To what extent will a “robo adviser” replace your financial adviser?

The wealth management industry has been subject to increasing pressure over the past few years, with an uncertain economic outlook, low-rate environment, and rising regulatory requirements. While compliance costs are raising the bar for new entrants, technological breakthroughs are simultaneously lowering these and enabling market disruption.

The fastest growing segment of the wealth management industry is now online and referred to as “robo advisory services”. The assets under management (AUM) of this segment are expected to grow by 2,500 percent by 2020 to reach a potential market value of US$489 billion⁽¹⁾.
The “robo adviser” buzzword is promising disruption in the wealth management industry, especially as the leading eleven pure robo advisers have seen explosive growth since market entry. They further increased their total AUM by 11 percent over the first six months of 2015 (to a total of US$21 billion) after growth of around 65 percent during the previous eight months leading up to the end of 2014\(^2\). Even if these new market entrants are still nascent and represent a negligible amount relative to the US$25+ trillion retail investable assets in the United States\(^3\), the top five robo advisory market actors in the United States already represent US$34 billion AUM in early 2016\(^4\).

In order to understand the extent to which these new solutions may replace the traditional financial adviser, we will describe their various roles as imagined by their founders, and unveil the range of actors tagged as “robo advisers”. Details on the scope of their services will enable us to highlight their current range of coverage within the wealth management value chain. We will also provide an overview of both US and European robo advisory markets, so as to identify the reasons for success and main challenges in this fast-growing, disruptive market. We will conclude by outlining the impacts and opportunities of this trend for incumbent actors and the wealth management industry at large.

**Robo advisers aim to independently replicate many of the activities performed by wealth managers through online access, and (supposedly) at lower cost.**

To better understand what robo advisers are, it is necessary to bear in mind that the financial industry is still suffering from a great lack of trust on the part of individual investors. This is a fertile ground for providers of new solutions claiming to empower the investor with the offer of full transparency and greater efficiency combined with significantly lower costs. Technology has made this possible through fast-growing, multi-channel online tools, and robo advisers are taking advantage of this situation to claim their place among the finance and investment professionals.

**Wealth management services were usually reserved for high net worth individuals, sometimes extending to the mass affluent segment.**

Robo advisers are targeting a broader customer base, including mass affluent and retail investors, and are continuously lowering the minimum amounts of funds required (some robo advisers are accessible with no minimum investment amount).

**Private bankers were used to meeting clients in muted private rooms.**

Robo advisory services are leveraging online and mobile channels to interact with customers 24/7, providing access to financial information on demand and delivering added-value services anytime and anywhere.

**Financial investments used to lack transparency.**

Robo advisers claim investor empowerment while making the tools used by incumbent actors available to mass investors, thus increasing the visibility of clients regarding how their money is invested.

**Management fees were eating up clients’ financial gains.**

Robo advisers are offering automated management services at low or no cost. Fees on AUM are reduced (but the spread remains significant, mostly between 0 percent and 0.85 percent) and Exchange-Traded Funds (ETFs) are widely used in order to reduce fees.
The term “robo adviser” covers a wide range of financial FinTechs.

Whether in New York, London, Luxembourg or Amsterdam, FinTech events showcasing the trends and innovations of financial and banking technology give FinTech seeds the opportunity to broadcast themselves to investors and potential clients. Many of these are tagged as “robo advisers”, but their service offerings can be very different from one another, resulting in various business models.

The core model of the “robo adviser” galaxy is based on the use of algorithms rooted in traditional Modern Portfolio Theory (MPT), financial analysis and analytics to develop automated portfolio allocation and investment recommendations tailored to the individual client. This is the predominant form of robo advice in the United States. It may be extended to discretionary asset management services and include automated rebalancing. Users continue to benefit from online, multi-channel access to monitor the evolution of their portfolio and the performance achieved.

Another fast-growing B2C robo advisory segment in the US market is the “hybrid advisory”, which combines robo and human advisory services. Famous names such as Vanguard and Charles Schwab are market leaders in this segment. Personal Capital, funded by BBVA ventures and Blackrock among others, also offers the possibility to contact a human financial adviser in addition to the robo advice functionalities. The recipe for asset allocation remains the same: extensive use of ETFs to benefit from low fees and diversification.

