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THE CAPCO INSTITUTE JOURNAL OF FINANCIAL TRANSFORMATION

INVESTMENTS

The hybrid advice model

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AUTOMATION

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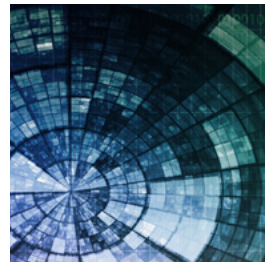
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The hybrid advice model

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ABSTRACT

Wealth management has traditionally meant a dedicated human financial advisor, providing tailored investment advice to primarily high-net-worth and ultra-high-net-worth clients. Over the past 10 years, innovations in financial technology, increased regulation, and changing generational expectations have challenged our understanding of the client-advisor relationship, and the wealth management industry as a whole. The rapid growth and proliferation of financial services technology firms has caused a shift in the market. The digital first, low-cost alternatives they provide have opened wealth management to a broader base of retail, affluent, and mass affluent customers.

While the wealth management debate has focused on digital advisor versus human advisor, a third option has emerged, the hybrid advisor model, which combines the best aspects of both traditional human advice and automated digital platforms. Firms that successfully employ the hybrid advisor model will be empowered to evolve their business, attract a new generation of customers, and serve them in a flexible and cost-effective manner, while realizing greater agility in their business models, technology, and product offerings.

1. INTRODUCTION

Wealth management has traditionally referred to working with a dedicated human financial advisor, one who provides tailored investment advice to primarily high-net-worth and ultra-high-net-worth clients.

However, over the past 10 years, innovations in financial technology, increased regulation, and changing generational expectations have not only challenged our understanding of client-advisor relationships, but altered our perceptions of the wealth management industry as a whole. In this relatively short period of time, we have seen exchange traded funds (ETFs) replace mutual funds, digital channels overtake traditional interaction methods, and a booming global fintech industry challenge incumbents on providing better products and services to the same customer base.

The rapid growth and proliferation of financial services technology firms has caused a shift in the market by providing digital-first, low-cost alternatives. This has opened wealth management to a broader base of retail, affluent, and mass affluent customers.

While the wealth management debate has traditionally focused on digital advisors versus human advisors, a third option has recently emerged: the hybrid advisor model. This new model interweaves the best aspects of both traditional human advice and automated digital platforms into one seamless experience.

2. WEALTH MANAGEMENT AT A TIPPING POINT

In 2008, a myriad of financial services technology companies entered the market, each launching their own digital-only, direct-to-consumer robo-advice solutions. These companies mainly offer low-cost ETF and mutual fund-based investment solutions with no-to-low investment minimums. Their mass affluent customer base, combined with their seamless adoption into the marketplace, has highlighted that wealth management is not just for the wealthy.

These firms have also pioneered a digital-first model within wealth management, one focused on ensuring the efficiency and ease of user experience. The success of these robo-advisors has proved to traditional wealth managers that it is possible to alleviate current customer pain points through digitization. Digitizing areas such as onboarding, document transfer, portfolio

analysis, and performance tracking have all proven to improve customer experience and reduce operating costs.

There is no question that these new entrants have paved the way in defining the future of wealth management. As their clients and assets under management (AUM) have expanded, leading digital firms have even been seen as genuine competition for their traditional wealth management counterparts. However, the current data suggests many of these firms have saturated their market, experiencing reduced AUM growth over the past 24 months.

“The ability to provide tailored human guidance, along with cutting edge digital expertise, can be a key differentiator in gaining the upper hand.”

One potential explanation involves consumer comfort with tried-and-true methods of wealth management. For instance, our research suggests that customers are not comfortable with investing large sums of money (more than U.S.\$100,000) in a solution that is digital-only. When it comes to their wealth, customers seem to want some level of human interaction to help guide them through complex financial decisions and product options facilitated by an exclusively-digital experience. Consumers also want flexibility in the way they interact with their financial institution. Ergo, a one-size-fits-all model is a thing of the past – even in the high-tech world of digital.

