Have Roboadvisors Jumped the Shark?
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About Silver Lane Advisors

Silver Lane is a premier M&A advisor to the financial services industry. From offices in New York, San Francisco, and Chicago, the firm serves a broad range of financial services clients, including investment and wealth management firms, multi-family offices, brokerage firms, private and commercial banks, trust and insurance companies, and financial technology firms.

Silver Lane advises on mergers & acquisitions, divestitures and sale transactions, recapitalizations, and joint ventures/strategic alliances. The firm also provides valuations, internal ownership transition planning, due diligence, special committee advice, and fairness opinions.

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Jumping the Shark

Executive Summary

“Jumping the shark” — it’s an idiom rooted in American pop culture that signifies the precise moment at which a hot trend has peaked and has started to lose steam. Simply stated, “jumping the shark” is bad, particularly for any trend built upon a virtuous circle or other positive feedback loop.

Perhaps no trend in financial services has garnered more attention over the past two years than the explosion of roboadvisors (or low-cost, automated investment advisory services), with countless media articles describing robos as “the next big thing” to shake up the investment world.

While the concept of offering automated investment advice online has actually been around for 15-plus years and current adoption rates are still low, the convergence of several forces suggests that consumer interest in this area is, in fact, growing quite rapidly. As discussed later, industry expectations are building — with forecasts that robos will grow 10-fold to more than $2 trillion of AUM by 2020e. Moreover, many market participants fear that roboadvisors (whose fees may undercut those of traditional advisors by as much as 75%) will irreversibly disrupt the industry’s current pricing model.

Yet the debate so far has focused on robos’ technology and has largely ignored its industry structure. New entrants continue to pile into the market, including AAA (described as the “tow truck guys” by one source),1 even as industry AUM remains small; consolidation has begun (LearnVest to Northwestern Mutual, FutureAdvisor to BlackRock, and Covestor to Interactive Brokers); and industry behemoths such as Schwab and Vanguard leapfrog the start-ups.

Has a shakeout begun? Has the independent roboadvisor trend “jumped the shark?” If not, what might cause these fintech disrupters to lose footing? Are there any history lessons that the flurry of media interest has neglected to consider?

Whether innovation will revolutionize an industry and how it will occur are dramatically different debates. To answer the latter question, robo advocates are quick to describe how online brokers disrupted traditional brokers during the 1990s. However, that only tells half the story.

The fact is that there’s yet another fintech innovation that has been even more successful than online brokers over the past 20 years; a disruptive technology whose penetration of U.S. households far exceeds that of online brokerage; an innovation used by 80% of households (compared to 30% for online brokerage); yet an innovation whose original investment thesis ultimately failed to support the wave of start-ups that sought to build standalone businesses.

This white paper argues that the investment thesis of today’s independent roboadvisors bears a striking resemblance to that of the original fintech disrupters: Internet-only banks (circa late 1990s). Despite massive consumer adoption of online banking, Internet-only banks failed because the offering was best leveraged as an extension of a brick-and-mortar bank, not as a standalone business.

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For all practical purposes, online banking wasn’t even invented until October 1994 — some two decades after discount brokerage came about. Internet-only banks were the trailblazers; they immediately grasped the market potential, lacked the “baggage” of traditional bricks-and-mortar banks, and aggressively began seeding the market.

Internet banks were trailblazers but failed; online banking is an extension of traditional banking, not a standalone business

Internet-only banks had a tremendous run until one thing happened: traditional brick-and-mortar banks woke up to the offering and flooded the market with product of their own. This proved to be the jump-the-shark moment for Internet-only banks, which lacked the mega-brands, infrastructure, and robust product portfolio of the industry “dinosaurs.” Within a few years of that pivotal moment, nearly every Internet-only bank had folded.²

This white paper provides a deep dive into the lifecycle of Internet-only banks, highlighting parallels with today’s independent roboadvisors. From this study, we draw several key observations:

- **Yes, this will be a big market.** We agree that a measurable percentage of investors don’t need handholding, even during market downturns. The idea of putting one’s retirement account on autopilot isn’t new, as evidenced by the runaway success of target-date funds.

- **However, independent roboadvisors’ account growth is lagging the success that Internet-only banks boasted some 15-20 years ago.** Roughly four years from launch, the two largest independent roboadvisors had opened approximately 60,000 accounts. In the same timeframe, the two largest Internet-only banks had logged 450,000 accounts. Consumers embraced online banking faster than they have adopted automated investment advice so far.

- **Traditional advisors have just now started to catch on, so the leaderboard will change.** Once Bank of America threw its weight behind online banking some 15 years ago, it started adding more accounts every 90 days than the largest Internet-only bank had added in its entire five-year life. As described below, Schwab and Vanguard are following the same playbook today by developing robo capabilities internally. Other players, such as BlackRock and Northwestern Mutual, have acquired their way into the market. The landscape will change.

- **Still, traditional advisors will feel at least some pain.** While many predict an across-the-board hit to the fee structure of traditional advisors, it’s more likely that the impact will center on lower-end offerings and/or on enhanced fee transparency.

- **Scale economies for independent roboadvisors will prove more difficult than expected.** Once the big boys jump in, the pure plays will have to do two things: (1) maintain high marketing expenditures to defend against much bigger brands coming into the space, and (2) add more live advisors to raise service levels. Both are costly but necessary to survive longer term. Depending on the model, the break-even point could be 40x larger than it is for a traditional advisor.