The scope of robo advisory tends to also encompass social trading platforms, algorithmic trading solutions and data analytics players, with a variety of brand-new solutions following the hype for automated forms of investment advice. B2B platform solution providers represent the third main segment of this new galaxy of FinTechs. Further developing their model, some actors have expanded their B2C solution of automated investment advice and discretionary asset management to also offer a B2B platform solution for professional actors, such as banking institutions and independent financial advisers. Other providers only offer white-labelled, automated advice and investment management solutions as a service for financial institutions. These toolkits enable professional players to easily and efficiently launch a digital wealth platform for their own end-user investors.

“Robo advisory” services are continuously evolving

In theory, robo advisers offer to leverage client information and algorithm-based portfolio management to develop automated portfolio allocation and investment recommendations tailored to the individual clients. This follows a clear, digitalized process:

- Prospects go online to define their profile: some financial planning elements are requested from investors to define an initial investment amount, regular payments and investment horizon. This is followed by an online questionnaire to collect the financial characteristics of the investors, as well as to assess their risk profile and field knowledge
- Based on this risk profile, a proprietary algorithm is run, based on MPT investment and diversification rules, to define the best-suited, personalized allocation (including diversification) to minimize risk and maximize performance
- The resulting investment recommendation is displayed online, on demand, for the future clients to visualize the potential gains and losses of the proposal, offering an on/off-track visual of their savings/investment objectives, as well as a more or less detailed composition of the proposed portfolio with exposure levels and target underlying securities.

The empowered investor can then accept and proceed with an online fund transfer/account opening. The robo adviser will provide discretionary management services steered by the risk profile/investment allocation selected. The majority of funds will be invested in low-expense ETFs also enabling diversification.

Robo advisers are extending their service offering in order to differentiate themselves from numerous competitors. In addition to the discretionary management services described above, additional paid investment advice can encompass an “active” advisory offering that provides more regular rebalancing proposals than “passive” quarterly reviews. Such services may also trigger additional fees. Several players are also offering financial account aggregation services, with the aim of providing a holistic view and therefore better tailored advice.

Innovation further came with tax-related functionalities that are now often a set catchphrase on many actors’ websites. Tax strategy is detailed for the investors, describing the options they have to select, as well as rules and priorities in selling their assets for generating gains or losses from existing positions, with the aim of optimizing tax payments. These
tax harvesting features have now been replicated by a number of robo advisers and are integrated into the “common” service offering of these online financial actors. An additional set of services included in the offerings dedicated to individual customers is related to risk analysis and value-at-risk considerations, while investing in specific themes is another developing trend.

B2B platforms are providing integrated online wealth management plug-and-play solutions, enabling them to offer standard robo advisory features with automated digital workflows (e.g., four-eye checks), investment recommendations, and electronic signature features. Pattern configuration according to the own philosophy of the financial adviser may also be provided, or this may be done through module selection for the D2C interface.

**Market overview in the United States and Europe**

The United States currently rule the robo advisory market, with certain solutions dating back more than 10 years and two clear B2C leaders: Betterment and Wealthfront, created in 2010 and 2011, respectively. They each claim to have around US$3 billion in AUM, with a slightly higher figure for Betterment. Their B2C offering is very similar and includes all the robo advisory basics: digital client onboarding and investor risk profiling, automated investment advice through algorithm-based allocation, discretionary management based on extensive use of ETFs and automated rebalancing. Their product offerings include individual retirement accounts (IRA), taxable accounts and trusts, and they both offer tax harvesting services as well, so as to minimize capital gains when withdrawing invested funds. While Wealthfront appears to be offering enhanced tax optimization services for accounts above US$100,000, Betterment focuses on its financial planning and brand-new financial account aggregation services. The former offers a more beneficial fee structure for small-sized accounts with free services below US$10,000 and a single 0.25 percent management fee above that figure, whereas the latter charges a similar scaled management fee that decreases as AUM increase, from 0.35 percent to 0.15 percent for accounts above US$100,000. The only additional costs incurred are associated with the ETF fees, declared to be 0.12 percent on average for the first solution, and ranging from 0.09 percent to 0.17 percent for the other. Numerous smaller players have entered the market with the support of venture capital, but none has currently reached a similar level of expansion and AUM. Many are charging fees on AUM, some are offering basic services completely free-of-charge (such as WiseBanyan) and charging for advanced services only, while others may charge additional setup and transfer fees, monthly flat fees, brokerage and custody fees.

