How to Kill a Robo-Advisor

By Kurt Rosentreter, CPA, CA, CFP, CLU, CIMA, CIM, TEP, FCSI, FMA

I Won Another Client from a Robo-Advisory Firm.

If you follow the financial press in Canada and elsewhere you have heard that something called robo-advisory is being positioned as the future of financial advice and a better way for consumers to invest their savings. It consists of investment firms using technology to manage investment portfolios, offering some degree of standardized investment portfolio advice, no personalized advisor relationship and low fees. The investment portfolios are built using index style products called exchange traded funds (ETFs) and a passive investing approach. Investors open RRSPs, TFSA and other accounts, transfer money or securities to these investment dealers, have their risk assessed and get a portfolio of ETFs built for them. You can even do all this from your computer at home. A monthly fee is charged, some administrative fees may exist, and you are set up in the self-described best option for your money management needs today. Sounds great right?

Even an article by Rob Carrick of The Globe and Mail on January 11, 2018 said: *"Robo-advisers also came to mind when a reader recently asked how to find an investment adviser who is trustworthy".*

Over the last few years money has been thrown left and right to start up financial firms in Toronto that have built robo-advisory platforms. These companies are now pursuing the clients of full service financial advisors to show them the better way. Their pitch: we can build you a better investment portfolio with much lower fees. These lower fees will result in better investment results. Financial advisors have been told to brace for a sea of investors who will finally snub her nose at the full service financial advisor channel and move their millions to robos to save fees. The future appears bright for robo-advisory firms and their executives who can be regularly found in the Canadian press talking up their "better way".

Even before I met Bill, I was skeptical about robo-advisory and its long-term success. We already have discount brokerages for people that want low cost investing and can trade on their own. Robo-advisors just seem to be an enhancement of discount brokerage with higher fees in exchange for portfolio design

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done for you. Sure, there will be some people that value the low cost guidance but will there be enough people for a new robo-advisory firm to pay for their technology, people, office lease, marketing and more? Can a robo firm earn profits when they charge low fees yet have tremendous infrastructure costs? Clearly robo firms are in a race to survive – survival means getting enough clients signed up paying monthly fees so that the robo firm can pay their bills. This will ultimately be their test and several robo firms have been helped by investments from large Canadian financial companies along the way. But can they convince enough people that they have built a better way to invest? I'm not sure. Read on.

Meet Bill. He is now another former robo-advisory client.

Bill called me weeks ago to discuss engaging our services for full service financial advice and investment management.

I asked him who he is working with now. He said three years ago he transferred his RRIF, Tax Free Savings Account and investment account to a robo-advisory firm in Toronto after deciding to leave his financial advisor. He was motivated by the low cost and heard ETFs were a good way to invest.

Now after three years of robo-advisory he has had enough and wants to get away.

Bill has followed my writings over the years (he had a copy of my seventh book) and felt that perhaps I could be a fit with him as a full-service advisor. I told him we also offer low fees and that I too use ETFs in portfolio design. In fact, I told him, I have been using ETFs since before robo-advisory firms existed and that I have written about the merits of passive indexed investing for more than a decade.

Bill and I booked a meeting a week later to continue our conversation in his home over a coffee. I asked him to send me copies of his investment statements from the robo-advisory firm, his tax return, will, details of his cash flows and net worth along with an email describing his financial goals. This background information would help me start to get up to speed on his financial facts as we headed into our first sit-down planning session together. Note he is not a client yet at this point.

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Meeting at his Home.

Bill, age 65 and divorced, welcomed me into his home to sit down and talk.

The Old Portfolio that the Robo-Advisors Sold Off

First, a bit about his investments before he moved to a robo-advisory firm. He showed me a statement from his old broker three years ago and with some questioning I noted the following facts:

- His TFSA: He held three Canadian bank stocks and shares in BCE.
- RRIF: He held six government strip bonds that he said he owned for more than fifteen years and paid him 6%/year in interest income.
- Investment Account: He held a balanced mutual fund, one U.S. S&P500 index ETF and two more stocks.
- Total portfolio of approximately $300,000 at that time with the old broker.