- **There still is an opportunity for independent RIAs to benefit from these changes.** Some critics argue that ETF providers that bolt on proprietary robo offerings are not providing truly independent advice; that they’re conflicted and simply cutting out distributors who were gathering too much control. Any time clients start to wonder whether they are being sold...
products or being advised, it usually increases the opportunity for conflict-free advice (whether automated or live).

**Today’s consumer wants “eAdvice,” not an “eAdvisor” — just as yesterday’s wanted online banking, not an Internet bank**

Ultimately, this white paper does not throw cold water on the future of automated investment advice. Quite the contrary, the time has arrived for this type of offering in selected market segments. However, we believe that today’s consumer wants “eAdvice” not an “eAdvisor,” just as yesterday’s customer wanted “online banking” not an “Internet bank.”

Whether robos agree or not, we believe that the counterpoints raised in this white paper about how this all plays out are important to consider as, in the words of Mark Twain, “History does not repeat itself but it does rhyme.”
Jumping the Shark
Section I: Introduction

Many children of the 1970s and earlier will recall the classic American sitcom, *Happy Days*. Set in the late 1950s to early 1960s, the story revolved around the Cunninghams, an idealized middle-class family from Milwaukee, Wisconsin. One of the most popular shows of its time, *Happy Days* ran for a remarkable 10 seasons — yielding seven different spin-off series, multiple novels, and even two musicals.

For those who remember the show, no character stood out more than Arthur Fonziarelli — a.k.a. “Fonzie,” a.k.a. “the Fonz.” Initially a minor character, Fonzie was the show’s breakout star — catapulting to cultural icon, whose trademark leather jacket was acquired by the Smithsonian for its permanent collection at the National Museum of American History.

Some 30 years after its finale, *Happy Days* is still contributing to the American lexicon. “Jump the shark” is a seemingly nonsensical corporate catchphrase, rooted in *Happy Days* history, which (as described below) suggests a popular trend is quickly running out of steam.

Independent roboadvisors face many of the same challenges that Internet-only banks did

This white paper draws upon this pop culture reference to illustrate parallels between the boom-and-bust experience of Internet-only banks in the 1990s and the business model risks undertaken by independent roboadvisors today. In a nutshell, the investment thesis of many independent roboadvisors bears a striking resemblance to those of ’90s-era Internet banks, yet the thesis did not play out as expected in the world of online banking.

This white paper documents how and why Internet-only banks jumped the shark some 10-15 years ago — focusing on NetBank as a prime illustration — and cautions that independent roboadvisors face many of the same challenges today. Our discussion is divided into three sections:

- This **Section I** lays the groundwork, briefly defining the terms jump the shark and roboadvisors.
- **Section II** provides a deep dive into the history of online banking, a market offering that was initially driven by tech disrupters but subsequently lost to traditional brick-and-mortar banks.
- Finally, **Section III** makes six predictions about the future of roboadvisors, and suggests that today’s disrupters must appreciate how and why the first-mover advantage that Internet-only banks had in online banking vanished — even as consumer usage soared.

Our point is not to argue that automated financial advice as a service offering is doomed; in fact, we believe quite the opposite, as all indications suggest a groundswell of adoption lays ahead. Rather, this white paper argues that independent roboadvisors must heighten their value proposition before more industry giants in wealth management develop their own competitive offerings. Because if independent roboadvisors do not better capitalize on their head start, then they do seem destined to jump the shark — much like The Fonz and Internet-only banks did decades earlier.
What Do You Mean by Jumping the Shark?

“Jump the shark” (also known as a “JTS moment”) is a phrase that originated in the TV industry to describe a point at which a fading series resorts to a nonsensical — if not ridiculous — gimmick or plot twist to recapture tapering viewer interest. But rather than rekindling such interest, this deviation from the show’s original premise is seen by the audience as a thinly veiled sign of desperation — a cue that the series has run its course and is irretrievably declining in quality.

“Jump the shark” is based upon the season premier of Happy Days’ season five, an episode in which Fonzie, dressed in swimming trunks and that trademark jacket, accepts a dare to literally jump over a shark on water skis during a Cunningham trip to Hollywood, California. This caricature — a cartoonish depiction of an American icon — stood in stark contrast to Happy Days’ origins of universally relatable experiences against a backdrop of 1950s nostalgia. While the subsequent decline in Happy Days’ popularity was gradual, critics widely regard the “jump the shark” episode as the show’s peak — the first in a series of writers’ plot gimmicks and new characters, none of which came close to captivating audiences like the original premise and cast.

And What Exactly Is a Roboadvisor?

The term “roboadvisor” is broadly used to describe a wide range of automated investment advisory services that offer low-cost solutions through web-based and/or mobile applications. While their business models vary, often these services are generally akin to a “set it and forget it” retirement portfolio. Clients answer a relatively limited number of questions about their income, age, investment goals, and risk tolerance. Based on this information, the roboadvisor builds an investment portfolio, periodically rebalances the assets based on market conditions and/or changes in the clients’ lives, and charges fees that are as much as 75% lower than what a full-service advisor might demand.

Countless media articles have described robos as “the next big thing” to shake up the investment world. But despite what you may read, the concept of roboadvisors is not new.

