Waiter Robot

# What Investors Really Want
# from Their Financial Advisors:
# Can Robos Deliver?

- Investors want much more than just investment returns. They want quality service too.
- All financial advisors do the same three things to meet investor needs. By "all" we mean Robos, humans, and everything in between.
- Successful financial advisors are like professional waiters. Picture a Robotic waiter versus a human waiter.

In his popular book *What Investors Really Want*, Professor Meir Statman draws analogies between investor behavior and nutrition. For example, we all know that we should eat nutritious low cost meals by dining on health food at home, but that's just not fun for most of us. We'd much rather indulge in rich foods at expensive fancy restaurants. We want what Dr. Statman calls "utilitarian rewards."  Similarly, investors know that a diversified low cost portfolio is theoretically best, but we'd rather have the amusement, and bragging rights, of expensive risky investments like hedge funds and specialized equity managers.

In keeping with this dining analogy, investment advisors are like waiters, serving the diverse appetites of their clients. Clients want their advisors (waiters) to guide them through their investment choices (menu selections). A successful financial advisor recognizes that the ingredients for satisfying clients are as follows:

- **Menu**: A successful waiter needs a good menu with tasty selections that serve a variety of palettes. A successful financial consultant needs a variety of solutions that meet a wide range of investor needs. Robos are accomplished at developing comprehensive menus.

- **Selection**: A successful waiter helps diners select something they'll like. A successful consultant identifies client needs and matches them to a solution that will make them happy. Robos are limited in their ability to provide this advice.
- **Follow up**: A successful waiter asks for feedback and makes changes as necessary. A successful financial consultant monitors progress toward achievement of goals and recommends changes along the way. Robos, by definition, cannot provide the hand holding ("trusted advisor") that has traditionally characterized this guidance.

In the following I address each of these key essentials for successfully serving investors.

## Menu of Models

A tasty menu item has quality ingredients and skillful preparation. In investing, we create models that are analogous to menu items, with each model designed for a specific type of investor (diner preference). Risk is the quality ingredient and packaging that risk to provide the highest return is the skillful preparation.

Let's start with basics of models and then move on to refinements. Most models start by identifying points on the Efficient Frontier, like the 5 points shown in this graph. Each numbered portfolio theoretically provides the highest return for the indicated level of risk. Dr. Harry Markowitz won a Nobel Prize in 1990 for the "Theory of Portfolio Choice" that is recognized as the birth of Modern Portfolio Theory (MPT). The Efficient Frontier is the centerpiece of MPT.  Most advisors, especially Robos, stop here.
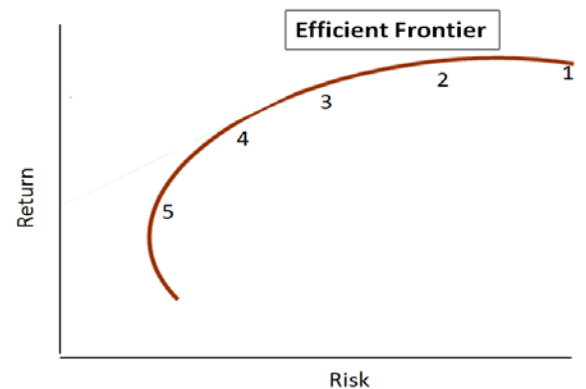
But most don't realize that another Nobel Prize winning theory refines the Efficient Frontier.  Dr. William F. Sharpe also won a Nobel in 1990 for his Capital Asset
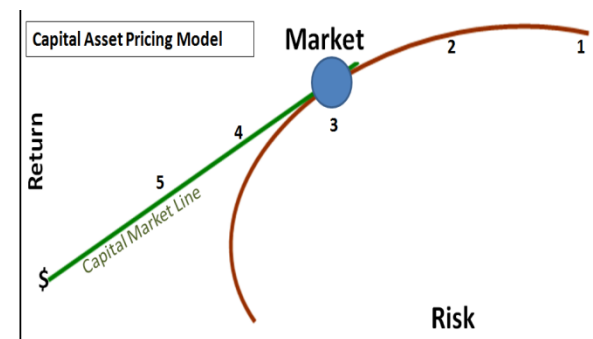
Pricing Model which, among other things, shows that risk control is best achieved with cash. As shown in the graph on the right, the Capital Market Line, which blends the "Market" with cash, dominates the Efficient Frontier at low levels of risk – it provides higher returns for the same level of risk. It's important to realize that the "Market" in this context is the entire world of risky assets, not just the U.S. stock market. This represents a challenge because we can't know the real composition of this Market, but we can guess. Here's an example:

**Example of a World Market Portfolio Estimate**

|  | Asset | Sample ETF | Allocation |
|---|---|---|---|
| Equity | Broad US Equity | Vanguard US Market Index (VTI) | 31 |
| | International Equity | Vanguard All World ex US (VEU) | 20 |
| | Global Real Estate | SPDR Global Real Estate (RWO) | 9 |
| | Commodities | iPath Commodity ETN (DJP) | 7 |
| | Global Infrastructure | iShares Global Infrastructure (IGF) | 3 |
| Bond | US Bonds | SPDR US Bond (LAG) | 20 |
| | International Bonds | iShares Foreign Bond (IGOV) | 10 |

