

# LEANING INTO THE TURN

## Asset managers are racing to find a new business model

By Maha Khan Phillips

Last year, two US-based mutual fund giants, Charles Schwab and Vanguard Group, launched new robo-advisory solutions for their clients. Schwab Intelligent Portfolios charges no advisory or account service fees and takes no commissions, earning revenue from the proprietary exchange-traded funds (ETFs) it offers as part of its provision. The firm also launched Institutional Intelligent Portfolios, a platform that enables Schwab custody clients to create their own portfolios. Vanguard Personal Advisor Services, meanwhile, piloted its project for around two years before launching to the larger market and has seen its business rapidly grow to over \$31 billion in assets under management.

Both launches are indicative of changing business models in asset management driven by wider market trends. The biggest trend is being led by investors, who are wary of paying high costs in a low-yield environment and want better engagement from their providers.

“Asset management fees have been far too high for far too long. With developments in technology and huge increases in the general speed of knowledge, there is a trend to make sure asset managers are providing value for money. Fees are under pressure, particularly on the institutional side,” explains Andrew Drake, partner at PricewaterhouseCoopers in London.

There are also regulatory drivers, such as MiFID II in Europe and the Retail Distribution Review in the UK, put in place to level the playing field for investors and to move away from high-commission charges. Scott Burns, global head of asset management at Morningstar,

suggests that these developments are changing the nature of distribution and advice models, as well as product proliferation.

“The bigger trend that is happening is the change we are seeing globally from commission-based advice to fee-based advice. Fees are dropping, and the move from active versus passive to the growth of multi-assets is all being driven by the change in this distribution model of wealth that asset managers serve,” he says.

### VERTICAL INTEGRATION

This change has long-term implications for investment companies, which are finding less reward in offering high-cost products. Richard Phillipson, a London-based principal at global advisory firm Investit, suggests that it will be vertically integrated companies—those owning as many components of the investment business process as possible—that will see the most success in the future, particularly because of the move towards defined-contribution pension provision.

“The addressable part of the market in other areas is disappearing. There is less investment churn in the defined-benefit space now, and there’s more passive investing and liability-driven investing, which doesn’t churn products. You’ve got the diversified-growth portfolios to fight over, but even that’s a declining part of the market,” he says.

It means that the wholesale market is shrinking, and on the retail and wealth fronts, investment firms are pulling the advisory components in-house as much as possible in order to make up for lack of opportunities elsewhere, according to Phillipson.

## ADAPTING TO ROBO-ADVISERS

These new market dynamics have been a catalyst for the rise of robo-advisers. Burns believes this trend has less to do with the growth of digitalisation and more to do with the changing nature of advice models. Robo-advisers, which primarily provide automated wealth management solutions, are estimated to grow into a \$225 billion market by 2019, according to MyPrivateBanking. The digital trends research provider also estimates that a new “sub-species” of hybrid robo/human contact service strategies will account for 10% of total investable wealth by 2025, growing to \$3.7 trillion of assets worldwide by 2020 and to \$16.3 trillion by 2025.

In the US, firms like Betterment and Wealthfront have launched offering pure robo-advice, while in the UK, Nutmeg is a key provider of robo-advisory services (though it is now looking to also start offering financial advice—see sidebar). Meanwhile, high-profile traditional firms have entered the market as well, including BlackRock, which purchased FutureAdvisor last year, and Deutsche Bank, which added Anlage-Finder (Investment-Finder in English), a robo-adviser for both experienced and first-time investors, to its maxblue online investment platform. Fidelity, which initially made its foray into the market by working with Betterment, revealed last year that it would be testing a new proprietary retail robo-adviser of its own called Fidelity Go.

Vanguard Personal Advisor Services has been, as its name implies, at the forefront of these developments, with \$31 billion under management as of December 2015. Ten billion dollars comes from existing assets on which Vanguard already offered advice, but \$21 billion has come from its new service. Vanguard’s offering is both automated and

human, and Nick Blake, the company’s head of European marketing and policy, says that demographic factors influenced its decision to launch the business.

“Like the rest of the world, we are experiencing the baby boomers now reaching retirement. For the next 15 years, something like ten thousand Americans will reach retirement age each day. So, what we were starting to experience was a lot of that boomer generation



Nick Blake

moving from accumulation to decumulation, and for some people that involves complex choices. More and more people in that position were asking for help,” Blake says.

Vanguard had built an automated retail business some years ago, but that hadn’t been successful, according to Blake. “When we surveyed clients, the general result was that they just wanted to talk to someone. They wanted technology but also to be able to have a reassuring conversation.”