The old full-service accounts were commission based meaning he paid no annual advisory fees and instead paid approximately 1% per trade when he bought or sold equities. He paid less if he bought bonds. He said he and the broker hadn't traded much – I told him that means his fees were likely only a few hundred dollars a year – he was not paying a lot! I pointed out that his move to robo-advisory from this low-cost advisor likely meant he actually moved to a higher cost solution at robo. He was surprised to hear this.

I asked Bill what happened to all these securities when he moved to the robo-advisory firm – I said the bank stocks were solid investments and the old bonds offered interest rates that cannot be matched today….

Robo-Advisory Portfolio Design: Potentially Inferior Investment Returns from Inferior Design

A Tax Disaster and Disregard for Solid Investments

"Kurt they sold everything. They said they don't hold individual stocks so they sold my old bonds paying 6%, sold my bank stocks, sold my BCE shares with a 5% dividend that I held for 30 years and put all my money into ETFs. I paid trading commissions to them on all the sells and worse they triggered a ton of income tax

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that year which ended up clawing back my Old Age Security pension. They completed disregarded taxes and fees to make me fit into their model. They said this was the only choice and didn't care about holding otherwise excellent investments nor did they factor in my tax position or my OAS pension."

I told Bill that made no sense*. "I know that now Kurt. Why would they do that to me?"*

I suggested that because they only way robo firms can make money is to treat everyone the same – they need to put everyone in the same few securities (ETFs) to standardize the work so they can amass as many customers as possible with as little effort as possible. Only through mass standardization can they hope to make a profit for the company owners. Couple that with lack of focus on tax planning and retirement income and you had salespeople merely getting rid of everything that didn't fit their model.

Duplication Means No Plan, No Common Sense

I reminded Bill that he had also provided us with copies of recent statements from his three investment accounts at the robo-advisory firm. I told him I had brought an analysis of the portfolio they had built him. I explained what I saw and what I thought about it. Here is what I told him:

- <u>All three</u> of his investment accounts <u>held exactly the same</u> ETFs:
  - The same government bond ETF was held in all three accounts.
  - A real return bond ETF was held in all three accounts.
  - The same Canadian equity index ETF was put in all three accounts.
  - A Canadian real estate stock ETF was held in all three accounts.

I said that duplication of same products across three accounts is not a plan – it just looks like this was easiest for them to do. Besides feeling there is no plan under this strategy, there are other reasons this is bad planning. For example, I said to Bill, the TFSA, RRIF and investment account have three different tax impacts each year. A RRIF is tax sheltered for life. A TFSA is tax free for life. And the investment account is taxable annually. Why wouldn't you put the lowest taxed products in the investment account and the highest taxed products in the RRIF? It appears no sensitivity to tax planning was considered at all.

"Kurt I agree. I have paid a lot more tax each year I have had my accounts with the robo-advisory firm than I ever did in the past. I can see why now."

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Bad Performance Will be Magnified under this Robo Portfolio Design

Putting the same product in every account means that if one product has a bad year you will have a bad year in every account. This robo-advisory approach to portfolio design has concentrated your risk through the product duplication across accounts. This can make your portfolio more volatile and risky than a normal portfolio design that would use different products in different accounts.

Selling 6% old Bonds to Buy Bond ETFs is Outright Dumb in a Rising Interest Rate World

Then I showed Bill what the robo-advisory firm did with his bonds that had paid 6%/year for years.

They put the money into bond ETFs (portfolio of government bonds with a small annual management fee) that have provided an investment return of less than 1.6% over the last three years (source: www.globeinvestor.com, December 31, 2017). I told Bill that his current investment return is less than his old 6% bond that they sold because of the fees paid inside the ETF annually that he now pays and because his investment return in the ETF is now tied to rising and falling bond prices that are affected by market interest rates and other factors. I explained how a bond ETF can be a “wild ride” compared to GICs or individual bonds held until maturity like he used to have.

