Investor Bulletin: Robo-Advisers

Feb. 23, 2017

The last few years have seen the growth in availability and popularity of automated digital investment advisory programs (often called "robo-advisers"). These programs allow individual investors to create and manage their investment accounts through a web portal or mobile application, sometimes with little or no interaction with a human being with the potential benefit of lower costs than traditional investment advisory programs. The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to educate investors about these programs, and to help investors using robo-advisers to make informed decisions in meeting their investment goals.

What is a Robo-Adviser?

The term "robo-adviser" generally refers to an automated digital investment advisory program. In most cases, the robo-adviser collects information regarding your financial goals, investment horizon, income and other assets, and risk tolerance by asking you to complete an online questionnaire. Based on that information, it creates and manages an investment portfolio for you. Robo-advisers often seek to offer investment advice for lower costs and fees than traditional advisory programs, and in some cases require lower account minimums than traditional investment advisers. The services provided, approaches to investing, and features of robo-advisers vary widely. You can find information about these topics in the adviser's Form ADV Part 1 and Part 2 brochure.

While robo-advisers have similarities to traditional investment advisory programs, there are also differences. Before making a decision about whether to invest through a robo-adviser, or in deciding which robo-adviser might be best for you, you should do your own research. Make sure the robo-adviser and the investment portfolio it puts together for you are a good match for your investment needs and goals, and that you understand the potential costs, risks, and benefits of using that particular robo-adviser. Below we've highlighted some issues you may want to consider in making these important decisions.

What Level of Interaction with a Person is Important to You?

The amount of human interaction available to you may vary from one robo-adviser to another. Some robo-advisers may offer the opportunity to contact an investment professional to discuss your investment needs (this hybrid of both automated and personal advice is sometimes referred to as "bionic" advice). Other robo-advisers may only make technical support staff available, which will limit you to relying on the information on their websites or other sources you find to address your questions about investing.

If a robo-adviser does make an investment professional available to you, the format and amount of the interaction may also vary. For example, a person may be available by email but not by phone, or available only for a limited number of in-person meetings. In some cases, a robo-adviser may offer access to a person only for accounts that meet a certain minimum account size. Still other robo-advisers may offer limited, if any, involvement of an investment professional in the creation and management of a client's account.

Unlike a traditional investment adviser, there may be no initial or subsequent conversation with a person to gather information about you and your personal financial needs. However, the robo-adviser may be able to offer you lower costs and fees by limiting the expense associated with a human adviser's time.

As with any adviser, it is very important you take the time to learn about the robo-adviser's services, including the level of interaction with a person, and find out answers to any questions you may have. Here are a few questions to consider:

- *How much human interaction is important to you? Would you like to be able to ask a person questions about your investments, the investment strategy being used, and potential risks? Would you like to be able to speak with a person during market events, such as periods of exceptional volatility or downturns? Do you prefer being able to talk in person or on a phone, or is electronic communication fine with you?*
- *What is your level of financial literacy, especially when it comes to investing? Your ability to ask a person questions about investing (for example, about the robo-adviser's investment strategy) may be limited and you may need to rely almost entirely on the robo-adviser's online disclosures or other sources of information that you find on your own. Are you comfortable using online resources?*
- *As with a traditional adviser, you may be interested in how often you will have contact with the robo-adviser. For example, how often does the robo-adviser follow-up with clients to confirm any changes that would affect their investment choices? Would you have to contact the robo-adviser with any updates to your financial situation?*

What Information is the Robo-Adviser Using to Create a Recommendation?

A robo-adviser uses information you provide to create a recommendation. As a result, a robo-adviser's recommendation is limited by the information it requests and receives from you, typically through an online questionnaire. It is important to keep in mind that some robo-advisers may obtain and consider only limited information about you. In addition, as with traditional advisers, in many cases the burden to update this information will fall on you. Here are a few questions to consider:

- *Would you use the robo-adviser for a specific financial goal (for example, retirement, buying a home, or investing for your children's education), or to meet your overall financial needs more broadly? Does the robo-adviser's recommendation take into account your purpose in using the robo-adviser?*
- *Does the robo-adviser's recommendation take into account relevant personal financial information, given your goal? For example, does the robo-adviser ask for information about high interest credit card debt or student loans you may have? Does it take into account your bank and savings accounts? Does it take into account your real estate holdings, such as your home, or other investments such as retirement accounts? Does it take into account other assets that you have?*

- *How does the robo-adviser take into account your tolerance for risk? How you respond to the robo-adviser's questions about risk can affect what portfolio the robo-adviser recommends. In addition to the initial makeup of your portfolio, how does your risk tolerance impact how the robo-adviser might rebalance your portfolio (for example, in the event of a market decline)?*

What is the Robo-Adviser's Approach to Investing?

Different robo-advisers have different approaches to investing, including different investment styles and different products offered. Some have several pre-determined portfolios of investments that they will recommend for you that you may or may not be able to customize. Some robo-advisers focus solely on a limited range of investment products, such as broad-based exchange-traded funds, or ETFs.