Many digital advice firms recognized this trend, and have quickly pivoted their business models to focus on enabling financial advisors to connect with consumers through their platforms. They realized that there was more potential for growth if they partnered with large financial institutions that offered pre-existing customer bases with a larger pool of assets. In return, the financial institutions would receive a white-labeled version of a digital platform, one tailored to their business that could help accelerate their digital agenda.

Furthermore, established robo-advisor firms have chosen to pivot by supplementing their existing digital-only offerings with human advisors. Firms have found that customers still want access to a human advisor for guidance and advice, especially as their financial

needs become more complex. Customers also want their advisor available as needed through the channel of their choosing. However, these services come at a cost to the customer, with increased fees and higher minimum investment requirements.

Large financial institutions recognize that their traditional business model, which has gone unchanged for over 100 years, is being challenged in a major way. The fees they charge, channels they engage their customers through, and client segments they wish to attract, are all shifting day by day. In the face of this turbulence, firms need to understand that choosing not to embrace digital creates a tangible risk of being left behind.

While traditional wealth management firms have been slow to adapt, many are gradually seeing the value of using the technology provided by digital advice firms. The ability to provide tailored human guidance, along with their cutting-edge digital expertise, can be a key differentiator in gaining the upper hand.

In early 2015, a surge of acquisitions and partnerships began as wealth managers sought the best digital advice platforms for modernizing their businesses. The new medium they sought would automate core functions of investment and account management, and enable the advisor to focus on both holistic financial planning, and building relationships with clients.

Whichever avenue they take, one thing is common: firms of all sizes see the hybrid approach as a pillar of their growth strategy, something that can ensure their status as top-tier wealth managers for this generation and the next.

3. THE HYBRID ADVICE MODEL

In its simplest form, the hybrid approach combines the best components of human-based financial advice and digital advice, offering a flexible and tailored wealth management solution to clients of all demographics.

The hybrid advice solution is underpinned by a flexible business model that can support customers throughout their financial lives, spanning from mass market to ultra-high-net-worth. The hybrid approach has three models to offer to customers, which depend on their customer segment (defined by investable assets), as well as the complexity of their financial needs.

The level of human interaction, product complexity, fees, and accounts offered changes between business models. The business models shown in Figure 1 indicate the optionality of the solution, and illustrate the flexibility of the hybrid approach to meet the needs of all consumer segments.