Robos have been around in some form for 15-plus years

Just as home banking predated Internet banks by some 15 years (see below), so too did online advice exist well before the term “robo” entered the industry vernacular. The list of companies that attempted (with varying degrees of success) to automate the investment process in the late 1990s is quite long: Advice America, Asset Planner, DirectAdvice, FinanCenter, FinPortfolio, Ignite Sales, mPOWER, TeamVest, ValuEngine, and (of course) Financial Engines. In fact, an equity research report by Chase H&Q from October 2000 reads like a modern business plan (but for a couple of statistics):

Historically, professional financial advice was only available through a broker or a financial planner. However, with the rise of the Internet, professional-quality advice is becoming available online. In the years ahead, we expect an explosion in the availability of online advice as investors seek it out and as financial service [sic] firms rush to provide the services as customer attraction and retention tools. Forrester Research estimates that the number of households seeking online advice is expected to grow from 3 million today to 21 million by 2003.2

Although roboadvisors have been around for 15-plus years in some form, the movement is still early in the adoption curve. According to a recent report by A.T. Kearney, roughly 20% of “banked” U.S. consumers (meaning they or someone in their household have a checking and/or savings account with a financial services provider) are aware of

roboadvisor services;\(^3\) roughly 3% of such consumers have adopted the technology to date, with another 48% indicating varying levels of interest in robo-advisory services.\(^4\) A.T. Kearney goes on to predict that roboadvisors will, in fact, become mainstream over the next three to five years — growing at a 68% compound annual rate to $2.2 trillion in U.S. assets by 2020. (See Figure 1 below.) This implies that roboadvisors’ control of Americans’ investment assets will rise more than 10-fold from just 0.5% today to 5.6% five years from now. Not bad!

However, even while robos would only control less than 6% of U.S. investment assets by 2020, the fear is that automated services will erode industry pricing for all. A.T. Kearney has attempted to illustrate the potential impact to industry-wide revenues using two different scenarios:

- **In the base case,** A.T. Kearney assumed that traditional players maintain current pricing (of 1.0% on average) as AUM shifts toward the robo

\(^3\) “Hype vs. Reality: The Coming Waves of ‘Robo’ Adoption,” A.T. Kearney (June 18, 2015), pg. 6.

\(^4\) Id. at 7-8.
These forecasts underscore how large and potentially disruptive the burgeoning roboadvisor wave may be to the future economics of the investment management industry. If Scenario #2 occurs, the continued follow-on capital investments needed from VCs and various other institutional investors for independent robos to achieve the “magic” crossover threshold — i.e., where these models can afford to self-reinvest (a discussion for another time) — will be pushed ever-higher.

The discussion that follows in Section II highlights the lifecycle of another wave of fintech disrupters, Internet-only banks, with a particular focus on how and why that sector jumped the shark — thereby relinquishing its market opportunity to revolutionize the traditional banking industry.
Clearly, a JTS moment doesn’t encompass just television; it can apply to literally any trend or industry that requires ongoing creativity and innovation to constantly reinvent itself. Product lifecycles, particularly in the tech industry, are key examples.

Within financial services, perhaps no trend is as exciting and (at times) unsettling as the wave of digital disruption that is reshaping our industry. Ask industry observers for historical examples of how technology can revolutionize financial services, and many will quickly cite online brokerage. It’s easy to understand why: online brokers transformed the trading industry in the 1990s with a brash new cost structure and commission model, drawing more than 30% of U.S. adults to trade stocks online.\(^5\)

Online banking has been even more revolutionary than online brokerage

But while online brokerage often garners the most attention, online banking is actually the bigger success story. Simply stated, few (if any) fintech innovations over the past two decades have become as pervasive as online banking. A near-ubiquitous offering whose penetration of U.S. households soared in only 10 years from 10% to 80% by 2010,\(^6\) online banking eliminates the need to stand in line, is available 24/7, and offers steadily improving security. What’s not to love?

But just as online banking illustrates that technology can drive profound changes in retail financial services, so too does it underscore the difficulty in predicting exactly how that transformation will materialize. Today’s online banking world is dramatically different than what the markets originally envisioned at the industry’s nascence.

Think back: Internet banks were the fintech disrupters of the 1990s. Riding a wave of investment and technology euphoria, institutional and retail capital chased the names (at times pushing valuations well across the $1 billion threshold) only to discover that many of the strategies were misguided. In fact, the perceived competitive advantage of Internet banks — a low touch, branchless strategy — ultimately proved to be a material disadvantage once they exhausted a niche pool of early adopters and price-sensitive customers. Consequently, customer acquisition costs spiraled and the economies of scale — which looked so obvious on paper — proved fleeting, if not downright nonexistent.

Moreover, once traditional brick-and-mortar banks awoke to the fact that online banking was of tremendous appeal to customers, they flooded the market with product — coopting the marketing appeal and customer base of online start-ups. NetBank (also known as Net.B@nk in the late 1990s) was one of the first — and arguably the most successful — of the FDIC insured, Internet-only banks. Launched in October 1996, IPO’ing less than a year later, and hitting a peak share price of $249, NetBank was the industry darling — growing to more than 230,000 accounts by year-end 2001. Even still, once Bank of America threw its weight behind its own online offering, it was

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\(^6\) Penetration of U.S. households with Internet access. Andrea McKenna, “More Consumers Embracing Online Banking, Bill Pay,” American Banker (June 2010).
adding more accounts every 90 days than NetBank did in five years.

Despite the tremendous appeal of online banking, Internet-only banks failed due to flawed business models.

