Kitces Part 1: How robo misunderstood the advice model

Graham Hand (/author/1) 22 February 2018

Introduction to Michael Kitces (MK), interviewed by Graham Hand (GH)

Michael Kitces is recognised as the publisher of the #1 financial planning industry blog in the United States, based on awards and surveys. His website, kitces.com (https://www.kitces.com/start-here/), is also home to the popular Nerd's Eye View. He speaks at 50-70 conferences a year, consults widely to financial planning groups, and is a Partner and Director of Wealth Management with Pinnacle Advisory Group (Washington DC).

I met with him in Sydney at the Portfolio Construction Forum's Finology Summit 2018, where he presented two keynote addresses including 'Robo-advisors are NOT the future (but technology is)'. He presented a slide which showed total robo-advisor assets at US$20 billion versus total US investable assets of $33.5 trillion. That is 0.06%.

GH: Your writing highlights how standalone robo advice businesses have struggled in the US. Putting aside the potential of robo as a technology, do you see a future for a pure robo advice business model?

MK: Not much of one. My expectation in the US from the beginning when all these startups were proliferating was that one or two would survive, they would be the first to get to some level of economies of scale and they would be the brand leaders in the space. Ultimately, all they really are is an asset management company in the distribution business. Asset management distribution is highly competitive, it has horrific client acquisition costs and it's dominated by brand. So one or two could grow large enough to establish themselves, at least in a niche. And everybody else would die on the vine.

The robo advisers took financial advice job titles too literally. They figured what financial advisers do to create portfolios seems relatively simple, so we can replicate that for a fraction of the cost. They did not understand that the overwhelming majority of financial adviser compensations are commissions for product distribution. They are not actually paid for advice. They are paid for product distribution. And the robos brought an operational efficiency solution to a marketing problem. It was like bringing a knife to a gun fight … it doesn't go well.

During the dot com era, there were 100+ online brokerage platforms that tried to emerge. One or two independents were survivors, like etrade, the rest was dominated by incumbents such as Schwab and Ameritrade and Fidelity. I expect the same thing with robo, as I forecast from the start. One or two like Betterment or Wealthfront might at least survive, although I don't know that they will ever justify the valuations they have set.

All the rest are gone. When FutureAdvisor was bought, I said this is the highest price you will ever see for a private transaction for a robo adviser. BlackRock was willing to pay a premium for a first mover opportunity, but now they seem unable to capitalise. The gap is so far between B2C and what enterprises now need that even BlackRock has been leapfrogged by the second-coming players – the rise of what we're now calling Model Marketplaces – and now BlackRock is trying to push their funds through any technology company as a distribution channel. In theory, they bought FutureAdvisor so they did not have to do that, but they are pushing the others because FutureAdvisor did not work out as well as hoped.

GH: The other problem is that most robo advice offers in Australia are priced around 80 to 100 basis points, while many large incumbents are priced around 60 basis points (0.6%). Robos are not even achieving a fee structure like Wealthfront and Betterment have done at 15 to 25 points.

MK: It's a market-sizing thing. The dynamics for all these are: assume you've achieved scale then work backwards to your pricing. The hope is the VC funds bridge their funding needs between here and scale. The US market is deep enough that if you get that scale, you can justify that price point, but here the market is not as large. When they work backwards through the math, ironically you end up with companies that are less cost efficient than existing products.

GH: The other issue you write about is the Cost of Acquiring a Customer (CAC). Do you think startups completely misunderstand that?

MK: A few of them are learning it now watching the troubles of the others, but again, Betterment and Wealthfront thought the problem was the cost to deliver advice. It wasn't actually advice delivery. It was the cost to distribute asset management through advisers with commission compensation. Literally, the compensation was a distribution charge of the asset manager.

They didn't come to the table with a superior asset management distribution strategy, they came with a superior financial advice portfolio application system, which is not what the cost was and not what advisers were being paid for. We had put this 'adviser' label on our business cards and they took us at our word, that this was our primary value proposition.

GH: I look at the US robo offers and see the price point at 15 to 25 points, and would have expected a lot more success. Why is it at such low pricing that Betterment and Wealthfront have not done better? They are not startups anymore, they've been around for eight years.

MK: These are asset management distribution challenges. It's not 'If you build it, they will come." If price were the only determinant, why doesn't Vanguard have a 99% market share? As immense as they are, Vanguard's market share is about 12%, which took 40 years of brand building. Investors are not hyper-rational, extremely efficient consumers who can identify the best deal, identify legitimate players from illegitimate ones, and then be willing to move.

Financial services is one of the lowest trust industries around the world, but we built something that should have been intuitively obvious in the lowest trust industry out there. People think a) it's a fake price and I'll be stung on the back end, or b) you can't possibly know what you're doing because nobody else is using it. It gets back to, "I don't trust the brand promise that your software is making." Building a high trust brand in a low trust industry is ludicrously expensive. It's not a technology problem. It's not a cost problem. It's an asset management distribution problem.

GH: Does the advice model need face-to-face contact to build trust, the 'warmth' discussed at this conference.

MK: The most trusted brand in the US is Amazon. All computers, no human contact. Can't even get a human if you want one. We don't have any problem learning to trust technology companies, because they are doing it by default in a trusted industry. Robo advisors try to frame themselves as tech companies, but they are managed accounts in the asset management business. Good luck scaling that fight for the brand.

Graham Hand is Managing Editor of Cuffelinks. This is Part 1 of the interview with Michael Kitces, and Part 2 next week explores where financial advisers have gone wrong and how they should position for the future.

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