Two Robo-Advisors, Two Income Strategies

By Kerry Pechter *Mon, Nov 10, 2014*

Two robo-advisors, Betterment.com and SigFig.com, have retirement income generating functionalities. But are they robust enough to put an advisor with retirement income training out of work? Read and judge for yourself.

While the greybeards of the retirement industry struggle to migrate from product cultures to planning cultures, the new generation of so-called robo-advisers has cherry-picked their best practices and focused on the *process*—the web-mediated delivery system. And their growth has alarmed the incumbents.

So far, robo-advisers have been lacking in the area of retirement income planning. Perhaps because retirement isn't yet a top-of-mind concern for their target market, or because income plans can be too complex or idiosyncratic to automate, the robos have fed mainly on the lower-hanging fruit of aggregation and asset allocation services.

But that's changing. Last spring, Betterment.com, the online broker-dealer and registered investment adviser that now partners with Fidelity, has a payout function. Just this month, SigFig.com, a smaller firm, also announced a payout function markedly different from Betterment's.

RIJ recently visited these firms' websites and talked with their principals. The big-picture takeaway: Advisors who are glorified salespeople have a lot to fear from robo-advisers. Serious retirement specialists who know how construct custom plans out of combinations of safe income sources and risky investments will be far less vulnerable.

Income and wealth preservation

San Francisco-based **SigFig**, launched in May 2012, added a retirement payout function to its asset allocation and portfolio tracking functions this month. To access it, just go to the site and click on the Diversified Income button. If you answer a question or two about yourself, SigFig provides a model portfolio.

For a hypothetical 62-year-old retiree, SigFig's wizard recommended an all exchange traded funds (ETFs) portfolio of BlackRock iShares (see chart). Built for income, it has an equity-to-fixed income ratio of about 35:65. The equity ETFs focus on dividend-paying stocks. The bond ETFs reach for yield through higher-risk bonds, longer-maturity bonds, or attractively priced mortgage-backed securities.

%	Asset Class	Investments	Estimated Amount
5.9%	Mortgage-Backed Securities	MBB iShares Barclays MBS Bond	$590.00
12.5%	US Treasuries	TLT iShares Barclays 20+ Year Treas Bond	$1,250
6.6%	US Treasuries	TLH iShares Barclays 10-20 Year Treasury Bd	$660.00
11.7%	Credit	CLY iShares 10+ Year Credit Bond	$1,170
28.2%	Credit	HYG iShares iBoxx $ High Yield Corporate Bd	$2,820
5.0%	Equity	PFF iShares S&P U.S. Preferred Stock Index	$500.00
9.9%	Equity	IDV iShares Dow Jones Intl Select Div Idx	$990.00
20.2%	Equity	HDV ISHARES CORE HIGH DIVIDEND E	$2,020

That fund is intended to provide income while preserving principal. That's a worthy objective, but it may not help clients who need to maximize income from savings or fill gaps between income and expenses. Interestingly, the similarity between SigFig's 4% target and William Bengen's famous 4% safe withdrawal rate is coincidental, SigFig founder Michael Sha told *RIJ*. SigFig clients can choose to receive regular checks in any amount they wish.

SigFig sees its Dividend Income portfolio as a big improvement on the imbalanced, high-cost portfolios that many of its new clients arrive with. "Healthy portfolios need proper diversification across asset classes, and retirees need portfolios that are risk-appropriate and that keep fees as low as possible," Sha said.

"Older investors who are seeking income, they're not getting those things right. So we created a mixed portfolio. We think it will generate a yield that's twice as high as bonds with only a little more volatility."

The portfolio requires a minimum deposit of $100,000 and costs 50 basis points a year in addition to average ETF fees of under 20 basis points a year, and uses a dynamic asset allocation technique that buffers volatility by moving money into bonds as volatility increases and into stocks as volatility drops.

A SigFig phone rep pointed out that retirees would pay as much as 1.10% a year for the same portfolio, plus underlying ETF expenses, if they buy it from BlackRock through Fidelity Investment's online **platform**. For that service, BlackRock requires a $200,000 minimum investment, double SigFig's requirement.