Figure 1: Hybrid advisor model

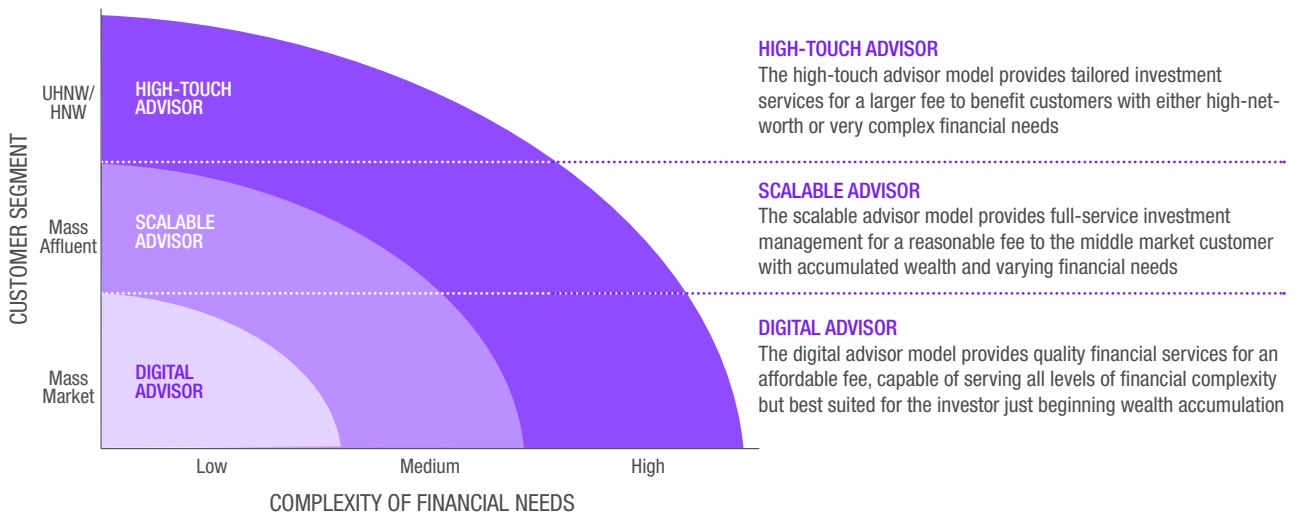


Table 1: Annual proportion of interest income resulting from term transformation

	DIGITAL ADVISOR	SCALABLE ADVISOR	HIGH-TOUCH ADVISOR
	Provides mass market investors access to affordable, quality financial services	Enables advisors to offer mass affluent investors financial services suited to their needs	Offers investors with complex financial needs a dedicated and tailored advisory experience
ADVISOR ROLE	Ongoing access to call center support model	Advisor guidance during account opening, Ongoing access to advisor guidance as needed	Dedicated human advisor guidance from account opening to ongoing portfolio management and reporting
DIGITAL FEATURES	On-boarding, omni-channel access, account funding, model generation, investment management, rebalancing, tax-loss harvesting, and reporting	On-boarding, omni-channel access, account funding, model generation, investment management, rebalancing, tax-loss harvesting, and reporting	On-boarding, omni-channel access, account funding, reporting
ACCOUNT MINIMUM	U.S.\$0 – U.S.\$100,000	U.S.\$100,000 – U.S.\$500,000	U.S.\$500,000+
COST TO CUSTOMER	Low (e.g., 0-30bps)	Medium (e.g., 30-150 bps)	High (e.g. 150bps+)
ACCOUNT TYPES	IRAs, retirement, goal-saving	IRAs, retirement, goal-saving, financial planning, 529s	IRAs, retirement, goal-saving, financial planning, 529s, estate planning, insurance, lending, healthcare
PRODUCT OFFERING	ETFs, equities	ETFs, equities, mutual funds, fixed income	ETFs, equities, mutual funds, fixed income, real estate, insurance, annuities, alternative investments

3.1 The hybrid advisor value chain

Managing investments using automated technology enables advisors to grow their existing businesses by focusing on financial planning and customer relationships, while scaling their business to serve a larger customer base. With flexible business models, advisors can engage customers at a younger age, and continue to provide cost-effective services to them as they move through different stages of life. Digital capabilities also dramatically enhance the advisor value proposition by improving communication through both mobile applications, and on-demand access to portfolio performance.

Today, people have become so accustomed to having information readily accessible to them and finance should be no different. The hybrid model facilitates this modern accessibility and ease. It allows clients to benefit by having instant access to real-time financial data through their desktop and mobile devices, while instant messaging and chatbots allow them to connect with advisors on demand. This increased connectivity has the added benefit of encouraging more frequent interactions between clients and advisors, which strengthens their relationship and mutual regard. Centralizing all financial information into one platform

