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The Rise of the Robo-Advisor

By Mark Allen, SVP New Ventures

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A multi-trillion-dollar opportunity is up for grabs as millennials increasingly favor automated investing. Financial institutions should pay attention.

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From their origins in the back office more than a decade ago, robo advisors have moved front and center with investors and are poised to become a major force in a multi-trillion-dollar industry. A.T. Kearney projected in 2015 that total robo advisor assets under management in 2020 will total $2.2T[1], and Deloitte expects this number to multiply by 2025[2]. With low starting deposits and no requirement for in-depth market knowledge, as well as none of the costs of a premium human financial advisor, these applications for automated management of invested funds appeal to consumers who would not otherwise invest in the market. As artificial intelligence technology has matured, robo advisors have grown capable of handling complex, time-consuming activities like rebalancing and tax loss harvesting. These improvements have made them an increasingly appealing alternative to hiring experienced human fund managers. There are now more than 100 robo advisor options available to consumers, and even experienced investors use them.

Robo advisory has graduated from its experimental stage and is a proven solution that large financial institutions are already embracing in big ways. Credit unions and small financial institutions still not offering robo advisory services stand to lose out. Those that fail to adapt are at risk of struggling to retain members, assets and growth. The key for credit unions to win in this new market is to adopt integrated solutions -- robo advisory services embedded in the banking apps members already use and understand. But while the benefits of integrated robo advisory are clear, implementation takes expertise and thoughtful strategy.

From a consumer experience perspective, a key benefit of a robo advisor is ease of use. Robo advisors provide automated, personalized portfolios responsive to user preference and market performance. Users provide the advisor with data such as their age, income, investment objectives, investment experience, risk tolerance, investment time horizon, and total and liquid net worth. Based on this information, the robo advisor instantly builds a diversified portfolio, often a combination of lower cost Exchange-Traded Funds (ETFs). The robo advisor then uses a sophisticated algorithm to rebalance the user's portfolio based on how different ETFs in the portfolio perform.

Robo advisors are a less expensive option for end users than paying for traditional advisory services because fewer people are involved in managing invested funds. Whereas a personal

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[1] Epperson, Teresa, Bob Hedges, Uday Singh and Monica Gabel. Hype vs. Reality: The Coming Waves of "Robo" Adoption. A.T. Kearney, June 2015, https://www.atkearney.com/documents/10192/7132014/Hype+vs.+Reality_The+Coming+Waves+of+Robo+Adoption.pdf

[2] The Expansion of Robo-Advisory in Wealth Management. Deloitte, 2016, https://www2.deloitte.com/content/dam/Deloitte/de/Documents/financial-services/Deloitte-Robo-safe.pdf

financial advisor might charge a 1.25% asset-based fee, a robo advisor could charge between 0.25% and 0.9%, according to Investopedia[3]. There is still a human element in this automated alternative, in that robo advisor investment portfolios are originally compiled by a team of investment professionals. These people monitor market activity of the individual funds.

The savings associated with limiting human involvement may lead some to perceive a compromise on quality. However, a study by Vanguard[4] using Morningstar data found that in "every asset class over every time period, the cheapest quintile produced higher total returns than the most expensive quintile." In other words, the lower the ratio of what you spend on investment services to how much you invest, the greater the returns you will see on your investment services spending.

Robo advisors can make investing more transparent. More than half of people with 401(K)s find explanations of their retirement investments more confusing than explanations of their health care benefits, according to a 2013 CNBC report[5] citing data from Charles Schwab. A 2019 survey by The Harris Poll for TD Ameritrade found the majority of respondents could not answer basic questions about their 401(k) or individual retirement account[6]. That is a recipe for poor choices. Many employees who attempt to manage their own 401(k)s guess what the appropriate investments for them might be. Even as many 401(k) participants think their retirement investments are doing better than before, according to a 2018 Charles Schwab survey[7], nearly three quarters of those surveyed said they want personalized 401(k) advice.

As automated investing removes barriers of entry for people looking to invest their money, the financial services industry will need to adapt to contemporary expectations. That means no more obscuring important details in fine print of common types of investment portfolios such as for retirement savings. The shift to user-friendly investing may thrust current financial services companies into a state of unpreparedness and discomfort. But it is also a huge opportunity for growth through offering more transparent services such as robo advising. Prospective automated investing users are willing to go big. A 2015 A.T. Kearney[1] survey found that likely adopters were willing to invest 19 to 40 percent of their assets through robo advisory.

Opportunity for major growth

Robo advisers have been particularly successful in growing their assets by targeting financially secure millennials. These are people in good jobs, mostly in their 30s, who are starting to build

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[3] Chen, James. "Advisor Fee." Investopedia, Investopedia, 5 Apr. 2019, www.investopedia.com/terms/a/advisor-fee.asp.

[4] Wimmer, Brian R., et al. "Quantifying the Impact of Chasing Fund Performance ." Vanguard.com, Vanguard Research, July 2014, pressroom.vanguard.com/nonindexed/Quantifying_the_impact_of_chasing_fund_performance_July_2014.pdf.

[5] Koba, Mark. "Can't Figure out Your 401(k)? You're Not Alone." CNBC, CNBC, 19 Aug. 2013, www.cnbc.com/id/100965792.

