

THOUGHT FOR THE WEEK ARE ROBO-ADVISORS THE WAVE OF THE FUTURE?

SYNOPSIS

- The rise of “robo-advisors” has created a tremendous amount of buzz throughout the financial community.
- These low-cost allocation tools are mostly geared for younger investors who are willing to stay invested through volatile times.
- Although robo-advisors may be beneficial to some investors, they most certainly are not suited for all.

THE RISE OF FINANCIAL MACHINES

Technology has a long history of disrupting industries by replacing human labor with machines and software. In most instances, technology can provide scalability, lower costs over time, and productivity gains.

The financial services industry is no different, and improvements in technology have lowered costs for investors over the past two decades. The most recent advent in the investment arena that has gained a tremendous amount of attention from financial advisors and investors alike are robo-advisors.

A robo-advisor (robos) is a web-based wealth management tool that provides automated portfolio management advice with little to no interaction from financial advisors. These online tools use the same software as traditional advisors, and some even offer attractive services such as tax harvesting and reinvesting dividends.

These technologies are typically low cost and require smaller account minimums, which leads many to believe that they could disrupt the financial advisor industry for good, where humans are replaced entirely with machines.

The robos argue that they are superior for three reasons:

1. **Fees:** Advisor fees take away from performance, so the robos argue that they can improve returns

by reducing fees paid for money management services.

2. **Overlap:** The algorithms used by robos are based on similar financial concepts and theories that human advisors follow.
3. **Overkill:** Many clients do not need the full suite of services offered by a financial advisor.

Hence, robo-advisors were mostly created to meet the demands for those who have a long runway for their financial future and rather simplistic investment needs.

“The single most important service that a financial advisor performs is managing investor emotions.”

For example, a 25-year-old earning enough to put away a few thousand dollars each year into a retirement fund may benefit from a robo-advisor. This investor is a long way away from retirement, so if his portfolio dropped 30% in a year, there’s plenty of time to recover any losses.

RIGHT SHOE, LEFT FOOT

Although some may enjoy the idea of paying a fraction of the cost for a fraction of the service, robos are most certainly not suited for all investors.

For example, a retiree who requires income to pay bills, needs help through volatile times, and/or is afraid of outliving a nest egg has a much harder time handing control over to a computer.

Those who have complex financial needs will also find little value in these automated solutions. No website will ever truly know an investor as well as another human who has spent time learning about the intricacies of an investor’s personality and financial needs.

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Recognizing their limitations, robos have become more competitive over the years. Many have recently announced the option to speak to a “representative” a few times each year for a nominal fee, but how many retirees want to speak to a stranger about the safety of their nest egg the next time it feels like the world is ending?

Simply put, while robo-advisors may make sense for Millennials because of their time-horizon and basic investment needs, these tools are putting a right shoe on a left foot for most other investors.

IMPLICATIONS FOR INVESTORS

The single most important service that a financial advisor performs is managing investor emotions. Keep an investor from selling into panic just one time, and that advisor can change the future for her client.

The chart below shows the number of big dips in the S&P 500 since 1950, along with the average size of the drop and frequency of big dips (crashes).

S&P 500 DIPS OF 10% OR MORE FROM 1950 - 2015

Total Occurrences	28 Times
Average Dip	-21.6%
Median Dip	-16.5%
Average Length	7.8 Months
Greater Than 20% Dip	9 Times
Greater Than 30% Dip	5 Times

Source: *Global Financial Private Capital Analysis, Bloomberg*

These numbers may appear frightening, but consider the following three key conclusions:

1. **Big Dips Happen:** The S&P 500 experienced 28 dips greater than 10% (also known as a

“correction”) since 1950, so these dips are to be expected from time to time.

2. **Losses Don’t Last:** The average recovery time from a correction was less than eight months. Hence, paper losses rarely persist for more than a year and highlight the inherent dangers within panic selling.
3. **Large Losses are the Exception:** The S&P 500 only saw five drops greater than 30% in 65 years, or roughly once every 13 years. Furthermore, more than two-thirds of corrections failed to develop into a 20% or more loss.

The net result of this analysis is that investors lose money when they assume that the market is crashing every time it falls. The reality is that crashes are very rare, and when they do occur they usually persist for a short period of time.

If panic selling, not volatility, is the reason why investors lose money when the market dips, then I find it very hard to believe that a computer program that has no ability to create a personal connection will prevent an investor from panic selling.

The bottom line is that robo-advisors have their place in the investment community but for specific investors. Financial advisors offer far more than just financial advice, and their true value cannot be replicated with software.

Sincerely,

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