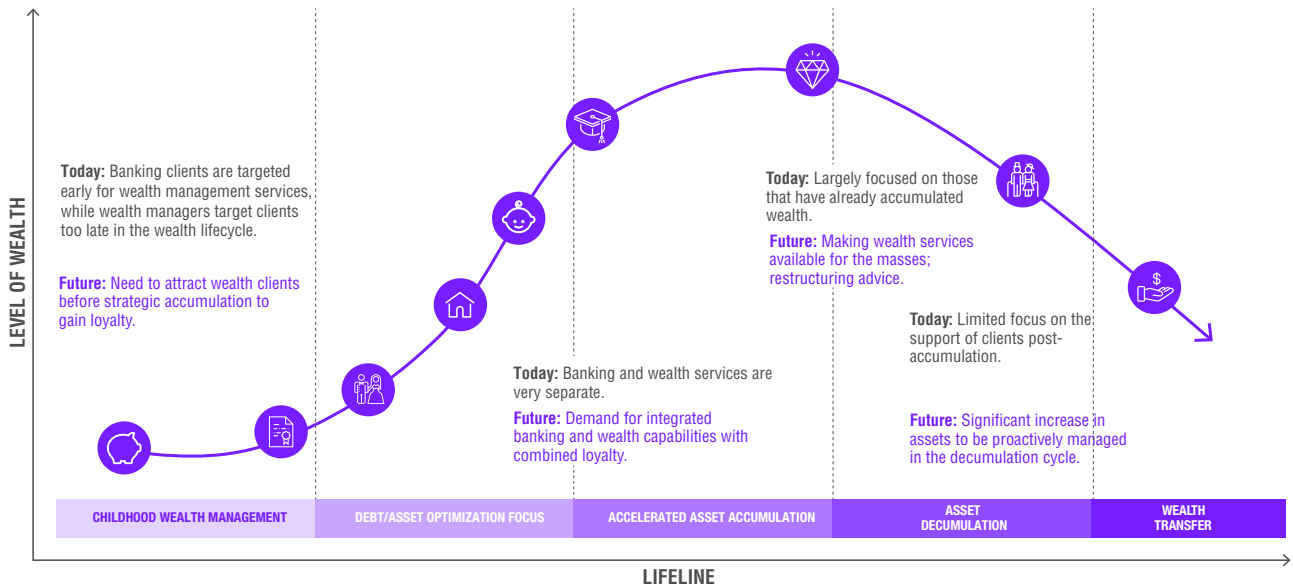
has finally allowed clients to plan and monitor portfolios – across all accounts, products, and investment solutions – at any time they please. Moreover, these upgrades in business model flexibility have also yielded flexibility in fee structures, thereby allowing clients to pay for the exact level of service they would like.

3.2 Variants of the hybrid advisor model

Multiple hybrid business models enable advisors to efficiently offer services based on customer segment, and complexity of financial need. The “digital advisor,” “scalable advisor,” and “high-touch advisor” variations allow advisors flexibility to serve clients across their entire wealth lifecycle.

For a mass market investor, value is driven from simplicity, and the ability to easily interact. The mass affluent do not derive value or make decisions based on performance – not because they don’t want to make money, but rather because they lack the financial expertise to do so. Northwestern Mutual reported that a third of Americans do not have a financial plan (2015). This suggests that the problem lies not in a shortage of tools, but rather in the ability to use them.

Figure 2: The wealth lifecycle



The digital advisor model targets mass market investors seeking affordability and quality financial services. Here, human advisors only provide initial guidance and setup, after which a digital platform takes over for on-boarding, omni-channel portfolio access, account funding, model generation, investment management, and rebalancing. Given their ability to easily serve a large customer base, products offered in this model are quite like those historically offered to the mass market, such as ETFs, equities, and cash management. However, investors with digital advisor accounts can seamlessly graduate to scalable or high touch service levels as assets and financial complexities grow.

The scalable advisor model allows both robo and traditional advisors to serve mass affluent clients in an efficient and cost-effective manner. With the scalable model, advisors provide a more active role in investment decisions, and help manage complex financial instruments in a client's portfolio. Investors, therefore, receive both an enhanced digital experience and full-scale advisor services.

Many say that once a client accumulates enough wealth to be considered ultra-high-net-worth (UHNW), there is no longer a role for digital in the wealth management experience. The reality is that over 60% of UHNW individuals are under 45 years of age. As the investor begins to grow assets and contend with more complex life events, even HNW and UHNW individuals will seek out the ability to get answers to complex questions

anytime and anywhere – something that reaches beyond the scope of measured advisory visits.

A high-touch advisor model is specifically designed to provide investors with complex financial needs with a tailored advisory experience. Advisors not only encompass the traditional offerings of lower-tier services, but provide clients with personalized assistance on financial, retirement, and estate planning. Product scope for high-touch advisors is expanded to include real estate, annuities, and alternative investments. This allows advisors to both leverage their client's assets to hedge, and invest using more exotic solutions. Advisor-client interaction is also not solely limited to digital channels, and often requires a much higher frequency of in-person meetings to establish trust and demonstrate a dedicated focus on the client's financial picture.

