OPTIMA VIEWS

Investor 2.0

Introduction

Will you sleep better when your wealth manager is just a click away?

There are several new online investment advisory services vying for a piece of the wealth management market. These services share a common business model typically offering customized, model portfolio management based on proprietary algorithms developed under the guidance of well-known leaders in investment management theory. They are offered to investors online without an advisor or intermediary.

In this paper, Optima Group, takes a closer look at four of these online firms. We dissect their offerings, delivery models and target markets and examine the prospects for their future growth as well as their market challenges.

1. Betterment
2. Wealthfront
3. FutureAdvisor
4. Jemstep™

In our view, these firms are of interest to traditional providers for two primary reasons.

1. Over time, online firms may build themselves into sizeable competitors attracting a significant share of a younger generation of investors.
2. These firms may provide a roadmap of features that are appealing to younger investors particularly with regard to delivery and client management services. This roadmap may prove helpful to established firms wishing to redesign offerings to meet the demands of future markets.

Given existing market realities, we believe the hurdles to growth for some of the early online entrants may be insurmountable without significant resource allocations to awareness building initiatives. However, we also believe that the offerings of these firms are consistent with the sensibilities of a new generation of investors and in that regard are instructive for firms wishing to penetrate new markets over the longer term.

The Players-Defining Elements

In the table below, we offer comparative data on four leading online investment advisory firms. While they have their differences, they share the following features:

- Services are all accessed and delivered online. Although call center and online chat options are available to provide information or functional assistance, in-person access to financial advisors is not offered.

- Services are limited to investment management. This includes asset allocation, investment product selection, automatic rebalancing (excluding Jemstep) and reinvestment of dividends. Risk/goal assessments are made through proprietary online questionnaires.
- The primary engine of portfolio design and management is Modern Portfolio Theory.
- Investment vehicles are largely ETFs. Underlying asset management is passive.
- Pricing is fee based and well below the average for a typical wealth management relationship.
- Minimum investments are very low allowing access to investors of any size. To date average per account AUM is low suggesting limited penetration of the HNW market.

These firms' core value propositions are also similar. They all promise:

- *Sophisticated investment management* – Investment management processes are guided by complex algorithms designed and applied by leading technologists in line with widely tested and respected investment theory.
- *Customized portfolios* – Portfolios are built by aligning the findings of proprietary risk/need questionnaires with appropriate allocation models.
- *Low costs* – Fees are contained due to efficient operations, the selection of low fee investment products (typically ETFs) and the elimination of the financial advisor as an expensive and largely unnecessary middleman.
- *Simplicity* – As Betterment's slogan puts it, "investing without all the hassle." The customer simply answers a few questions, transfers the desired money into the account (excluding Jemstep) and lets the account run on autopilot. Reporting is online and in real time, rebalancing and reinvestment are automatic.

By marrying technological genius with the best investment thinking, these firms claim to offer the most advanced product at the cheapest price with the most efficient delivery system and the simplest, user-friendly interface.

Differences

While similar in many respects, there **are** differences between these online firms. Most important, Betterment is structured as a fund wrap platform. Investors decide how much they want to invest and Betterment allocates the cash across a short list of up to six ETFs. While not technically a fund wrap, Wealthfront takes a similar approach, investing client money in a preselected set of ETFs and mutual funds.

In contrast, FutureAdvisor aggregates client's existing accounts in a variant of a broader UMA structure. The firm then "optimizes" portfolios by suggesting reallocations to better performing or less expensive investment products. It does not require that these suggestions be taken but it will implement changes upon client approval. Jemstep is the most open, or least restrictive platform. In essence, Jemstep's software aggregates clients' accounts for the purpose of offering product and allocation recommendations. The client is left with the option to implement these trade recommendations on his or her own.