As a result, the firm launched a hybrid model that allows clients to engage with a certified financial planner at any point in the process of making an investment. “The service is a combination of technology and people. We’ve lowered the amount people can access the service from to \$50,000. We’re trying to democratise availability of advice in that

way. The cost is 30 basis points, which is lower than you would get elsewhere. It actually goes down, depending on what the assets are,” says Blake.

## INVESTING IN THE LONG TERM

There is another reason existing providers want to be in this market, and that is because they want clients they can later integrate into all of their services. One of the unintended consequences of moving from a commission to a fee-based model is that the amount of money an investor needs to bring to an adviser is going up, says Burns. This means that firms must also consider how to retain clients for the long term. “There are two reasons why people don’t qualify for advice: They don’t have enough assets, or they don’t have enough assets now. Wealth platforms are being faced with the challenge of how to scalably bring those people along the growth curve so they are still inside the system,” he says.



Julie Barker-Merz

It is something that Julie Barker-Merz, president of BMO Investor-Line, has considered during the launch of her own operation. The Bank of Montreal was the first of Canada’s big banks to launch a robo-advisory business with the creation of BMO SmartFolio in January. The minimum account size is \$5,000 Canadian. “We have 900 bank branches across the country

who can offer this to consumers. Our hope for SmartFolio is that it will attract new investors to the company who will not just use SmartFolio but will have other needs met in the future by the company,” she says.

BMO decided to launch its product after recognising that there was a gap in the market. “There was a real need for advice. We worked for a number of years on how we could provide data-driven advice to help with decision making. The feedback we have had is tremendous, and the advantage for us is that we have the trust and credibility of a large financial institution. In Canada, there is generally a conservative spirit when it comes to investing. It has really made a big difference to be the first bank to say we’ve come up with a different option to traditional investing,” Barker-Merz says.

The firm’s advisory fee is charged on a sliding scale based on the amount of assets invested, starting at 70 basis points up to the first \$100,000. “We actually have to have a human interventionist during the portfolio management process, even if it feels like there’s a robot doing it for you. That’s the 70 basis points. Then you pay the management expense ratio (MER) on the ETFs on top of that. The MER is low; we aren’t expected to get above 30 basis points, though we are targeting between 20 and 25,” she says.

BMO also made the decision early on to build its capability in-house rather than acquiring an existing startup. “We did actually look at acquiring, because we thought it would be the shortest path to getting here, but it was expensive and the valuations were off. What we would have bought would be the user experience. The expensive part is actually

the back end and plugging things into our existing infrastructure and everything that happens after you buy the product. The easy part, in terms of the build, is the front-end user experience," she explains.

## WINNERS AND LOSERS

In its March 2015 report, *Hungry Robo-Advisors Are Eyeing Wealth Management Assets*, Morningstar argues that stand-alone robo-advisors will find the market challenging a few years down the line. "The current legion of stand-alone robo-advisors will have to invest heavily in advertising, or consolidate to gain scale, be acquired or partner with established brokerages, or go out of business," the research provider suggests.

Morningstar calculates that the break-even client asset level for robo-advisors is \$16 billion to \$40 billion, which was 8 to 20 times the client asset level for leading robo-advisory firms when the report was published. Stand-alone

firms will need to build serious scale to be able to compete against traditional houses entering the space.

Angelos Gousios, associate director of European retail research at Cerulli Associates, agrees with this assessment. "In the US, it is the large financial groups which have hijacked growth in this space. The fintech providers hold less than a third of assets at the moment in the US, and we think something like this might happen in Europe, with banks being best positioned to capitalise on this growth. They already have millions of customers, a brand, and customers engaged in their online framework."

But a lot of them are dragging their feet, he says, which is where stand-alone firms and startups have a chance to push ahead. "If they play their cards right, they can be the main winners of this."

CREATE-Research, a research boutique specialising in future trends and global asset management, believes there are three new business models emerging for the mass affluent

# Simplifying the Investment Experience

## WILL CLIENTS CONTINUE TO NEED "HUMAN CONTACT"?

*Nutmeg is one of the most visible robo-advisory brands in the United Kingdom. Nick Hungerford, chief executive, talks about where he sees the firm positioned in the market and about offering financial advice in the future as part of its investment proposition.*

### What is your size, in terms of clients or assets under management?

We currently have 95,000 registered users (we don't disclose our AUM).

