Digital Banking

Fintech: Changing the Way We Save and Invest

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- **Budgeting, portfolio management, and financial planning platforms are gaining momentum**
- **Both beginning and sophisticated investors embrace these companies because of their affordable fees, simplicity, and user-friendly tools**
- **Banks can incorporate some of these platforms in order to improve customer acquisition and increase fee income**

"We can reinvent the entire thing."
–Marc Andreessen, Co-Founder of Andreessen Horowitz[1], on finance[2]

Budgeting, portfolio management and financial planning platforms are increasing in popularity, especially among Millennials, who seek assistance in managing increasingly complex financial needs, such as balancing spending with paying down heavy student debt and saving for the future. This should be good news for banks except that young people are also more willing to utilize nontraditional financial services, especially if these alternatives are technologically-advanced and embrace their values and preferences. However, some of these platforms offer tools and advice appealing to older investors as well. Therefore a review and analysis of fintech innovations in budgeting, portfolio management and financial planning can prove valuable to the bank's digital strategy. This brief expands upon our previous research on Millennials, student loans, and their implications for the banking industry.

If Millennials already use apps to buy groceries, transfer money, and take out their dry cleaning,[3] why would they hesitate about using an app to rebalance their retirement portfolios or manage their budgets? Increasing levels of student debt and a more uncertain economic future have created the need for tools that allow Millennials to plan for their financial needs and invest accordingly. In addition, a growing general preference for digitalization and simple design has attracted older, more sophisticated investors as well. As a result, three major categories of consumer fintech apps have emerged, offering budgeting, portfolio management, and financial planning services. The most successful companies in this space have value propositions based on attractive interfaces, simplicity, and low fees. These qualities have allowed them to seamlessly integrate themselves into the lives of their customers.

Market Size

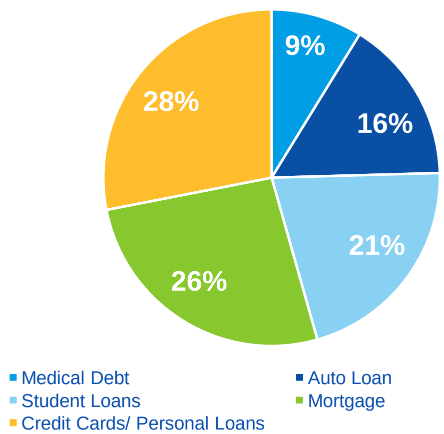
Millennials currently make up 26% of the U.S. population, with more individuals on the older side than the younger side, 39.8 million (16-24) vs. 43.5 million (25-34). Using data from the Bureau of Labor Statistics' Consumer Expenditure Survey, we found that younger consumers under the age of 25 have a negative savings rate; whereas, older consumers between ages 25-34 tend to have a positive savings rate (Chart 2). However,

[1] Andreessen Horowitz is a $4 billion venture capital firm whose portfolio includes Airbnb, Box, and Facebook.
[2] Anthony Effinger. "Andreessen on Finance: 'We Can Reinvent the Entire Thing.'" October 6, 2014. Bloomberg Business. Available at http://goo.gl/HXn5f3
[3] Geoffrey A. Fowler. "There's an Uber for Everything Now." May 5, 2015. Wall Street Journal. Available at http://goo.gl/zf0zNs

the picture shifts when taking income quartiles into account. Savings rates tend to be positive across all age ranges in the second quartile and above, and are negative across the board for those below the first quartile.

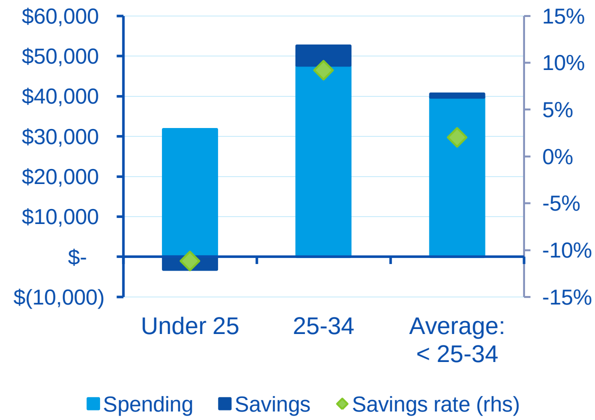
Consequently, we believe that budgeting apps can be a valuable tool for older Millennials, who are starting to amass savings, as well as for younger Millennials as a learning tool for the future. Meanwhile, portfolio management platforms would be primarily attractive to the older cohort who has the funds to begin investing for retirement or other purposes. Banks can benefit from offering loans to younger Millennials who are short of money, while offering loans and taking deposits from the older set which saves more.