Hybrid advisory solutions, which combine robo with human advisory services, are also expanding fast. By order of AUM volume, these are Vanguard Personal Advisor Services in the lead (about US$21 billion), followed by Charles Schwab Intelligent Portfolios (about US$5.3 billion) and Personal Capital (US$2 billion), the latter being funded by BBVA ventures and Blackrock among others. These actors have a proven track record in asset management and differentiate themselves by offering investors a possible contact with human advisers.
The investment threshold is significantly higher, starting at US$5,000 at Charles Schwab and reaching US$50,000 at Vanguard. The former charges no advisory fee, while Personal Capital charges 0.89 percent below US$1,000,000. Less harmonized than the two pure robo advisory offerings, these players may not be targeting the exact same clientele.


The European robo advisory markets are not yet saturated in comparison with the US maturing market, and have not reached the same level of maturity, especially as the service offerings appear to be very dependent on the country in question and local regulations.

The UK market is the fastest developing center for robo advisory in Europe, perhaps partly due to the local legislative evolution toward unrestricted access to pension schemes effective from 2015. Individuals can access advice for the management of their assets, but do not need to ask incumbent wealth management actors and engage related fees. As such, the same digital automated advice and discretionary management at lower cost applies, based on risk profiling and investments mostly directed to ETFs and funds. Nutmeg leads the UK market and now advertises on TV. Specialized in individual savings accounts and pensions, the service is accessible with just £1,000. No brokerage service is available, but bulk orders are placed during trading windows to keep costs down and pass savings on to the investor.

Other robo advisers are targeting the UK expanding market, such as the Italy-based firm MoneyFarm, which raised around €16 million in November 2015 to accelerate its entry into the UK market, scheduled for the spring of 2016. This solution also offers automated rebalancing based on the decisions of its investment committee and brokerage services. With more than 50,000 active users in Italy, it speaks for the flourishing B2C robo advisory market in Europe. Several FinTechs have also been launched in France recently, mainly oriented toward individual investors. Some interesting seeds are offering aggregation of insurance contracts for global risk assessment and recommendations, or investment recommendations at securities level. The market is still too young to validate these expanding models, but most of the offerings are related to French life insurance investment products.

Belgium-based Gambit Financial Solutions, a provider of solutions in investment advisory, portfolio optimization and risk management, already servicing a number of major European actors in private banking and asset management, has extended its offering toward automated advice with Birdee Institutional. This online and discretionary management solution, which includes visual portfolio management and robo advisory services is designed for private banks and retail banks targeting the mass affluent segment. Gambit also recently announced its willingness to market a dedicated robo advisory solution for individual investors in the near future, but the priority defined in launching their offering may underline the potential trend in the market: a growing interest in solutions offering a white-labelled platform to be tailored to incumbent actors’ needs. And among European B2B/B2B2C platform solutions, many of which are still seeds at the moment, another UK-based FinTech called WealthObjects is targeting private banks and investment firms with a digital platform that provides modules for automated investment and financial planning supported by an omni-channel, automated workflow to handle client onboarding and enhance the digital D2C offering.
Challenges and evolution of the robo advisory market

Key characteristics of the robo advisory market include accessibility, convenience, transparency and control, in addition to a personalized service at low cost, which implies having a large customer/AUM base to generate profit. This may soon give rise to sustainability challenges currently looming over the horizon in the robo advisory market. Perhaps the hype has blown over or the market is simply maturing in the United States, and while growth in AUM continues, its pace is decreasing, as shown by recent figures published by The Economist (7).