“Can a bond ETF that this robo-advisory firm used throughout my portfolio lose money Kurt?” Bill asked.

I explained to Bill that bond ETFs can lose a lot of money: -5%, -10% even -15% under the wrong market conditions.

“Even a GIC would have been better Kurt” Bill said.

Then I showed him how the one-year return on all the bond ETFs (in every account remember!) is negative (source globeinvestor.com, December 31, 2017). Rather than getting 6% return he was getting on the good old bond the robo-advisor sold off, he is now losing money on 60% of his entire portfolio this year.

“Kurt, why would they do this?” Bill asked.

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I explained to Bill that robo-advisory firms use ETF products that hold stocks and bonds in order to make their portfolio models work easily and to make money for their firm through this mass standardization. If they had kept your old bonds (and even your good bank stocks and BCE shares) they would have had to offer you more personalized service. They would have had to deal with bond maturities and stock advice and monitor the stocks – all of this takes people and time and money that robo-advisory firms cannot afford to do on their low fees. So rather than put in the time to help you, they sold your good securities and put you into products that suit their business model – even if these products are crap.

And in moving bonds into bond ETFs they moved Bill into higher risk, more volatile products that are now losing money and may continue to lose money if interest rates rise in Canada. They did this to suit their means, not to suit Bill's goals or understanding. There was absolutely no reason to sell high quality, high paying bonds from years ago – even the old broker knew this and held them for Bill.

I suggested that if Bill believes interest rates are going to continue to rise in Canada that he needs to get out of these bond ETFs now and go back to GICs and individual bonds – unfortunately now at interest rates of 2% to 3% and not the 6% he had.

Good Old Diversification by Country – Where Did it Go?

We then turned our mind to geography. I asked Bill why there is almost no U.S. equity exposure in the portfolio.

"I don't know Kurt. I just followed their advice" Bill said.

I pointed out that in 2017 the U.S. market returns were up almost 20% and the Canadian stock market was among the worst in the developed world up only approximately 6% (source: www.globeinvestor.com, December 31, 2017).

I asked Bill why didn't they rebalance to give him some additional exposure to the U.S. stock market, the largest market in the world? I pointed out that the U.S. start market is up 90% over five years compared to less than 30% cumulative return for the Canadian market to December 31, 2017. They've had lots of time to increase your U.S. stock market exposure.

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"I don't know Kurt. I don't hear from them. I guess that's how robo-advisory works. If I have questions I can book an online chat. That tends to work faster than trying to call. I guess I can contact their people and ask".

I asked him if perhaps he had held more U.S. equity in past years. I asked how much they rebalance and perform trades to take profit, sell losers and reposition for market potential.

"They don't trade much Kurt. I don't recall seeing any more U.S. exposure before either."

I suggested to Bill that whatever he has saved in fees by moving to robo-advisory was far surpassed in lost returns over three years from the bonds he was forced to sell, the poor returns on the bond ETFs and the missed exposure to the roaring U.S. stock market over all three years he has been there.

Fees

Bill made it very clear throughout our initial two conversations that the main reason he went to the robo-advisory firm was because they convinced him their low-cost approach to investing was best.
While he knows generally he was paying a monthly fee he had never added up the total cost of what he was paying. So we did. We added the costs we saw on his statements. We added the trading commissions. And we added up the administration costs outlined on the robo-advisory firm's website.

Robo-advisory is not as cheap as we thought it would be! Here's what we found for Bill's accounts totaling $300,000 overall:

- He pays a monthly fee that varies by portfolio size. Bill's fee is $80/month or $960/year. That equates to 0.32%/year as an annual cost of the assets.
- Trading costs are $9.99/trade up to a yearly maximum of $100.
- He also pays an account fee of $100/year for RRSPs and $75/year for non-registered accounts. The robo firm is waiving the higher fee.
- So add it all up and he may pay approximately $1,235/year or 0.41% of the portfolio. Plus HST.
- Let's also not forget the embedded costs of the ETF products. They range from 0.10%/year to 0.25%/year.
- So all in Bill is paying approximately 0.40% + 0.10% equals 0.50%/year plus HST.