Online Provider: Summary Stats

Firm Name	Betterment	FutureAdvisor	Wealthfront	Jemstep
Inception Date	2007	2010	2008	2008
AUM	$340	$13	$427	Tracks $2,000
Client #	25,333	169	5,481	10,000
Avg. Client $	$13,400	$76,900	$87,028	NA
Offering Description	Online model-based, fund wrap program utilizing stock/ treasury bond ETFs with automatic rebalancing and dividend reinvestment (six stock and six bond ETFs)	Online investment advisory service that optimizes clients' existing portfolios and transitions clients to low fee index funds/ ETFs when possible to lower fees – includes automatic rebalancing and reinvestment	Online model based financial advisory service with portfolios using ETFs from 11 asset classes (one ETF choice per class) including U.S. and international stocks and bonds – automatic rebalancing and reinvestment with tax management	Online investment and portfolio management advisory service providing trade recommendations (ETFs and Mutual Funds) for do-it-yourself investors – ongoing monitoring and rebalancing signals
Min. Investment	None	None	$5,000 $100,000 to qualify for tax loss harvesting	None
Target Market	Sophisticated investors seeking an efficient and thoughtful technological investment application – $10,000 to $10,000,000 IPA	Sophisticated portfolio management for all investors	"New generation" of investors. The investment choice of Silicon valley	Investors looking for high quality, low cost investment advice
	All inclusive, annualized fee ranging from 0.35% for portfolios under $10,000, 0.25% for $10,000 to $100,000 and 0.15% for portfolios over $100,000	0.5% of AUM	First $10,000 free, then 0.25% of AUM	Free under $25,000; Monthly fee: $17.99 to $150,000 $29.99 from $150,000 to $300,000 $49.99 from $300,000 to $600,000 $69.00 above $600,000
Advisory Board	NA	Sequoia Capital	Investment team led by Burton Malkiel and Charles Ellis	Jonathan Tiemann, Terrance Odean
Value Proposition	Simplicity, taking the mystery out of investing with sophisticated, diversified goal-based portfolios built on a Nobel-prize winning investment strategy and fully automated	Long-term investment program based on diversification, tax efficiency and low cost – automated management	Sophisticated investment management and advice without the hassle, high fees or high account minimums – enable anyone with $5,000 to access MPT driven portfolios Sophisticated risk measurment algorithms to determine client's risk tolerance	Unbiased investment advice based on fact and expert analysis made clear and comprehensible to the layman customized to each investors' profile and goals at low cost
Reporting	Real time continuous online	Real time continuous online	Real time continuous online	NA

Source: 2013 company and SEC filings, company websites and publicly available documents, materials and media reports

Target Markets

The overriding message of these firms is explicitly populist. With very low or no stated investment minimums, they claim to be making quality investment management available to everyone. This may be true. To date, average client sizes are on the low side ranging from just $13,000 at Betterment to $87,000 at Wealthfront, far from the $1 million minimum for many wealth management programs.

However, beyond the loose size parameters, market segmentation for these firms is more well-defined and their value proposition more narrowly targeted.

Betterment, Wealthfront and FutureAdvisor were all founded in the last few years by apparently well meaning but hubristic GenXers and Millennials. They have crafted their brand and their marketing message to target people like themselves, who, as investors, have many or all of the following characteristics:

- Are well-educated, relatively successful, early-mid stage professionals/entrepreneurs with some disposable income but limited time or energy to spend on investments.
- Trust in the ability of top flight computer engineers and programmers to build a better investment mousetrap by applying the findings of renowned academicians.
- Have a high comfort level with technologically mediated communications and online interactions.
- Have limited interest in, and assign relatively limited value to, the role of financial advisors in providing investment management solutions.
- Are confident in their own ability to select an investment service while understanding their personal limitations with regard to time and area expertise.

These investors have a greater tendency to see advisors as, at best, of neutral value, and at worst, incompetent or self-serving. They assign no "value" to the personal relationship and are certainly not willing to pay extra for it.

The market message of Jemstep is similar in some respects but the tone and target profile are somewhat different. Jemstep targets investors interested in a quality investment software/service that will help them manage their retirement investments. These are likely older generation do-it-yourselfers who still believe in their own judgments with regard to investments but appreciate the value of "intelligent" and reputable management tools.

Appealing to the New Generation of Investors

Clearly, the recent crop of online advisory firms is built, by design or accident, to appeal to the Millennial generation.

Back in the 80's and into the 90's, it was common to classify investors into two main types; those that preferred that advisors make their investment decisions for them (advisor-directed) and those that opted to make their own investment choices (self-directed). Advisor-directed investors turned to brokers, and later, as delivery options expanded and their assets grew, to wealth managers and RIAs, for advisory services. This group tended to be older and, in general, wealthier than self-directed investors. Self-directed investors typically opted for discount brokerage relationships fueling the growth of industry leaders like Fidelity and Schwab. They were generally younger, and not surprisingly, more technologically competent and savvy.

