An Emerging Price War in the World of Investment Advice

By RON LIEBER  AUG. 22, 2014

So let’s say you want to put all of your investments in index or exchange-traded funds, having realized that neither you nor the professionals stand much of a chance of picking stocks or mutual funds that will outperform the overall market.

And let’s also say that you want someone to run the portfolio for you, pick the right combination of funds and rebalance the mix when individual market sectors rise or fall.

You might turn to the big-name firms we once knew as discount brokerage firms. But you won’t get much of a discount.

Fidelity and BlackRock’s new offering will cost 0.55 to 1.10 percent annually. People with less money pay more fees, as is standard in these arrangements. Merrill Lynch’s Merrill Edge division, for low-balance customers it doesn’t want its brokers bothering with, wants 1 percent annually for its assistance. And TradeKing, home of the $4.95 stock trade, asks for 0.50 to 1.0 percent each year in the service it introduced this month.

Fees this size are incongruous enough on their own coming from some of the same firms that have helped democratize investing for the masses. Should they really receive $2,000 each year, year after year, for keeping an eye on a basic $200,000 portfolio? The pricing is particularly striking given the recent emergence of start-ups like Betterment, FutureAdvisor and Wealthfront. Those firms will run your money for 0.15 to 0.50 percent annually, though you can’t go visit one of their storefront employees to discuss it face to face.
Fees matter, a lot. A difference of half a percentage point compounded over time will cost most upper-middle-class investors hundreds of thousands of dollars over a lifetime of retirement saving. Huge parts of the financial services industry have grown and thrived because people don’t notice high fees, talk themselves into believing that the fees are worth it or don’t do the math to see how much they actually cost over time.

So how much longer can the more established players really expect to charge two to four times more than the upstarts for their help?

Charles Schwab may be about to offer an answer. In a call with analysts last month, the company’s chief executive, Walter Bettinger II, said that the company was “fast at work on what we believe will be a groundbreaking and market-impacting introduction of an online advisory solution.”

He wouldn’t say more, but it may well be something aimed squarely at the start-ups.

After all, according to Grant Easterbrook, who follows the emerging firms for the consulting firm Corporate Insight, the start-ups put people through an online questionnaire to identify their goals and risk tolerance, then set them up in a portfolio of low-cost investments that the firms and their software rebalance. “That is relatively easy to copy,” he said, plus the older firms hold out the promise of much more guidance for those who want it later.

Until the establishment players mimic more automated offerings, Bo Lu, a co-founder and the chief executive of San Francisco-based FutureAdvisor, with $200 million under management, professes not to be worried. “There is a strong culture here in the Valley of products trumping announcements,” he said.

He notes that other potentially competing services from big companies have already come and gone. For any future one to succeed, it needs to pass through a series of gates: Create the service, open, be great, get even better over time and persist in the face of nasty internal turf wars and various vice presidents moving up and around. “Maybe this is hubris, but I’ll worry about it when they get to Gate 5,” he said.

The more traditional players don’t seem particularly worried about him, either. They say that they offer plenty of tools for people who want to build
their own portfolio of index or exchange-traded funds, even if they do have to do the buying and rebalancing themselves. A target-date mutual fund is a potential all-in-one solution that rebalances itself. Some companies, however, may stuff their own (sometimes expensive) mutual funds inside them, and competing funds may have wildly different allocations and levels of risk in funds with identical target retirement dates.

Being able to talk to a human being face to face still matters to many people, and seeing storefront branches in major cities inspires confidence, even if it is costly. “We find that customers will have additional questions,” said John Sweeney, executive vice president for retirement and investing strategies at Fidelity. “Life changes, they have additional needs and they will want to know what else we can do.”

While the start-ups did begin with a rather one-note proposition — a portfolio of low-cost investments that runs itself — they’ve added features like tax-loss harvesting, retirement withdrawal tools and single-stock diversification services for people who may have a lot of company stock from an employer.

As for the annual fee differential, Richard J. Hagen Jr., TradeKing’s president, said the company set its fees at two to four times the cost of the start-ups (though generally less than its online brokerage firm brethren) after surveying customers about what they thought was fair. “We feel like this is a heck of an offer,” he said.

Mr. Lu of FutureAdvisor said he wasn’t surprised by the brushoff from many bigger companies. He once worked at Microsoft and understands how executives in established organizations think. “We’re still 0.1 percent of the industry,” he said. “You can be paid to believe something as long as we’re small enough that you can justify that we’re not going to be the future.”

In some ways, the future has already arrived. Even before we know what Schwab will do, Vanguard, in its Personal Advisor Services offering, recently began providing investment advice and financial planning for just a 0.3 percent annual fee.

Competitors have to be crossing their fingers at this point and hoping that prices like that will not stick. And perhaps they won’t. Vanguard may not be
able to afford to keep the price at that level. And a start-up that charges just 0.25 percent annually needs $1 billion under management simply to collect $2.5 million a year in revenue, something only Wealthfront has achieved so far. “How many employees can you have with that amount of money?” Mr. Hagen of TradeKing asked.

Brands also matter plenty when it comes to where people store their life savings. It remains to be seen how many people will trust new companies and their software to control their money. “This appeals to very smart engineers and others who feel very confident in themselves,” said Esther Stearns, a longtime financial services executive who oversaw a low-cost advice offering called NestWise that did not last long. “But who is going to find their way to those websites and have the courage to click? Who is going to feel confident that they are saving the right amount of money for their kids to go to college?”

The start-ups are betting that younger adults raised on technology will have plenty of confidence. Their founders and venture capitalists are also acting on faith that those same customers will know better than to pull all of their money out of the accounts when the next big stock market correction hits, which is no sure thing.

So there is no guarantee that all of this low-cost assistance will persist. But it remains true that good advice is too expensive, and not enough people have their money in the right kind of low-cost portfolios. We all ought to root for the innovation and resulting price war that seems to be unfolding before our eyes.

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