Ultimately, it was the banking industry giants — and not the online trailblazers — that truly harvested the spoils of the revolution. This isn’t the way that the story was supposed to play out. In the words of baseball great, Yogi Berra, “The future ain’t what it used to be.”

Internet Banks: In the Beginning

Online banking has actually been around in some form for 35 years, although in the early 1980s the term meant little more than using a dial-up modem to access an account using a landline telephone. Four major banks in New York City — Chase Manhattan, Citibank, Chemical, and Manufacturers Hanover — made the first retail push, offering so-called home banking access to all customers in 1981 via a videotex terminal.

Nevertheless, retail adoption of home banking in those early days was essentially nil given low penetration of the PC-like technology and limited functionality. At best, these efforts resulted in an increased use of fax machines and telephones to facilitate transactions — but few truly electronic transactions (at least in the form that we speak about today).

The bank credited with pioneering any measurable customer interest in U.S. online banking was Stanford Federal Credit Union, which offered Internet banking to all of its customers in October 1994, followed by Presidential Bank and Wells Fargo a year later in 1995. Internet-only banks first emerged at the same time Presidential and Wells took the leap, led by Security First Network Bank, NetBank, Wingspan, directbanking.com, and BankDirect.

The Internet would forever reshape the way banking products and services are delivered:

- **Financial transactions were well suited to the Internet.** They tended to be small, repetitive, and inexpensive to process.
- **The demographics of online customers were attractive.** Online customers were wealthier, better educated, and buyers of multiple banking services. In essence, the Internet customer was the ideal banking client.
- **Demand was growing at a 75% CAGR.** Jupiter Communications, the leading authority on Internet research at the time, predicted that the number of U.S. households using online banking products would grow at a 75% compound annual rate — from 2.5 million in 1997 to 13.1 million in 2000.

By forgoing the traditional branch model and marketing directly to consumers, Internet-only banks predicted a substantial cost advantage to brick-and-mortar banks. Key among these cost advantages was transaction processing, which at the time was estimated to be $1 per average transaction using human tellers; $0.85 using call centers; $0.27 using ATM machines; and a mere $0.01 using the Internet. (See Figure 4 below.) This $1.00 to $0.01 cost differential was the biggest reason why many analysts projected a 50% cost advantage for Internet banks vs. small brick-and-mortar banks. Through reduced infrastructure and overhead costs, Internet-only banks would be able to pass these savings on to customers in the form of attractive interest rates on deposit products.

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As an historical footnote, Security First’s banking operations were eventually sold to RBC, while the software development activities were spun off as S1 Corporation.

This 50% cost advantage is based on projected noninterest expenses to total average assets of 2% for Internet banks vs. 4% for small brick-and-mortar banks.
The Emergence of NetBank

As an early mover in the online banking sector, NetBank was expected to be one of the biggest beneficiaries of this seismic shift. Incorporated in February 1996, NetBank purchased a bank charter and commenced operations as a thrift institution in October 1996. Buoyed by the dot.com bubble of the mid- to late-1990s, NetBank went public in July 1997 at $12 for an implied equity market capitalization of $75.6 million. At the time, the bank only had 2,680 accounts and $43.6 million in deposits ($32.0 million of which were in money markets), although the investment thesis at that time sounded compelling.

Even from these humble beginnings, NetBank only needed to achieve modest success to be a meaningful player. The IPO underwriters pointed out that the bank would hit its target of opening 52,000 to 65,000 accounts by the year 2000 by capturing just 40 to 50 basis points of the projected online marketplace. The company would pass on the savings from its low-cost, branchless operating structure to the consumer in the form of attractive interest rates on checking, money market, and CDs. The company priced CDs as much as 200 basis points above the national average and waived minimum balances and monthly fees, driving account base and deposit growth unmatched by its traditional banking competitors. Figure 5 below illustrates deposit rates at NetBank compared to other Internet banks and the national averages as of November 10, 1999:

Once the accounts were in the door, NetBank planned to cross sell other products and services into this customer base — thereby increasing noninterest income. In the short-term, the company planned to offer credit cards to its customer base (which were expected to have below-average charge-offs due to its customer demographics) and, medium-term, a full range of consumer loans such as installment loans and home equity lines, as well as fee-based products such as brokerage accounts and mutual fund sales.

Another attraction of NetBank was that, unlike other Internet companies, it was profitable. In fact, NetBank had to remain profitable, Wall Street argued, because it was a thrift institution regulated by the government. But the upshot was that NetBank’s earnings trajectory eclipsed that of traditional brick-and-mortar banks: the company was profitable only one year from commencing operations, much sooner than a typical start-up bank, which normally would take three to five years to show a profit. Moreover, NetBank’s branchless strategy and pricing advantages would translate into a sustainable growth rate of around 30% several
years out, significantly better than that of traditional banks.

Wall Street’s approval could not have been stronger. As one analyst wrote:

NetBank is new, exciting, and successful. It is the right business at the right time.... NetBank has devised an operating strategy that makes it almost a perfect embodiment of the successful Internet company.... The upside potential for this company at this time is so strong that it is hard to quantify.  

Where NetBank’s Story Began to Unravel

Two years following its IPO, NetBank appeared to be unstoppable. The shares soared 20-fold to $249 at their peak in April 1999 for an implied equity market capitalization of $2.24 billion. NetBank had actually outperformed early analyst projections, particularly in terms of the number of customer accounts. Accounts grew at a rate of approximately 2,000 per month on average in the two years following the IPO, swelling to 50,000 in 1999 — a year earlier than originally expected. Moreover, management raised guidance in mid-1999 to 4,000 monthly account openings, with an exit rate of 6,000 per month as the company entered 2000.

