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No-so-'smart' investment aids

Automated services generate fees, but is their advice worth the money?

The financial services industry has undergone changes since I entered it more than two decades ago, and it seems to be changing at an accelerated pace in the past few years. Just like many other industries, financial services companies are now competing with technology-based competition from firms like Betterment.

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Personal Finance

Many of the changes in the financial services industry over the past decades have been to drive cost down. We've now reached the point where only the largest of money management firms can achieve the scale necessary to make money on funds with such low-cost structures. Investment management firms are always looking for ways to raise revenues, which ironically adds cost to the investor in their low-margin industry.

One way is through the use of a robo-advisor, an online wealth management service that provides automated, algorithm-based portfolio management advice without the use of human financial planners. These services emerged as a new way to generate advisory fees on a large scale using today's mobile technology.

The focus of robo-advisory firms is purely on investment management and not on financial planning. They invest solely in funds rather than individual stocks. There is a perception that if a service is automated, then it will cost less. Robo-advisory firms actually add an additional fee layer on top of the cost of the funds they are buying for their customers.

Robo-advisors are automated programs. There is no dedicated advisor to call when the market experiences a high level of volatility. In the recent brief selloff after the Brexit vote, one leading robo-advisory halted trading in their service, which prevented customers from getting out of their positions or adding to their positions to take advantage of the correction.

The markets quickly recovered after Brexit, but what if the correction was not so brief? How would these automated programs have handled things?

The history of most robo-advisors is too short to judge whether the extra cost of the service improves performance, even though the services claim to expect better performance than a typical "do-it-yourself" investor. One study from 2014 showed no better result from the robo-advisors compared with the broad market indexes.

Another recent development in the financial services industry has been the development of many "smart beta" strategies, which attempt to outperform the market indexes by weighting various factors differently than their weight in the index.

Burton Malkiel, a retired Princeton University economist, has been a strong proponent of index investing for many years, primarily because of their low cost. He argues that low-cost indexes outperform actively managed funds over time because of their low turnover and better tax efficiency. He recently concluded that smart-beta strategies aren't right for individual investors because they are riskier and have long periods of underperforming the stock market. According to Malkiel, smart beta is just a new way for fund managers to justify higher fees.

Cost is definitely an important factor in choosing an investment program, and the reduction in the average cost of investment management programs has been generally positive for investors. However, there are many other factors that help determine the long-term success of a financial plan.

For example, tax-efficient investing can have a big impact on the performance of an investment program. The particular type of investment account you choose can have a large impact on future retirement income. Taking advantage of the tax benefit of qualified dividends can also make a big difference.

All professions are facing challenges from new technology-based offerings. Predictably, those professionals that deliver a high value of advice to their clients will not only remain in business, but will prosper as the need for customized personal advice is growing. Those that provide a commodity-type service or that fail to monitor and understand dynamic information won't be able to compete. NHBR

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