Ready or Not, Robo-Advisors Are Here

By Brooke Southall

Robo-advisors, the hottest trade-media topic of 2014, are showing potential to reinvent key elements of financial advice, asset management, indexing, and asset custody.

These automated platforms, bunched mostly around Silicon Valley and launched largely in 2009 and 2010, deliver rudimentary investment management, mostly of exchange-traded funds (ETFs) and primarily over the Internet.

Robo-advisors, most of them venture-backed firms, have been viewed as a contemptible curiosity by the advisory industry during an incubation period of minuscule asset holdings and, well, robotic service offerings.

But like the ugly duckling that becomes a swan, in 2014 robo-advisors gained a demi-acceptance as companies such as Wealthfront, Betterment LLC, Jemstep Inc., and Personal Capital—diverse in their business models but uniformly known as robos—captured imaginations by gathering multi-millions and even billions in assets.

Big legacy players have further stoked the excitement because they have stopped ignoring the upstarts and started to imitate, co-opt, and even talk about them with a degree of respect.

Aging Advisor Conundrum

New York-based Bloomberg LP and LPL Financial started and then squashed robo-like efforts (BloombergBlack and NestWise), but the notoriously cautious Charles Schwab Corp., TD Ameritrade, and Fidelity Investments have started to embrace some aspects of robo-advisors.

Vanguard Group has a pilot program called Vanguard Personal Advisor Services (VPAS) with $10 billion of assets. VPAS is not all that robotic, but its call-center-based offering gets lumped into the robo-category because it is new, robo-priced at 30 basis points, and allocates ETFs in robo fashion.1 The “pilot” tag will be lifted by July.

Schwab rolled out Schwab Intelligent Portfolios “for free” in 2015, a claim that got contradicted when Schwab disclosed to the Securities and Exchange Commission that Intelligent Portfolios will charge a de facto 30 basis points on assets. It will collect this virtual fee by including proprietary ETFs, or third-party ETFs that trade on its OneSource platform, in the portfolios it manages for robo-clients. It also will allocate up to 30 percent of those portfolios to cash held at Schwab Bank—a rich source of revenues because of the spreads earned on bank loans.

TD Ameritrade Institutional likewise has set up robo-compatibility with Jemstep, Trizic, and Upside Advisor. Envestnet announced its acquisition of Upside on March 2, giving that two year-old firm, which just moved from San Francisco to Mountain View, California, a dramatically improved upside.2

Fidelity Institutional Wealth Services is teaming up with Betterment, mostly on behalf of its registered investment advisors (RIAs). That effort, Betterment Institutional, already has attracted assets from 90 RIAs, and the company credits Fidelity for its introduction to most of those firms. Both David Canter of Fidelity and Jon Stein of Betterment say that RIA prospects run the gamut from small firms that use Betterment’s platform for all custody and asset management to larger firms that plan to move hundreds of millions in passively managed assets to the platform. In February 2015, Betterment announced that it had raised $60 million in new venture capital.

Fueling all the interest is a chronic advisor conundrum: How will the aging advisor force ever serve two vast underserved constituencies, the mass affluent and their poorer relations, the Millennials?

Numerous announcements about ever-larger rounds of venture capital (VC) have led RIAs to realize that robo-advisors are not going to die for lack of capital. About $310 million of VC now is invested just in robos that disclose that kind of information. And the VCs investing in many robos are rich and have enviable track records, even by VC standards, of hitting it big.

Most people in the financial advisory business seem to know a robo-advisor when they see one, but they struggle to define a common set of characteristics for these fledgling enterprises.3

Strictly defined, robo-advisors distinguish themselves from the pack in a handful of important ways.

Cheap, Unbundled

The largest robos have unbundled the delivery of portfolios constructed using modern portfolio theory (MPT), which leads to diversified portfolios that emphasize assets with low correlation to each other.

The average price for this MPT service is about 30 basis points before adding in the underlying fees of ETFs and other products.
that comprise portfolios. This separation of portfolio management from wealth management is considered one of the main disrupting acts executed by robos. It has been compared to discount brokers of the 1980s, like Schwab and Quick & Reilly, separating the cost of a trade from the incidental advice included in the choice of which security to buy. Stripped of any pretense of holistic advice, robos offer a dirt-cheap commodity for investors at all levels—something that could and should give asset managers and financial advisors pause. Indeed, Wealthfront's wealthiest growth comes from its direct-indexing product, which has fee breakpoints up to $1 million.