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I told Bill these costs are indeed lower but not as low as I thought they would be for a relationship that includes no detailed, personalized financial planning, no tax advice, no retirement cash flow design, and is a standard portfolio in a box that is producing lower current returns than his old portfolio with basic customer service that includes online chat instead in in-person meetings.

And then I pointed out that his old broker holding the bonds, bank stocks, mutual fund and ETF had a lower annual cost than he is paying now. He actually moved to a higher cost solution provider to get less.

"Really?" said Bill. "The robo-firm told me they would be much cheaper than mutual funds."

I explained to Bill that robo-advisors using ETFs are cheaper than mutual fund products. Mutual funds have embedded fees that can approach 3%/year a year. But your old broker only had one mutual fund. Most of your portfolio was in stocks and bonds where there are zero costs unless you trade. I showed Bill how his old portfolio was better performing and lower cost – offered by a broker that he admitted he liked more than the chat room he has today.

"And my old broker knew my name Kurt and picked up the phone first ring always!"

I then taught Bill about fees and commissions and Canada's history with high cost investing and poor transparency. I explained how many, many financial advisors over-use mutual funds, wrap accounts, segregated funds and people do end up paying 1.50% to 3%/year in fees unnecessarily and with little value. But there is also a growing number of financial advisors that charge full service advisory fees for 0.25% to 1.50% and offer relationships, financial planning, regular communication and use ETFs and stocks and bonds to keep product costs down.

I explained that if Bill focuses on value that he can find reasonably low costs for advice and investment products in Canada without moving to robo-advisory.

I told Bill that the advisory fees we charge in our practice are 0.60% of a client's portfolio each year (same as the robo-advisor described above) and here's what the client gets for that fee:

- Customized, monitored portfolio design using ETFs, stocks and bonds with regular rebalancing.
- Tax smart portfolio design.
- Visible, potentially tax deductible annual fees that decline as portfolios grow.

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- Full financial planning services including: retirement planning, tax planning, goal discussions, real estate advice, eldercare, children's planning, career financial advice, debt planning, estate structuring and help with insurance to name a few.
- Access to a team of ten professionals that are CFA Charterholders, CFPs and Chartered Accountants with more than 100 years of combined experience.
- A caring, conscientious approach that treats every client equally and importantly.
- A team of people that will talk to you in person as much as you want.

"Kurt you charge the same fees as the robo-advisory firm does?" Bill said.

I explained that fee can be lower, the same or higher depending on the services you want, products you buy and our role in ongoing management of your finances in partnership with you.

"Kurt why does anyone go to robo-advisory firms when they offer so little for the same fees as full service – in some cases their fees are actually higher," Bill says.

I explained to Bill that there is a lot of marketing going on to the public stating that full service advisors have high fees. And some do.   But the public needs to start by understanding what fees they do pay and then have a frank conversation with their full-service advisor about value, preferences and even what securities they can put a client's portfolio.   Advisors that choose to only use mutual funds and segregated funds will lose clients to robo-advisory. But the vast majority of financial advisors that want to serve their client's best interests will be glad to explore fee choices, service levels and investment product types.

Robo-Advisory vs. Discount Brokerage

I asked Bill why he didn't go directly to a discount brokerage firm and build his own portfolio when he decided to leave his full-service advisor three years ago.   I explained that discount brokerages are offered by all the major banks, there is telephone support to help with trading, costs are as low as $10/trade and there are few other fees (so cheaper than robo-advisory firms) but you do need to decide yourself what to buy.

"Could I have kept my 6% bonds and my bank stocks?" Bill asked.