Chart 1
Millennials: mean % of monthly debt payment by type



Source: Wells Fargo

Chart 2
Annual average savings by age of consumer unit



Source: Bureau of Labor Statistics

Budgeting: gain control of your daily finances

The ease of smartphones could be the catalyst for reversing young people's dire savings situation. Spurred by the success of first players, such as Mint, a new wave of apps tracking consumption patterns has come on-shore, assisting young individuals with boosting their savings without the need for constant monitoring and adjustment. These apps could appeal to someone just starting college or his/her professional career and carrying a heavy student debt burden, creating the need to balance spending with paying down debt. The aim of these apps is to virtually emulate the time-consuming and mundane task of budgeting in order to make it easier to save; therefore, they have the potential to reverse the youngest Millennials' lack of savings. [4] We have categorized budgeting apps into two groups:

Virtual Savings Jars: These platforms help users to achieve their savings goals by organizing their finances. They consist in software that tracks income and expenses, updates spendable cash after every transaction, and categorizes expenses into fixed and variable categories (needs vs. wants). In addition, the software help users build up their savings by first taking out their desired savings amount from their spendable income. Any cash left unspent by the end of the month automatically rolls over into savings as well. One company in this space is Level Money, described as "the digital equivalent of opening your wallet and seeing how much you have left."[5]

[4] Josh Zumbrun. "Younger Generation Faces a Savings Deficit." November 9, 2014. Wall Street Journal. Available at http://goo.gl/XVarWb
[5] Tara Siegel Bernard. "Make a Resolution to Budget? Here are Some Apps to Help." January 3, 2014. The New York Times. Available at http://goo.gl/k33xxr

Another example is Digit, which analyzes users' historical spending patterns and automatically makes small transfers from a checking account to a Digit-managed savings account, from which the funds can be withdrawn at any time. Digit's strength lies in helping users save in a seamless yet transparent way.

Virtual Ledgers: These platforms are aimed at helping users to smooth their income and spending. Startups like Even do not analyze spending to help boost savings; rather, they aim at combating income volatility. Their primary users are those with uneven paychecks who desire a steadier stream of income. The software first calculates the user's average paycheck. Then, on good weeks, when the user outearns that average, the surplus is put into an Even-managed savings account; on bad weeks, when the user falls short, he/she still gets that average paycheck because the company withdraws money from savings or extends interest-free credit to the user. These apps make money by charging a regular fee, for example Even charges its users $3 per week.

Each of these online budgeting innovations serves to boost savings by reinforcing positive habits. Users who desire to have a clearer picture of their finances might not necessarily want to create a budget themselves, and could feel comfortable and willing to hand over that responsibility to an app. Ultimately, the aim of these budgeting apps is to make money by giving users more confidence and control over their finances. These platforms are primarily aimed at young people with relatively simple financial needs, such as teenagers, college students, or new graduates that have just joined the labor market. However, they could also appeal to a wider segment of the population that experiences significant income volatility such as part-time or temporary workers and small business owners. In this case, the customer base of budgeting apps is broader than just Millennials and encompasses anyone seeking to gain a deeper understanding of their personal finances.

Portfolio Management: let the algorithm work for you

The 1-3% annual portfolio management fee charged by bankers can often be a deterrent to investing, even for high net worth individuals.[6] In response, a new segment of automated portfolio management apps, or robo advisors, has emerged offering lower fees—typically 0.25-0.35%. These robo advisors appeal to the needs of a generation already willing to adopt new technology and to consider non-traditional alternatives.

Taking the user's age and anticipated time until retirement, the algorithm behind automated portfolio management apps assesses the user's risk profile and determines the optimal asset allocation, which can be reset as needed. By offering low fees and minimum investments, along with easy-to-use online tools, automated portfolio management apps appeal to both beginners and investors with more sophisticated needs.

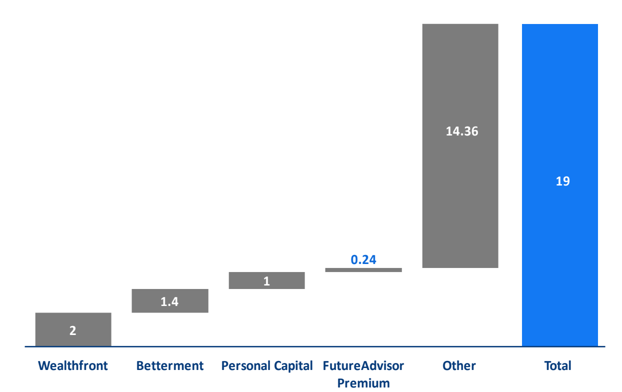
Platforms like Acorns and Betterment are purely algorithm-based and appeal to investors who might not possess a large sum of money to invest. Their users are not necessarily interested in the fine details of their investments and don't require interaction with a human advisor. On the other hand, some portfolio management apps offer more personalized asset allocations for a higher fee by gathering detailed information about the user's financial preferences and behavior. One example is Wealthfront, the most popular and widely-accepted of the portfolio management apps, claiming several Silicon Valley entrepreneurs among its loyal clients. Wealthfront recently reached a milestone of $2 billion in assets under management in just three years, with an average customer holding of approximately $115,000.[7]

