INTERNATIONAL JOURNAL OF RESEARCH CULTURE SOCIETY
Monthly Peer-Reviewed, Refereed, Indexed Journal
Volume - 8, Issue - 7, July - 2024

ISSN(O): 2456-6683
[Impact Factor: 9.241]

IJRCS

DOIs:10.2017/IJRCS/202407014 --:-- Research Paper / Article / Review

Robo-Advisory Services: Revolutionizing Investment Management

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Abstract: *Rapid digitalization, the growth of e-commerce, and the advent of algorithmic trading facilitated the entry of such robo-advisors into the market that offer a completely automatic investing experience to their users (Sironi, 2016; Jung, Dorner, Weinhardt, & Pusmaz, 2018). Robo-advisors have become known as an online platform offering investment advice and other investment management-related services (Bhatia, Chandani, & Chhateja, 2020). Robo-advisors are a new and revolutionary approach that is reshaping the current state of financial advisory services. Robo-advisors have the potential to transform the future of the investment advisory industry. Robo advisors, however, are unable to offer investors the human touch and emotional support. While some investors find automatic investing to be convenient, others might prefer the guidance and human touch of a professional financial advisor. Robo-advisory service usage depends on a customer's perceived ease of use and privacy. Hence, there is a necessity to have both robo-advisors and human interventions in place.*

Keywords: *financial advisory services, investment, investment management, robo-advisors.*

1. INTRODUCTION:

Without the help of professional advisors, most retail investors find it challenging to take financial risks (1). The main objective of the financial advisory industry is to enable individual and institutional investors to choose appropriate investments and achieve their investment goals. Developments in technology have led to the birth of robotic services, so-called robo-advisors, in the fields of finance and investment (2). Rapid digitalization, the growth of e-commerce, and the advent of algorithmic trading facilitated the entry of such robo-advisors into the market that offer a completely automatic investing experience to their users (3, 7). Robo-advisors have become known as an online platform offering investment advice and other investment management-related services (2). Robo-advisors are gaining popularity in retail and private banking. They assist their users in making financial decisions, such as measuring risks, selecting portfolios, and rebalancing portfolios. According to (1), "robo-advisors are digital platforms that comprise interactive and intelligent user assistance components, using information technology to guide customers through an automated financial advisory process." Robo-advisors are also known as automated financial advisors. According to (4), robo-advisors possess the ability to give investors cost-effective investment solutions at any time. Also, since such recommendations are based on algorithms rather than human judgement, they are devoid of bias or human error. In the future, people could use such services in addition to human financial advising services (1). Robo advisors, however, are unable to offer investors the human touch and emotional support that they so desperately need throughout the bear market phase (4).

In developing countries like India, robo-advisory services began in early 2015 and are in their budding phase (2). However, such services have been in existence in developed countries for more than a decade now (2). Robo-advisory services first started in the USA.

Market reports say that only 20% of investors know about these services, and the level of usage of these services is very low–about 3% (2). The clients of robo-advisors are typically younger investors with lower-valued portfolios (5). (1) suggest that robo-advisors have the ability to transform the financial advisory industry.

2. HISTORICAL CONTEXT:

Advisory services relating to finance first started in the US in the 1950s (1). In general, personal investment advice and wealth management were highly expensive, and these services targeted ultra-high-net-worth individuals, i.e., individuals with a net worth higher than $30 million in the 1950s. Therefore, only the rich could afford such services. A major breakthrough in the accessibility of financial services occurred during the 1970s with the emergence of discount brokers, which made financial advisories accessible to the US middle class. Discount brokers provide services at a lower cost than traditional financial advisors because the former only perform buy-and-sell orders for a reduced commission rather than giving real financial advice. Thus, a much wider range of investors could then access the stock markets.

Due to the high costs associated with receiving individual investment advice, only very wealthy individuals were able to make use of this service in the past. Recent developments have brought low-budget investors into the ever-evolving financial advising sector.