Exchange-Traded Funds
Many robo-advisers utilize ETFs. ETFs have unique characteristics that may make them more suitable for certain investors and less suitable for others. To learn more about ETFs, including how they differ from mutual funds, read our Investor Bulletin: Exchange-Traded Funds (ETFs). Also, certain robo-advisers may use hypothetical performance for newer ETFs in their marketing materials. To learn more about performance claims, read our Investor Bulletin: Performance Claims.

Some robo-advisers may recommend emerging market funds or invest in smaller companies, which could be more volatile or potentially less liquid. The investment style of the robo-adviser can make a big difference in the asset allocation of your portfolio. In addition, some robo-advisers have additional features that can affect returns on your investment. Also, in some cases robo-advisers may not have been tested under stressed market conditions.

You should take the time to understand how the robo-adviser develops a portfolio recommendation, and what pieces of information it uses – or does not use – in developing the portfolio. Here a few questions to consider:

- *Does the robo-adviser offer a limited range of investment products, such as only ETFs? Are the investment products utilized by the robo-adviser appropriate for your goals?*
- *Does the robo-adviser only offer certain limited portfolios within those investment products? How many different portfolios could your money possibly be invested in? What portfolio does the robo-adviser recommend for you and why?*
- *What type of accounts does the robo-adviser manage? For example, does the robo-adviser manage individual retirement accounts (IRAs)? Taxable accounts? 401(k) accounts or college savings plans?*
- *How does the robo-adviser handle volatility? For example, does the robo-adviser have the ability to freeze sales (not let you sell your investments for cash for a certain period of time)?*

- *How often is your account rebalanced? Rebalancing can have tax implications, depending on the type of account. What would trigger a change in the asset allocation or investment categories of your portfolio?*

Tax Loss Harvesting
Does the robo-adviser utilize tax loss harvesting? Tax loss harvesting involves selling investments that have experienced losses in your account, which may result in tax implications. The value of tax loss harvesting can depend on your particular tax situation in a given year. It also may implicate rules against wash sales. Make sure you understand the tax implications of any sales, and consider whether you may wish to consult a tax adviser. For more information about wash sales, read IRS Publication 550, Investment Income and Expenses (Including Capital Gains and Losses).

What Fees and Costs Will the Robo-Adviser Charge?

Fees and other costs can greatly impact your return on investment. One of the main benefits of a robo-adviser can be lower fees and costs – so it is very important that you understand what you would be charged. A robo-adviser may offer lower-cost investment advice, but if the robo-adviser utilizes investment products with high costs, your total overall costs could still be high. It's important to understand your *total* costs.

Also, in some cases, a robo-adviser may offer services that are not significantly different from services you could obtain through a traditional investment advisory program or through investing in a product such as a target date retirement fund. It is worth considering whether one product or service can offer what you need at a lower overall cost than another. Here are a few questions to consider:

- *What fees would you be charged directly by the robo-adviser? Are there any other costs (e.g., brokerage fees, management fees for ETFs purchased for your account) that you would pay directly or indirectly?*
- *How is the robo-adviser compensated? Does the way it is compensated create any conflicts of interest with you, the investor? For example, is the robo-adviser paid to offer particular products or does it offer only products with which it is affiliated (e.g., mutual funds sponsored by the robo-adviser or its affiliates)?*
- *Are there penalties or fees if you want to withdraw your investment, or transfer or close your account? Liquidating an account may have tax implications for you as well.*
- *Does the amount you are charged depend on how much money you invest?*
- *Can the costs and fees change over time?*
- *Does the robo-adviser pay a referral or marketing fee, or other incentives for finding new clients? Robo-advisers may use different marketing techniques, such as paying money to others or providing discounted fees for making client referrals. You should understand if a robo-adviser has that kind of feature, even if you are not paying a fee yourself.*

Licensing and Registration – How Do You Find More Information?

Firms that provide advisory services in the U.S. are typically registered as investment advisers with either the SEC or one or more state securities authorities. Although the services that they provide are automated, robo-advisers in the U.S. must comply with the securities laws applicable to SEC or state-registered investment advisers. Use the SEC's Investment Adviser Public Disclosure (IAPD) database, which is available on Investor.gov, to research the background, including registration or license status and disciplinary history, of any individual or firm recommending an investment. In addition, a firm that provides robo-adviser services may be affiliated with a broker that can execute the robo-adviser's recommendations by buying and selling specific securities for your account. You can research that broker using the Investment Adviser Public Disclosure (IAPD) database as well, which is again available on Investor.gov.

Finally, like traditional investment advisers, robo-advisers are also required to file a Form ADV. Robo-advisers may also offer certain information about their advisory business on their websites or in communications with clients. Check the robo-adviser's website regularly to see if there is any updated information.

Additional Information

Investor Alert: Automated Investment Tools

Ask a question or report a problem concerning your investments, your investment account or a financial professional. Report possible securities fraud.

Visit Investor.gov, the SEC's website for individual investors.

Receive Investor Alerts and Bulletins from the Office of Investor Education and Advocacy ("OIEA") by email or RSS feed. Follow OIEA on Twitter @SEC_Investor_Ed. Like OIEA on Facebook at facebook.com/secinvestoreducation.