Banks and brokerage firms are realizing the benefits of algorithms. Betterment, for example, recently partnered with veteran player Fidelity to make Betterment's platform available for use by Fidelity advisors in a "white label"

[6] "Ask the Algorithm." May 9, 2015. The Economist. Available at http://goo.gl/O7T5f0
[7] "Ask the Algorithm." May 9, 2015. The Economist. Available at http://goo.gl/O7T5f0

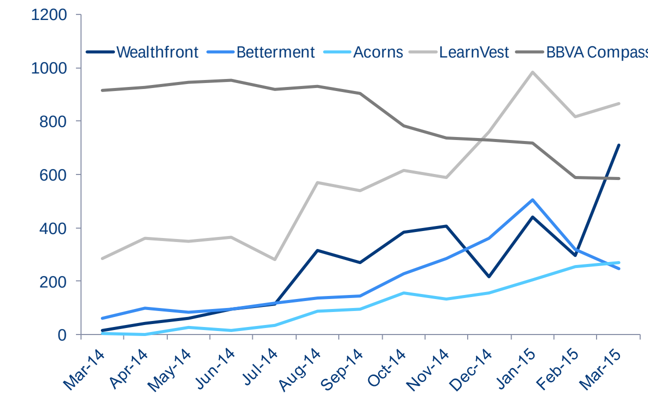
version.[8] The partnership is aimed at helping advisors save time and focus on more value-added activities by eliminating a paper-based sign-up process and streamlining asset allocation and tax reporting.[9] Fidelity research found that 56% of senior broker-dealer and RIA[10] firm executives "would like to partner with digital advice providers or incorporate them into their existing business."[11]

Chart 3
Assets under management by robo advisors (billion $)



Source: The Economist with data from Goldman Sachs

Chart 4
Unique visitors to website (thousands)



Source: Compete, Inc.

Financial Planning: expert advice for a lower price

Apps also exist for those individuals, who would prefer that a human guide them through more complex financial planning, but are unable or refuse to pay high management fees. In most cases, their customer base mainly consists of beginning investors who would like a greater level of control over their portfolio. In other cases, apps in this space which require higher initial investments are more easily accessible to older investors with greater net worth.

LearnVest, which originally launched to help women become more financially savvy, now has 1.5 million subscribers. Although its basic software is free to all, customers have the option of paying for a remote personal financial planner to advise them on spending, investing, and budgeting. Unlike the portfolio management apps, LearnVest does not automatically allocate assets for the user; instead, the user typically must do it his/herself using the advice of a personal remote planner. At $20 a month, LearnVest's financial planners are still cheaper than in-person consultations with a traditional advisor, and the company has close to 10,000 paid subscribers.[12] LearnVest was acquired by financial services company, Northwestern Mutual for $250 million last March. A similar app, Personal Capital, was one of the first apps to be made available on the Apple Watch. Like LearnVest, Personal Capital offers a financial dashboard for free, but charges users for a Personal Capital Advisor, which requires a $100,000 relationship minimum, along with a fee on assets under management. With

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[8] See Betterment Institutional. https://www.bettermentinstitutional.com/
[9] Lawrence Delevingne. "Robo Advisor Betterment Works with Fidelity in RIA Push." October 15, 2014. CNBC. Available at http://goo.gl/hN6eIW
[10] RIA: Registered Investment Advisor
[11] "As Digital Advice Providers Proliferate, New Challenges and Opportunities Surge." Fidelity Investments. Available at https://goo.gl/uX9BDx
[12] Northwestern Mutual. "Northwestern Mutual Acquires LearnVest to Redefine the Financial Planning Experience." March 25, 2015. PR Newswire. Available at http://goo.gl/NHnqJ1

a relatively higher minimum investment than other apps, Personal Capital's clients are typically older, with an average age of 45. This indicates that financial planning and portfolio management apps are not geared solely towards Millennials, and can pose a challenge to incumbents and traditional institutions that rely on an older client base.

