FEATURE

ROBO-ADVISORS: RISE OF THE MACHINES?

How will upstart robo-advisors' entry play out in the 401(k) market?

BY JUDY WARD

Here come the robo-advisors. Can they win over 401(k) sponsors and participants?

"I believe that the robo-solutions that are in place now in the retail market aren't going to penetrate the 401(k) space," says J. Fielding Miller, CEO and co-founder of CAPTRUST Financial Advisors in Raleigh, North Carolina. "But I think a version of it will."

The new breed of robo-advisors starting to enter the 401(k) market, such as Betterment's Betterment for Business, hope to convince plan sponsors that their managed accounts and innovative technology give participants investment customization and a user-friendly experience for a low fee. Louis Harvey, president and CEO of Boston-based financial services market researcher Dalbar, Inc., says he "very definitely" sees potential for the robo-advisor model, particularly to help lower-balance 401(k) participants. "There's a huge gap in the 401(k) market at the individual participant level that I would expect the robo-advisor tools could fill well," he says.

But keep in mind that sponsors and participants want more than a pure technology solution, says Randall Long, founder and managing principal at Irvine, California-based SageView Advisory Group. "There's a great marriage between a robo-solution and 'boots on the ground,'" he says. "Technology can only take you so far. Ultimately, people want human interaction."

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Where Robo-Advisors Make Sense

Long sees the appeal in robo-advisors' approach, pointing as an example to its stronger abilities to aggregate participant data on outside investments. Robo-advisors' reliance on passive investments meshes well with current trends in 401(k) plans, he says. And while previous iterations of online advice got limited participant acceptance in part because of people's reluctance to utilize the technology, he thinks that heavy use of smartphones since then has increased overall comfort with technology-based solutions.

From a technology standpoint, "a robo solution has a lot of advantages over what's out there right now," Miller says, referring to target date funds. He cites the improved capabilities around risk profiling of participants, the ability to capture data on a participant's assets outside the plan and take that into account when building that participant's 401(k) portfolio, more capacity to integrate projected Social Security benefits, and greater aptitude than target date fund offerings in helping with drawdown strategies.

"At the participant level, it's a much more robust experience," Miller says. "The technology is going to help them plan and save and invest much better than a target date fund solution, which really is designed for nobody in particular," he says, referring mainly to the lack of customization.

Still, Long says, "I don't think that robo-advisors are going to overtake the financial services industry." Rather, he sees robo-technology meshing best with lower-balance participants' needs. "That's where it will head," he says. "For somebody who is just starting to invest, it is a great way to start accumulating. But once somebody gets to $50,000 or so in assets, they're going to want to talk with someone."

When Harvey talks about the current gap in 401(k) services, he's thinking of the ability to help participants such as a young employee with a $5,000 401(k) balance who wants guidance on how to invest the money. "The plan advisor in that situation doesn't want to waste his time on that. It is not practical. And it is not in his DNA: The plan advisor wants to deal with the CFO and CEO," he says. "You have got millions and millions of people like that in plans."

"Enter the robo-advisor," Harvey continues. "I see a perfect fit there, but it does call for a collaboration between the plan advisor and a robo-advisor. I don't see the robo-advisor as a replacement for the plan advisor. Frankly, I think the plan advisor could add a lot of value by introducing that."

In this scenario, Harvey says, the plan advisor would help the plan sponsor with the investment lineup and all the other spon-

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sor-level things that plan advisors do today. The robo-advisor "would deal with the people who are not being served today," he says. "This is all presuming that the robo-advisor doesn't come in and say to the plan sponsor, 'Hey, why don't you fire Charlie and hire me as the plan advisor?'"

Miller agrees on the participant niche that robo-technology would help. "I think that the robo-advisor is a small-investor phenomenon, and it will be that way for a long time," he says. "When people start to get more money saved, when they have substantial assets and there is more at risk, they really do want to deal with someone. I think that advisors will continue to get pushed upmarket — but that's where they want to be, anyway."

Miller has an interesting take on how robo-advisors could succeed in the 401(k) market. "I think there's some potential for traction," he says. But I think it is more of a technology play than an asset management play.

"The way it is offered now, it is an asset management play, using technology. What is valuable about what they offer is not the asset management component, but the technology component," Miller says. "If they strip out the technology component and overlay it with other investment solutions, they have a better chance of getting traction. I envision that someone will offer up the technology of robo-advisors as a solution, and then overlay whatever investments a sponsor wants to use in the managed account program." He's already met with a company prepared to offer robo technology for less than 10 basis points on participant assets.

That scenario provides a better solution for plans, Miller believes. "Where the plan advisors would come in is that they would be the ones to put together the investment construct to go along with the technology," he says. "That's a pretty compelling story. You have got all the technology benefits, but you don't carry the burden of the robo-advisor asset management fee. The plan advisor fee would be a lot less than a robo-advisor fee."

The Challenges Ahead

As they enter the 401(k) market, robo-advisors face some hurdles. "The challenge for robo solutions is that they have to be integrated with multiple providers," Miller says. "They have got to get all that 'piping' in place, and that is going to be hard."