The flagships of pure robo advisory, Betterment and Wealthfront still have to increase in size to confirm sustainability. Each of them has raised over US$100 million in venture capital over the past years to launch their offering and attract investors, but the increased share of players like Vanguard and Charles Schwab does indicate that it may be tough for them to further expand to a profitable model. The client acquisition cost will be critical for all actors, in particular while targeting the mass affluent to retail segments with low-cost offerings. Fees on AUM will probably not be further reduced, as they represent the basis for revenues; therefore, it is more likely these players will charge fees to cover the additional services developed and offered as differentiators.

The consolidation occurring on the US market will probably intensify. The third pure robo advisory player by order of size is FutureAdvisor, with about a fifth of AUM in relation to the two leaders. It was acquired by Blackrock in August 2015 for an undisclosed amount rumored to be as high as US$150 million. It was stated that the solution would “operate as a business unit within its BlackRock Solutions technology platform” and “continue to serve existing clients”. On the B2B segment, the Jemstep platform solution was acquired by Invesco Ltd on 12 January 2016.

Robo advisers will also come under tougher regulatory scrutiny. These digitally-enabled market entrants are very young on the market, and their role and scope is evolving very quickly. Nevertheless, they are obliged to comply with the existing regulations of the countries in which they provide their services, just as incumbent actors must comply with registration requirements, especially regarding the provision of financial advice. In the United States, individuals or firms who receive compensation for giving advice on investing in securities are deemed to be investment advisers and must be registered investment advisers (RIA) with the Securities and Exchange Commission or an individual US state’s securities agency. Similar rules are in force in the United Kingdom (FCA authorization), France (AMF registration), Luxembourg (CSSF authorization and supervision), and other European locations where the MiFID obligations apply (in addition to compliance and internal audit provisions).
requiring firms to act in the best interests
of the customer and to assess investment
suitability), as well as other country-
specific regulations depending on the
investor’s country of residence.

The ESAs (European Securities and Markets
Authority (ESMA); European Banking
Authority (EBA); and European Insurance
and Occupational Pensions Authority
(EIOPA) provided a discussion paper on
automation in financial advisory services
in December 2015, and will probably issue
further guidance on procedures to be
applied within the robo advisory industry.
While new players in Europe are mostly
accepting Europe-based investors, some
are restricting their offering to country-
specific clients, but in all cases FATCA
regulation constraints will also have to be
checked. Further regulations governing
the funds industry, such as the UCITS
and AIFMD directives, will also have to be
followed, in particular given that the
automated advice and discretionary
management model of robo advisory is
generally based on the use of mutual funds
and ETFs investments.

While recent news indicate that US
agencies are looking at certain actors
to confirm that appropriate controls
are in place and advice is unbiased, it
is noteworthy that the online investor
risk profiling process requires just a few
minutes and is completed by the individual
alone, with no guidance from a qualified
professional. Without discussing whether
robo advisory solutions run the risk of
making investment recommendations
based on faulty information or wrong
assumptions, this gap is nevertheless
obvious given the reinforcement of
Investor protection set out by MiFID II for
investment firms, and thus the fairness in
the treatment of these actors can be put
into question. Reporting duties, including
loss reporting and execution venues, may
also be challenging for new players. As for
the nature of investment advice (whether
independent or not), the algorithm-based
solutions do not always detail the type of
market analysis their recommendations
are based on. As robo advisers claim
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However, while transparency is at stake
and MiFID II regulation prohibits
inducements, the growth of robo advisory
is putting into question the intrinsic value
of financial advice. Market orientation will
be key in reshaping the industry: a war on
prices would further threaten revenues
for both market entrants and incumbent
actors. For this reason, an enlargement of
the offering may well happen in the near
future, and the perceived value of services
delivered will be key in retaining clients and
pricing services.

