How do Robo-Advisors Compare to Traditional Financial Advisors?

By Mark Haser, MBA

Introduction

A robo-advisor is a service that provides investment management online with minimal human interaction. In 2010, Betterment became the first robo-advisor made available directly to retail investors. Since that time, the use of robo-advisors has increased significantly, and investors have continued to debate the merits of robo-advisors in relation to traditional (i.e., human) financial advisors. In this brief, we provide an overview of how robo-advisors work, explain the key difference between robo-advisors and traditional financial advisors, and discuss when, how and for whom the use of robo-advisors can be beneficial.

Overview of robo-advisors

Robo-advisors aim to automate the entire investing process, making it easy for anyone to get started investing. As the first step in creating an investment portfolio, a robo-advisor will provide the investor with a questionnaire to determine the level of risk the investor is willing to take, the investor's general financial goals, and the time period for those goals. From there, the robo-advisor can develop an appropriately diversified portfolio using primarily ETFs and index mutual funds.

Robo-advisors ease portfolio maintenance by automatically investing cash deposits and periodically re-balancing the portfolio if it drifts away from the designated target allocation. To help client's stay on track, most robo-advisors provide guidance as to how much money is required to fund each goal; they also alert the client if the goal appears to be underfunded due to market conditions. For those clients in high tax brackets, robo-advisors can even realize capital losses to help minimize taxes, a process known as "tax-loss harvesting."

Differences between robo-advisors and traditional financial advisors

Although those services sound a lot like the support that a traditional advisor provides, there are differences.

A robo-advisor provides a relatively narrow set of services, namely that of portfolio construction and investment management. Financial advisors, on the other hand, have a very broad skillset that enables them to provide comprehensive advice to help clients accumulate, protect, and transfer their wealth. To achieve these goals, financial advisors offer portfolio construction and investment management as part of a more integrated suite of services, including budgeting, tax planning, insurance analysis, and estate planning. This difference in scope is the key distinction between a robo-advisor and a traditional financial advisor.

In contrast to a robo-advisor, traditional financial advisors help their clients to see the big picture and assess trade-offs towards achieving their goals. Financial advisors provide recommendations about long-term decisions, such as buying a home, paying off debt early, and purchasing insurance policies. These types of decisions require a level of human interpretation and situational awareness ill-suited to robo-advisors. In addition, financial advisors help investors to stay calm in turbulent markets, whereas robo-advisors' ability to keep their clients from panic selling in a major downturn is yet to be tested. Finally, one of the key roles a traditional advisor plays is to coordinate the services of other advisors, including estate attorneys and accountants.

As you would expect, robo-advisors, with their highly cost-efficient, scalable, and narrow set of services, tend to cost less than a human advisor. The industry benchmark for a human advisor that charges clients based on a percentage of assets is ~1%. This fee tends to scale down as the level of assets increases. Robo-advisor fees, on the other hand, range from about 0.15-0.50% of assets under management and tend not to scale down since they are already low. Robo-advisors also, on average, have a lower minimum level of assets required to invest (although investment minimums vary widely for traditional and robo-advisors).

Who can benefit from a robo-advisor?

As mentioned above, robo-advisors can help investors with fewer assets who don't meet the investment minimum of most traditional financial advisors. For this very reason, many robo-advisors today target the millennial demographic. However, it is not just smaller investors who stand to benefit from robo-advisors.

Do-it-yourselfers ("DIYers") are another market segment that can benefit from a robo-advisor as they generally prefer not to hand over the reins of their financial lives to a traditional advisor. For DIYers who are already comfortable with other aspects of financial planning, such as budgeting and doing taxes, yet who don't want to take on the time and effort required to manage an investment portfolio, a robo-advisor can be a good solution.

One final group that may benefit from using a robo-advisor are those investors with simple financial situations who are in high tax brackets. A relatively straightforward financial life may not require the full-fledged services of a traditional financial advisor. At the same time, a high tax bracket provides the greatest opportunity for investors to lower their current taxable gains using the automated tax-loss harvesting from a robo-advisor.

Bottom Line

With their “smart” algorithms, low fees, and low asset minimums, there is a lot to like about robo-advisors. While studies have shown that less than 1/3 of Americans between 18 and 29 are actively investing in the stock market, there is little doubt that robo-advisors have helped to increase this level of participation and given many millennials an earlier start on saving for retirement and other goals.

The thing to keep in mind is that robo-advisors are really not advisors at all, but algorithms that help to automate the investing process. In this sense, robo-advisors can be a helpful tool; however, investing should not be done in a vacuum, but rather as an outgrowth of a sound financial plan—ideally one that incorporates principles of cash flow management, tax planning, risk management, and estate planning.

Artemis Financial Advisors
54 Chandler Street
Boston, MA 02116

617-542-2420