Filling the gap: Will automated advice kill the traditional advisor?

Traditional insurance orthodoxy is that insurance products are sold, not bought. But a perfect storm of regulatory, technological, social, demographic and economic changes is turning this on its head. Wholesale changes in insurance distribution are coming, and the success of these could impact society as a whole.

The advice gap, being individuals who are unwilling or unable to get financial advice and guidance at a price they are willing to pay, has been widening in many developed markets around the world. Three drivers of this global trend are shown in the diagram below.

- **Increased need for financial advice**: Financial advice is of increasing importance to a wider proportion of society. Social and demographic changes mean that individuals have a longer future to provide for than ever before. Governments in many countries, however, are increasingly attempting to push the responsibility for long term financial support back to the individual. As part of this, people are being given more and more financial choices, but financial illiteracy is limiting their capability to make those decisions.

- **Decreased drive of individuals to seek financial advice**: Despite these factors that should, in theory, drive up the perceived value of financial advice, customers are increasingly turning away from it. Why? Regulatory change is the main reason - the

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1 Pensions Freedoms, in the U.K., which have for the first time allowed individuals to take out their pension funds rather than purchase an annuity, are a good recent example of this. Australia has allowed similar freedoms for over 25 years.

2 Only 57% of Americans are financially literate, according to the S&P Global FinLit Survey 2014. In the U.K., one in five cannot read a bank statement and one third cannot perform a simple calculation to add interest to an earned savings balance (U.K. Financial Capability Strategy, October 2015).
cost of advice is more transparent than ever\(^3\) and consumers are highly aware of this and typically unwilling to pay the sums involved\(^4\). This regulation follows historic misselling scandals, which in part explain high levels of mistrust in financial services – globally it is the third least trusted industry\(^5\). Against this backdrop, is it any wonder that individuals are turning away from traditional financial advice?

**Decreased availability of financial advice:** The gap widens further, however, when you consider what is happening to these traditional financial advice firms. With increasing regulation and the shadow of past miss-selling driving up the cost and perceived risk associated with providing financial advice, they are becoming increasingly selective over the customers they choose to accept. For example, in the U.K., the proportion of advice firms that ask for a minimum portfolio of £100,000 (US$ 144,000) to invest has more than doubled from around 13% in 2013 to 32% in 2015\(^6\).

This discussion reveals a paradox - individuals need financial advice more than ever, but its perceived value is significantly lower than the cost of providing it.

Measuring the advice gap globally is difficult, with the regulation of financial advice around the world at different levels of maturity. Perhaps it is worth considering those markets where reforms are already embedded. In 2015, two thirds of financial products were sold in the U.K. without financial advice, up from 40 per cent three years ago\(^7\). In Australia, 79% of adults do not use a financial advisor, or plan to, whilst Australian advisors say that the cost of providing advice is four times the fee that customers are willing to pay\(^8\). Whilst these are developed world examples, they have global significance as regulators around the world embark on reforms similar to those implemented in these markets, with the aim of reducing the bias introduced by opaque commissions. There are clearly, however, unintended consequences for the wider provision of financial advice.

So the advice gap is there, and it is getting wider. But if traditional advisors cannot fill it, why should anyone else care? We should consider what happens if the gap is not bridged. Assume that without financial advice, individuals are not motivated to save, or the savings are not invested in a way that optimises returns. Not only is there the risk of creating an underprivileged minority, but the economy as a whole misses out on the returns that could be realised from investing these funds over the longer term. For insurers, these individuals deserted by current distribution channels represent a missed opportunity to sell to a wider customer base.

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\(^3\) There are many examples of this from around the world, including: the Retail Distribution Review in the U.K.; the Fee-Based Investment Advice Act in Germany; the Future of Financial Advice regulation in Australia; the proposed Fiduciary Standard in the U.S.; the Retail Distribution Review in South Africa; the Financial Advisory Industry Review in Singapore; and, the Canadian Securities Administrators is considering whether to cap or abolish embedded sales and trailing commissions on funds.

\(^4\) 55% of Americans who have not worked with a financial advisor before thought it would cost more than they could afford (TIAA/CREF online survey of 2,000 adults, August 2015. The average cost of financial advice in the U.K. is £150 ($215) per hour (U.K. Government Money Advice Service), but only 8% of adults would be willing to pay more than £100 ($143) an hour for advice (YouGov research for BoringMoney).

\(^5\) Trust in Industries 2014 vs 2015 (Edelman Trust Barometer)


\(^7\) Financial Advice Market Review Call for Input, Financial Conduct Authority, October 2015

\(^8\) Investment Trends August 2015 Direct Client Report
The case for the traditional advisor

Customers will always prefer human intervention

There is a significant evidence from surveys that today’s customers have a strong preference for traditional advisors. Large majorities of investors in Canada (81 per cent), the US (73 per cent) and the U.K. (69 per cent) believed they would still want the help of an investment professional, instead of the latest technologies and tools, in three years’ time. This currently represents the traditional advisors’ greatest strength relative to their automated competitors. LV and Liberty Mutual, the case studies referred to here, are examples of insurers that are looking to ease customers into automation by still ensuring access to traditional advice channels.

