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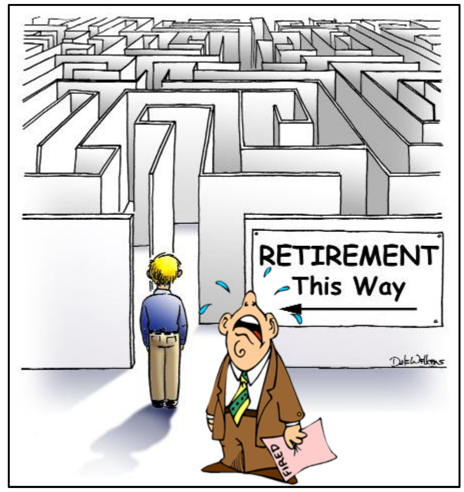
How to Fire Your Investment Manager

"A respect for evidence compels me to incline toward the hypothesis that most portfolio managers should go out of business – take up plumbing, teach Greek, or help produce the annual GNP by serving as corporate executives." (1974)

Paul Samuelson – Nobel Prize economist (1915 - 2009)

Navigating the Retirement Maze



When I was in business school, the banking industry was once described to me as adherents of the "3-5-3" rule: borrow at 3 percent, lend at 5 percent, on the golf course by 3pm. Several financial crises, merger binges, and regulatory overhauls later, the banking industry of today is a far cry from that of thirty years ago. Since the 2008-09 financial crisis, the number of commercial banks has fallen by 17 percent, and existing players are scrambling to remain viable in an era of megabanks.

The mutual fund industry is experiencing a similar change. In the past decade, the message of low fees has reached the masses, and index funds and exchange traded funds (ETFs) have seen enormous growth, mostly at the expense of actively managed funds. Not exactly what Wall Street foresaw for what they called "Bogle's Folly" forty years ago, when the first index fund debuted.

So, which institution is positioned to become the next victim of change? It's the financial management industry, firms that call themselves "advisors" which dispense little advice and mostly shuffle assets among different mutual funds. Two years ago, Wall Street Journal columnist Jonathan Clements wrote an article entitled: "It's Time to End Financial Avisers' 1% Fees." The trend has already begun, and the industry will never be the same.

Earning their pay?

The typical model for investment advisors the past several decades has been to charge between 1 and 1.5 percent of assets per year. What does a client get for that? Initially, the client is queried about their overall financial situation, investment timetable, and tolerance for market risk. Then the firm puts together a portfolio of funds that is suitable for the client's needs.

After creating the portfolio, the firm monitors the holdings, periodically reports on the progress of the portfolio, and occasionally makes adjustments. The initial consultation with the client, the filing of the paperwork, and portfolio construction might take between ten and fifteen hours of effort. Monitoring the portfolio and communicating with the client during the year, and doing some rebalancing of assets and tax-loss harvesting at year end, might require an additional ten hours annually.

If the client has a $1 million portfolio, they are paying the investment firm around $10,000 a year on an ongoing basis plus the fees of the funds. And as their assets grow, so does the fee. $10,000 a year for ten hours of effort sounds like nice work if you can get it, as the saying goes. However, like many other careers that have been displaced by technology – think manufacturing, travel agents, and telemarketers – the "only manage your assets" advisor is being made obsolete.

Robots are stealing their jobs

Enter the "Robo-Advisor," as the new online investment services are referred to by the press. What began as a handful of startups trying to offer a less expensive way for investors to manage their financial assets, has grown into robo offerings by all the major online brokerage firms. Vanguard, which launched its Personal Advisory Services two years ago, has already accumulated $47 billion in assets, four times that of the two leading independent robo firms, and charges only 0.30%. Schwab's "Intelligent Portfolios" has over $10 billion in assets, and charges no fee for accounts of a small as $5,000, with their compensation coming from fund fees and cash balances.

How does a Robo-Advisor work? When you set up your account online, you are asked a series of questions about your age, goals, risk tolerance, and time frame. (Sound familiar?) It then uses that information to create a portfolio of low-cost ETFs that it monitors around the clock, and rebalances automatically when required. It will also shift your portfolio holdings over time, much like a target date fund. No human intervention required.

When I researched the Robo-Advisor offerings recently, I came away thinking that they weren't bad for first efforts, but still left much to be desired. Many of them lack what I consider adequate asset class diversification. Also, their asset allocation algorithms don't factor in a customer's other assets held by 401(k) plans or other financial institutions. However, this is already beginning to change.

Robos: The next generation

One complaint that Robo-Advisor customers have expressed is the absence of human interaction regarding their particular financial needs. Several brokerages have already addressed this with telephone advisors to augment their automated services. One of the leading independent robo firms is also adding the human element to its service offerings, while another one offers integration to a client's other accounts and helps them create a retirement plan.

Additional innovations that are in the works include financial planning features, and more sophisticated back-end asset allocation. Even IBM is talking about using its famed AI computer Watson in wealth management applications. As software engineers continue to refine the robo offerings, and as the robo marketplace becomes increasingly more competitive, expect customers to get much more for their management fees.

The fate of the human advisor?

In Kurt Vonnegut's classic 1952 novel "Player Piano," he described a dystopian world where automation has replaced the jobs of the working class. Financial advisors who limit their practice to only managing a client's assets face a similar future. Am I concerned about my own career? Fortunately, when I entered this business I decided to offer a complete set of financial planning services to clients, including retirement, estate, insurance, college, and tax planning. It's a lot more work than just managing assets, but it provides more value to my clients than only managing their portfolios, and more relevant advice than that given by a 23-year old phone advisor.

Is your financial advisor an "only manage assets" dinosaur, soon to become a victim of the Robo-Advisor "asteroid"? If so, then maybe it's time to start investigating other alternatives that either save you money or offer you more services.

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