The World Wide Web (WWW) was introduced in the 1990s, which led to another turning point as an even larger number of investors, ranging from high-net-worth investors to retail investors who manage their own portfolios, could then access online trading facilities. The rapid development of information technology took place in the years that followed. It brought about increased connectivity through computers, laptops, tablets, smartphones, etc. and reduced information asymmetry as information could be accessed readily and more quickly. As a result, the cost of transactions decreased considerably. Algorithmic trading surfaced, offering new prospects to prospective investors and embodying fully automated investment products. A robot exists virtually rather than physically. While some robo-advisors were in operation as early as 2008-2010, the name “robo-advisors” was not yet coined (4). The robo-advisory companies, which later became known as robo-advisors, were there to offer investment advice in the wealth management industry using technology. During the financial crisis of 2008, ‘Betterment’ was the first robo-advisory firm to be established in the US (6). Since then, there has been a significant increase in the number of robo-advisors worldwide, and the assets under management (AUM) of these advisors have grown at a faster rate as well. The introduction of robo-advisory services resulted in the emergence of a new class of low-budget investors who had not previously been catered to by traditional financial advisors. According to (7), the primary target group of robo-advisors are the people born between the mid-1990s and early 2000s, i.e., millenials, a group of investors who are rather technologically savvy.

3. ROBO-ADVISORY PROCESS:

The robo-advisory process includes the following steps:

i. **Investor registration and filling out an online questionnaire:** When an investor gets himself registered on the website of the robo-advisor, the investor is first asked to fill out a questionnaire for the purpose of assessing the investor’s risk aversion, investment time horizon, and other factors. The assessment is necessary for constructing the investor’s suggested investment portfolio. The process of filling out the questionnaire and submitting it is fully automated.

ii. **Selection of appropriate asset classes:** The selection of asset classes, e.g., stocks, bonds, commodities, currencies, etc., is done on the basis of the investor’s response to the questionnaire and may take into consideration factors such as risk preference, investment goals, time horizon, tax conditions, etc. The techniques used for suitable asset class selection may vary from one robo-advisor to another, depending upon the profile of the individual investor. For example, a person’s investment goal could be to accumulate retirement savings, which would therefore indicate a longer investment horizon.

    Robo-advisors primarily offer passive investing options, such as through the use of exchange-traded funds (ETFs) that track benchmark market indices, rather than attempting to beat the market through active stock selection or market timing. This approach is consistent with the core principles of robo-advisors, which are directed towards reducing costs and diversifying investments to achieve long-term growth. Robo-advisors automate the procedures of portfolio construction and asset allocation, often on the basis of modern portfolio theory.

iii. **Determining portfolio weights for the asset classes:** After determining the asset classes that need to be taken into account, appropriate portfolio weights for each asset class need to be selected. These weights represent the proportion of each asset in relation to the other assets that should be included in the target portfolio. The majority of robo-advisors calculate portfolio weights for the present asset classes using modern portfolio theory.

iv. **Conducting investments and rebalancing portfolios:** In the next step, the investment is done, and then algorithmic rebalancing of the portfolio is carried out to ensure the stability of the portfolio weights and therefore the risk level.
v. **Continuous monitoring:** Continuous monitoring of the portfolio takes place, and robo-advisors also offer 24×7 accessibility, which sets them apart from traditional wealth managers.

4. STRENGTHS OF ROBO-ADVISORS:

i. **Low fee structure and low minimum investment:** In the financial advisory sector, robo-advisors' low fees and low minimum investment requirements are true game changers. Fees are lower because robo-advisors mostly make investments in exchange-traded funds (ETFs), which frequently benefit from a built-in low-cost structure.
ii. **Fully automated investment experience:** The robo-advisory's fully digital approach is advantageous in terms of usability. This concept looks promising, particularly in an era where smartphones, tablets, and other electronic devices are ubiquitous.
iii. **Established algorithms and automated rebalancing:** A great deal of the investing process is automated by robo-advisors, such as portfolio construction, rebalancing, tax-loss harvesting etc. Investors save time and energy by not having to actively manage their investments on a constant basis.
iv. **Less emotional decision-making:** A study by Vanguard, a global investment management company based in Pennsylvania, reveals that financial advice can beat ordinary retail investors by up to 3%, which is partially due to the fact that professional investors are less influenced by emotions (8). These results suggest that since robo-advisors are not driven by emotions, they are probably beneficial.

