CFA SINGAPORE INSIGHTS

By Pranay Gupta

To robo or not to robo?

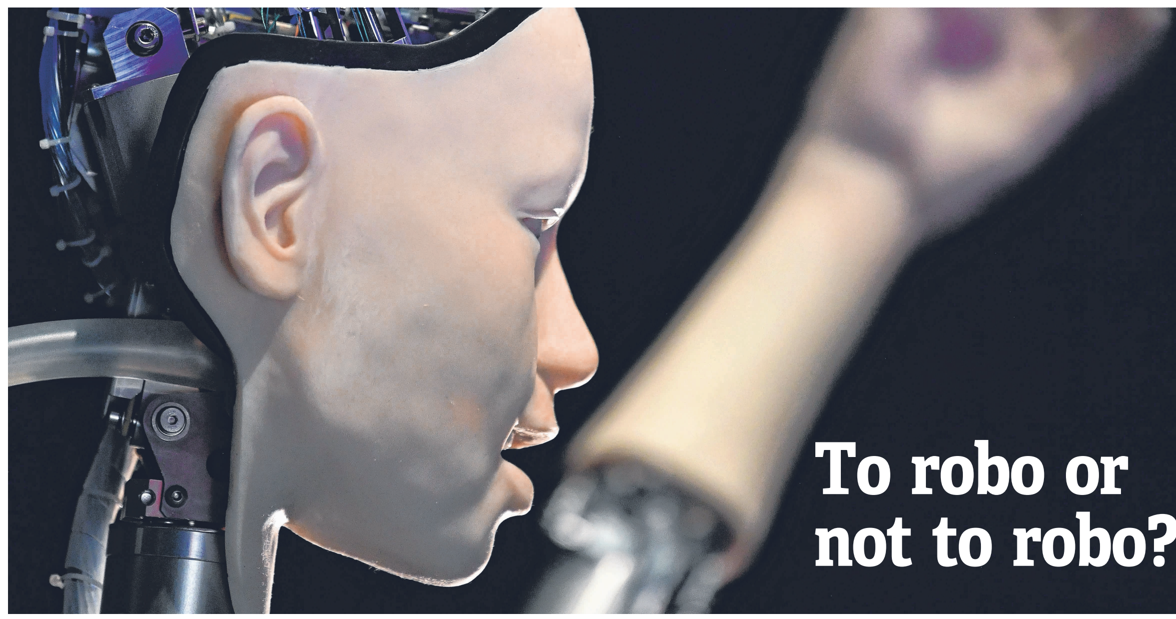

PHOTO: AFP

Is it safe to invest your money with a roboadviser?

HAVE you ever contemplated having an investment account with a roboadviser? It's as easy and convenient as shopping for groceries or booking a taxi on your phone. Answer a few questions online, provide some bank details and within a few clicks you have an investment account invested in stocks and bonds.

Roboadvisers, or robos as they are known, are fintech companies that use technology to make investing easy and accessible for everyone. No need to go to a bank, no need to spend hours with financial planners or deal with stockbrokers. And surely, the slick websites that robos have, the sheer ease of operation and above all the name itself – robo this, bionic that, AI the other – must surely mean they are really smart investment companies. But do you really know what a robo does with the hard-earned money you may give them?

The Asset Managers

In the physical world, to which most of us non-millennials are accustomed, asset management is a heavily regulated, skill-based business which is scrutinised at every level before a company is allowed to manage anyone else's money. Regulators protect the rights of small consumers by enforcing rules of disclosure, fairness and legality. Not only the asset management firms, but also the individuals working in those firms are licensed and closely monitored. And the penalty for disobedience can include fines and incarceration. Getting a licence for operating an asset manager is not easy, and becoming a portfolio manager in an asset management company is a much sought-after job for a finance professional, which can take even a decade.

The Robos

Enter the robos. Robos are made up of technology professionals skilled in web design, databases, cloud architecture and application program interfaces. They have all the tech geeks one could imagine, but they seldom have any experienced investment managers as staff. Generally, robo firms don't have publicly traded funds which could be scrutinised. They don't have any published performance track records which you can examine upfront. They don't even disclose who, if anyone, is the portfolio manager or analyst who constructs the models or what the process is by which investment decisions are made. In fact, in most robos there isn't a single person who has ever managed money in their life for anyone. And you can be sure that there is no smart robot or bionic man behind the scenes who is a substitute.

Technology versus Finance skill

It would be fair to say that asset managers don't have the best technology skill and most probably couldn't do the "tech" part of fintech to any enhanced level. But equally, a fact which is being overlooked today, is that robos don't have any finance and investment skill and they certainly are challenged in experience for the "fin" part of fintech. Yet somehow the naive public is unaware of this fact, and the regulations are sketchy at best.

So why do robos exist and why are they flourishing? Robos have exploited two basic facts:

☛ That the fee structure charged by bank distributors and asset managers is far too high, and

☛ That the real problem for any investor is asset allocation, not security selection, which can be facilitated by using passive ETFs.

By implementing a business model where robos use technology to decrease product cost and provide a portfolio invested in lower cost passive ETFs, robos are targeting these inefficiencies of traditional product manufacture and distribution. But low cost alone, does not make a robo portfolio right for any investor. The basic skill required to manage any portfolio in a robo or a traditional asset manager is still investment skill, and that is what robos completely lack.

The Regulators

What is somewhat surprising however, is that financial regulators who otherwise are diligent about firms operating in their industry have been lax in the regulation, governance and monitoring of robos, which at the end of the day provide investment management services to the most vulnerable of investors – the common man.

What do the regulators need to do?

A robo is the same as any other asset manager, and should be regulated as such. This will create a common playing field.

Robos should be required to disclose performance of their aggregate assets against their respective benchmarks as publicly available data for all to see and evaluate.

Robos must be required to provide performance attribution of their portfolios to make it clear to potential investors what value they are adding or subtracting above market return.

B2B robos and B2C robos should be treated the same. Just because the B2B robo provides its services to a bank, it is still the entity that makes the investment decision. Both types should be treated the same for licensing and governance.

The compliance and risk function in a robo need to be as strong as an asset manager. They are both prone to the same risks.

As for the asset managers and bank distributors – regulators need to incentivise them to use technology to reduce inefficiencies which give rise to high charges. And there can be no better way to incentivise them for this, than by capping the front-end and distribution fees they are allowed to charge, to bring it to a similar level as that of a robo over time.

What should the Consumer do?

Don't be beguiled by the slick online marketing of robos. The only solution is to invest only with a firm that can demonstrate both investment skill (with published track records) and technology skill (to reduce distribution charges). That is the essence of Fin+Tech. And neither a robo alone nor an asset manager alone is likely to provide this combination. The only winning business model is a business partnership where a robo provides the technology platform, and an asset manager provides the investment expertise, distributed through a technology-savvy distributor to minimise costs.

Don't be swayed by the inexpensive investment products which robos manufacture on their own without asset management skill. As is always the case with anything in life – if you pay peanuts you get monkeys. So, unless you want a monkey managing your hard-earned money, invest only with a robo-asset manager combination, not a robo trying to manufacture investment products on its own.

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