5 *Robo-advisers*: the automation of financial advice

Automation marks the evolution of asset management

In the world of financial advice, automated tools are increasingly being integrated into the process of providing advice to clients on their investment decisions. Although the current models retain the human factor to a greater or lesser degree, automation poses a number of regulatory and business challenges.

Traditionally, the private banking and asset management sector has been considered conservative in its approaches, but technological and demographic developments are transforming the products and services characteristic of this business segment. Now new opportunities are opening up for financial institutions to capture clients who feel more comfortable with digital channels and who until now have not had access to personalised advisory services.

Asset management products, which until recently were limited to wealthy clients, are reaching new customer segments. Thanks to the cost reductions inherent in automated advice systems, the proliferation of passive investment products and changes in consumers' attitudes, the barriers to entry have been lowered considerably. By way of example, Vanguard, a traditional asset manager, now offers its automated Vanguard Personal Advisor Services (VPAS) to clients with portfolios starting at US$100,000.

The term “robo” suggests non-existent or very limited human intervention in the process, but in fact the degree of automation varies widely, and for the time being the field is dominated by hybrid models. We can summarise the main common characteristics defining these services under three headings:

- **Automation** of investment decision-making processes: either by means of tools used directly by the client, with little or no human intervention (e.g. Betterment and Wealthfront), or using hybrid models (e.g. Personal Capital and FutureAdvisor) with algorithms that use the information provided by the client to generate a recommendation to the investor.
- **Transparency**, **speed and flexibility** and **low cost of service**, with very modest or even zero fees for the client, and good digital experience.
- The products sold are generally based on **passive investment** models, especially through exchange-traded funds (ETFs), although the personalisation of portfolios is maintained based on the data provided by the client, allowing different risk profiles to be defined.

We can see automatic advisers as forming part of the world of FinTech, in which investments reached US$290 million in 2014 alone (more than double the amount invested in 2013)[4]. However, traditional managers (such as Charles Schwab and BlackRock) and the major banks[5] are also incorporating these tools into their portfolio of products to reduce costs and reach the new customer segments that prefer to interact through digital channels. Some of the pioneering start-ups have signed strategic alliances with traditional players: for example, Betterment has teamed up with Fidelity Institutional Wealth Service, and FutureAdvisor with BBVA Compass.

Market estimates for 2020 vary from consulting firm A.T. Kearney's projection of US$2 trillion in assets under management, counting both new clients and those taken from the traditional advisers[6], to the US$490 billion

4: “The Rise of the Robo-Advisor - Wealth Management Disrupters Garnering More VC”, *CB Insights*, 18 Feb. 2015 <https://www.cbinsights.com/blog/robo-advisor-wealth-management/>
5: Dunkley, Emma, Martin Arnold, “UK banks set to launch ‘robo-advisers’”, Financial Times, 22 Jan. 2016 <http://www.ft.com/cms/s/0/afb03182-c107-11e5-9fdb-87b8d15baec2.html>
6: Epperson, Teresa et al. , *Hype vs. reality: the coming waves of “robo” adoption,* A.T.Kearney, 2015 <https://www.atkearney.com/documents/10192/7132014/Hype+vs.+Reality_The+Coming+Waves+of+Robo+Adoption.pdf>

predicted by Cerulli Associates, from the current level of US$18.7 billion[7]. The bulk of the market is currently centred on the United States, although some firms in Europe (Nutmeg, Wealth Horizon) and Asia (Dragon Wealth) also have this type of service.

Regulators are assessing the risks and opportunities associated with automated advisers

The European financial authorities, as part of their market monitoring tasks, have shown interest in the automation of financial advice. In particular, they are assessing the various ways in which consumers can use automated tools to receive financial advice without human intervention or with very limited human intervention. In December 2015 the EBA (European Banking Authority), ESMA (European Securities and Markets Authority) and EIOPA (European Insurance and Occupational Pensions Authority) published a joint discussion paper on automation in financial advice[8]. The discussion paper describes the main characteristics of the automated financial advice tools observed, gives a preliminary assessment of the potential benefits and risks, for both consumers and financial institutions, and presents a general view of how the market might evolve.

The document firstly tackles the definition of the concept of automated advice, which takes in various kinds of tools, not only robo-advisers, but also comparison and finance planning tools. Some of the issues raised concern consumer protection as it relates to the information that consumers receive from these tools and its consideration as advice. Mention is also made of clients' proper understanding of the risks assumed by signing up for products, just as with advice given by human managers. As regards to the algorithms used, the matter of transparency in the process is raised, for both clients and supervisors, as is the need for products recommended by advisers to be suited to the specific needs of each client, as well as the possible risks deriving from failures in the functioning of the tools.

The salient benefits relate to cost reduction, with a positive effect on both the institutions, which will be able to enlarge their customer bases, and on consumers, who will gain access to services which hitherto have been reserved to affluent segments. Lastly, mention is also made of a possible improvement in the quality of service, which may reduce the bias deriving from human intervention.

Conclusions

The digitisation of advice is a reality that opens up new opportunities for institutions and clients. All advice tools contain a greater or lesser degree of automation, even if they include the human element. And clients' increasing familiarity with digital channels means that automated advisory tools for financial planning are in growing demand. It is likely that the supply of services will evolve towards more complex portfolio planning and management tools and with a more diversified product offering. Nonetheless, these changes are not expected to lead to the disappearance of specialised services for high-net-worth clients, which are difficult to automate, nor will human intervention be completely eliminated.

7: Leonhart, Megan, "Digital advice to hit $490 billion by 2020: Cerulli", Wealth management.com, 4 Nov. 2015
<http://wealthmanagement.com/technology/digital-advice-hit-490-billion-2020-cerulli>
8: *Joint Committee Discussion Paper on automation in financial advice*, EBA, 2015
<https://www.eba.europa.eu/documents/10180/1299866/JC+2015+080+Discussion+Paper+on+automation+in+financial+advice.pdf>

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This report has been produced by the Digital Regulation Unit:

Chief Economist for Digital Regulation Unit
Álvaro Martín
alvaro.martin@bbva.com

Vanesa Casadas
vanesa.casadas@bbva.com

Israel Hernanz
israel.hernanz@bbva.com

Alicia Sánchez
alicia.sanchezs@bbva.com

Javier Sebastián
jsebastian@bbva.com

Pablo Urbiola
pablo.urbiola@bbva.com

With the contribution of:

Tomasa Rodrigo
tomasa.rodrigo@bbva.com

David Tuesta
david.tuesta@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey
Alvaro Ortiz
alvaro.ortiz@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Global Areas

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

Azul Street, 4
La Vela Building - 4 and 5 floor
28050 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com