The Future of Robo-Advice

By Joe Mansueto   *Thu, Mar 31, 2016*

'I'd love to see several of the start-up robo-advisors thrive in the coming years. But most face serious economic headwinds,' writes the founder and CEO of Morningstar, Inc.

Many people often ask me what I think of robo-advisors—the many automated investment management sites that have emerged over the past few years. On the investment side, robo-advisors aren't breaking new ground. What impresses me, though, is what they have done with user engagement.

They've created compelling user interfaces that are written in a friendly, casual voice with clear explanations. They make investing more accessible and less intimidating. I'm a design fan, and many of these offerings have done an excellent job with it. They've made investing more enjoyable and easier to fit into your digital life.

Is this another instance of technological disruption that will render a profession (financial advisors) obsolete?

I don't think so. Robo-solutions work well for those early in their careers when their financial affairs are often simpler. As people age, their financial lives inevitably become more complex—there may be a divorce, a special needs child, care of elderly parents, insurance needs, annuities, housing assets, social security, estate planning, and other factors to consider.

At that point, people highly value working with a financial advisor who can put together an appropriate financial plan. It's hard for a computer algorithm to take into account the multitude of possible individual situations and create a plan in a way that engenders trust. By Morningstar estimates, the value of financial planning is significant—it can provide an additional 1.6% of return per year.

There's also the emotional and behavioral aspect to investing. If the market plunges, investors often want to speak to someone. Logging on to a website and interacting with an online tool may not suffice. The future of the financial advisor is secure and arguably more important than ever.

That said, robo-advisors are good for the investment industry and here to stay. They've put people into sensible portfolios that are low-cost and diversified with regular rebalancing. They should produce reasonable, index-like returns over time. It's not revolutionary, but does fill a market need. Many investors who use these services have few alternatives. They have low account balances that are too small for financial advisors. Robo-advisors can step up to fill the advice gap and get people investing earlier in their careers.

Over time, robo-advisors may add financial planning capabilities with artificial intelligence features to enhance their appeal. We'll see them evolve to hybrid solutions that incorporate licensed advisors into their solution via phone and video. One example of a robo-advisor doing this today is Personal Capital.

We'll also see financial advisors use robo-tools to manage their smaller accounts. Instead of being harmed by technology, financial advisors can turn the tables and leverage it to expand their practices. We'll increasingly see robo-technology built into advisor platforms and asset management firms offering robo-solutions to their distribution partners.

Over time robo-advisors will add financial planning capabilities to move up to larger accounts, and financial advisors will add robo-tools to move down to smaller accounts. The sweet spot may well be the hybrid solution that integrates robo-tools with licensed financial advisors.

I don't think pure robo-advisors will replace financial advisors any time soon. It reminds me of the introduction of no-load (no sales commission) mutual funds in the 1980s. Common wisdom was that their cost advantage would enable them to take over the fund industry. But investors voted with their feet and sought to work with financial advisors. Funds sold through advisors became dominant while no-load funds sold direct to individuals languished. Robo-advice is also reminiscent of online banking in the 1990s. Many start-ups emerged. But who dominates online banking today? The big firms—Chase, Wells Fargo, Bank of America. Scale is a large advantage.

You can see that pattern starting to form from the fourth-quarter 2015 asset levels of robo-advisors, according to *Investment News*:

- Vanguard, $31.0 billion
- Schwab, $5.3 billion
- Betterment, $3.3 billion
- Wealthfront, $2.8 billion
- Personal Capital, $1.8 billion

Even though Vanguard and Schwab entered the market after the other three firms on the list, they quickly sprinted to the top of the charts. That gap will only widen in coming years.

Stand-alone robo-advisor firms face a challenging future. Morningstar equity analyst Michael Wong wrote an insightful research piece about robo-advisors last year and concluded that stand-alone firms will need $16 billion to $40 billion of net assets to break even. That's far from today's asset levels for these firms.

Moreover, Michael estimates that it will take tens, if not hundreds, of millions of marketing dollars to raise sufficient assets. He estimates a $1,000 cost to add a new account, after factoring in attrition, and up to a decade to recoup marketing costs. It will be hard for robo-firms to self-finance their growth.

Firms that already have large customer bases have an overwhelming advantage. Charles Schwab has $2.5 trillion in net assets, and TD Ameritrade has $700 billion. Converting a small fraction of these dollars to a fee-based account is far easier than the challenge of a stand-alone robo-firm spending millions to attract new clients.

So the long-term viability of most pure-play robo-advisors is in doubt—especially as Schwab and Vanguard enter the fray. Pure-play robo-advisors will need a large amount of assets under management to turn a profit with low fees. The marketing spend to get there may not make economic sense, though. I believe many hope to exit by selling to a strategic firm. We've seen Blackrock purchase FutureAdvisor, Invesco purchase Jemstep, and Interactive Brokers buying Covestor.

I am a big believer in automated advice—Morningstar's been a "robo-advisor" for more than a decade, though one selling investment services through an employer's retirement plan. Today, we manage more than one million retirement accounts with assets of more than $40 billion. So automated advice works, it scales well, and is a terrific way to service many smaller accounts. Our advantages are a trusted brand and lower distribution costs because we sell through retirement plan providers and plan sponsors.

Morningstar has also invested in Sallie Krawcheck's Ellevest, a start-up that focuses on meeting the investing needs of women through an automated investing offering. Sallie is an investment industry star with a large following among her women's network, more than one million LinkedIn Influencer followers, and regular media appearances. The combination of Ellevest's unique focus on women with Sallie's stellar reputation should prove a winner.

I'd love to see several of the start-up robo-advisors thrive in the coming years. But most face serious economic headwinds. They'll need to evolve their offering to incorporate more financial-planning capabilities (either licensed advisors or automated financial planning) and find creative ways to lower client acquisition costs.

They'll also need to find ways to develop an economic moat—or sustainable competitive advantage—to thrive in the long run. They must develop scale to drive cost advantages and create meaningful brands as intangible assets.

If they can do these things, they'll have a shot at success. While robo-advice may have a good future, the incumbent brokerage, advisory, and banking firms are much better positioned to reap its benefits.

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