Assignment 5: Robo-Advising

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(a.) What are the issues associated with traditional financial advisory services? What are the “pain points”?

Traditional financial advisory services have both pros and cons when providing personal financial advices. While they have a chance to communicate with customers and provide suggestions for them based on their risk preference, financial situations and goals, it is also known that this process possess some inevitable concerns and disadvantages. The primary concern is that some potential customers do not believe in this type of service because of its high commission fees and human biases. Traditional financial advisers generally impose three layers of service fees on investors including an advisory fee, a fund-management fee and a one-time “sales load.” The summation of all previously stated and the expenses incurred result in a very high cost of service. In addition, because it is done by people, different people have different forms of biases which can negatively affect portfolios. Because of all these reasons, it is difficult for customers to trust these financial advisors.

Second, inefficiencies and ethical issues are also big concerns in this case. In many cases, financial advisors only inform investors of their holdings at the beginning and end of quarters so that investors would not know whether the trades are consistent with their goals. Additionally, there are hidden fees and misalignment of interest from customers’ side. This asymmetry of information is challenging for the client to know why the advisors suggest certain products.

Moreover, many financial advisors have mislead their customers by claiming they have used modern portfolio theory, or other comparable methods, when providing the advice, when they just provide advice based only on clients' risk exposure.

(b.) What is Wealthfront's core service and value proposition?

In Dec 2011, Wealthfront launched its new robo-advisory services. The new robot advisor aimed at automating the entire asset management process to reduce the costs and human biases associated with human services. Their product was designed to implement a service that automatically chooses the optimal investment strategies for the customer based on their algorithms. They also are able to eliminate the cost of retail locations as the product requires minimal human interaction.The value added also includes the service of tax loss harvesting, direct indexing and single stock diversification.

(c.) How does Wealthfront carry out portfolio construction? What are its value-added services?

Wealthfront has four principles to which all portfolios are built. The investment principles that their strategy is built around is the first of these. Based on Harry Markowtiz's Modern Portfolio Theory (MPT), Wealthfront's application of these principles is able to move their clients' return values closer to the ideal "efficiency frontier" of a perfect investment strategy.

The second portion of portfolio construction is client risk-profiling. A number of factors are taken into building the appropriate amount of risk each client is willing to, and able to, take. Additionally, the balance between taxable and retirement investment mixes are created.

Third in creating a portfolio, Wealthfront determines which investment-vehicles are ideal for each client. By analyzing the risk tolerance and market conditions, the algorithm creates a “passive index-tracing” ETF which represents major asset classes. They determine an optimal portfolio with a basket of asset classes, such as U.S. equity, real estate, and energy so that the investment would profitable and less risky. After understanding, the proper investment vehicles and the amount invested in each vehicle is selected for the consumer.

Lastly, monitoring and rebalancing are the final portion of portfolio construction. As it has been studied, adjusting weights of certain investments is necessary in the ever-changing market in order to retain the desired growth and return. As this is an iterative process done through algorithm, it is much more efficient than a human investor who will have to analyze the market, see trends, and take the time to change all weights as they see fit.

Wealthfront’s value-added services include a daily tax-loss harvesting service and the introduction of dynamic Direct Indexing, both to boost the total return by significant percentages when compared to traditional financial advisors.

(d.) Overall, do you believe that Wealthfront can address the problems associated with existing financial advisory services? What factors enable them to do so? What factors are missing?

With the existing financial advisory services that Wealthfront it does not seem feasible that they can address all the problems in its current state. The company has done a great job in automating the entire process of financial advising to optimize clients portfolios with minimal intervention, but that is where their expertise stops. Wealthfront has faced difficulty acquiring new clients to their service. According to the case, the company currently spends around $1000 to acquire a new client, but with minimal return. From this point, one can clearly see that there are still many potential investors that Wealthfront has not reached. Additionally, my consumers are still skeptical of the product as some people do not feel like putting their money to a system that they do not understand and let the “robot” make the investment for you. The idea is not yet generalized, and that is why Wealthfront needs to incorporate some human factor in their financial advising service. Ultimately, this might be unnecessary as the idea is accepted by majority of people, but the current state calls for a change.

(e.) What are the key differences between Wealthfront and Betterment? How do you evaluate their different business models?

At conception, Wealthfront and Betterment essentially had the same business model. The difference in these two is an additional service that Betterment added to their business in late 2014. Wealthfront has continued to use this same business model, while Betterment decided to include human elements in its business. By introducing a new service for human adviser, Betterment has broadened their target market significantly. As stated above, Wealthfront’s high cost, low reward to acquire a new client is hampering their growth. Now, for Betterment, this cost is greatly reduced by integrating with human adviser and leveraging its existing client base with B2B service. Betterment believes that a “human touch” is critical in building client trust and educating unsophisticated investors. Robo-advisory services alone can not create business relationships, and a hybrid of human and robot has better equipped Betterment to be a dominant company in the field.

(f.) Do you think a bionic model, currently experimented by financial advisor incumbents, that integrated both automated and human services can be the solution?

In current stage, the market shows that a bionic model which integrates both automated and human services can be the solution. In this situation, human services are mainly used to interpret and explain what the robot advisor is suggesting with the investment fund, and is a key in providing insights and such advices so that clients would build a trust with the services and company. While, automated service are still providing suggestions with its algorithm and analysis based on that, it is important to keep in mind that human services could also serve to change robot's suggestions based on customers' decision in some circumstances.

(g.) What is Wealthfront's current financial situation? Can it break even or make any profit from its current operations?

Beginning in 2016, several industry incumbents including Vanguard and Charles Schwab launching their own service in robo-advisory service and automation. Wealthfront is now faced unprecedented competitive pressure from these companies gaining market share. In additional, several high-ranked executive members left the company in 2016 leaving a public show of concern from within the company. Although Wealthfront keeps on its belief of minimum human intervention, and introduced another new feature 'Path' - a fully automated goal-planner - the momentum of growth has continued to slow. From Rachleff's point of view, if Wealthfront does not come out with a way to increase momentum for the company, the company would eventually lose growth momentum, and therefore lose the game. And while Rachleff believes that either a merger or acquisition could be an acceptable option for the company, his desire to find much better alternatives is what drives him. While the firm is still making profit now, the significant slow of growth has forced the company is on a turning point to which a move is needed to continue its profitable ways.

(h.) What are the strategic moves that Wealthfront should take?

One reasonable suggestion for Wealthfront is to pivot and include human element for the service. Additionally, they can provide more service such as standard and premium services based on different target or group of people. There are still many people out there who need professional advisor to assist their investment choice and get a overview about how well their investment is doing. It is important for Wealthfront to fulfill the need of customers from different groups, rather than trading all the customers equally through the robo-advisory service.

Another possibility would be what Rachleff spoke about, a merger or acquisition. While this is not his ideal outcome, it may be necessary for the company. If Wealthfront is not able to allocate enough resources to incorporate a human element into their product as described previously, they must find someone who can. If he does not want to sell fully, a strategic partnership with an established financial institution would be feasible. Especially as Charles Schwab has incorporated robo-advising into their practice, many established financial management firms will be searching for a way to stay current with market trends. A partnership could satisfy this desire. In either case, Wealthfront must make a strategic and impactful move to stay relevant in the future market.