operate viably in economic terms. This is less than half of what an advisor in an established Wealth Management firm needs. It is only possible because they operate in a very lean organizational structure, producing nearly 60 % lower costs than existing Wealth Managers by achieving significant cost savings in respect of personnel, operating expenses, and through digitalization (see Figure 2).

This results in continually growing cost pressure on established Wealth Managers and banks who must keep up with Robo-Advisors in order to secure their existing customers' loyalty and win new customers. As we expect the next generation of investors to be more open-minded for online investment advisory solutions, massive shifts of AuM in favor of Robo-Advisors are very likely. Wealth Managers therefore need to think of possible solutions to participate in this development in the near future.

Fig. 2 – Savings potential with Robo-Advisory in three pillars



Source: Deloitte Consulting GmbH

How to

In this context, it is wise to consider integrating Robo-Advisors or its functionalities into the business model of the incumbents with the goal of easing the cost structure and achieving notable savings. As we have pointed out, there are a number of factors that allow Wealth Managers to utilize Robo-Advisory in different ways to enable new or different revenue drivers and at the same time optimize the cost-income ratio for advisory business. The three options available are to cooperate, build, or create a platform. Introducing a fully integrated Robo-Advisory offering into the existing service offering should be seen as an add-on rather than a substitute to the existing advisory business.

Cooperate

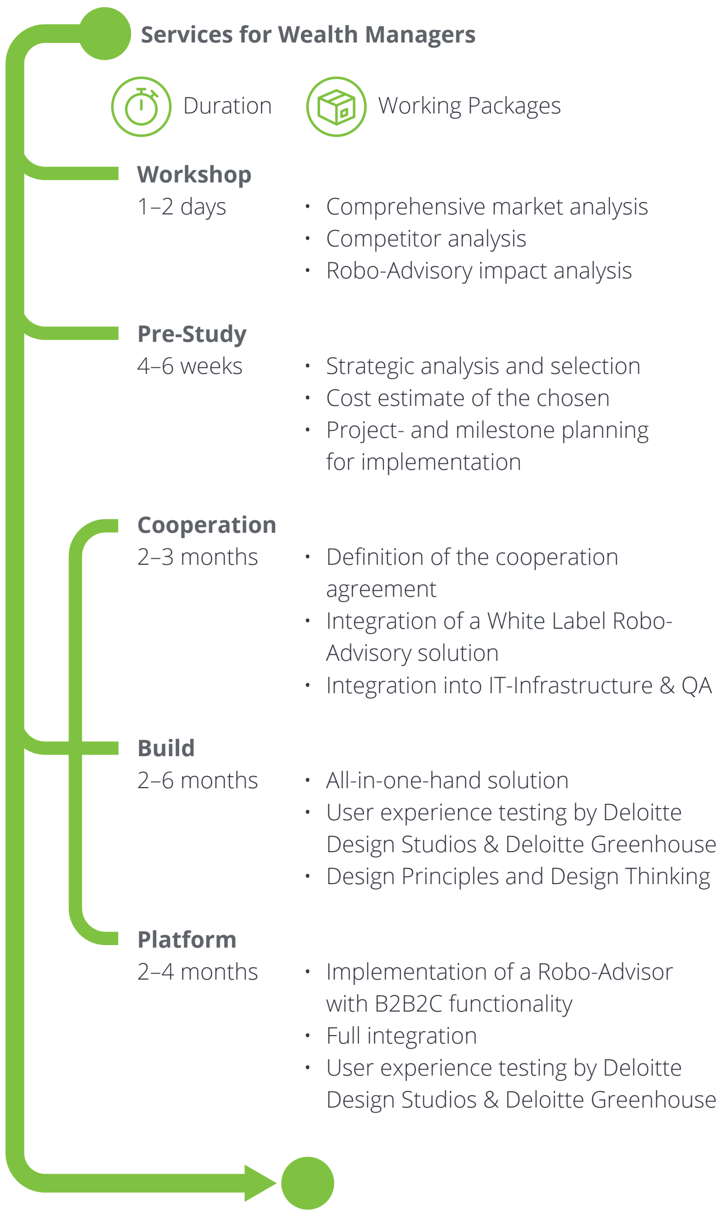
Wealth Managers can establish a partnership with an existing Robo-Advisory firm that may only offer B2C, but is also capable of providing its service as a B2B or B2B2C solution. The distinguishing factor when choosing a B2B2C or white labelling instead of a classic B2B offering is whether the Robo-Advisory brand will be visible (co-branding) or whether it is fully integrated into the bank or Wealth Manager. There are plenty advantages in buying an existing solution that has proven its B2C capabilities and some Robo-Advisors have already announced a number of cooperation agreements. Beyond pure technology, they can be easily attached to the existing infrastructure, e.g. through APIs. Another significant advantage of such a cooperation is the number of lessons learned that a Robo-Advisor can bring to the table, helping to build a successful Robo-Advisory offering that attracts not only existing customers. Often working with a small but specialized team, these companies know how to work with client data as well as with indirect feedback and act on it in a timely manner. However, one has to keep in mind that in most cases the integration of a Robo-Advisory solution requires additional implementation support. Robo-Advisory firms are not capable of fulfilling all the requirements needed to close a partnership with a bank or Wealth Manager and at the same time run their daily B2C business. Thus Robo-Advisors and banks alike prefer to cooperate with implementation partners. These on the one hand know how a bank operates and what requirements are needed to successfully implement a third party solution and, on the other hand, can cater for the much-needed freedom to implement a distinguishing offering.

