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Buyer beware: Not all robo-advisor portfolios are created equal

In today's world of drone-delivery services, voice-controlled smart speakers, and self-driving cars, it shouldn't come as a surprise that technology has also found its way into the financial services industry. Thanks to the entry over the past few years of robo-advisors—which provide automated investment-only management services—security selection and asset allocation advice is now available at a low cost to almost anyone with internet access. Further, there appear to be no signs of slowing growth, with robo-advised assets expected to reach $1 trillion as soon as 2020 according to a report issued by BI Intelligence earlier this year.

With expected growth of this magnitude, it's likely that new players will continue to enter the digital advice market. Morningstar recently addressed the threat these automated investment providers represent for many traditional (human) advisors, who are having to "defend" themselves (and their fee) from these new low-cost alternatives. However, it is our opinion that robo-advisors should be subject to the same due diligence scrutiny as any human advisor or asset manager prior to investors handing over their hard-earned nest egg.

For instance, is it reasonable to expect that end investors can—and will—without the aid of a human financial advisor, accomplish critical tasks that help achieve long-term goals, such as:

- Perform a professional level of due diligence on the robo-advisors and their offerings;
- Ensure the algorithm-assigned portfolio reflects their true risk tolerance and required return;
- Fight human nature and stop themselves from leaving the market during times of volatility? After all, experienced

advisors know that the results of a risk profile questionnaire go out the window when market turmoil hits their clients' portfolios.

Well, thanks to BackEnd Benchmarking and The Robo Report™, which tracks the performance and positioning of some of the most prominent providers in the digital advice arena, we now have an idea of what this process looks like for end-investors. Their most recent report focuses on 17 robo-advisors at which BackEnd Benchmarking opened taxable accounts seeking a balanced allocation of approximately 60% stocks & 40% bonds.

In reviewing this report, two differences among robo-advisors stand out—and they will have an impact on end investor outcomes:

1. The **asset allocation** between "balanced" portfolios varies between the robo-advisors; and, as a result,
2. **Portfolio returns and risk** materially diverge between the balanced portfolios offered by the robo-advisors.

Let's take each of these points in turn, starting with asset allocation.

Asset Allocation

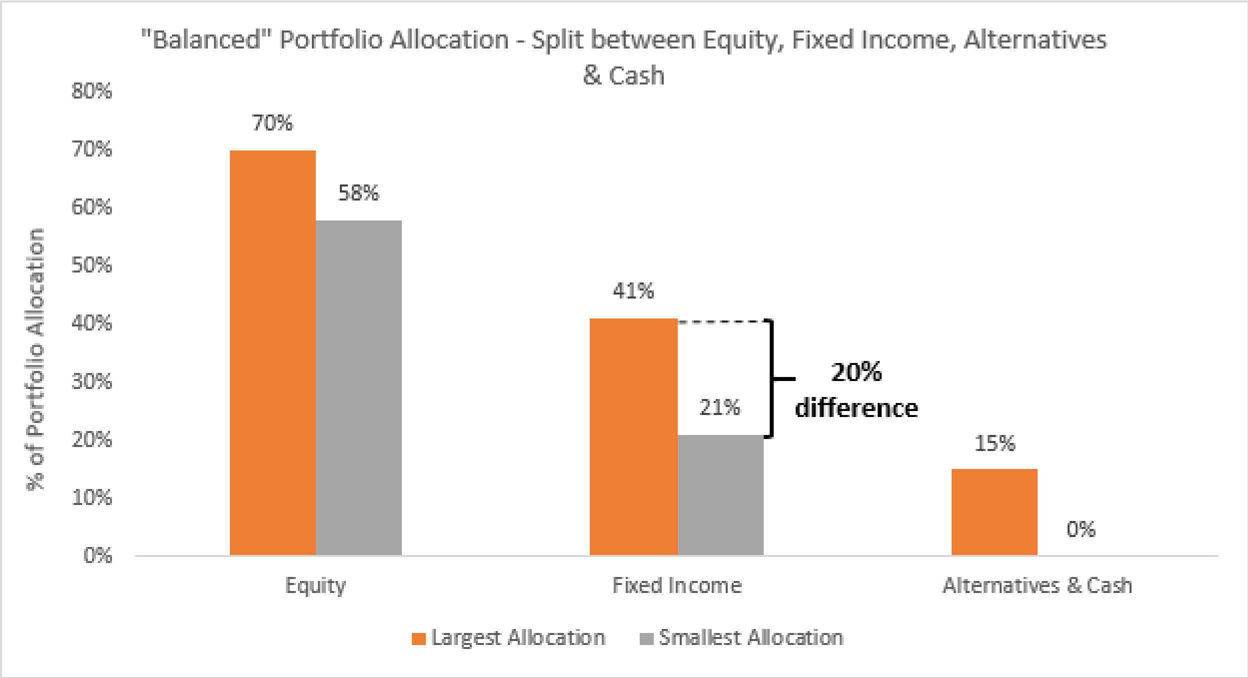
Multi-asset investing is no easy task. It requires forecasting the expected future behavior of individual asset classes, determining an optimal mix of asset classes to meet a desired outcome, constructing an investable portfolio aligned with the strategic asset allocation, and dynamically managing these exposures continuously as markets and circumstances change.

