The rise of robo-advisers

The recent market swoon is giving robo-advisers their first test. One headline said that robo-advisers were "unphased" by the stock selling. I wonder if their clients were unphased as well.

A robo-adviser is an online wealth management service that provides automated algorithm-based portfolio management.

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They are designed to work in conjunction with, or even replace, investment advisers like me.

The four biggest players are Vanguard, Schwab, Betterment, and Wealthfront. Actually, Vanguard is a bit different because clients can speak to a person about their account. Fidelity is expected to introduce their own robo-adviser service this year.

Robo-advisers are less expensive than traditional advisers, with annual fees ranging from zero to 0.5 percent of a portfolio's assets. How can they be so cheap? Schwab's Intelligent Portfolios has no management fee, but the majority of assets are placed into Schwab products.

Accordingly, Vanguard's robo-adviser service mostly recommends Vanguard funds. Fidelity's will recommend Fidelity mutual funds along with Blackrock ETFs. In all of these examples, the securities that you own have management fees.

Because of low minimums, it is thought that robo-advisers are designed for smaller accounts. The dollars managed by robos say that large accounts are jumping in, too, as the top companies have about $10 billion under management.

While each robo-adviser will invest your portfolio differently, most rely on the Efficient Market Hypothesis theory where a client holds a diversified portfolio in order to lower the volatility.

One survey showed this to be very comforting for potential clients. They may, however, be disappointed during a bear market.

Securities that move independent of each other during good times often become very correlated once prices fall. Look no further than 2008 when nearly everything except Treasuries fell!

As an adviser of nearly 20 years, I know how important it is to own a portfolio that fits each client's goals and comfort level. If you invest too aggressively, the client will panic when the market falls.

A down market will be the real test of robo-advisers. Since clients can't talk to anyone about their holdings, it will be interesting to see what happens. Will clients weather that storm?

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