Taking robo-advisors to the next level

Personalizing the investment experience with goal-based investing

Introduction

FinTechs are disrupting the world of traditional wealth management. FinTechs are companies that exist at the intersection between traditional financial firms and technology providers. These companies leverage digital technology and advanced analytics to unbundle financial services and harness economies of scale by targeting consumers directly and using software rather than humans to deliver financial advisory services. But banks and other traditional wealth managers can borrow from the FinTech playbook and compete effectively in this new environment.

Rising to the challenge of disruptive innovators

Robo-advisors are the most direct expression of the FinTech trend in the world of personal wealth management. Robo-advisors, as the name suggests, are automated investment solutions that guide individuals through a self-assessment process, engaging them with digital tools and helping them shape their investment strategies and manage their portfolios.

Robo-advisors provide services such as portfolio rebalancing, using investment algorithms based on passive strategies and diversified portfolios. They also engage individuals with digital tools featuring intuitive and easy-to-understand graphical representations of otherwise complex mathematical relationships to guide them through the process and shape their investment behavior.

Introducing simplified, scalable and less expensive investment products, firms that use robo-advisors are often described as disruptive innovators. What makes them disruptive? Explaining the difference between technology and innovation can help answer that question.

Two kinds of innovation

For businesses, technology refers to the processes and tools by which a firm transforms information and data, human labor and economic capital into products or services of greater value. The introduction of new technology modifies the way that firms operate and how consumers access services and products. Innovation involves a change in existing technology, which can take two different forms: disruptive or sustaining innovation.

- Disruptive innovation refers to the creation of new products or processes outside of the mainstream businesses in a particular industry. In the near term, disruptive innovators sometimes deliver reduced product performance. Yet they are typically cheaper, simpler to use, and appeal to new customers or create new needs within an existing market.
- Sustaining innovation refers to improvements in product performance that allow existing firms to improve the quality of their offerings, help fend off competition or increase commercial margins either by operating at lower cost or charging higher, yet still affordable, prices.

Robo-advisors, with their ability to create a new market among consumers who may not previously have been able to afford professional financial advisors, are an example of disruptive innovation.

Goal-based investing as a differentiator

The traditional approach to wealth management asks investors to decide on an acceptable level of risk. But any investor's appetite for risk will change over time, especially as the investor approaches important milestones in life. Goal-based investing is an investment methodology where performance is measured by the success in meeting an individual's specific goals, such as funding a child's education or saving for retirement. Goal-based investing is an approach that allows established, professional wealth managers to compete with each other's improvements in products and services. As such, it is an example of sustaining innovation.

In order to create sustainable business models, wealth managers need to strike the right balance between disruptive and sustaining innovation. Goal-based investing can be applied in conjunction with robo-advisor technology to enable traditional wealth managers to compete successfully against disruptive innovators such as the FinTechs. Robo-technology can help wealth managers digitalize their businesses in an efficient manner, by providing a platform for delivering automated investment advice to both affluent and mass-affluent clients who account for a large portion of global wealth but have been underserved in the past. ("Mass affluent" investors are individuals or households with $100,000 to $1,000,000 to invest.)

While FinTechs may have taken the lead in the technology innovation race against banks by pouring resources into software enhancements, they still seem to be fairly undifferentiated with respect to the methods of portfolio construction.

Robo-advisors typically rely upon traditional Modern Portfolio Theory, in which the expected return on a portfolio of assets is maximized for a given level of risk, and the risk/return potential of an individual asset is assessed within the context of the overall portfolio. This approach might be too restrictive for long-term model portfolios, particularly if multiple investment horizons and goals have to be taken into account. The excessive simplification of most robo-advisors' automated investing strategies might reduce their competitive advantage. Thus market players need to further differentiate themselves by means of enriched value propositions and engagement models.

This impasse can be addressed by using a goal-based investing approach to enhance the benefits of banking digitalization. Goal-based investing can enable wealth managers to segment their offerings according to the personal goals of their clients, and hence tier their pricing to correspond to the value-added level of the advisory relationship.

Building a better robo-advisor

The key to success in this effort is linking sophisticated, probabilities-based, multi-period financial risk-return simulations and client profiling to support thorough, but personalized investment decision-making. Techniques such as mark-to-future simulations can be used to fine-tune portfolio allocations to align with client preferences and the client's investment lifecycle. Mark-to-future methods exploit scenarios produced by multiple analysts, weighted according to probability, to determine which stocks have become too risky to hold in the index of concern.

Financial advisors can verify whether a given set of an individual's investment constraints complies with the simulated total return of the portfolio by measuring the probability of achieving or under-performing a defined investment goal. In essence, the probability measure becomes the key variable in portfolio modeling and the key driver to determine where portfolio performance lies against a stated goal at any time in the investment journey.

In addition to providing this sophisticated financial modeling, wealth managers need to be able to communicate with their clients using clear, informative graphic design and good user-experience principles. In the end, all investment firms, both the FinTechs and the traditional firms, will have to differentiate themselves and provide a holistic approach to wealth management in order to attract new clients.

This requires them to consider the implications of portfolio management choices in terms of their competitive advantage, and hence the adoption of more advanced techniques to create model portfolios, generate value-added reporting to facilitate the communication between advisors and investors, and help individuals understand the implications of their investment choices for the long term.

An altered competitive landscape

After the global financial crisis of 2008-09, wealth managers increasingly adopted fee-only business models, in which the ability to increase the price of added-value financial advice became a strategic imperative. In such a competitive environment, reducing costs for risk monitoring, investment analysis and reporting without sacrificing key information is critical.

Industry leaders need to be able to streamline their advisory capabilities using tools such as robo-advisors in a way that creates a scalable, sustainable business model, yet retains a personalized client-to-advisor relationship.

Conclusion

The advisory model that a wealth management provider chooses can make the difference between winning and losing in the marketplace. Empowering investors to manage their investments in a transparent manner should be a key factor in evaluating any project of banking digitalization. And understanding how investment risks and returns can unfold becomes an imperative, not just for the short term but also in the long term where capital protection is a top priority. Goal-based investing sets the principles for this new investment language to help financial advisors, human or automated, align their customers' interests with the financial health of the institution.

With goal-based investing as a guiding principle, wealth managers can employ robo-advisors to give their customers the benefit of technology-driven portfolio management to help investors to grow their wealth at lower cost, while they deliver the added value of a more personalized investment experience. For banks and other traditional wealth managers, combining disruptive innovation with sustaining innovation may be the most disruptive strategy of all.

About the author

Paolo Sironi is the author of *FinTech Innovation: from Robo-Advisors to Goal Based Investing and Gamification* (West Sussex: Wiley, 2016), *Modern Portfolio Management: From Markowitz to Probabilistic Scenario Optimisation* (RiskBooks, 2015), and co-author of *The FinTech Book* (West Sussex: Wiley, 2016).

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