

What Is A Robo-Advisor and How Do They Work?

Know more about how robo advisors work, identifies some of the pros and cons of using robo advisors for your investments, discusses robo-advisor fees and feature.



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From drones to self-driving cars, machines that perform functions previously handled by humans are marching off the pages of science fiction and into reality. So if they can make a self-driving car, how about a self-driving investment program?

That idea has been reality for a few years now. Automated wealth managers, more popularly known as "robo-advisors" are here and they are growing fast, stepping into roles that have traditionally been filled by financial planners and investment advisors.

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Is a Robo-Advisor Right for You?

This guide provides information about how robo-advisors work, identifies some of the pros and cons of using robo-advisors for your investments, discusses robo-advisor fees and features, and offers 10 things to look for when choosing a robo-advisor.

How Robo-Advisors Work

Robo-advisors use algorithms to translate your investment risk tolerance into a diversified investment portfolio. This includes both determining asset allocation and choosing individual mutual funds to populate that allocation.

Some robo-advisors also offer tools designed to help you with retirement planning. For example, if you specify a retirement income target and retirement date, the program can tell you how much you need to contribute to your IRA or 401(k) each year to meet that target.

As you may have noticed, asset allocation, security selection and retirement planning are all functions that human financial professionals perform. Can robo-advisors do it better? The results have been mixed, but conceptually there are both pros and cons to the robo-advisor approach.

Pros and Cons of Robo-Advisors

Robo-advisors address two problems that have traditionally plagued the financial industry: cost and human error. Here's we assess the risks and benefits:

Pros



Lower charges

Robo-advisors offer investment management for a fraction of what human investment advisors charge. Since some investors perform above average and some perform below average, overall it is the fees that play a large role in determining how well individuals keep up with the market and make progress toward their goals.



Lower risk of being affected by market extremes

As for human error, aside from the fact that some investors are more competent than others, the fact is that time and time again professional and amateur investors alike have gotten caught up in the emotion of market ups and downs. They get more aggressive during bull markets and more tentative during bear markets. A robo-advisor can smooth out those extremes, keeping your portfolio on an even keel.

Cons



Limited by past data

The other side of the coin is that a robo-advisor cannot see into the future any better than a human investment professional. In fact, robo-advisors work by looking into the past rather than into the future, and that can have its limitations.



Market models may not be accurate

The formulas used by robo-advisors to make decisions are based on the historical behavior of different assets. The problem is that history does not always repeat itself in a predictable manner. In particular, when bond yields are unusually low and stock valuations are unusually high, the historical risk/reward characteristics of these asset classes may not be especially relevant. That would make the type of models used by robo-advisors less effective.

How to Choose a Robo-Advisor

If you decide to use a robo-advisor, what is the best firm to use? That largely depends on your needs. If you work through this shopping list of ten things to look for when choosing a robo-advisor, you should have a better sense of which is the best firm for your needs.

1. The base fee

Robo-advisors typically charge a fee based on a percentage of the assets you place under their management. A base fee of 0.25% seems common among industry leaders. Since the premise of robo-advisors is to lower investment expense through automation, checking the base fee is a good place to start. Note that, in addition to this fee, you will also have to pay the expense ratios of the funds that are used to build your portfolio.

2. Trading fees

Are there fees for each trade within the program? This could quickly become quite expensive, so look for robo-advisors that do not charge such fees. Also, if you plan to make some self-directed trades through the same firm, check that their commissions are competitive with those of leading [discount brokers](#).

3. Fee reductions for higher balances

In theory, management should get more cost-effective with bigger account sizes. Typical robo-advisor accounts are less than \$100,000; but if you have more than that to invest, you should see if you can get a reduced fee.

4. Captive vs. outside products

Some robo-advisors are affiliated with fund families and use their own products to build investment portfolios. You may get a broader range of choices from a robo-advisor that uses independent investment products.

Also check to see if the robo-advisor's asset-allocation model can account for assets you have outside their account such as an employer's 401(k) retirement plan.

5. Tax treatment

If you are planning to place a taxable portfolio under a robo-advisor's management, understand what tax-efficiency strategies they use and whether you are able to employ techniques such as tax-loss harvesting when needed.

6. Minimum account size

Make sure you have enough to qualify for a firm's services and are not so close to the minimum that you might fall below it after a market downturn or a withdrawal.

7. User interface

Play around with the user interface. It should be simple to use and work effectively on the device of your choice.

8. Socially responsible investing capabilities

If your investment guidelines include prohibitions against certain types of investments for ethical reasons or particular sectors you want to positively target, make sure the robo-advisor's system can accommodate these priorities.

9. Retirement-goal targeting

Besides managing your money, some robo-advisors offer tools that can help you see what level of saving will be necessary to meet your retirement goals. Integrating these targets with your investment program can help make sure saving for retirement is properly coordinated with investing for retirement.

10. Rebalancing methodology

Automated investment allocations need to be reset periodically to make sure they stay in balance. Look into each robo-advisor's methodology for rebalancing. Overly frequent rebalancing can be inefficient, while doing so too infrequently can lead to portfolios getting out of alignment as asset values change at different paces.

Choosing the best robo-advisor is just a first step. Once your program is in place, monitor it to make sure the fees are staying competitive and the robo-advisor is delivering as expected.

Read Our Robo-Advisor Reviews

Wealthfront Investing: Learn about Wealthfront's investment app, how robo-advising works, and what it's like to put your investments on auto-pilot.

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