This complicated process can yield significantly different results depending on the beliefs and outlook of the individuals and firms who are involved in the creation of the portfolios, as illustrated in the chart below. For instance, *The Robo Report*™ revealed that, depending on the provider, a "Balanced Portfolio" could have between:

- 58-70% allocated to equity
- 21-41% invested in fixed income
- 0-15% earmarked for Alternatives and Cash

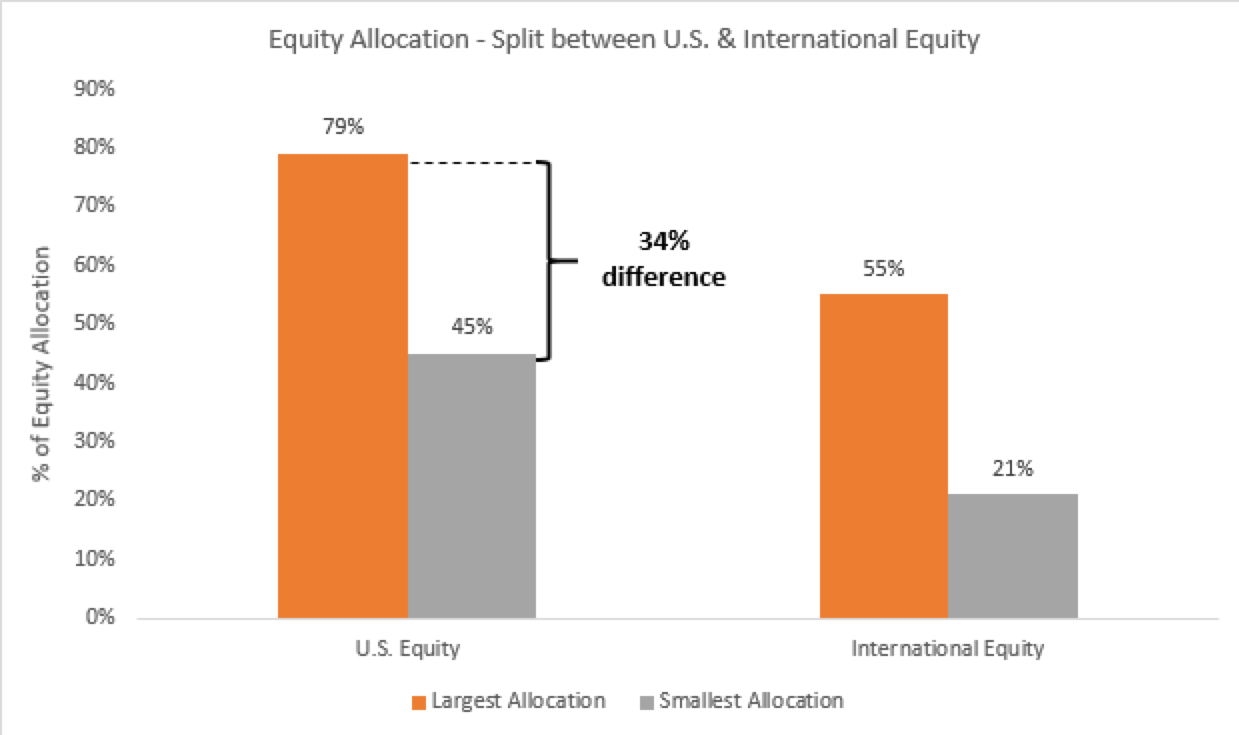
Those are 12%, 20% and 15% allocation differences within each asset class.

These differentials should instill caution in the investor who assumed that all portfolios labeled "Balanced Portfolio" would have similar risk tolerance.



As of September 2017. Source: BackEnd Benchmarking - The Robo Report™ Third Quarter 2017 (edition 5).

The asset allocation variance doesn't stop there. Within the equity allocation, providers vary in the relative size of allocations to U.S. and international equities, as shown in the chart below:



As of September 2017. Source: BackEnd Benchmarking - The Robo Report™ Third Quarter 2017 (edition 5).

With a 34% difference in U.S. equity allocations, major disagreement also exists among the observed robo-advisors as to the appropriate amount of international equity exposure.

The examples above only scratch the surface of how different these portfolios are from one another. Similar differences exist in the split between value versus growth styles, U.S. versus international bond exposures, tax-management within the bond and equity positions, etc.

So, why should investors be aware of these discrepancies? Because the risk profiles of these "Balanced Portfolios" are very different… which can lead to very different return outcomes.