"A lot of firms focus on Millennials and other younger segments of the industry, but we have a healthy chunk of users who are older," Sha told *RIJ*. "Over half of our clients are over 40 and lots are in their 50s and 60s."

A fluctuating income stream

Betterment.com, an online broker-dealer and registered investment advisor with about 50,000 registered users, offers retirees a balanced portfolio from which they can draw a fluctuating income that has a 99% chance of lasting, not for life, but for however many years the client chooses.

Like SigFig, Betterment isn't trying to win medals for customized income generation. "This is not a soup-to-nuts retirement income plan at all," said Alex Benke, CFP, product manager at Betterment. "This is about delivering on a need that we hear about from our retirement customers. They always ask us, 'I have x amount of money. How much should I take out each year?' We had no good answer to that question, so we built this model." More than 20% of Betterment's assets come from people who are over 50, he told *RIJ*.

"Margaret," a hypothetical Betterment client

Margaret is a 65-year-old college professor, and she is likely to live to age 85 based on her family history and health. Using Betterment's income service, her $500,000 Roth IRA is allocated for a 20-year time horizon at 56% stocks and her expected monthly withdrawal this year is **$1,941**—an annual rate of 4.65%. She also has income from Social Security, a pension, and 401K.

If the markets go up: In the first year, her Betterment portfolio grows by 7% and her new balance is $510,000 even after a year of making withdrawals. She's a year older, however, and now her new recommended allocation is slightly less risky. Her monthly withdrawal rate will now be about **$2,062** (4.04% of the new portfolio balance, but about 4.12% of the original value).

If the markets go down: If the markets were down 7%, her new balance would be $443,350 after the withdrawals. The new withdrawal rate will be **$1,791** per month, or $150 lower than the original starting withdrawal amount, and 3.52% of the original value.

Although the withdrawal amounts do change depending on Margaret's portfolio performance, her average withdrawal over 20 years is expected to be around **$2,503** assuming an average market return of 6%. This dynamic withdrawal strategy virtually guarantees that her capital will last for the full 20 years. Every retiree can customize his or her time horizon.

At the Betterment website, a new client indicates his or her age and retirement status (Yes or No) and the underlying software generates an asset allocation. For a hypothetical retired 62-year-old, the algorithm recommended a 56% stock/44% bond portfolio. "Our typical recommended asset allocation for people in their mid-60s is about 50% to 55% stocks and 50% to 45% bonds," Benke said.

To learn their safe withdrawal rate, clients enter their specific account balance and the number of years they want to plan to receive income. Using a stock/bond slider, they can also indicate their equity risk appetite. Betterment then calculates a payout rate with a supposed 99% chance of lasting for the period. Alternately, if client chooses his or her own withdrawal rate, Betterment will estimate its sustainability.

Betterment uses a customized version of the 4% rule. In one example on the Betterment website (see “Margaret” at left), 4% is the initial withdrawal rate for an anticipated 20-year payout period. Each year, however, the income payment is adjusted up or down, depending on changing market factors and the client’s rising age. Betterment credits **Vanguard** and **J.P. Morgan** as the sources of its dynamic adjustment method, but claims to be the only place where an investor can apply that method to a live portfolio.

“Our strategy is to take a total return approach. The income from dividends will be about 2.5%. The most of the rest of the withdrawals will come from interest or growth. We’re also minimizing taxes through tax-harvesting,” Benke said. “Using an automated selection algorithm, we check the accounts every day. If we see anything in a loss, we sell it and buy an equivalent ticker in order to avoid violating the wash sales rules.” Tax harvesting alone adds an estimated 77 basis points to Betterment’s returns, he added.

Betterment’s prices are even lower than SigFig’s. Investors who bring $100,000 or more pay 15 basis points per year, plus another 17 basis points or so for the underlying ETFs in the recommended portfolio. There’s no extra charge for using the retirement income service. Prices are a bit higher for smaller accounts: 25 basis points a year for deposits between $10,000 and $100,000, and 35 basis points for people with less money who agree to contribute at least $100 per month.