All told, NetBank accounts had grown 19x in the two years following the IPO. But as impressive as 4,000 accounts per month sounded, Wells Fargo in mid-1999 was adding 75,000 online accounts per month. Moreover, 15% of Wells Fargo’s online sign-ups were new customers to the bank. Bank of America was even more successful, attracting 1.7 million accounts compared to NetBank’s 50,000 — a 33x advantage. (See Figure 6 below.) While Internet-only banks had uncovered an underserved market, the traditional bricks-and-mortar banks with large competitive moats soon caught on to the trend.

The second emerging development was that NetBank was struggling to sell loan products into its customer base. The investment thesis at the time of the IPO centered on the quality of the company’s account base, which opened the door to a range of consumer loans. As a result of these weaker-than-expected loan generation capabilities, NetBank continued to purchase more than 70% of its loans from the secondary market. Combined with NetBank’s decision to pay a premium of 125 to 150 basis points to attract deposits, the company’s net interest margins compressed to 1.9% vs. a target of 3.0% and comparable thrifts’ margins of 2.9%. In effect, all of the cost savings from NetBank’s branchless strategy were being passed through to the customer, which, in turn, appeared to be reluctant about deepening its relationship with the company vis-à-vis purchasing additional products.

By 2001, Wall Street analysts — many of whom had cheered NetBank’s branchless strategy just a few years earlier — became increasingly convinced that a lack of physical presence was actually the company’s biggest competitive disadvantage. This is not to say that NetBank failed to continue attracting deposits. In fact, the company’s account base continued to swell, growing another 4.5x from 1999 to year-end 2001 to an impressive 230,000.

The problem was that the industry “dinosaurs” were growing materially faster. As impressive as NetBank’s success was, the fact was that Bank of America was adding more accounts quarterly than NetBank had in its entire five-year existence. Moreover, despite NetBank’s branchless infrastructure when it started in the late-1990s, its cost structure, at almost 270 basis points on average assets, was actually higher than that of a typical full service bank.

### Five reasons why Internet-only banks were fundamentally flawed

Gradually, several key takeaways started to emerge:

- **Internet-only banking ultimately appealed to a niche segment.** This was primarily comprised of those depositors seeking high interest rates on checking, money markets, and CDs, and not requiring services provided by a branch.

- **Cross selling didn’t really work.** Internet banks were good at attracting spread business but ineffective at developing fee income from cross sales. Their customers were primarily just chasing the highest CD rates and generally did not purchase additional services.

- **Traditional banks provided superior customer service.** Without the ability to “touch” the customer, Internet-only banks failed to develop a viable asset strategy to originate loans. This forced such banks into the secondary loan market, which was a margin headwind vs. the original plan, among other challenges.

- **Traditional banks were quick to catch on.** Once traditional banks recognized that customers liked Internet banking, they flooded the market with product. The real winners were the technology enablers that got banks on to the web.

- **The cost advantages touted by Internet-only banks proved mythical; they never really existed.** Internet banks needed to provide above-average interest rates to attract accounts; marketing expenses continued to ramp; and the cost to purchase loans escalated.

### NetBank Jumps the Shark

For the purposes of our roboadvisors white paper, this is really where the parallels between robos and Internet banks end. However, the rest of NetBank’s story is valuable as a case study of how a weak business model can subsequently drive a series of bad corporate moves.

In true “JTS” fashion, the real turning point in NetBank’s lifecycle was an aggressive acquisition spree to diversify away from Internet banking and into the mortgage business and other financial services end markets starting in mid-2002. From a mortgage standpoint, two deals stood out at the time as potentially transformational in the short-term — the acquisition of mortgage brokers, Market Street Mortgage and Resource Bancshares Mortgage Group.

Despite the fact that these deals effectively acknowledged that the Internet-only banking model didn’t work as originally intended, both transactions were heralded at the time. Netbank had primarily been a deposit gatherer, purchasing loans from other financial providers. The larger of the two acquisition targets, Resource Bancshares, had primarily been an asset creator, originating and processing mortgage loans funded by short-term borrowing. Combined, Netbank could generate assets through Resource Bancshares’ mortgage processing network and Resource Bancshares had access to low cost funding through Netbank deposits. The result was expected to be higher margins with reduced credit and interest rate risk.

Even years before the Financial Crisis of 2008-09 eviscerated the mortgage industry, NetBank’s business model overhaul increasingly showed signs
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Section II: Internet Banks as the Original Fintech Disrupters

of stress. Margins in the mortgage business began to rapidly deteriorate as the company struggled with price competition on the front end, off-and-on secondary market demand for non-conforming production, and a flattening yield curve that made it difficult to earn spread income — with NetBank squeezed both on its held-for-investment portfolio and its held-for-sale mortgage loans.

Before long, it became evident — both internally and externally — that NetBank’s mortgage-related earnings were unsustainable. This raised multiple red flags because the mortgage business produced 91% of corporate earnings in 2002, while the Internet bank generated only 9%. On the bank side, NetBank proved to be little more than a midsize lender (at best) that depended to a great degree on third parties for loan production. Cross-selling never fully materialized inside the bank.