Traditional advisors are needed to help customers understand advice

The financial illiteracy referred to earlier supports the view that many customers will still need the help of a traditional advisor to guide them through decisions of such significance to their future. The advice provided could be inappropriate if customers do not understand how the information they provide will be used, or know how to interpret the advice received.

Widespread use of automated advice could increase financial market volatility

It has been demonstrated that algorithmic trading increases volatility in financial markets and amplifies system risk as a result. Whilst there is limited evidence to suggest that automated advice in isolation contributes to this, the risk remains that its widespread use could exacerbate it. The European Supervisory Authorities noted in

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9 CFA Institute.
10 International Organization of Securities Commission Technical Committee, July 2011
their recent discussion paper on automated advice that “…there may be a ‘herding risk’ that a significant volume of consumers end up transacting in the same way in relation to the same financial products / services. This procyclicality could increase volatility in the market…”11. Traditional advisors, it could be argued, are better placed to make counter cyclical decisions that would mitigate this risk somewhat.

The case for automated advice

Reduced costs for advisors, lower fees for customers

As noted previously, the high costs of providing advice have deterred both customers from seeking it and advisors from providing it. Clearly, the costs associated with providing automated advice are much lower than a traditional advisor. For example, whilst a human advisor might charge 1% to 2% of assets a robo advisor (such as Betterment) may charge 0.25% to 0.5% for ongoing management12. Reducing costs makes a wider section of consumers viable for advisors to take on. Scalable Capital, referred to in the case study, provide a clear demonstration of how technology can widen access to superior investment advice.

Automated advice is more reliable

Humans are subject to various cognitive biases. Examples include confirmation bias, being the tendency to reach conclusions before all the facts and data have been analysed, and optimism bias, whereby our subjective confidence in the judgements we make is greater than their objective accuracy. Using automated advice, which eliminates these biases, may lead to a wider range of options being considered for the consumer, and ultimately more suitable advice being provided. Insurers and regulators may also benefit from the robust audit trail that automated advice can provide – clear documentation of information received, advice given and the rationale for it, protects both customers and insurers.

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11 Joint Discussion Paper on Automation in Financial Advice, Joint Committee of the three European Supervisory Authorities, December 2015
12 Wall Street Journal, 28 February 2016
**It could be a better customer experience**

Regulation, complexity and a lack of focus on the customer in the past have meant that over time the customer experience has left much to be desired. For example, in the U.K., the typical minimum time to get a quote for a retirement investment package takes 30 minutes, whilst applying for a new credit card takes less than two minutes\(^\text{13}\). Today’s customers expect full digital interaction, and there is now a direct link between overall customer experience and omnichannel delivery\(^\text{14}\). The expansion of automated advice offers new ways for insurers to focus on the end customer, not the advisor, as has often been the case in the past.

**Conclusion**

There is clearly an unmet need for financial advice amongst a large portion of the population, and it is in the interests of both insurers and society to bridge the advice gap. But does this mean that the role of the traditional advisor will disappear?

There is a relationship between the level of automation that customers will accept and the complexity of a product, as represented above, but we should not expect that relationship to be static. As technology develops and individuals become increasingly prepared to rely on digital interactions we can expect to see this relationship shift, and with it the decline of the traditional advisor. Perhaps in developing markets, where

\(^{13}\) “Freeing the future”, KPMG / Association of British Insurers

\(^{14}\) “Saving the Customer”, KPMG Nunwood Customer Experience Excellence Centre, April 2016
widespread use of financial advice is in its infancy, customers will even bypass a period of widespread use of traditional advisors and move more quickly to automation. Insurers and regulators will need to ensure that the new risks arising are understood and controlled. But insurers that accept and anticipate this change will be best placed to grab those potential customers currently stranded in the advice gap by existing distribution models.

The analysis suggests that automated advice, whilst not without risks, could provide fast, impartial advice to customers. The challenge that remains is how to reconcile this to the customers’ belief that a human advisor is necessary to fulfil their financial advice needs.

This leads to hope for both traditional and automated advisors, over the medium term at least. Imagine an advisor that combined the established intelligence of robo-advisors such as Betterment, with the access to a traditional human advisor in the way that Vanare and LV are proposing. The result would be a narrowing of the advice gap as the cost of advice is reduced, and the supply of advice is increased as each traditional advisor would have the ability to service a much greater number of customers. With this, the role of the traditional advisor would change – to survive they would need to move further up the advice value chain as automated advisors become increasingly able to perform their current activities.

But if we look beyond this, it is possible to see an era where a combination of artificial intelligence and societal change reduce the perceived value of the human interaction in financial advice to a much greater extent. It is already possible, and common, to ‘chat’ with a computer on many companies’ websites. Why not ‘chat’ about your financial needs and options with an automated advisor? And remember that surveys about customers’ preferences for human interaction are based on today’s investors. When 57 per cent of American teenagers have met a friend online, but only 20 per cent have met a friend made online in person\textsuperscript{15}, it seems less of a stretch to suggest that customers in the future would be willing to build trust and take guidance through digital means alone.

\textsuperscript{15} “Teens, Technology and Friendships”, Pew Research Center, August 2015