In response, veteran industry players, Vanguard and Charles Schwab, have now developed their own low-fee financial planning apps to appeal to people looking for a cheaper way to manage their portfolios. With a $5,000 minimum investment, Schwab Intelligent Portfolios closely resembles other robo advisor apps, but users have 24/7 access to a Schwab investment professional. On the other hand, Vanguard's entry into the consumer fintech space, Vanguard Personal Advisor Services, appeals to investors with more sophisticated needs, requiring a minimum relationship of $50,000.

Implications for Banks

The emerging and already fragmented segment of consumer fintech innovations is often perceived as a disruptor to the banking industry. However, although innovations like peer-to-peer lending or crowdfunding are widely considered a threat to traditional banks, it is not clear that budgeting, financial planning and portfolio management apps would fall in the same category.

Regarding robo advisors, 40% of traditional advisors don't believe that algorithm-based firms pose a legitimate threat to their business, as their target markets differ greatly.[13] The former focus on affluent clients, typically 40 years old and older, who are more likely to use traditional wealth management services because of their product offering, personalized services, and tax strategies. Most robo advisors offer tax-loss harvesting, but this may be insufficient for those who typically pay 40% of their income to the IRS.

In addition, the reliability of robo advisors has not been tested yet, and their performance in periods of extreme volatility is yet to be seen. As these platforms gain popularity, they could also attract the attention of regulators. The SEC and FINRA[14] recently issued a joint announcement warning regarding automated investment tools, urging consumers to consider their limitations before using them.[15] The announcement specifically alerts users to the downside volatility inherent in these tools, especially taking into account the probability of higher future interest rates. More regulation would bring additional costs, which could erode the competitive advantage of a low fee structure.

However, despite these uncertainties, we believe that banks should incorporate budgeting, financial planning and portfolio investment apps into their business models, mainly as complementary products that support client acquisition efforts and bring in some fee income in the process. Savings and investment apps have an advantage in that their young client base is a continued source of growth for their business. This is why, if banks incorporate these services into their offerings, they have an opportunity to attain a critical base of customers whose financial situations will eventually become more complex. By attracting customers at a young age, banks increase their ability to cross-sell more advanced banking products and services over time. Moreover, the popularity of portfolio management and financial planning apps with higher minimum relationship balances shows that there is strong demand for simple, mobile, and affordable versions of these services for older, more sophisticated investors as well.

[13] Steve Garmhausen. "When Financial Advisors Meet their Robo-Rivals." April 18, 2015. Barron's. Available at http://goo.gl/zyoGBa
[14] SEC: Securities and Exchange Commission, FINRA: Financial Industry Regulatory Authority
[15] "Investor Alert: Automated Investment Tools." May 8, 2015. SEC. Available at https://goo.gl/jjM4Jh

We do not believe that the rapid proliferation of fintech will render banks obsolete; however, banks may find it more difficult to stay profitable in an environment of prolonged low interest rates and outdated options.[16] A critical difference between traditional banking and financial disruptors is that the latter's revenue models are based primarily on fees. In the current environment of low interest rates, and thus low net interest margins, banks will have to look to fee income in order to protect profitability. The increasing competition from fintech companies could leave traditional banks with fewer sources of potential non-interest income unless they are successful in attracting the same customer base that flocks to savings and investment apps.

Bottom Line

Consumer fintech platforms targeting young individuals have surged in popularity. The primary qualities of these apps making them attractive to Millennials are their low fees, user-friendly interfaces, low or no minimum relationship balances, and online do-it-yourself tools.[17] Moreover, these options are gaining appeal among older individuals signaling that disruption to traditional models could increase and become widespread over time. Budgeting apps help users feel more confident about their financial picture in order to achieve short-term goals, while portfolio management and financial planning apps do the same for long-term goals. The increasing competition coming from consumer fintech companies provides incentive for banks and other traditional advisors to develop and/or refine both their strategies to appeal to a younger client set and their use of technology to improve the experience for all clients.

The incorporation of robo advisors, financial planning and budgeting should be just one element in a bank's digital strategy, with the potential to impact customer acquisition, brand recognition, and profitability. As these financial innovations are aimed primarily at addressing young's people financial needs, they could be used as an effective tool for client acquisition. Unlike peer-to-peer lending or crowdfunding platforms, budgeting and portfolio management apps present low barriers of entry and should be relatively easy to incorporate into a bank's product offering. In addition, if the bank provides a highly competitive and differentiated digital solution, its brand recognition could increase significantly among certain groups that rely greatly on social media to express their customer experiences. Moreover, successful incorporation of these innovations can provide a huge boost to the bank's bottom line if greater savings deposits can be captured at a low cost and become a stable source of funding.

[16] "An Uneasy Symbiosis." May 9, 2015. The Economist. Available at http://goo.gl/jcd3yZ
[17] "Digging into Digital Advice." 2014. Fidelity Investments. Available at https://goo.gl/xOr8hZ