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I explained he could have transferred all the securities he liked to the discount brokerage and continue to hold them with no ongoing cost. There only would have been a cost if he trades. This is the lowest cost option of all.

He said he knew about ETFs but would have needed some help to get the trading symbols and understand the exact ones he wanted to buy. I explained that the customer service team on the phone and online at the discount brokerage would help him with this. They cannot provide advice on what to buy but they can educate you about products.

"So I can have all the same products and more at a discount brokerage with lower cost than an robo-advisory firm offers?" Bill asked.

I explained that discount brokerages are more established, have large teams of support to keep wait lines down, offer stocks, bonds, ETFs and mutual funds and have lower costs than robo-advisors.

Communication

I could tell from my two conversations with Bill that he valued having someone to talk to about money, about taxes, about dying and what his kids will get, about how to generate cash flow each year, what accounts to draw the money from, the stock market, bitcoin, marijuana stocks, interest rates and the housing market in Toronto. And he wondered how all of this would affect his finances, his lifestyle and his goals. In other words, he's pretty normal. Money is emotional and important and few Canadians can invest and turn off emotion.

Unfortunately robo-advisory firms have forgotten that. They think people can invest like robots and this may in the end be their Achilles heel. You cannot just stuff everyone's money into a box (of ETFs), put them on the shelf and move onto the next person. Sending people to a chat room or failing to talk about the world around their portfolio causes people to worry.

I asked Bill if the robo-advisory firm every talked to him about these broad financial topics.
'No Kurt,", Bill said. "I have a type of account manager who answers my account questions. I can also arrange for a portfolio manager to contact me. I can contact them through a chat online or I can phone in. More than once I've had to wait to talk to someone live. They don't know me at all and I don't know them. I'm just an account number to them".

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And with the robo-advisory firm's goals to have hundreds of thousands of clients – clients that the robo-advisory firm needs to pay their bills - the chance of thousands of clients getting a phone call or meeting when the stock markets are falling and you are worried about your money could be a long wait. Let's not forget: robo-advisory services and companies have been born in Canada in the middle of a long bull stock market in the United States. No one has faced steep market declines since 2008. What happens when we have the next serious recession and the stock market falls sharply? The equity ETFs that the robo-advisory bought for the client will fall too. The real test of success for robo-advisory firms will be in down markets when worried clients see mounting losses and potentially have no one to talk to.

"Kurt, you must be busy, how much time would I expect to get from you when my portfolio is only $300,000?

I told Bill we develop personalized communication plans for each client no matter what size. We schedule regular meetings (one to four each year) often at client homes or offices. We use phone calls for trade instructions and more time sensitive details and decisions, we send emails with data where we want a client to read something and have a written copy and we send statements and offer online access with rates of return to show performance results. Our team of ten is in the office everyday and everyone knows every client by first name. Three people are dedicated to each client and I myself as the senior advisor conduct every meeting with you. We will not just talk about your portfolio construction, strategy and results but we will talk about your goals, world events, family matters, taxes, dying, careers, homes, debt, divorces, health issues, babies and much, much more.

Goals

The robo-advisory firm quizzed Bill about his investment profile in order to build his portfolio.

I asked Bill if they ever asked him about his goals – his financial goals and dreams – what this pool of money is designed to accomplish. And did they quantify his goals and attach time lines?

"No Kurt, they have never in three years asked me about my goals in a detailed fashion".

Isn't that the point of seeking out financial advice? Isn't it all about your goals and investment products are merely tools to help achieve your goals? Bill explained to me that his pool of money is to help him live a good quality of life each year in retirement and leave as much as he can to his kids when he is gone.

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That's his goal and the purpose of the plan we create for the money. The robo-advisory doesn't have this information – they didn't ask in three years. How do they know what kind of investment portfolio to build if they don't have the roadmap?