NetBank’s diversification efforts failed

By early to mid-2003, NetBank tried to diversify further. The plan was to roll out a series of new products to improve its 90/10 earnings mix to a point at which one-third would be from the mortgage business, one-third from the bank, and one-third from transaction processing. This rollout included the following:

- **NetInsurance**: A property and casualty agency business that allowed customers to get auto quotes online and homeowners quotes over the phone. The effort failed and was shut down in November 2006.

- **Small business banking**: A collection of businesses, the most complex of which was QuickPost, a joint venture of sorts with UPS (described below). This activity was also shut down in November 2006.

- **Indirect auto finance**: An auto finance business that NetBank launched in Florida. By mid-2004, the effort was only generating $20-$30 million of loans per month — 80% of which was in Florida. The segment was first hit by the Florida hurricanes (e.g., Katrina), then aggressive competition from captive auto finance groups (remember GM’s “employee pricing for all”), and eventually the subprime collapse (which was particularly pronounced in Florida).

- **RV financing**: Financing for recreational vehicles (boats, RVs, aircraft, etc.), started in mid-2005 and shut down by November 2006.

- **Transaction processing**: ATM services for retail and other non-bank businesses such as grocery stores. NetBank sold the business in May 2007 for $18 million after writing down the unit.

None of these diversification efforts worked. Of the above products, QuickPost was arguably the most ironic as the model abandoned NetBank’s origins as a tech-savvy player to essentially become an old-school bank. The general idea was that NetBank customers, both consumer and commercial, would drop off checks at UPS each day. Each UPS office would then bundle these checks and overnight them to a NetBank facility in Atlanta for processing. NetBank would clear the checks the next day for the customer, helping small businesses limit losses on bounced checks and gain access to working capital sooner. NetBank ultimately shut this offering down in November 2006, when it was still 18-24 months from breakeven and losing more than $1 million per month. Of course, *QuickPost proved to be a transitional technology, at best, as a short time thereafter the precise same result could be achieved instantaneously with an iPhone!*

Ultimately, NetBank’s earnings turned negative even before the mortgage crisis, and by May 2007 the company sold its deposit franchise to EverBank for a 3.4% deposit premium. The bank ceased being a deposit-taking institution and was in the process of shutting down its mortgage platform, just shy of the 10-year anniversary of its IPO.
Jumping the Shark
Section III: Predictions about the Future of Roboadvisors

With these history lessons in mind, we thought it would be worthwhile to step back and outline our top predictions about the future of roboadvisors, drawing some parallels between this emerging segment and the experiences of the Internet-only banks in the 1990s. We offer our top six predictions below, rank prioritized by our level of conviction (highest to lowest), followed by two “bonus” calls.

Prediction #1

Yeah, this will be a big market. OK, let’s start with the easy one. We are an optimistic bunch and the future of fintech, in our view, promises innovation, significant growth opportunities, productivity gains for advisors, and enhanced experiences for clients. Online financial advice fits squarely into that vision. Just as a substantial portion of the discount brokerage and banking world moved online in response to client demand, so too will a portion of investment advisory. The convenience factor is simply too compelling, if for no other reason.

As noted earlier in this report, online investment advisors are expected to gather $2.2 trillion of assets by 2020. We won’t opine on whether that’s the right number, but we’ll agree with the direction. After all, the idea of putting one’s retirement account on autopilot isn’t new. We’ve all seen the runaway success of target-date funds (TDFs), which, by some accounts, have amassed more than $1 trillion in assets and 20% of the defined-contribution retirement market, while capturing roughly 40% of new 401(k) contributions annually.

It’s true that TDFs have benefited as a qualified default investment alternative (QDIA) and, yes, custom TDFs are mounting a challenge to pre-packaged funds. Still, the market is opening to automation.

Roboadvisors will likely steal some share from other products, such as TDFs and even online brokerage. In fact, some critics believe that roboadvisors, particularly in the 401(k) market, are essentially a slick interface on top of a TDF. In any event, NextCapital recently announced an update to its 401(k) digital advice platform that allows it to replace TDFs as the default option in 401(k) plans. Betterment also recently rolled out a 401(k) product that reportedly will only charge 10 to 60 basis points, depending on AUM, compared to a reported average of 144 basis points industry-wide. However, some industry participants believe that the biggest component is likely to come from people who aren’t getting any advice currently. Point being, automated financial advice is likely to be accretive to overall industry AUM — but not 100% additive.

Prediction #2

Robos’ account growth will lag the success of Internet banks some 15-20 years ago. To some extent, this is a loaded prediction because it’s already true; robos have been adding accounts at a slower rate than Internet banks did in the 1990s. For example, Figure 7 below illustrates the number of accounts at the two largest Internet banks in the late 1990s (TeleBank and NetBank) and three of the most-discussed roboadvisors (Wealthfront, Betterment, and FutureAdvisor):

10 Andrew Bary, “Target-Date Funds Take Over,” Barron’s (July 5, 2014).
Because these companies were all founded in different years, the figure above measures where each company was starting with the third anniversary of its launch. For instance, NetBank commenced operations in 1996, so the first datapoint above shows its accounts from 1999 and beyond. Likewise, Betterment launched in 2008, so the Year 3 datapoint above represents the number of accounts in 2011. What’s also worth mentioning about the figure above is that Years 4-5 for TeleBank and NetBank were in the middle of the dot.com bust, yet both companies continued to post meaningful account growth. We believe this fact addresses the question about whether Internet-only banks failed as a result of the tech bubble deflating. That wasn’t the case. These companies grew through that market crash; it was their flawed business models as standalone companies that ultimately took them down.