[6] The Harris Poll. Retirement Savings Pop Quiz: Exploring Americans' Understanding of 401(k) and IRA Accounts. TD Ameritrade, Mar. 2019, https://theharrispoll.com/wp-content/uploads/2019/03/Retirement-savings-pop-quiz-research-final-approved-Read-Only.pdf

[7] 2018 401(k) Participant Survey. Charles Schwab Corporation, Aug. 2018, https://content.schwab.com/web/retail/public/about-schwab/Schwab_401k_Participant_Survey_deck_2018.pdf

wealth — think doctors, lawyers or employees of startups. These consumers feel they don't have much time to manage their finances. They tend to be "verifiers," meaning they tend to look for confirmation of their decisions, rather than seeking outside advice before they decide. On top of wanting a time-saving solution, they're highly comfortable with technology, making them ideal candidates for robo advisors.

Historically, the advisory industry waited until generations reached the point of having considerable resources to invest. Even successful millennials are, for the most part, a decade or so away from being in such a position. That is where robo advisors have a special edge. Dynamic automated investing can meet the needs of young professionals in a way that has not been done before. The combination of millennials' comfort with technology and their potential to develop financial resources over time means the traction robo advisors have with this market segment is likely to continue long into the future.

Another previously neglected market segment robo advisors can reach is middle class consumers of any generation who want to grow their savings or retirement funds but cannot afford to work with human investment advisors. Whether for middle class cost-conscious consumers or up-and-coming millennial professionals, robo advisors offer an opportunity for financial institutions to graduate these digital clients to more sophisticated investment products as their assets grow and their needs evolve.

Doing it right

As large financial institutions are betting big on robo advisory services, now is an urgent time for credit unions and community banks to start offering robo advisors. Large financial institutions have already had success with their own offerings. Wells Fargo's "Intuitive Investor" combines algorithm-driven investing with access to human financial advisors. Investment firms Vanguard and Blackrock ground their technology in their firms' seasoned financial expertise. Other major financial institutions to offer robo advisory include JP Morgan Chase, Bank of America, Goldman Sachs and Morgan Stanley. These large firms have pushed robo advisory through its risky, experimental stage and into mainstream digital banking.

Small financial institutions stand to benefit the most from robo advisors that are integrated into their main mobile and online banking tools, but few, if any, integrated solutions exist. Stand-alone robo advisors go unfunded when users set-up their account and then never open it again. When a robo advisor is integrated into a users' digital banking environment that they already use regularly, they cannot forget it is there. Adding another experience to a credit union's digital banking platform also makes it stickier and deepens customer engagement offering the potential for improved retention. When members start investing, they will have one more reason not to take their business elsewhere. Finally, when credit unions offer a robo advisor solution, they elevate their perception as a full-service, modern financial institution on par with bigger financial institutions, making it easier to cross-sell other offerings to younger people who might otherwise discount a credit union or community bank as behind the times.

Integration is also the greatest obstacle in implementing a robo advisor. Even as standalone applications, robo advisors must meet significant compliance requirements (as does all financial technology). The need to meet these requirements is one reason financial institutions are better equipped than pure tech companies to offer robo advisors. What makes integration challenging is that robo advisor products are generally securities that fluctuate in value being worth more or less than their original value going forward. Bank and credit union deposit accounts are federally insured to $250,000 and do not experience value fluctuations. That makes offering access to the two account types in the same application complicated, requiring very clear disclosures prior to and at the point of transfer, particularly from a federally insured account to a securities account.

With ease of use being such a critical selling point for members considering setting up robo advisor accounts, integration into the member's everyday digital platform is crucial. Importantly, an integrated robo advisor offered by their trusted credit union catalyzes members to overcome inertia or fear and make the choice to invest in the market for the first time. Moreover, the user is more likely to log in to their account to track progress, add contributions, and make other adjustments to conditions such as time horizon or investment objectives. These adjustments are key to member satisfaction. Over time, a user's investment objectives, risk tolerance, time horizon and other factors change. Updating the robo advisor helps it adapt accordingly and continue to provide desired results.

However, while integration is ideal, it is also challenging. The solution for small financial institutions is to rely on a technology vendor with banking expertise that can navigate compliance issues without sacrificing ease of use for members.

Capturing the multi-trillion-dollar opportunity

For financial services companies looking to appeal to younger demographics, robo advisors should be an easy sell. Short term concerns about working with customers who have limited assets are outweighed by the longer-term gains as young consumers increase their earning potential through career advancement -- as well as transference of wealth from older generations, an important but overlooked factor. The global aggregate net worth of millennials is expected to reach $24T USD by 2020, a 2015 Deloitte[8] report projected.

Millennials are a key growth target for financial service companies. The companies that are best able to deliver on the investment experience this group is seeking will have the greatest opportunity to grow their client base and offset the loss of aging clients. Robo advising is one way to provide the desired "Do It Yourself" approach and is a low cost and pragmatic way to help attract these current lower net worth clients during a time of limited competition. Capturing these clients in the next few years allows financial institutions to connect with these investors before competitors, and retain them over the longer term, when the largest financial rewards are to be found.

Author Mark Allen is SVP New Ventures at Access Softek. Previously, he led two successful CUSOs as CEO over 26 years. He is an industry-recognized expert in building broker dealer insurance and lending businesses for digital and mobile channels.

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[8]Millennials and wealth management: Trends and challenges of the new clientele. Deloitte, June 2015, https://www2.deloitte.com/lu/en/pages/financial-services/articles/millennials-wealth-management.html#