Build
'Build' describes the in-house creation of a Robo-Advisory offering from scratch which is integrated into the existing infrastructure and in most cases uses the overall brand image. It is fair to say that building a Robo-Advisory offering is a tough challenge, as a number of factors are often overlooked such as design principles, customer approach and segmentation, customer support, to name but a few. The positive fact of building an offering directed at B2C clients is a high degree of customization, fitting into the existing IT-Infrastructure and target operating model (TOM) alongside the ownership of clients and their respective data, as this remains with the Wealth Manager.

Platform
Firstly, this might include the acquisition of a Robo-Advisor. On the one hand, buying an established player is a fast way to obtain a desired solution in a well-developed state as well as the relevant know-how to run the Robo-Advisor. Another and yet widely under-represented possibility is to leverage an existing platform. This can be based on either the purchase or cooperation idea and describes the approach of building a platform for B2C clients but at the same time opening up a B2C and B2B2C platform to local and international companies looking to enhance their existing advisory business through Robo-Advisory. Thus, a Wealth Manager can introduce a new revenue stream by allowing others to use the platform. While some do not like the idea of becoming a technology provider as they do not see the potential of anonymized client data, which as a whole can enhance the Robo-Advisory offering over time. This of course requires an environment in which such ideas can be tested and implemented with time being the most critical investment, a problem most banks and Wealth Manager face at the moment within their advisory business.

Introducing a Robo-Advisory offering using one of the above-mentioned categories is not the most difficult part. It is rather the approach and, once implemented,

Fig. 3 – Deloitte's modular concept



Source: Deloitte Consulting GmbH

the constant need for innovation that distinguishes an offering from the competition. It is therefore wise to partner with a company that has experience in working end-to-end with their clients rather than being a pure technology provider. Once a Wealth Manager understands the potential generated by adding a Robo-Advisory offering to the advisory business, it is important to analyze which specific needs the Robo-Advisor can address. This is why Deloitte has developed a modular concept (see Figure 3) that enables the gradual analysis and an approach tailored to the individual situation of each Wealth Manager.

Outlook

Although Robo-Advisory firms have not been in the market for very long, their impact is already visible. But how they will change the market in the long run is one of the most interesting questions. Which of the above approaches will be the most successful? The answer is rather simple – it depends. Like their customers, most Wealth Managers are unique. In some cases it might be wise to make a unique, best-fitting and customized Robo-Advisory offering, in other cases cooperation is more successful, but without doubt Wealth Managers will need to integrate Robo-Advisory in their service offering!

The need to integrate more cost-efficient service offerings and simultaneously satisfy changing client needs are the drivers of Wealth Managers that cannot be ignored. Robo-Advisory is the technology which can provide good services for a comparably low end-customer price and at the same time be the beginning of the introduction of lean and state-of-the-art banking technology. The trick is to choose the best approach to integrate this technology. Comparing, evaluating, and analyzing Robo-Advisory companies and their different business models is a complex task. To be able to show weak points in business models, user experience, and other crucial success factors, as well as finding the perfect match for Wealth Managers, Deloitte developed a scoring system which will be presented in the next Robo-Advisory in Wealth Management abstract.

Deloitte Consulting has a team of dedicated experts who will help you to examine the topic of Robo-Advisory in an interdisciplinary way and to position yourself for the future. Our dedicated consultants, scientists, and developers create meaningful insights, enabling clients to outperform their competition. Deloitte's breadth and depth of industry knowledge helps you achieve innovation not just once, but consistently over time. Working with Deloitte's Wealth and Investment Management practice, will help you to understand your opportunities in the Robo-Advisory space.

Deloitte services include:

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- Customer Analysis & Segmentation
- Customer Experience Strategy
- Business Strategy
- Product Leadership
- Applied & Predictive Analytics
- Data Security

In a nutshell, Wealth Managers who allow themselves to be prisoners of cost-saving topics, regulatory requirements, or are busy defending "the old way of doing things", will experience extremely tough times in years to come – being innovative is not a matter of extracurricular activity, but it is essential to survive. Bringing Robo-Advisory firms and Wealth Managers to one table to discuss the value added by joint use cases may be a real opportunity to take a first step into the future of a digitalized experience in wealth advisory services.

Contact us

Dominik Moulliet
Senior Manager
Financial Services Solutions
Tel: +49 69 97137 198
Mobile: +49 151 5807 1047
dmoulliet@deloitte.de

Julian Stolzenbach
Manager
Financial Services Solutions
Tel: +49 69 97137 179
Mobile: +49 172 1314 669
jstolzenbach@deloitte.de

Andreas Bein
Senior Consultant
Financial Services Solutions
Tel: +49 69 97137 190
Mobile: +49 151 58071 126
abein@deloitte.de

Ilma Wagner
Consultant
Financial Services Solutions
Tel: +49 40 32080 4531
Mobile: +49 151 5807 0336
iwagner@deloitte.de

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