The hybrid model has many inherent benefits that spans across all parties, which make it an attractive and mutually beneficial option for financial advisors, businesses, and clients alike.

The greatest benefit of the hybrid approach is that it increases the scalability of financial advisors, therefore allowing them to attract and serve more clients while maintaining high quality service. This is mainly because the implementation of a digital platform helps to automate manual and time-consuming processes for both client and advisor.

The most material client benefit of the hybrid approach lies in how it allows them to choose their level of human and digital interactions. The solution provides flexibility, allowing the client to choose their level of advice, product access, fee structure, and digital experience. Hybrid enables a personalized solution that is cost-efficient to the business and provides material growth opportunity for the financial advisor.

The digital platform also acts as a catalyst for driving business growth through acquisition of new customers and, subsequently, new assets. A digital offering provides a low-cost feeder channel to attract millennial customers, who have huge earning potential over time.

The hybrid model enables advisors to attract new assets from new and existing customers, and, equally important, allows the advisor to retain assets currently managed. This is because a fundamental principle of the hybrid approach flexible business model lies in its ability to allow advisors to service customers regardless of their demographic, available assets, or stage in financial life. As a client accumulates more wealth, and their financial needs become more complex, the hybrid model allows advisors to efficiently transition clients from a digital-only experience to one with more human interaction and enhanced services.

As advisors realize efficiencies of scale, they can also see how implementing a digital platform provides

the parent business with enhanced transparency and control across the value chain. Supervisory regulation within financial services requires firms to ensure products and services meet the needs of their clients. Digital platforms provide automated guidelines to enhance monitoring, supervision, and risk scoring.

4. UNIFYING THE CUSTOMER EXPERIENCE

The hybrid approach has the potential to provide a unified platform accessible by the financial advisor and the client, thereby providing a consistent experience. In addition, the hybrid approach enables channel flexibility across desktop, mobile, and tablet. Furthermore, solutions that use cloud-based technologies allow customers to seamlessly move between platforms with no impact to the user experience. In the future, this platform unification will provide the client with a holistic view of their wealth across multiple providers and products.

The hybrid approach is enabled by a digital platform that can cater to all demographics, regardless of assets and complexity – one flexible enough to evolve at the rate of technology, industry, and customer demographic change.

The digital platform enables a truly multi-channel experience, with an open API architecture that allows