### What are your client demographics?

Nutmeg is designed to work for everybody, be they super wealthy or simple savers, experienced investors or newcomers. Our typical customer is urban, technologically capable, appreciates high-quality products, and is time poor.

### Do you offer just ETF products or other products as well?

We generally prefer to use ETFs because they're easy to trade, low cost, and aim to track the movement of market indices with a high degree of accuracy.

### How do you see yourself positioned in the wider asset management industry?

Obviously we sell direct to consumer, so we are a retail wealth manager. Pre-Nutmeg, there were two options within retail wealth management. The first option is the DIY platform that allows customers to manage their own investments, and Hargreaves Lansdown is the most prominent of these. The second option is wealth managers offering high-end, expensive services that cater to the wealthy. We sit in the middle of the two, offering the best of both worlds: We aim to provide high-end wealth management service to people of all levels of wealth at a price comparable to doing it yourself.

We differ in many other ways, too. We have a single, low management fee, with no entry, exit, or trading charges, and

are totally transparent on investment performance. We offer our customers a very simple investing experience: a fully managed, globally diversified portfolio that can be set up in under 10 minutes, with no expensive lunches or expensive offices cutting into clients' returns in the form of high fees.

### Someone told me you are building a personal advisory business.

We're increasing the scope of our services to include financial advice. We're in the early stages of defining how it will work and are watching very carefully to see how the market evolves to help deliver the best outcome for customers.

### How much potential for growth do you see, and what's driving that growth? How much growth have you posted, year on year?

Last year we doubled in size, introduced a successful pension product, reformed our pricing, began developing an advice proposition, and transformed our operational platform.

### How much of the asset management business do you think robo-advisors will operate one day?

It's likely that a high percentage of customers will invest using technology-enabled solutions. It's our belief that most people will require some sort of human contact, even if it's at the level of administration.

### How does your technology work?

Nutmeg's core systems, everything from the website right through to our core trading and wealth management platforms, have been built in-house by our own development team. We believe that owning our end-to-end delivery capability gives us much more flexibility. The ability to build what we need when we need it means we can move quickly to seize new opportunities as they arise.

and retail client market. The first is virtual mobile advisers, a model that will eventually take the form of call centres in which advisers use mobile phones or tablets to talk to customers in real-time video meetings. “The personal element will remain intact in that the mass affluent will still have a designated adviser but with one difference: The designated advisers will interact with clients not through in-person meetings but remotely through mobile and digital media,” the firm wrote in its 2015 report, “Why the Internet Titans Will Not Conquer Asset Management.”

Online advice platforms, such as robo-advisers, make up the second business model. The third model will be consolidated platforms, mobile-based platforms that aggregate retail savings and create a bridge between banking, savings, and online advice platforms. “It is entirely possible that the breakthrough in this space will come from a mobile telephone company, not from a financial institution,” the report notes.

### QUESTIONS AND CHALLENGES

Which models will dominate in the future is not yet clear. “We do think the industry is heading in the direction of being disrupted by technology, but at the moment it’s difficult to predict what shape it will take going forwards,” says Luba Nikulina, global head of manager research at Willis Towers Watson.

Some consultants are concerned about any business model that is purely algorithmic in nature. “I’m sceptical about robo-advice, in the sense that I don’t think clients will be fine if performance goes down and they start to lose

money,” says Cara Williams, global head of wealth management and technology solutions at Mercer.

There are also regulatory and risk implications for the future. In April, the Massachusetts Securities Division warned that robo-advisers, as they are typically structured, may not be able to carry out the fiduciary responsibilities required of an authorised investment adviser. “Entities that create computer-generated portfolios but fail to do the necessary due diligence to know their customers and who specifically decline most if not all the fiduciary duty are not performing the duties of investment advisers,” warned William Galvin, secretary of the commonwealth of Massachusetts.

But Barker-Merz says automated solutions are bringing a lot to the table by making things simple for the end investor. “We have made things very complex over the years, and we’ve done customers a disservice as an industry. There’s a barrage of information that’s hard to decipher, and it is exhausting for people.”

Whichever direction the industry heads, it is clear that it will not be business as usual. “There’s a fairly dramatic shift going on. Firms that rely on the old way of doing business, who say, ‘You should hire us because we know everything and you know nothing,’ are going to disappear, because clients are becoming more savvy,” says Jackie Alvarez, principal at Investit.

Maha Khan Phillips is a financial writer in London and author of the novel *Beautiful from This Angle*.



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Phone 1-949-542-4200  
Toll Free 1-877-328-2999  
[www.globalfinancialdata.com](http://www.globalfinancialdata.com)