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In the 2000's, a new investor type has arisen, in part a by-product of the ubiquity of online and mobile technology. Investors of this type are typically later GenXers or Millennials. They prefer to have their investments managed for them, but not via the traditional advisor-investor relationship. Rather, this group has greater confidence in, and is more comfortable with, technology driven investment solutions accessed impersonally over the internet.

A recent Pew Research Report on Millennials captures the salient traits of this generation. According to the report Millennials:

- "Are history's first 'always connected' generation. Steeped in digital technology and social media, they treat their multi-tasking hand-held gadgets almost like a body part. More than eight in ten say they sleep with a cell phone glowing by the bed."
- "Cast a wary eye on human nature. Two-thirds say "you can't be too careful' when dealing with people."
- "Are on course to become the most educated generation in American history, a trend driven by the demands of a knowledge-based economy."

Millennials have the highest comfort level with new technologies and the greatest trust in the value and worth of technical expertise and education. At the same time they have the highest level of mistrust in people and the quality of their intentions. Taken together, these characteristics define a profile uniquely in line with the offerings of online advisory firms.

Hurdles to Growth

Growth to date of online advisory firms can be best described as lethargic. Founded in 2008, Jemstep claims to advise a respectable $2 billion on its platform. But neither Wealthfront nor Betterment have yet reached $500 million in total AUM, and the latest entrant to the market, FutureAdvisor, has attracted less than $20 million.

We believe that slow growth is not the result of a poorly designed service or a lack of compatibility of the offerings with the market's needs or expectations. Rather, it is a result of very low levels of brand awareness and referral support due in part to a value proposition that can only be born out over time.

For many of the better known consumer market technologies the "build it and they will come" advice seemed to apply. PayPal, Facebook, YouTube, Twitter and the like attracted expansive user bases quickly, almost virally, and have never looked back. Growth was based on market fit/need/demand, superior technology, user friendliness, ease of access and the strength of customers' clear and immediate positive shared experiences of the product.

For online investment advisory services, the relative value of the offer can only be realized and truly appreciated over time, one year, three years, even five to ten years. Product loyalty and commitment are based on results not theory. This means that if there is to be an engine driving "viral" growth it is only likely to appear several years out.

Lacking the benefit of a widespread "buzz," online providers are forced to build awareness in other ways. Wealthfront has taken steps in this direction by highlighting on their website client profiles of respected professionals employed by leading Silicon Valley firms. Most online firms also have programs that provide discounts to existing clients for referrals. However, by most standards, brand building efforts have been modest. Also modest have been expenditures for marketing, advertising and other promotional initiatives.

While these new online firms struggle for recognition, some established providers are more aggressively courting this market. Leading discount brokerages, the current likely havens for the technologically savvy Millennials, are adding managed portfolios delivered online without advisory help. Schwab, a marketing powerhouse, offers both mutual fund and ETF Managed Portfolios with just $25,000 minimum investments. Schwab has also recently added global strategies from Windhaven for investors with a minimum of $100,000. Windhaven offers three ETF based portfolios using dynamic allocation strategies at costs below 1%.

It is worthy of note that Schwab's revenues from these programs have grown at an annual rate of 11% over the past three years, the fastest of any of the firm's core businesses.

Conclusion

One important issue for established wealth managers is to evaluate the significance of online advisory firms as a competitive threat. Does the online model represent a gamechanger in the space?

First, the online model is not targeted at, and will not likely gain significant share of, the ultra-high-net worth market. The wealth management needs of the $10 million plus IPA individuals, even those of the Millennial generation, are complex and go beyond simple model-based investment management. For this group an advisory relationship that includes a team of field experts in planning, trust, tax and so forth is most appropriate.

Also, despite generational changes, there is likely to remain a significant share of the investor population that still prefers a personal advisory relationship. Particularly higher asset Baby Boomers and even GenXers in the $500,000 to $10 million bracket, may be more secure with a dedicated advisor, more detailed financial planning, and the support of an established and accessible provider with deeper resources.

Optima Group, Inc.

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