Perhaps one reason to explain why roboadvisors have been slower to attract accounts than Internet banks were is that the financial benefits offered by Internet banks were more immediate and measurable. Internet-only banks offered depositors an investment premium of 200-plus basis points over the average rate paid by brick and mortar banks. In contrast, independent roboadvisors offer customers a fee break of perhaps 75 basis points on average or charge fees to people who historically weren’t paying anything because they lacked advisors.

Prediction #3

Traditional advisors have caught on, so the leaderboard will change. Roboadvisors have awoken the sleeping beast, which exactly mirrors what happened with Internet-only banks 15-plus years ago. Early in the lifecycle for both online banking and online financial advice, skeptics loomed large and traditional players were slow to enter the market. However, as the online thesis began to play out some three to four years into the trend, the industry giants caught on.

As discussed in Section II above, once Bank of America threw its weight behind its own online banking product, it was adding more accounts every 90 days than NetBank did in five years. Likewise, while NetBank had grown its accounts by 19x in the two years following its IPO, Wells Fargo was adding 75,000 online accounts per month (15% of which were new to the bank) to NetBank’s 4,000 monthly tally.

Schwab and Vanguard are following the same playbook today. For instance, when Schwab announced its own robo, Intelligent Portfolios, the brokerage firm attracted 33,000 accounts and $2.4 billion in AUM in less than three months. (Schwab followed this up with Institutional Intelligent Portfolios, which allows advisors to create portfolios for the clients using more than 450 ETFs across 28 asset classes.) We estimate that it took Wealthfront approximately 3.5 years and Betterment a little more than four years to generate this many accounts, while Schwab’s 90-day AUM grab is bigger than either roboadvisor.
Vanguard’s foray has been even more powerful. When the firm cut the minimum on its Personal Advisor Services product from $500,000 to $50,000, and lowered fees from 70 basis points to 30 basis points (plus fund expenses, which typically range from five to 19 basis points), it drew in $10 billion of new capital on top of the $11 billion that was in its previous program (Vanguard Asset Management Services). Vanguard’s offering, which targets retirees or near-retirees rather than millennials, matches investors with an advisor if the investor wants to talk to a live human for assistance. Clients with more than $500,000 in assets have a dedicated advisor, while anyone with an account below that level will work with a team. Figure 8 below illustrates the reported AUM by Vanguard, Schwab, and the five largest independent robos combined:

Going forward, it is our view that most customers will look to the Internet as just an additional delivery channel to complement the way they currently access their investment accounts, much like they already use online banking. The table is set for traditional advisors like Vanguard, Schwab, and Fidelity (if it chooses to go it alone, or evolves its eMoney platform purchase) rather than continuing with platform access deals) to leapfrog the hard-fought gains of the largest independent robos.

**Prediction #4**

While many predict an across-the-board hit to the fee structure of traditional advisors, it’s more likely that the impact will center on lower-end offerings and/or on fee transparency. Our sense is that traditional advisors that wish to combat the roboadvisor wave are more likely to create a new, low-touch automated service offering (or to lower fees on semi-automated services) as a complement to their existing books of business, rather than to cut pricing across all channels. One study estimates that 8% of top advisory firms currently offer some sort of robo-advice, with another 20% planning to do so in the next 12-24 months.\(^\text{15}\)

We believe this is the right move, even if it means rolling out a complementary, semi-automated product for smaller accounts at a lower price point. Chances are, if you see a way of cannibalizing your existing business, then somebody else sees that same opportunity. The world’s most successful businesses constantly reevaluate their product offerings and pricing tiers to ensure continued growth. What if Apple had not added music functionality to the iPhone out of fear of losing iPod sales? Or killed the iPad because it would cannibalize sales of laptops? A traditional advisor that’s proactive about creating a robo offering (at least) for smaller and/or low-touch accounts is more likely to retain those assets longer term. Vanguard is one example. As mentioned above, the firm

\(^\text{15}\) Blackrock, The Elite RIA Study (2015), pg. 16.
roughly doubled its AUM in its Personal Advisor Services to $21 billion albeit partly by cutting fees from 70 basis points to 30 basis points. Net net, the move was more or less revenue neutral because it doubled assets by halving fees.

But while we don’t expect roboadvisors in the near-to medium-term to materially impact traditional advisors’ fees on high-touch, high-end offerings, we do believe that robos will be successful in forcing more transparency into the fee discussion. Many investors agree with the argument that the fee structure is often opaque at many larger institutions. Advisors that are charging, say, upwards of 1.5% to manage a fairly standardized ETF portfolio without providing a lot of other value are clearly vulnerable. Investors will want more transparent fee structures to understand what they are paying and how they are paying it.

**Prediction #5**

**Scale economies for independent roboadvisors will prove more difficult than expected.** Once again, we draw parallels between Internet-only banks and independent roboadvisors. Once the big boys jump in, the pure plays will have to do two things: (1) maintain high marketing expenditures to defend against much bigger brands coming into the space, and (2) add more live advisors to raise service levels. Both are costly but necessary to survive longer term.

First, we believe that marketing will always consume substantial resources for these companies. The industry giants have immeasurably more valuable brands, which is evident by their impressive asset gathering capabilities on recent robo launches. Also, competition will likely only increase over time as players enter the market, whether robo or traditional. And finally, independent roboadvisors’ lack of a physical presence inhibits their ability to stay in front of potential new customers.