**It Knows Your Name**
An aspect of robos that separates them from, say, an E*Trade account is that the E*Trade account doesn’t know who you are. A robo-site directs you to a questionnaire to create data to feed an algorithm that customizes your portfolio. In this respect, robos begin to take on more of an advisory element as opposed to pure investment management. These bells and whistles mimic separate accounts, i.e., tax-loss harvesting, but automated.

**First to Market**
For now, the robo-business is the domain of maverick entrepreneurs, with bigger players choking on channel conflicts and a deadlier affliction—being set in their ways. Schwab now has rolled out its Intelligent Portfolios and has called its offering “conservatively” a $400-billion effort, which is Wall Street-speak for a hybrid of a project and an aspiration.4

Schwab’s projection contrasts with comments by TD Ameritrade chief executive officer Fred Tomczyk, whose company was first-to-market years ago with its ETF management service, Amerivest, which never hit the big time. But Tomczyk told analysts in a fall 2014 earnings call that Amerivest is essentially a robo-offering because it is a dirt-cheap way to buy a portfolio of ETFs. Amerivest’s long tenure with lukewarm reception from the market, however, seems to belie the promise of robo-offerings as asset allocators.5

**Robo-Culture**
Behind robo start-ups, of course, are people. Executives and engineers at robos, however, vary from the prototypical personnel in asset management or the financial advisory business. These founders seem to have quarantined themselves from the contagious culture of Wall Street often known for charging high fees and then obscuring them.

The Wall Street business model holds that investors can’t handle the truth, but robo start-ups come from Silicon Valley, where all the information is at the consumer’s fingertips and every process is automated. As such, robos draw upon executives from venture capital firms and successful dot-coms such as eBay, LinkedIn, Microsoft, Amazon, Intuit, and Facebook.

Many start-up entrepreneurs come to the game already rich. As such, their main job is not to lose a fortune that, wisely managed, could last a few generations.

So it is not surprising that rich people so often start RIAs, family offices, and, now robo-advisors. Netscape founder James Clark is an example of a pioneer of this Silicon Valley career path; in 1999 Clark founded myCFO, now part of the wealth management firm Harris myCFO.

Below are brief synopses of some of the robos that should be on your radar:

**Motif Investing:** Motif, founded by Microsoft alums in Rancho Cordova, California, bypasses the diversified portfolio for packaged investment concepts or “motifs,” which the company describes as weighted portfolios that reflect trends or other investment ideas. For example, if you believe that global warming will catch people short, Motif has a portfolio invested in high-water real estate and air conditioners for you. The firm has raised $86 million in four rounds from seven investors.6

**Covestor:** Boston-based Covestor Ltd., founded in 2006, allows an investor to mirror the real trades of successful individual or professional investors. It has raised $23.9 million in four rounds from six investors.7

**CircleBlack:** New York-based CircleBlack Inc., founded by BloombergBlack founder John Michel, is aimed at busy investors who want simplified approaches to complex but effective investing, helping advisors compete more effectively.

**Personal Capital:** Founded in 2009 by Bill Harris of Intuit and PayPal, Personal Capital Corp. has raised $104.3 million in seven rounds from nine investors. The Redwood City, California, firm (with operations in Denver) tried to go direct to consumers but soon realized the need for human-advisor interaction and has adjusted to a call-center model. Its Mint.com-like presentation of accounts gives it a robo-feel and gets it lumped into the robo-advisor category.

**Betterment:** Betterment is a classic robo-advisor: It goes direct to the consumer with a low-cost model and MPT customized to a user’s profile. Started by Jon Stein as a young Harvard grad, Betterment raised $45 million in four rounds from 12 investors, then surpassed $100 million in February 2015 in a round led by Francisco Partners. The New York City firm uses a purely online model and has a business-to-business platform for RIAs.

**Wealthfront:** Wealthfront epitomizes robo-advising. Founder Andy Rachleff, an early eBay funder, has attracted $129.5 million in five rounds from 33 investors—$64 billion in October 2014 alone. For 25 basis points Wealthfront delivers MPT-based portfolios under the direction of Burton Malkiel. The company has zeroed in on millennial investors who work in technology. Wealthfront manages $1.8 billion, much of it from employees of companies such as Google, Facebook, and Palantir. Rachleff says he is playing a winner—take-all game where first to “product fit” wins.8 Wealthfront’s chief executive officer, Adam Nash, recently revealed a new strategy to take the firm upmarket using what it calls direct index investing, or building its own ETFs. Its portfolios now are composed principally of Vanguard ETFs.

