The custom fitted individual as the future of financial advice

By John O'Connell

Digital wealth management (colloquially termed ‘robo’ advice) heralds an industrial revolution within retirement savings that has the potential to shift the industry from a mass production (as in product) approach to a mass customisation (as in custom solution) approach.

Those in the industry who dismiss ‘robos’ as just a fund-of-funds fad are missing the point that with the advent of true granular digital advice approaches (next stage robos) will come a marked industry shift.

The mutual fund industry, and subsequently the exchange traded fund (ETF) industry are by definition, a product push approach to investment savings. They are a market-centric approach.

The mass customisation afforded by digital wealth management means individually managed accounts at scale based pricing. This has the promise to shift the industry to an investor-centric approach which in turn will catalyse the adoption of goals-based wealth management. Investment outcomes custom fitted to each individual’s life circumstances. This will greatly improve an individual’s understanding of their likely retirement outcome and through this, their level of engagement.

When Australia introduced its mandatory retirement savings system – the superannuation system - it also accelerated a major shift of responsibility. Retirement systems where the employer bore the risk (defined benefit funds) were replaced with a more individual centred approach, the defined contribution schemes. These are what we live with today, a superannuation system where the individual bears the risk of their retirement funding.

Let me repeat that: the individual bears the risk of their retirement funding.

That's right, at the front end, the client end, it is an individualised system. However at the backend, the product end, the industry still bears all the hallmarks of the prior defined benefit era. It has simply failed to move on from a mass production mindset to a mass customisation mindset. The customer is no longer a large employer – who can employ suitably qualified staff to oversee and understand the defined benefit scheme - but rather, the customer is a woefully unprepared 'joe public'.

To incentivise joe public to 'get involved', the government made the system tax advantaged. To stop the system being abused they introduced various measures from Reasonable Benefits Limits (remember those?) to annual caps, to all the changes slated for next July. What began as an individual responsibility retirement savings scheme burgeoned into a complex set of rules and measures.

The industries mass production mindset means there is an ever growing and well-intentioned array of potential investment choices, but a lack of context as to why this complexity is required to fulfil the individual's retirement needs. Complexity that flies over the head of the individual trying to make the purchasing decision. In short, there is a failure of relevancy that comes from the lack of individuality. The result is a disillusioned customer lacking engagement. It doesn't seem to matter whether that customer buys the product direct (retail funds), through a financial planning intermediary, or via an industry fund (wholesale), the end state is a general lack of engagement in what is a major personal asset choice. The industry seems to misinterpret this signal as unfulfilled demand. It responds with more products of ever more complexity. As the industry product menu increases, many products (or 'packaged strategies') are forced to address a niche, only performing in a very select part of the economic cycle … Product overproduction is rife.

The result of over production is just as many products likely to underperform as outperform the economic cycle. As the capital markets primary purpose is to fund the private sector, which in turn is the economy (the government sector is better described as a transfer agent), then it stands to reason that the median performance will closely align with the economy's performance. Leave some room for fees for the various layers of management in the system (trustee, asset consultant, admin provider, custodian, fund/asset manager, broker), and the result is sub-economic cycle performance. Index funds invest in the same economic universe, but they have less complexity (just follow the index) and hence less fees. This leads to the commonly cited observation that, after-fees an index fund will typically outperform the median active fund manager.

This debate that has as its sole focus market risks (risks embedded within asset class benchmarks and any fees from associated investment managers), but fails to account for the only relevant risk for an individual bearing the risk of a defined contribution scheme, namely, the risk of not achieving their meaningful retirement goals.

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The result is an industry competing for the client's heart through a product strategy that in aggregate must fail.

All the evidence points to that it is already failing. Every year an increasing weight of money moves to index (passive) management. Presumably this means there is an increasing number of individuals voting with their feet to disengage.

This is a building societal problem as the government has mandated individuals contribute almost 10% of earnings to their retirement scheme, yet through their behaviour, it is clear the individual is overwhelmed by complexity and product choice. In order to address this, I believe the industry needs to move from a market-centric perspective towards an investor-centric perspective.

This means moving from a focus on mass production, to a focus on individually customised solutions that address a client's essential retirement consumption goals – a replacement income that provides a dignified retirement in relation to their working life and social standing – as well as applies excess funds to a risk seeking portfolio that satisfies their aspirational consumption goals.

The target-date-fund approach is a mass production attempt to address retirement consumption goals. It is a step in the right direction but fails in that it does not address the individual's specific needs. Digital wealth management does not mean a new investing science. What it does mean is a new engineering challenge that places its emphasis on treating each client as an individual goal based challenge.

Digital wealth management is the beginning of the era of mass customisation. It is as much a refined process automation and distribution approach rather than a new investment solution. The advent of factor based investment approaches as well as the increasing granularity of exchange traded funds are catalysts that help propel the industry change.

Those who see digital wealth management as merely stopping at fund of fund 'robos' are at risk of missing the bigger picture. An industry picture which will be centred on the individuals personal goals.

Far from being overrun by passive 'opt-out' approaches, active management will regain its industry leadership so long as it moves its focus from a market centric approach to custom portfolio management. Bespoke tailored portfolios that have a meaningful connection to an individual's consumption goals.

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