Other refinements to models are like the house specialties that set some restaurants apart, like "Black & Blue" charbroiled steaks, or "Mama's Homemade Lasagna." Models can be refined in two ways:

- Market views can adjust asset weightings, which is timing. For example, the current bond manipulation to zero interest argues for shorter duration bonds because there is no reward for taking duration risk. Robos can incorporate their forecasts into their models.
- Active managers can be used rather than all passive. Investors want active managers, and advisors want to give clients what they want, but it's very difficult to identify skilful active managers. Advisors don't want to spend the time, energy and money that it takes to identify skill, as summarized in our Infographic, so underperforming active managers are the norm. Robos have decided to be all passive, so they're not even trying to add value through active management.

## Selecting a Model

Selecting a model is like selecting a menu item. There are three ways that investors can choose:

- **Risk-based** is like the diner who asks the waiter for his best recommendations: "order for me." Investors don't know their risk capacity. They want their advisor to tell them. Risk questionnaires can help with the guidance of an advisor. Robos use this approach and the following age-based approach.
- **Age-based** uses a target date fund glide path to identify an appropriate asset mix. It's like ordering bland soft food for older diners versus more exotic dishes for the youngsters. Robos use this approach and the preceding risk-based approach.
- **Goals-based** uses a model that is expected to earn a return that will produce the desired objective. Calculators help advisors solve for the return that will match cash flows with targeted ending wealth. Then a model is selected that is expected to earn at least that desired return. Goals-based investors are like the discriminating diners who are seeking a culinary treat. Even though they're the most challenging, they're the most likely to appreciate good service. Robos do not use this approach, which puts them at a disadvantage relative to human advisors who use it.

## Follow up

Just as waiters help diners through the various courses of the meal, advisors help their clients navigate through life's courses, monitoring progress toward achievement of objectives and making changes as necessary. We call this follow-up "Portfolio Navigation." If you've exceeded expectations, you can save less (spend more) and/or reduce risk. If you're trailing expectations, you can save more (spend less) and/or increase risk. Investors have choices. Some of this navigation can be automated, so Robos provide some of it, but they can't provide the emotional guidance that humans can.

Portfolio Navigation
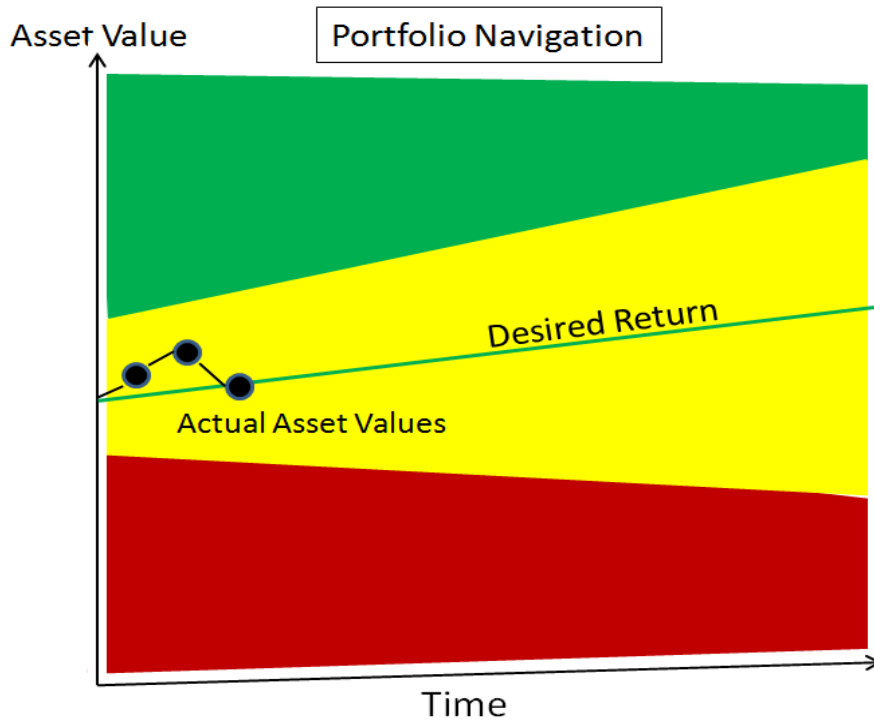
## **Conclusion**

Investors want to make money, just as diners want to be nourished. But both want more. They want to have fun and to brag about the experience. Successful advisors are like successful waiters. Both require three key competencies that are easy to understand, although challenging to do right. Robos can compete in some aspects, like providing an extensive menu, but they are not very good at the other two competencies. Now you know.

Would you like to be served by a robotic waiter? No tip.

*Bon appétit.*

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