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INVESTMENT ADVISORY

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Robo-Advisors: What are your objectives?

Robo-advisors **seem to be the talk of the financial world at the moment. Type the term into an internet search engine and you'll see scores of articles on the subject. They also seem to be a major theme of just about every conference in the advisory sector nowadays.[1] But what are they and do they work?**

A growing market

Automated investment advice platforms – or *robo-advisors* – are websites on which you log in, answer some questions about your financial situation, objectives and priorities. Then, on payment of the fee, the system uses algorithms to give you advice on how and where to invest.

The upside to these websites is that they are relatively easy to use and offer tools to build and manage a diversified investment portfolio.[2] To see how your investment is doing and manage it accordingly, all you have to do is log on to the website and click to the right page. With the machines doing the calculations, this can cost a lot less than the services of a human advisor.

With those advantages, it may seem like we are in the midst of a revolution in the investment advice sector. In fact, 2014 appeared to be the breakthrough year for robo-advisors, as each quarter saw new websites raise increasingly larger sums of money.[3] By the end of January this year, the largest of these, *Wealthfront*, raised USD 130 million.

¿Hasta la revolución?

Not bad; yet this is actually miniscule when you compare it with the big players, who spend more than double that figure on marketing alone.[4] Collectively, robo-advisors managed less than USD 20 billion in assets at the end of 2014;[5] whereas, by the end of June this year, total retirement assets in the US were up to USD 24 trillion. So if a revolution is rally on the cards, it hasn't happened yet.

[1] http://www.cnbc.com/2015/10/19/is-the-future-for-robo-advisors-bright-or-a-bust.html

[2] *ibid*

[3] http://techcrunch.com/2015/01/27/will-2015-see-the-death-of-the-robo-advisors/

[4] http://www.ft.com/intl/cms/s/0/8832a6d4-5b05-11e5-a28b-50226830d644.html#axzz3sNa2Dhr3

[5] Corporate Insight

Of course that doesn't mean it never will – one market analyst[6] forecasts that robo-advisors will manage USD 300 million by the end of 2016 and USD 2.2 trillion in the US by 2020.[7] One other sign of a product making an impact is when the big players buy the smaller ones to use their technology – in some cases, this has already happened.[8]

Meeting investors' needs

Nevertheless, there is a danger that investors use these websites as a replacement for other investment strategies. Somewhere up to 94% of the difference in portfolio performance is driven by asset allocation.[9] That means looking at which kind of asset to own (the proportion of stocks, bonds, cash etc.), as opposed to stock picking (whether to own shares in particular companies, when to sell them to maximise returns). There are many people in the investment sector who do not focus on asset allocation[10] – thus not tracking that 94%. As robo-advisors offer advice on the premise that investors want to manage their own portfolio, they merely continue this mis-allocation of resources and may even be driven by conflicted interests.

Robo-advisors then recommend portfolios using little basic knowledge of their situation: some only ask four questions to determine risk tolerance and financial objectives.[11] Consequently they have no idea why you're investing and what your priorities are. Financial planning is something which is constant – it has to adapt to your life, so your plans and needs may change overnight; yet you've already answered the four questions.

Not only do investors' lives change but the markets move too – and for many different reasons. Many robo-advisors use modern portfolio theory[12] – i.e. attempting to maximize return against a given amount of risk. The problem is that they define risk as volatility, which in reality is just one element of risk and doesn't show the whole picture. For example, private equities show little volatility because their prices are only published occasionally – in between reporting periods, who knows what is happening to the company.

As well as volatility, modern portfolio theory also relies on historical returns. Whilst a retrospective look can help us understand the future, it can by no means forecast it. After all, economic environments change all the time: for

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[6] A.T. Kearney http://www.bloomberg.com/news/articles/2015-11-06/a-money-managing-robot-is-about-to-join-bofa-s-thundering-herd

[7] http://www.advisoryhq.com/articles/best-robo-advisors-comparison-reviews-ranking/

[8] http://fortune.com/2015/08/26/blackrock-robo-advisor-acquisition/

[9] https://blogs.cfainstitute.org/investor/2012/02/16/setting-the-record-straight-on-asset-allocation/

[10] http://info.financialexpress.net/feinsight/how-to-judge-your-multi-asset-fund

[11] http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2015/09/30/3-reasons-why-robo-advisors-may-not-be-for-you

[12] http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2015/09/30/3-reasons-why-robo-advisors-may-not-be-for-you

example, central bank interest rates may go up, certain sectors may bubble or nosedive – none of these can be predicted accurately.

Also, the danger with a retrospective view is the tendency for investors to act emotionally. For example, if everyone else is selling, an investor may feel the pressure to do so when it could be better to hold on. Similarly, if a particular investment is showing signs of peaking, people may be inclined to hold onto it because it has done so well to date, whereas it may be the perfect time to sell.

It may come as no surprise that, as someone who these websites are attempting to replace, I don't expect robo-advisor websites to dominate the sector in the near future.

However, I try to take a neutral approach to new market developments and I take pride in the fact that I'm open to new technologies. The thing about robo-advisors, though, is that the technology isn't new. The platforms may be sleeker, look hyper-sophisticated and be more user-friendly nowadays but they are merely a repackaging of old unexciting software based on stock-picking. Essentially they are piggy-backing a failed approach to investment. I'm surprised there isn't anything more sophisticated available which offers more added value to investors, at which we can all say 'wow'.

To me, investment advice isn't like booking a flight, ordering a book or other things we tend to do online nowadays. It is a service which is tailored to the individual, depending on every aspect of that person's financial profile. Not only that, to deliver the best service the advisor needs to get to know the client in order to spot opportunities which may fit into the client's ever-changing goals and priorities. That's the added value a human advisor can offer, which a software programme cannot.

For further information, please contact us by e-mail on info@mbmg-investment.com or call +66 2 665 2536.

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