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Are You Ready for Robo-Advice?

By Thomas H. Davenport

For several decades we have assumed that the best financial planning and wealth management advice came from smart human advisors. Over the last decade or so, those smart humans were augmented with computer systems that make recommendations on the optimal portfolio given a certain risk profile and wealth level. For the most part, these systems, which run on a combination of rules and algorithms, are used directly by the advisor or a technology specialist. The advisor then translates and reports their recommendations to clients. In some cases, the advice is based on complex models, such as the Monte Carlo simulations used by Financial Engines for retirement planning.

Today, however, the personal finance world is abuzz about the use of "robo-advisors," or smart machines that can tell you how best to invest and maximize your wealth. There are a variety of startups that have taken this on, including Betterment, WealthFront, FutureAdvisor, and several others. These companies either allow you direct access to automated investment advice, or they will manage your investments for you—all at substantially lower cost than human advisors typically charge. And since most people are not very happy with their investment advisors (at least according to a recent State Street Bank study), it probably won't be hard for robo-advisors to outperform them. They usually recommend a low-cost balanced portfolio with index funds and ETFs, and that's generally considered the key to long-term success in personal investing.

This technology is likely to have some substantial impacts on the structure and staffing of financial institutions. Adam Schneider, a Deloitte principal who serves the financial services industry, has begun to talk about "bankerless banks" and "advisorless advice." He said in one interview that "There is real room to decrease the amount of human intervention in banking," and he told me that advising is an obvious target. "If you combine the 'robo-advisors' (though he doesn't like the name) with systems that can do speech recognition like Apple's Siri, you have a very powerful combination," he said. Schneider believes that while there will be substantial dislocations for human investment advisors, the change will ultimately improve the industry through better advice at lower cost.

Who will be affected by these systems? Clearly the companies that already primarily focus on self-directed investors will be the first adopters. The Vanguard Group, Fidelity Investments, and Charles Schwab Corp. fall into this category, and each of them has announced either their own robo-advisor (Vanguard will still use a human interface) or a partnership with a startup. I interviewed an investment advisor for one of these three self-directed firms, and he said he hears the robotic footsteps:

“Our advice to clients isn’t fully automated yet, but it’s feeling more and more robotic. My comments to clients are increasingly supposed to follow a script, and we are strongly encouraged to move clients into the use of these online tools. I am thinking that over time they will phase us out altogether,” he worries.

If you’re an advisor for one of these firms, the future is now. A big part of the human advisor’s job is to direct clients to online tools. This is not as easy as it may seem; Fidelity, for example, has 12 different retirement calculators to choose from. The other things advisors are increasingly doing in these firms is motivating behavior change—stimulating clients to take the actions they need to take. The advisor I interviewed said, “I often feel like I am more a psychiatrist than a financial advisor.”

Grant Easterbrook, a fintech startup analyst at Corporate Insight who has done extensive research studies on online advice, says that there are some ways in which human advisors can add value to automated advice. He said that while creating an investment portfolio is relatively easy to automate, it’s hard to provide complex financial planning for individuals with substantial assets without any human touch. “It includes tax planning, estate planning, life insurance–-decisions that involve complex data inputs and information gathering. Human advisors can motivate the client to gather all of that information and then ensure that it’s correct. Clients also are often overly optimistic about their finances and undisciplined about following up, and advisors have to correct for that. Overall, I think most Americans, particularly wealthy ones, will still want at least some level of human validation before making complex financial planning decisions.”

So that begins to suggest the role of human advisors going forward. Ironically, if humans themselves were more rational, there might be a greater short-term opportunity for robo-advisors. Instead, we irrational humans need to be calmed down, motivated, second-guessed, and psycho-analyzed, and other humans seem to be the best at doing these things. If we can ever teach a computer to fathom the depths of irrationality among humans, then we’re really in trouble.

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