Returns

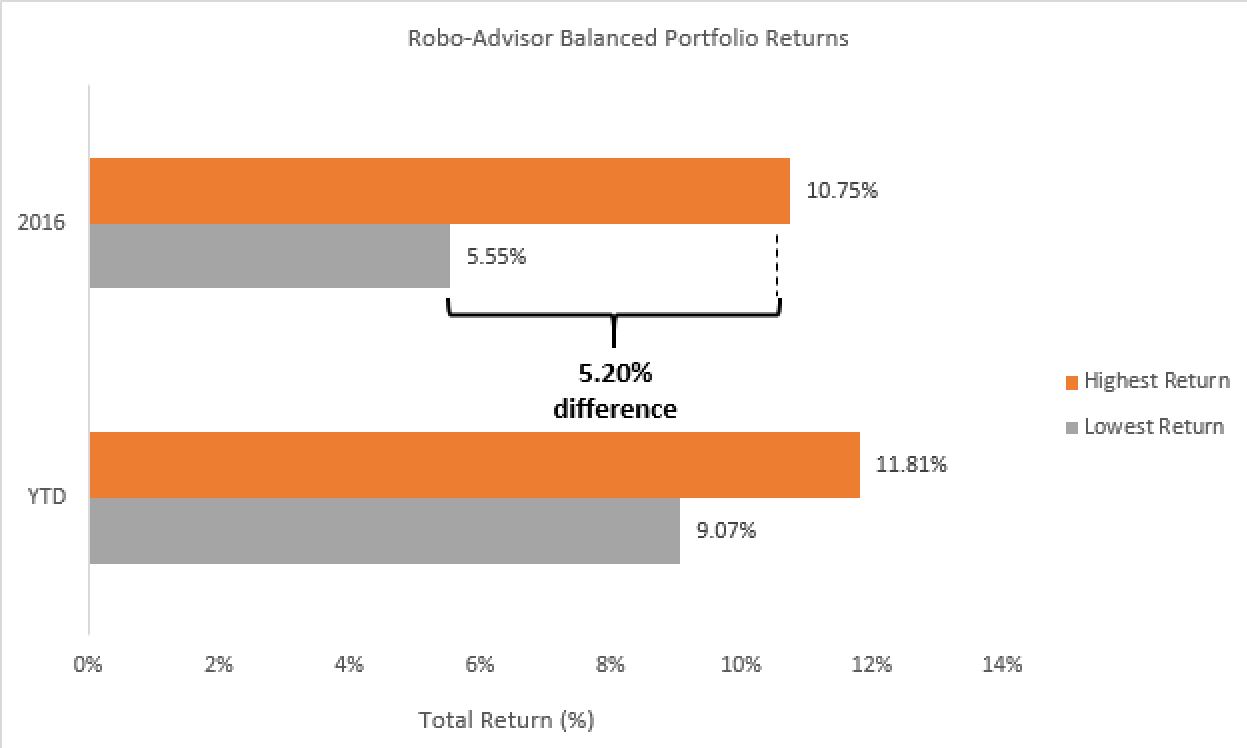
Consider this: U.S. and international equities have enjoyed returns of +16.40% and +23.58%, respectively, year-to-date through October 31st, 2017 (Russell 3000® Index and Russell Global ex-U.S. Large Cap Index, respectively). That means that the return differences YTD for hypothetical "U.S. Heavy" and "U.S. Light" equity portfolios, applying the allocation weights identified above, would be material:

	U.S. Allocation	International Allocation	Total Equity Return
Hypothetical "U.S. Heavy" Equity Portfolio	79%	21%	17.91%
Hypothetical "U.S. Light" Equity Portfolio	45%	55%	20.35%

As of September 2017. U.S. & International allocation source: BackEnd Benchmarking - The Robo Report™ Third Quarter 2017 (edition 5). Return source: Morningstar Direct.U.S. equity returns represented by Russell 3000 TR USD Index; International equity returns represented by Russell Global ex-US Large Cap NR USD Index. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

A 34% difference in the U.S. vs international equity allocation resulted in a 244-basis point performance differential within the equity portion of the portfolios. Said another way, an investor in the hypothetical "U.S. Heavy" equity portfolio would be $2,440 behind an investor in the "U.S. Light" equity portfolio by October 31 if both had started the year with $100,000.

Of course, these allocation differences create performance differentials across the entire portfolio—not just the equity portion. In 2016, the difference between the best- and worst-performing "Balanced Portfolio" was 5.20%. On a $100,000 account, that equates to about $5,200 in just 12 months. The differential in 2017 hasn't been as large as of October 31—but the year isn't finished yet. The most alarming aspect that, by name, these portfolios are assumed to have similar risk profiles.



As of September 2017. Source: BackEnd Benchmarking - The Robo Report™ Third Quarter 2017 (edition 5).

The Bottom Line

At first glance, robo-advisors seem like a welcome solution for investors overwhelmed with complex investment choices and decisions. However, not all robo-advisors are created equal: Cost and performance are important factors in the evaluation, but so are their underlying portfolio allocations, risk profiles, and whether the portfolios are being managed to maximize after-tax returns.

For traditional advisors, this may be the opportunity to step in and perform the due diligence required on behalf of clients. Finding a low-cost, digital advice provider that aligns with your beliefs and incorporating this new alternative into your practice may be the best way to preserve—and continue to grow—your client base. After all, an advisor knows their clients better than any algorithm. Being proactive can go a long way in enhancing and growing relationships with clients.

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