I explained to Bill that we will write down his goals.
We will quantify his goals (e.g. how much he can spend each year after-tax and how much will be available in his estate someday after-tax).
We will review his goals each year and evaluate progress.
We will help him make adjustments to his strategies and portfolio each year to keep the goals in mind.
We will advise him on regulations, economic, taxation and other variables that could affect this plan that he cannot control.
And we will be there to talk to him as much as he wants about the ups and downs as we march towards his goals.

"Is there extra fees for all this work Kurt"?

I told Bill there are no extra fees for these value-added services.

Financial Planning

I have written seven personal finance books and at the heart of each book is the message that comprehensive and integrated financial planning based on your goals is essential to the best financial decision making for you. Further, products you purchase (investments, insurance) are merely an end to a means. You need a plan first, based on goals and strategies.

Let's look at an example: One goal you may have is to retire at age 62. A good financial advisor will help you to determine if you want to spend $50,000, $80,000, $100,000 or another amount each year in retirement. This is the goal with a timeline and dollar amount attached.

But your goal is affected by a lot of variables: how long you work, how much money your employer is saving for you, what your plans are for your home in retirement, what tax bracket you are in today and will be in after you retire, how long you live, the amount of savings you have, inheritances, whether you are debt free by retirement, how long you support your kids, divorce and much more - this is the integrated thinking and planning that I believe is essential to ensuring your retirement plan stays on

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track. Because at the heart of your retirement savings plan is saving money, using RRSPs, Tax Free Savings accounts, rental properties, small businesses and more that will combine to produce the asset base you need to live off in retirement. We haven't even started to talk about investing and stocks and bonds yet - there is a lot of essential planning to do first. Ultimately when we get to the last step to build an investment portfolio the parameters of the portfolio should match your overall financial plan. It just makes sense.

Professional financial advisors know this. Accountants know this.
Robo-advisors don't do this.

Back to Full Service

Bill sat back with his coffee and took in everything we talked about.

"Kurt, how long does it take to transfer three accounts from the robo-advisory company to your dealership?" Bill said.

I told Bill it takes thirty minutes of paperwork and two weeks to transfer his accounts to our brokerage from the robo-advisory firm. Then we can get together over a few meetings to build a financial plan, define goals and work together to understand what products really belong in your investment portfolio.

"Can we buy Bell shares again?"

"Yes we can Bill – and I'll even look for a bond that pays as close to that old 6% as we can find!"

The Future of Robo-Advisory in Canada

As a full service financial advisor with twenty-five years of experience working with humans and emotion I don't think the public wants robot investing techniques at any price. We're too emotional and want someone to talk to about our money – especially when the markets are falling and when life events hit us.

Manulife Securities

strong reliable trustworthy forward thinking

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And I don't believe financial planning advice to reach a person's goals can come from a canned portfolio. Factors like taxes, real estate plans, careers, how long you support your kids, health conditions and more all go into the core planning of investing, saving and spending strategies incorporated into a successful investment plan. Robo-advisors can never offer this level of care at $80/month.

And I think long established discount brokerages offer all the good of a robo-advisory firm without all the bad. You're better off at a discount brokerage if you truly want low fees and basic contact.

I think all it will take for full service financial advisor to be successful against robo-advisor firms is to offer professional planning services based on client goals, fantastic communication and price services transparently and fairly. If the Canadian public shops around a bit, they will quickly see robo-advisory offers little or nothing they need.

Kurt Rosentreter, CPA, CA, CFP, CLU, TEP, FMA CIMA, FCSI is a national best-selling author seven books on personal finance in Canada and the past co-founder of the national wealth management practice at one of Canada's "Big Four" public accounting firms. For the last fifteen years Kurt has been a core financial course instructor for the Ontario Chartered Public Accountant Association and also appears regularly in the national press as an expert on matters of money. Kurt is the owner of a national wealth management practice in Toronto working with professionals and business owners on all topics of personal finance. Learn more about Kurt at www.kurtismycfo.com.

Names and client details have been changed to ensure privacy.

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