That involves integrating technology with dozens of recordkeepers, a distinct task in each case because providers have systems that do things differently, he says.

Providers such as Betterment that enter with a bundled offering may find it challenging to buck the trend toward open architecture. Asked about the appeal of a bundled robo-offering to sponsors, Long says, "This is the first generation. The marketplace adapts. They [robo-advisors] will figure it out."

For robo-advisors to make serious headway in the 401(k) market, they'd have to convince a lot of plan sponsors to replace target date funds as their default investment for automatically enrolled participants. "That's where the money is going to be, for sure," Miller says of default investments.

The potential exists. Long has sponsor clients currently questioning whether they should keep their current target date fund family as the default investment. "They are asking, 'Is it really meeting the needs of our participants? Do participants need something more, particularly as they get larger account balances?'"

Although there's no technical reason why managed accounts couldn't displace target date funds as the dominant default, Harvey says, from a pragmatic standpoint it seems unlikely. "When you have a marketplace that is dominated by target date funds, and all the belief systems in place for target date funds, it is very difficult to replace them," he says, citing sponsors' fiduciary concerns. "You could say to sponsors, 'Here is the safe choice. Or you can try this new thing, the robo-advisor — and if it blows up in your face, you're on your own.'" If another market catastrophe like 2008 happens again and target date funds lose their credibility, he says, "Sure, it could happen. But absent that, target date funds are ensconced."

And to the extent more sponsors will want managed accounts as a default or just an investment option, robo-advisors also face the competitive reality that two major players — Morningstar and Financial Engines — already have spent years entrenching themselves in the 401(k) market.

While robo-advisors tout their fees as a competitive advantage, Morningstar doesn't sound interested in engaging in a fee war with these newcomers. "As with everything, it is a question of, what value are you getting for the fee?" says Jim Smith, Morningstar's Chicago-based head of workplace strategy for North America. "We stress value for fees, and

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we will continue to expand on that value. We would rather that you pay the same fee over time, and we give you more and more value for that."

Startup robo-advisors initially may be able to offer lower managed account fees than incumbents in part because they haven't invested in connectivity with record keepers, Smith says. On the downside, he says that means these robo-advisors can't utilize record keeper data in personalizing participants' portfolios. "We get a lot more data about individuals, and we are incorporating that," he adds.

"That's no small hurdle to get over, having that connectivity with providers," Smith says. "In the end, as robo-advisors start to realize what they need to do with connectivity, they may revisit their fees."

Beyond fees, Smith talks about how Morningstar sees itself competitively positioned against startup robo-advisors. Some of these newcomers offer participants pre-set models rather than individually personalized portfolio recommendations as Morningstar does, he says. Morningstar also gives participants a lot of broader help on financial wellness as well as planning for retirement, such as recommending a personalized drawdown strategy, he says. And Morningstar continues to invest in doing research that then gets incorporated into the managed account service, he says, citing a recent paper on optimizing Social Security benefits whose key findings Morningstar now is incorporating into its system to help participants near retirement. Morningstar also has a much longer track record as a company, he says.

For its part, while new robo-advisor competitors loom in the 401(k) market, Financial Engines recently took a big step in its evolution beyond that business model. "When we were founded in 1996, in some sense we were the original robo-advisor," says Christopher Jones, executive vice president of investment management and chief investment officer at Sunnyvale, California-based Financial Engines. "But over the years, we've evolved. We recognize that when you are talking about the broad population, a significant portion of investors out there want more than a virtual experience." Back in 2004 Financial Engines added phone-based support for investors to talk with advisors about their investment accounts or to get reassurance in times of market volatility.

And in November 2015, Financial Engines announced its acquisition of The Mutual Fund Store, LLC, a registered investment advisor with more than 125 locations across the United States. The company now can offer 401(k) participants from its plan clients the option to meet in person with a financial advisor. "Our objective is to change the economies of scale of providing investment advice to everyday Americans," Jones says.

While Financial Engines remains a huge believer in leveraging technology to handle participants' investment portfolios, Jones says, it also understands that some people want to talk face-to-face with an advisor. "That's certainly true, particularly when you are talking about older investors. They typically are more comfortable dealing with a human being," he says. "We've recognized that to reach the broadest range of investors and help the people who need help the most, we need to provide an opportunity to meet face-to-face."

"We are big believers in a hybrid model, a combination of humans and technology," Jones continues. "It offers a higher level of service, and ultimately, a less-expensive service." Financial Engines anticipates that some of participants' in-person meetings with its advisors will

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happen in their workplaces, and in other cases participants will come to a Mutual Fund Store location for a meeting. At press time, the fee structure for that service had not yet been announced.

Financial Engines sees the role of Mutual Fund Store advisors as different from plan advisors, Jones says. "We have no intention of replacing plan advisors and their relationship with plan sponsors," he says. "We are not in the business of plan design. We are not in the business of plan consulting."

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