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The move is driven by Wealthfront’s success at bringing in accounts with $1 million or more in assets, and the new product has a tier for investors with more than that amount. As a follow-on, the firm is automating tax issues surrounding account transfers. It will hold stocks and ETFs until short-term capital gains become long-term ones, and it will harvest tax losses along the way.

**Jemstep:** Jemstep appears to have the inside track with the robo-advisor-as-RIA-facilitator. The Los Altos, California, firm has no consumer offering. It raised $15 million in three rounds from one South African investor. Its principals have extensive business and legal experience. Other firms with more-recent plays for this business-to-business segment include Trizic and Upside Financial LLC. Upside has won over blogger Josh Brown’s RIA Trizic and Trizic has Peter Mallouk of Baron’s as an owner and potential user.

**FutureAdvisor:** This San Francisco-based firm has quietly raised $21.5 million in three rounds from investors including Fidelity parent FMR Corp. and Sequoia Capital since 2010. FutureAdvisor charges about double Wealthfront’s 25 basis points, but FutureAdvisor blasts the comparison as apples to oranges. Wealthfront (and Betterment), FutureAdvisor says, essentially gives each investor a single target-date fund and requires it to be invested with cash, which entails a tax hit. FutureAdvisor lets investors keep assets in pre-existing accounts with Fidelity and TD Ameritrade. Asset transfers are completed as transfers in kind, which are more tax efficient.

**SigFig:** SigFig Wealth Management LLC was founded with $15 million in one round from three investors by Parker Conrad and Mike Sha, formerly of Amazon, in 2012. It made a splash by providing its algorithm to USA Today and Yahoo Finance users with combined tens of billions in assets. The San Francisco company has human advisors to answer questions, helps aggregate accounts Mint.com-style, and manages portfolios of ETFs, charging 25 basis points for that service. Conrad left SigFig to find another robo financial firm, Zeris.

**Charles Schwab:** Schwab Intelligent Portfolios has an algorithm called Blue that “agnostically” chooses mutual funds that include 14 Schwab ETFs, 12 Vanguard funds, and eight BlackRock iShares ETFs, among 11 issuers. Eight of the 54 intelligent portfolio ETFs are funneled through Schwab ETF OneSource, Schwab’s no-transaction-fee ETF platform. All cash allocations are made to Schwab Bank savings accounts.

**What Could Possibly Go Wrong?**

A lot could still go wrong. Few analysts follow robo-advisors, but the principals of robo firms themselves are an easy-to-identify roster of critics. They are quick to point out weak spots among their rivals. The go-big-or-go-home philosophy says that—like in the world of Facebook, LinkedIn, or Google—only one contestant will reign supreme. This view favors front-running Wealthfront, Betterment, or maybe Schwab.

Another view holds that only a symbiotic balance between humans and bots will have staying power, and Jemstep, Personal Capital, Vanguard Group, and others enter the contest because of their various human dimensions. The pure-robo principals criticize the half-and-halves as stuck in the past right out of the gate with their dependence on long, trying phone calls with consumers.

If an all-of-the-above strategy is the order of the day, then Betterment may take the cake with its dual retail and RIA strategy. Competitors knock that plan as unfocused. Meanwhile Wealthfront gets bashed as the ditzy blond of the bunch, with pure automation that provides no grounding in reality and no real substance. The knock on Schwab is that it is still living in 1995 and that it’ll just bring a discount broker’s plodding attitude, fee opacity, and sense of urgency to a high-stakes Silicon Valley game.

**Future Shock is ‘Change’**

All robo-efforts must confront the fact that, if any of them is to succeed, clients will need to change their investing behavior and learn to trust a new brand. This is a giant “change” ask. In addition, as many prominent efforts add on rounds of VC money, the founders get extensively diluted, raising questions about how loyal and determined they will be in the long run.

Robo-advisor executives, however, are a determined lot of self-proclaimed disruptors who are making the case to sophisticated venture capitalists that they can take a big bite out of financial advisors, asset managers, and custodians alike. In five years, the advisory landscape—from process to product to asset parking lot—could look very different.

Legacy providers to RIAs have no guarantee that this will be a good thing. For RIAs themselves, it is all good. The means of getting A-level engineers to tackle challenges of the advice business just never came into place before. But with stock options in their pockets and paychecks from VCs, top young talent is pouring into the robo-advice business.

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**Endnotes**

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