Figure 3: The integrated digital platform

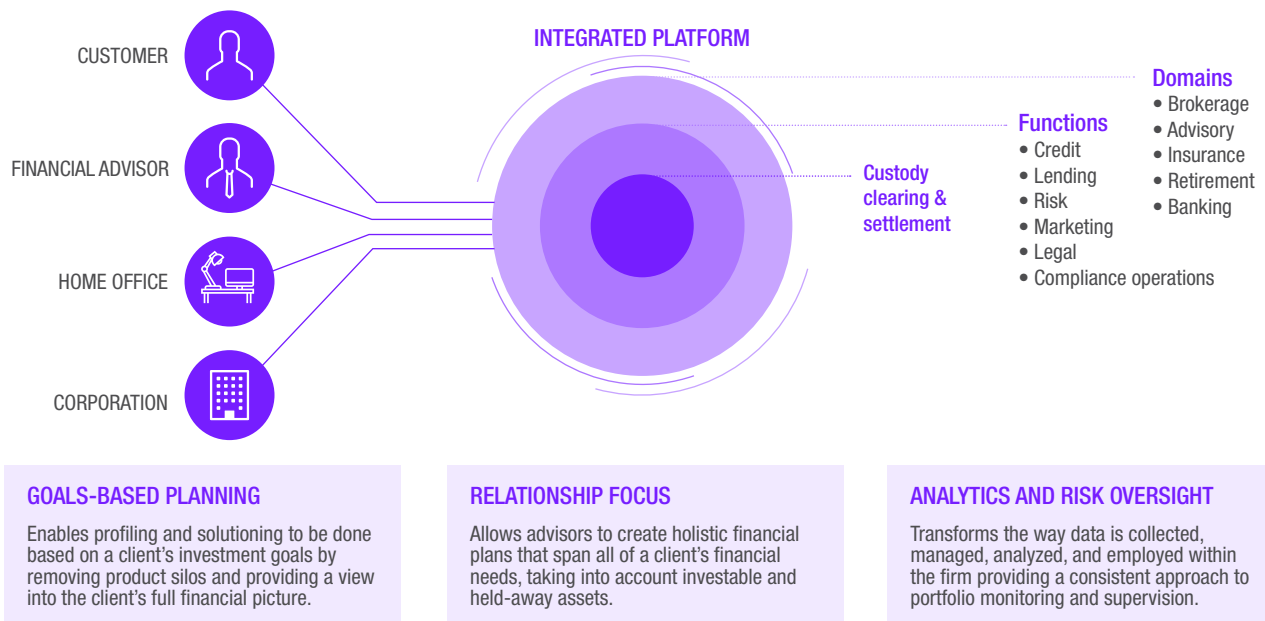
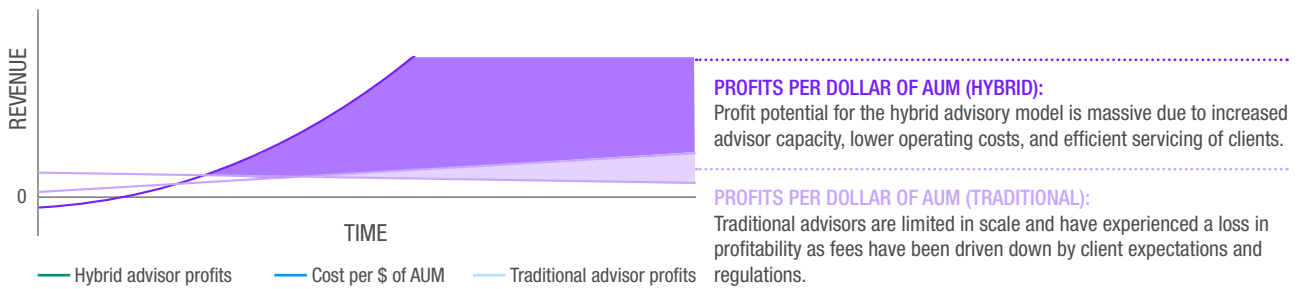


Figure 4: Hybrid advisory versus traditional advisory profit potential



for seamless integration with the fintech ecosystem, as well as existing legacy infrastructures. The digital platform provides a single point of entry for all users, helps reduce process inefficiency, opens up new products, and improves supervision and control.

A single point of entry allows advisors, clients, home offices, and corporations to interact through a common gateway defined by a holistic and consistent experience. The digital platform should be built in a way that supports multiple asset classes, products, and account types. This unified view of a client's wealth allows advisors to spend less time monitoring portfolios on separate platforms, and more time cultivating client relationships and managing their wealth.

Perhaps most importantly, in an environment with heightened regulatory scrutiny, the digital platform can transform the way data is collected, managed, analyzed, and employed within a firm. This enables a consistent approach to portfolio pricing, monitoring, and supervision.

5. BUILDING THE BUSINESS CASE

There are three main avenues to explore prior to undertaking a digital transformation and transition to the hybrid advice approach: partner, build, or acquire. The adoption of each of these avenues will be influenced by the firm's culture, budget, and appetite to disrupt.

5.1 The case for acquisitions

Acquisitions can offer a variety of benefits, including speed to market, increased profitability, and exclusivity, as well as greater strategic opportunities. With a newly acquired digital platform, wealth managers can enter new markets faster than with a build option, and immediately convert new or existing customers to a lower cost hybrid model.

