Investments: What Is A Robo-Advisor?

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The definition of a robo-advisor is an automated program that provides financial advice. More precisely, the program manages your investments through an automated algorithm rather than having a person monitoring your portfolio. This program is limited to investment trading, monitoring and trade execution (because other aspects of financial planning are very personal and cannot be programmed into an algorithm).

What are the advantages of using this service?

It is very similar to any other type of automation. Since a person is not doing the day to day work of managing a portfolio and a machine is doing it, costs will be cheaper. The number of portfolios can be “scaled” easily so that one program can manage an indefinite amount of portfolios if it has the memory and speed to perform the trade executions. There is also instantaneous trade execution because the machine does not think and can execute instructions at the speed of electricity if the instructions are clear. These features amount to freeing up time and cost to do other things. Another feature that is recognized is the fact that machines do not have emotions. Should a trade instruction be given, it will get done no matter what the market is doing. A person may have regrets, doubts, hesitation or change their mind which may be better or worse for the situation.

What are the disadvantages of using this service?

You need to find a service that fits your investment needs exactly. If you need a certain asset mix to feel comfortable due to preferences that you have, the algorithm should be flexible enough to allow a wide range of asset mixes. If it does not, you may get an allocation that is not exactly suitable for you, which can create additional risk. Execution in the markets is not perfect in extreme conditions: The algorithm may not always work. As an example, if you put in a stop loss order to sell a stock at $100 per share, and the market falls suddenly, the price may go through $100 per share from $105 to $95. Depending on how the order is put in to the algorithm, it may not get filled and you will have unintended consequences. If you tell the machine to sell at whatever price it can obtain, it may get the worst price because the order will be filled at the extreme changes in price. Situations like this benefit from a live person who can make a judgement call and know when to wait or when to settle for a given price. This type of expertise varies with each situation and it would be lost in an algorithm. Changes to your preferences have to be communicated properly, otherwise the execution may not be done correctly. Lastly, a person has to do the non-tangible aspects of your financial plan like risk tolerance, health concerns, retirement preferences etc. There may be attempts made to standardize such aspects to save money, but this is not a good idea because people would be forced into limited options which may not be suitable.

Who Benefits the Most and the Least From a Robo-Advisor?

The best use of a robo-advisor is for a straightforward situation with little trading, very standard and clear investment goals, and rebalancing that is straightforward. If you are making monthly purchases of a fund and buying at whatever price, this is a good use of a robo-advisor. If you rebalance your portfolio to a fixed percentage per investment product and the outcome will be good even if it is not perfect, that can be automated as well. If your portfolio has liquid securities and commonly traded funds, that makes it easier for automation. A small portfolio that is not complex is also the best suited for automation. As you get into corporate accounts, complicated derivatives, multiple registered accounts or mixing investment accounts with illiquid assets like real estate, businesses or physical assets, the automation should work together with the human element. If this is done well, the robo-advisor can be used for a part of the process. An investor who gets very emotional about their investments or has issues making decisions as the markets change would benefit from a robo-advisor.

The worst use of a robo-advisor is for someone who has unique preferences, can make good judgement calls and has complex needs.

Can You Combine Robo-Advisory With Traditional Advice?

The short answer is yes. The communication has to be clear so that the person knows when the machine would take over and vice versa. If the boundaries shift such as in a very volatile market, this also has to be communicated well. For the client who is using both methods, it would be useful to understand how both methods operate to see when each method would be useful or when it wouldn't.

How Do I Evaluate the Cost?

The answer to this question lies in the comparison. The Comparing would be done between the robo-advisor and the traditional advisor and what you are receiving for each component. There are human elements like comfort, reassurance, encouragement or perseverance which a person can provide that a machine cannot. Since the money belongs to a person ultimately, these factors have to be accounted for somehow. The costs should reflect what you are receiving in both scenarios. If you getting something that you are not using, make sure you adjust your comparison for this. If there is something they are doing for you that you would rather do for yourself, this is another adjustment that should be made to your comparison. The value determined in both cases has to be with respect to you as opposed to the average person or the statistic that most businesses use when marketing their services. Note that most robo-advisory firms are charging you for managing your portfolio. The fees embedded in the MER of the ETFs or currency conversions would be on top of this. The robo-advisory fee is basically a rebalancing fee and a portfolio asset mix starting fee. If you do not want to do a lot of trading, the monthly costs can add up.

What questions should I ask before engaging a robo-advisor?

This will depend on how much personalized service you need and how well you understand what the algorithm does. Leaving the monitoring and trading to a computer can work for you – but you should understand the limitations so you do not get caught with unexpected risks or outcomes. You must also know what the machine does not do so you can supplement that with human interaction or some assumptions on how to make your money work for you. In some cases you should be mostly invested in cash, be paying off debt, focus on tax reduction, revisiting your spending patterns, putting money into an illiquid asset like your house or your business, or keeping money liquid due to uncertainty. A robo-advisor is likely not equipped to tell you when to stay out of the investment game – so you will need to make these decisions.

Future Expected Changes

It is likely that many big institutions will get onto this trend to appeal to younger people who want to do their investing online and who want to start with small portfolios. It may be a way for the industry to offer advice to poorer clients without having to spend a lot of resources with staff or overhead. If technology is a convenience for people, this will be an extension of "do it yourself trading" but with a rebalancing and monitoring component added to it.

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