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Financial advisers set to become the new fund managers

Simon Hoyle August 28, 2017

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Technology is enabling financial planners to climb the value ladder, but at the same time it is kicking out the rungs behind them as they go.

The core of investment-focused value propositions of the past has been commoditised, bit by bit, forcing advisers to climb further up the ladder – and dependent upon technology to get them there.

The US-based financial adviser Michael Kitces told the Portfolio Construction Forum Conference in Sydney last week that this is leading to a position where "ETFs are the new stocks, and advisers are the new managers", and traditional fund managers are being squeezed out of the process.

"Our value proposition was built in some way, shape or form around bringing investment benefits to the table for clients – I'm going to get you alpha, I'm going to find you alpha, I'm going to bring you alpha to the table," Kitces said.

"All we're seeing is a natural evolution of the most effective way that advisers can bring value to the table today, when a lot of the things we did in the past, like I'll pick you stocks, we can now do online; or I'll pick you mutual funds, now I can buy those online. Or I'll give you an asset-allocated portfolio, now I can get one of those online.

"It's forcing us to continue to evolve the value proposition."

He said adviser business models were invariably shaped by technology and as it commodified one aspect of an adviser's value proposition it also provided the means to move into other areas.

This trend was apparent around the world, he said, and in the US it could be traced back to the mid-1970s, when stockbroking was deregulated and brokers were set free to determine their own fees.

Initially fees rose, but then very quickly declined – by as much as 90 per cent – as competition kicked in and then technology enabled automated trading. Advisers moved from selling stocks to selling mutual funds – eventually boosting the value of mutual fund assets from $US500 billion ($633 billion) to $US5 trillion in the process.

The same basic process happened again: technology smashed margins in the business of selling mutual funds but also paved the way for advisers to move into other areas. By the 2000s, mutual funds could be bought and sold online for a faction of the cost of transacting through an adviser.

"Consumers effectively start saying why would I pay a financial adviser to pick me a mutual fund when I can just buy them online" Kitces said. "I can look up online which ones to buy, in *Kiplinger* magazine or *Money* magazine or research them on Yahoo! Finance or morningstar.com.

"All of a sudden advisers started shifting out of the mutual fund business. And we shifted onto an asset allocation basis. We said, well, anybody can pick a mutual fund online; I will create for you a diversified asset-allocated portfolio – a higher value proposition, more complex, more sophisticated; and over the subsequent 15 years we saw an absolute explosion in asset-allocation and managed-portfolio models."

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"The adviser business model spurs the growth of entirely new adoption of investment strategies, from stockbroking to mutual funds to asset-allocated portfolios and various types of model portfolio – and I think what we're seeing now is another one of these inflection points, from the adviser that recommends asset-allocated portfolios to the idea that robo-advisers can create asset-allocated portfolios. If all you need is a diversified asset-allocated portfolio, reasonably aligned to your risk tolerance and based on your time horizon, I can write a software algorithm that does that and does it for a fraction of the cost of a financial adviser. That's the technology shift we're on the cusp of right now."

Kitces said the value that advisers deliver to clients comes in three types: alpha, beta and gamma, and that delivering beta to clients has been commoditised down to zero cost and zero value.

"That leads us in one of two directions," he said.

The investment value proposition updated

"We can go off to what David Blanchett of Morningstar in the US calls 'adviser's gamma': all the value we add for clients that doesn't have anything to do with the portfolio itself. Financial planning advice, behavioural advice, tax-related value-adds – all the different things we can do outside investment selection itself.

"Or, for those of us who want to continue to bolster our investment value proposition, we really, really need to figure out how to bring alpha to the table."

But the pressure is growing on advisers not just to pick fund managers to do that, because clients can pick fund managers themselves and they don't perceive value in advisers doing it for them.

The shift taking place in the US and spreading globally is for advisers to take the place of fund managers to deliver alpha to clients.

But advisers don't have the time – or in many cases the resources or even the skill – to analyse thousands of individual stocks. What they can do is analyse asset classes and, by extension of that, analyse ETFs.

"If all I do as an adviser is start charging a fee for managing the portfolio and I bring in some ETFs, from the client's perspective [they're] going to pay me as manager instead of the fund manager," Kitces said. "I'm going to cut the cost of your portfolio by about 40 per cent.

"It looks cheaper to the consumer and I get paid about the same thing, as an adviser, and the fund manager gets cut out of the picture.

"Most of us don't realistically have the resources to analyse thousands of individual stocks, one at a time, to try to work out which ones are good buys and which ones are bad. We manage at the level we're capable of, and the level we're capable of is to use ETFs as the building blocks, instead of the underlying stocks.

"So we end up in this world where the ETFs become the new stocks and advisers become the new managers."

Professional Planner is a media partner of the Portfolio Construction Forum Strategies Conference 2017.

2017, ETFS?, FINANCIAL ADVISERS, MICHAEL KITCES, PORTFOLIO CONSTRUCTION FORUM, TECHNOLOGY, VALUE PROPOSITION

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Simon's Profile

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