Buying established companies also allows complete control over any proprietary technology, hence allowing these firms to offer clients a completely unique and exclusive experience.

Despite a faster go to market timeline, acquisitions can be costly. They also demand a greater integration effort than partnerships with "out-of-box" solutions. Given the rate of robo-advisor venture capital funding, there also exists the risk of inflated valuations, which may force firms looking to acquire new technology to pay a premium.

5.2 The case for building

Building an in-house digital platform is an appropriate solution for firms with both the development capacity, and the dedicated strategic direction towards digital innovation. Vanguard, Merrill Lynch, Charles Schwab, and TD are all examples of firms that have done so, each having built their own proprietary digital platforms. Control is a critical pillar of the build strategy. Firms will have ownership of their own intellectual property, functionality, customer experience, and data. Furthermore, pricing, margins, and revenue potential will fall under complete command of wealth managers.

While a build strategy offers attractive control over the full IT stack, it also has the longest time to market of all possible scenarios. Stakeholder consensus, regulatory approval, and deep functional and technical knowledge can be difficult to obtain. Furthermore, given that there is no promise of immediate increased revenue, the initial cost can make it difficult to justify the price tag of building an in-house digital platform.

5.3 The case for partnering

Partnering is the fastest, cheapest, and least resource-intensive solution for constructing a digital wealth management solution. White-labeled platforms offer easy out-of-box integration, and often come pre-integrated with major custodian banks. Partnerships also allow for immediate customer acquisitions because they allow access to the partner platform's existing clients. For example, UBS and Wells Fargo have each embarked on partnerships to provide robo-advisor experiences to clients, while Raymond James and John Hancock each forged partnerships that allow them to offer both robo and hybrid advisor solutions to clients.

There are, however, lingering challenges with this approach. Partnerships limit a firm's control over system functionality, and can reduce the competitive advantage that a build or buy strategy offers. A partner strategy can also decrease revenue margins, as firms will be expected to pay licensing fees or share profits.

5.4 Economics

Although the choice to build, buy, or partner is highly dependent on each firm's differing long-term strategies, there are clear economic drivers for implementing a digital platform.

By optimizing the balance between revenue and cost drivers, hybrid models can help deliver a business strategy that increases profitability while decreasing operating costs. Through an expected increase in AUM, innovation acceleration, and an expanded customer base, the hybrid model offers multiple opportunities to drive revenue, while simultaneously diminishing operational and technology costs, reducing on-boarding costs, and lowering the overall cost of acquiring a customer (CAC).

5. THE FUTURE IS NOW FOR DIGITAL ADVICE

Independent of the form, digital advice and technology are the future of wealth management. Providing a digital experience has become a necessity for traditional wealth management firms. Customers and financial advisors expect better digital tools and the flexibility of human interaction to suit their specific needs.

Embracing the fintech ecosystem and using digital advice platforms to provide a hybrid approach, empowers wealth management firms to evolve their business. It can not only attract a new generation of customers, but serve them in a flexible and cost-effective way that will ensure the longevity of their relationships.

Although the future is bright for wealth managers who successfully complete this shift, pressure remains for continued innovation. Firms like Google, Facebook, Alibaba, and Apple, each already a leader in the digital marketplace, all pose massive threats to the financial services industry.

Additionally, the regulatory landscape since the 2008 financial crisis has encroached on traditional business models – as illustrated by the Dodd-Frank Act and the Department of Labor's Fiduciary Rule – while the SEC recently placed automated digital advice as a top examination priority for 2017 and 2018.

Firms that successfully employ the hybrid advisor model, one powered by a digital platform, will have the competitive advantage of greater agility in their business model, technology, and product offerings.

It is becoming clear that the changes happening in wealth management will benefit clients and advisors alike, and help democratize access to quality financial advice. Investment solutions once reserved for the ultra-wealthy will begin to trickle down and serve clients without distinction. Clients will be empowered to help drive their own financial independence, and advisors will grow their business by offering holistic financial advice, all of which culminates in the ideal wealth management experience.

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