Lastly, B2B platform providers are
not subject to the same regulatory
requirements as financial advice providers
and banks are looking for solutions that
are compliant with an ever increasing
regulatory framework in order to avoid
costly developments on their legacy
systems. Considering the B2B platform
offerings launched recently or being
launched as seeds, as well as the
acquisitions that have already occurred
over the last months, the B2B/B2B2C
segment might be the most active in the
near future.
Key opportunities and challenges for wealth managers and investment advisory service providers

- **New market entrants:** agile, flexible and non-bank players are entering the wealth management and advisory services market without the need to maintain heavy banking infrastructure, as opposed to incumbent players. Independent financial advisers could see both opportunity and risk in the emergence of direct B2C competitors, but also in the issuance of alternative B2B solutions to support their activity.

- **The mass affluent market,** which had become an expansion area of the wealth management industry in the past years, may be significantly attracted by online players and automated solutions through the commoditization of high value services (tax loss harvesting, financial accounts aggregation, etc.)

- **Business models are expected to evolve** due to intensified competition and a shift to lower cost asset management and financial advice, thus requiring industry players to focus on the most value-added services that require human expertise.

- **Service offerings will be globally enhanced** as low-cost robo advisory services reshape customer expectations regarding their traditional wealth management and advisory services, leading aging banks to include similar digital features into their offering.

- **The organizational impact** of service and relationship digitalization implies a review of the front office, both for multi-channel offerings and for the relationship manager role. The digitalization/automation of operational processes will also impact the digital strategy of existing actors and their human capital.

- **Investment management companies** may also reduce the need for intermediaries to distribute their products while including robo advisory services. Providers of **white-labeled platforms for automated advice and investment management solutions** therefore appear to be the most suitable targets for acquisition and integration in the short term.
What are the next steps for incumbent market players?
They must choose their positioning and make their selection within a range of strategic options:

- Ignoring the opportunity at first and focusing on servicing UHNWI and HNWI who require higher added-value services tailored to specific needs, while the robo advisory market matures, taking into account the risk of positioning as a late-comer
- Developing an in-house robo advisory solution to leverage internal expertise, architecture and resources. This should reduce the existing cost base for providing discretionary services to the mass affluent segment
- Acquiring a robo adviser at a fair price; this offers growth potential in relation to the firm’s strategy and digital IT roadmap. It could also enable it to serve a new fringe of customers at lower cost
- Partnering with an existing robo adviser to take advantage of this digital trend and its services in order to capture younger tech-savvy investors who may become the core clientele of tomorrow.

Incumbent actors may take advantage of inevitable market consolidation to integrate robo advisory services into their offerings and technologies.
Conclusion

- Robo advisory solutions are digitalizing and automating client onboarding, investor risk profiling, and investment allocation through algorithm-based assessment, providing online investors with on-demand access to financial advice.
- B2C solutions provide online discretionary ETF-based portfolio management at lower cost, including automated rebalancing and tax harvesting. B2B white-labeled platforms offer toolkits to quickly create bespoke D2C digital platforms for automated advice and investment management solutions.
- Robo advisory services have been maturing in the United States, where pure B2C robo advisers are facing increased competition from hybrid advisory players within the asset management industry. Development on European markets appears very dependent on local country-specific legislation and many FinTechs are still at seed or validation level.
- B2C robo advisers need to validate their business model to secure revenues and become profitable and sustainable, especially as the regulatory burden is expected to further increase, as highlighted by ESMA’s recent discussion paper on automation in financial advisory services. B2B offerings are further expanding and triggering the interest of major actors from the industry, with several buyouts having been completed.
- Incumbent actors may take advantage of inevitable market consolidation to integrate robo advisory services into their offerings and technologies. The perceived added value of service offerings is more than ever at stake, and offerings should be reshaped so as to highlight higher value services. Their pricing may evolve from an all-in fee to individual service selection in order to answer personalized needs and demands for transparency.
- Finally, big data analytics providers may further disrupt the offering through ad hoc automated advice that answers specific investment needs or questions. Major players from both the finance and big data sectors are funding such B2B solutions designed for global banks and hedge funds that already serve institutional customers in the banking industry and state securities agencies, among others. The players combining their experience in the wealth management industry with new technology solutions supporting automated advice and the omni-channel experience could be the future market leaders if they are able to leverage the data available on the market.

Sources
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