Domo Arigato Mr. Robo-Advisor

Introduction

Robo-advisors were first introduced to retail investors during the 2008 financial crisis; however, the technology behind it has been used by financial planners since the mid-2000s. The initial intention of the technology was to re-balance the investments of clients, specifically within target-date funds after the 2008 crash. However, it was not until early 2012 that robo-investing really took off within the consumer customer-base. Today, there are approximately 100 robo-advisors in operation in over 15 countries

(Deloitte, 2016). Due to this incredible growth, we've seen the rise of start-ups such as Betterment, Wealthsimple, and Personal Capital.

The process for investing with robo-advisors is a relatively simple one:
1. The investor completes an online survey, where software determines the investor's risk tolerance
2. The investor will invest an amount that meets the minimum amount of capital
3. The robo-advisor will generate a portfolio based on the investor's risk-tolerance; most of the time, a large part of your portfolio will be dedicated to safer investments such as short-term government bond funds

Rise of Passive Management

With the rise of automation in the workplace and in everyday life, we've seen capital gradually flow from active to passive management broadly, and into the sub-sector of robo-advisors specifically. Active management involves a trained professional - the portfolio manager – that is actively selecting stocks to invest in based on their research and expertise. Active management is usually in the form of a mutual fund. Whereas passive investments invest mostly in Exchange-Traded Funds (ETFs), in which the portfolio manager picks indexes to follow. The portfolio managers use an automated portfolio allocation algorithm which balances the risk and reward preferences of everyone to achieve "optimal", tailored results. Over the years, passive investments have become more popular due to disappointing returns from many actively managed funds and the decreased costs of ETF products - today, passive investments amount to $224 B and are projected to have an AUM of $2 T by 2020.

Broadly speaking, the arithmetic reasons supporting investing passively are simple. In an active management environment, investors essentially engage in a zero-sum game in which there is a winner and a loser for every investment. On the other hand, passive investments simply track an index and ensure investors meet market performance. Clearly, it is difficult enough for active investments to outperform passive investment. On top of that, consumers subscribing to active management also pay higher fees, making active management even less desirable. Although active management can prove highly profitable depending on the investment manager, our opinion is that passive investment can be extremely attractive in terms of price efficiency and returns for a retail investor's financial planning alongside active management. One of the pitfalls of investing with robo-advisors is that although technology is constantly improving, it cannot predict systematic risk. For example, the model wouldn't be able to react to situations that technology cannot predict. In addition, it lacks the "human intuition" of an active manager that technology cannot automate.

An Insider's Perspective in Robo-Advisors

To further our readers' understanding, we interviewed an industry expert who has worked at one of Canada's leading robo-advisory companies; the following quotes are synthesized from the interview:

Q: Why aren't investors allowed to make individual decisions on their portfolio on a robo-advisor platform?
A: It is a platform that is set up for people who don't want to make those investment decisions on their own - whether they don't have the time, knowledge, or confidence in their decision-making, or ability to consistently rebalance their portfolio, or that they won't panic when the markets change. Customizing portfolios require more time and thus more money. We want this platform to be more affordable.

Q: What are the general factors that influence the automatic trading of funds within a portfolio?
A: People deposit money, we place trades based on their risk tolerance.

Q: How do you decide which products to invest in?
A: We have an investment team that makes these decisions. They select optimum funds to invest in for each risk tolerance. Following that, they program it into the software.

Q: What does your typical investor look like?
A: Literally anyone. I've seen investors across the spectrum of age and wealth - basically anyone who doesn't want to do it themselves and doesn't want to pay high fees to traditional advisors. Others just use it as one part of their portfolios and have other assets elsewhere.

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