Second, non-marketing related costs at independent roboadvisors are also likely to rise over time, particularly in terms of their ability to offer a higher degree of hand-holding to the average customer. This seems poised to happen as roboadvisors expand their customer-bases beyond the initial group of technically savvy, early adopters; if such advisors wish to diversify into more sophisticated financial products; and/or if traditional advisors successfully pair a robo offering with live telephone advice, triggering a competitive response by the independent robos. We believe Financial Engines’ recent decision to offer access to live advisors for 401(k) participants supports this view.

**Prediction #6**

**There still is an opportunity for independent RIAs to benefit from these changes.** Most of this white paper focuses on why we believe independent roboadvisors will likely find it increasingly difficult to compete with industry behemoths that launch robo services. Even still, some critics argue that ETF providers that bolt on robo offerings are not providing truly independent advice; that is, if Schwab rolls clients primarily into Schwab offerings, and Vanguard allocates capital largely into Vanguard ETFs, are the product manufacturers simply cutting out distributors who were gathering too much control?

Other industries have grappled with this challenge, both from the perspective of consumer interests and antitrust laws, which then must be reevaluated to reflect disruptive technologies and/or business models. For instance, automakers historically could not sell cars directly to consumers, but rather had to distribute through dealerships which, in turn, were regulated vis-à-vis a state-by-state patchwork of regulation. Then came along Tesla, which circumvented these regulations in many states by creating company-owned “Experience Centers” that allowed customers to touch and feel the product, but then place orders online.
Likewise, the U.S. Supreme Court in 1948 dismantled the once-commonplace Hollywood “studio system” — with production, distribution, and exhibition all vertically integrated. However, technological innovation has essentially enabled newcomers such as Netflix to borrow a page from the once-barred vertical integration. That is, Netflix has started to produce more of its own content, which it then distributes on its own video subscription service.

This issue — whether an ETF product manufacturer that sells its own product via an in-house roboadvisor can adequately serve clients’ best interests — is outside the scope of our discussion and worthy of a white paper of its own. But what is worth mentioning here is that this precise debate is why there’s a pronounced market opportunity for independent RIAs to develop targeted robo offerings that balance (1) the ease of use and ability to reach smaller, younger clients on the one hand, and (2) the mission to provide independent advice on the other.

Moreover, this conflict-of-interest question is directly analogous to breakaway brokers departing wirehouses to form or join independent platforms so as to enhance their abilities to offer a wider range of product. The fact pattern might evolve as technology advances, but any time the debate starts to center on whether the client is being sold products or being advised, there’s typically an attractive opportunity to offer conflict-free solutions (whether automated or live).

**Bonus Prediction #1**

The B2B segment will prove more attractive than B2C. Internet-only banks generally did not survive but technology companies that enabled traditional banks to get into online banking thrived. The same principle applies here. Our sense is that “advising the advisor” will be a better standalone business than “advising the unadvised.” In fact, this appears to be what Betterment Institutional is doing; the business helps advisors to automate investment processes and back-office operations, among other features, under the advisor’s existing brand.

**Bonus Prediction #2**

**State Street and Invesco are the ones to watch.** As mentioned above, Vanguard entered the robo world through an internal product launch. Blackrock has also gotten into the game through the acquisition of FutureAdvisor (a deal that we see more as a technology purchase, as FutureAdvisor was falling further and further behind Betterment and Wealthfront). Other ETF heavyweights — including State Street and Invesco — would seem to be logical candidates to make the next big splash. The roboadvisor wave clearly can take several paths forward, with one potential being that the offering narrows in scope to a front-engine for low cost ETF funds. As such, State Street and Invesco have yet to make a major move in the space but would appear to be logical players given their major presence in ETFs.

**Conclusion**

By all means, roboadvisors have commanded tremendous interest from the media and venture capital firms with the thesis that changing technology, demographics, and customer preferences have created opportunities to disrupt high-cost, old-school business models in the financial services industry with low-touch, Internet-only delivery channels.

However, this thesis bears a striking resemblance to the investment frenzy that swarmed Internet banks in the 1990s. In a nutshell, the thesis for Internet-only banks did not play out as expected, even despite mass adoption of online banking as a service offering; Internet-only banks misjudged the motivations of its target customer base and underestimated the powerful response from traditional players.
Ultimately, the parallels between the investment thesis of independent roboadvisors and Internet-only banks underscores the immediate need for many independent roboadvisors to sharpen their value proposition before more industry giants in wealth management develop their own offerings. For in the words of another American icon, Mark Twain, “History does not repeat itself, but it does rhyme.” Otherwise, independent roboadvisors seem destined to jump the shark — much like The Fonz and Internet banks did decades earlier.
Covestor, an online investment marketplace, has been sold to Interactive Brokers.

Constellation Wealth Advisors LLC, a $6.2 billion bi-coastal multi-family investment office, has been sold to First Republic.

First Republic has acquired select assets and deposits in Puerto Rico from Doral Bank.

Fiera Capital has acquired 1 First Bank.

Prudential has divested its Wealth Management Solutions business to Envestnet.

Fortigent, a $50 billion outsourced provider to the wealth management industry, has sold a majority interest to LPL Financial.

Hanlon Investment Management, Inc., has acquired $70 billion in AUA from Interactive Advisory Software.

E*TRADE has divested Kobren Insight Management to Adviser Investments.

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