5. WEAKNESSES OF ROBO-ADVISORS:

i. **Lack of human interaction and personal contact:** While some investors find automatic investing to be convenient, others might prefer the guidance and human touch of a professional human financial advisor. Individualized advice that caters to specific instances and life events is usually not something that robo-advisors can offer.
ii. **Lack of flexibility:** pre-designed portfolios are a feature offered by the majority of robo-advisors in India. These pre-designed investment portfolios are built after careful consideration of many factors, such as investment goals, risk tolerance, time horizon, and financial situation. Even though this approach may meet the requirements of most investors, there are others seeking solutions to complicated financial situations or with unique investment preferences who may find the approach to be limiting. Personal contact is sought, particularly in the wealth management space, especially by high-net-worth investors.
iii. **Risk of technical errors or glitches:** The heavy dependence of robo-advisors on algorithms and technology makes them prone to technical errors or issues, which could hurt investment performance. Although unusual, these errors may lead to incorrect trades.

6. ROBO-ADVISORS AND HUMAN FINANCIAL ADVISORS:

According to a study by (5), using robo-advisors is associated with a decline in investors' likelihood to consult human financial advisors by 15.8%. Users of robo-advisors are more likely to be people who are concerned about falling prey to investing scams. Some of the factors attracting users to robo-advisory services include exposure to negative experiences with financial advisors, the need for financial services, confidence about one's own investments, etc.

The fee charged by robo-advisors is very low, around 0.25%, whereas financial advisors charge around 1%-1.25%. Robo-advisors can serve a much broader range of clients than financial advisors, who can only serve limited clients at any given point in time. Robo-advisors are accessible 24×7, which is a feature that distinguishes them from financial advisors. Investors who are worried about possible conflicts with human advisors may find that robo-advisors are a better option. In contrast to typical conventional fund managers' advisory solutions, robo-advisors will eventually assist investors in lessening their behavioural biases.

7. ROBO-ADVISORY PLATFORMS IN INDIA:

Full-fledged robo-advisors have entered India since early 2015. Some of the robo-advisory platforms in India that offer automated portfolio management and personalized investment advice include:

Table 1. Robo-advisory platforms in India

Firm name	Robo-advisory platform	Launch year
5nance		2010
Scripbox		2012
ArthaYantra	Arthos	2015
ET Money		2015
Fisdom		2015
Goalwise		2015
AngelOne	ARQ Prime	2016
FundsIndia	Money Mitr	2016
Kristal.AI		2016
5paisa	Auto Investor	2016
Kuvera		2017
Sharekhan	NEO	2017

There are also platforms in India that are not primarily robo-advisory platforms but that provide online trading services and algorithm-based investment solutions and tools, along with human financial advisory services. For example, Zerodha Coin, MoneyFrog, etc. Completely automated robo-advisory services are not yet in existence in India.

8. REGULATION OF ROBO-ADVISORS IN INDIA:

Robo-advisory firms come under the ambit of the SEBI (Investment Advisors) Regulations, 2013. However, there are no clear and specific guidelines that cater to robo-advisory services. In 2016, the Securities and Exchange Board of India (SEBI) came out with a consultation paper with regard to online investment advisory services and the use of automated tools to provide investment advice. According to the consultation paper, such investment advisors must comply with the existing SEBI (Investment Advisors) Regulations, 2013.

9. CONCLUSION:

Robo-advisors are a new and revolutionary approach that is reshaping the current state of financial advisory services. Robo-advisors have the potential to transform the future of the investment advisory industry. However, there is still a lot of potential yet to be unlocked. As of yet, robo-advisory platforms lack the necessary self-sufficiency to effectively conduct risk analysis for investors. Investors do not have constant financial goals. Since investors' objectives are constantly changing, risk profiling done at a single instance may not hold true and accurate in the long term for determining and predicting the right portfolio mix. This is one aspect that can be worked on with robo-advisors.

An investor who relies on robo-advisors may have specific concerns because these are a class of financial advisors that involve little to no human intervention. Especially in a bear market, any investor, upon realizing a loss, would undoubtedly prefer to seek advice from a human financial advisor who can empathize with them and understand them on an emotional level. Therefore, human interaction is inevitable. There is a greater need for better control, surveillance, and supervision of robo-advisories (6). This will help in gaining the trust and confidence of the investors, which will eventually increase their participation in the market. Customers' faith in technologically driven sources is mostly dependent on their level of trust, which is developed over time as a result of their repeated usage of and positive experiences with the service. Hence, there is a necessity to have both robo-advisors and human interventions in place.

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