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***Social Investing Part I***  
***The Opportunity to Address the Confidence Gap***

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# 1. Executive Summary

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## 1.1 Advice and Confidence Gap for Private Investors

The Retail Distribution Review (RDR) created an 'Advice Gap' among private investors, with many smaller investors unable or unwilling to justify the cost of paying for investment advice upfront. An additional less documented problem is the 'Confidence Gap' among potential investors, because even before RDR, there were large numbers of people who did not have sufficient confidence in their own understanding of investing to even approach an adviser.

Giving people the understanding, confidence and skills required to become self-directed investors is key to increasing the future wealth of millions of UK families. The increase in the ISA threshold, ability to switch between cash and stock ISAs and the abolition of the need to buy an annuity has increased the opportunity for private investors, and for the operators that cater for them.

## 1.2 Social Investing

Social investing is anything that allows clients to see other clients, communicate with each other or view and copy investments.

The FCA's recently issued guidance suggests that regulated entities can operate social investing platforms, as long as the operator has investment advisory and management permissions and ensures that any advice or investment management is suitable for the client receiving it.

By allowing clients to view each other's investments and identify and seek guidance from fellow-clients they know, social investing can bridge the confidence gap among novice investors. For more experienced investors, it avoids the upfront fees required to use a financial adviser following the Retail Distribution Review (RDR) and reduces the time necessary to research self-directed investments, as well as providing the reassurance of peers.

## 1.3 Opportunity

The clients least well served by the current market are a) those who previously used a financial adviser but do not have a sufficiently large portfolio to justify paying upfront fees for advice following RDR ('IFA Orphans') and b) clients holding savings in cash who would benefit from holding more risk-based assets but are put off by lack of confidence or understanding.

IFA Orphans hold investments of £30 billion<sup>1</sup>, while cash ISA holdings at April 2013 were £210 billion<sup>2</sup>. Investors with larger portfolios seeking alternatives to the upfront fees of a financial adviser or the high basis point charges of discretionary managers can also benefit from social investing.

Social investing offers existing financial firms the opportunity to reach these clients. Retail banks can attract more sophisticated investors and increase portfolio sizes, self-directed platforms can attract less confident investors and wealth managers can attract more mass-market investors. Meanwhile new entrants, whether start ups or established retail brands such as social networks, supermarkets or others, can use social investing to enter the retail investment market.

This paper explains why social investing and the harnessing of social media trading tools can improve the quality of the investment experience for novice and experienced investors, and benefit operators by expanding their client base and incorporating referral functionality to lower cost of acquisition.

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<sup>1</sup> BSP Estimate based on IMA Asset Management Survey 2012

<sup>2</sup> <http://www.hmrc.gov.uk/statistics/isas/statistics.pdf>

## 2. Social Investing

### 2.1 An Introduction to Social Investing

Social Investing is the act of facilitating the communication and sharing of individual and aggregated investment decisions via a network and allowing users to take guidance from their friends and peers before investing in suitable financial products.

Social investing fills the advice and confidence gap faced by many clients and potential clients in the modern investment market. Modern consumers, both naturally distrustful of professional advisers and often unable to justify the expense of advice, are at risk of under investing in risk based assets and having an over allocation of cash<sup>3</sup> in part due to a lack of confidence and understanding of financial markets. Social investing can address this confidence gap, as investors become more familiar with the investment decisions taken by friends, family and colleagues who they trust.

#### The Elements of Social Investing

**Table 1: The Elements that go into making an investment platform social**

Social Investing Element	Description
1. Aggregated Data & Market Insight	Show the most relevant client fund choices and related holdings by the different groups of clients and individuals
2. Client Network	Clients can interact with each other, create groups and individual profiles and for these to be viewed publicly
3. Analysis & Investment Sharing	Clients are able to post investment analysis and analyse and share investment portfolios
4. Social Guidance	Allow clients to receive guidance by following the monitored activity of other groups and individuals in regulated environment
5. Socially Guided Investment	Enable clients to manually or automatically copy investments of others, subject to suitability profiling

#### CONFIDENT THAT YOU ARE NOT BEACHING ANY REGULATORY CONSTRAINTS CHECK

Some of these elements, such as social guidance, are new concepts, whilst others, such as discussion forums, are more established but are being challenged by emerging social technologies. The elements that have the greatest potential to bridge the confidence gap and improve client acquisition for operators are the creation of client networks and socially guided investment. In these ways clients are able to view people they know who use the investment platform and lean on them for the guidance and support they are unable to find elsewhere.

#### Upside for Operators

From an operator's point of view, the introduction of a social element can deliver:

- Improved client trading decisions
- Increased transactions through increased confidence
- Increased number of client acquisitions through referrals
- Lower cost of client acquisition

<sup>3</sup> Blackrock – Global Investor Pulse Survey 2013

## Issues & Misconceptions

Social investing should not be confused with the emerging sector of social trading. Social investing is focused on guiding customers to make medium to long-term investment decisions. Social trading is the act of following customers into short-term, leveraged CFD trades, often at wide spreads, which make it very difficult for the follower to generate positive returns on an ongoing basis.

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## 2.2 The Market for Social Investing

While social investing can be suitable for any investor, it is likely to be of most benefit to those who are least well-served by the current market, put off by what they consider to be complexity and a lack of confidence in their own ability to make investment decisions. Most obvious and talked about within the industry are 'IFA Orphans', investors who previously used an IFA, with a portfolio of less than £100,000, but are put off by having to pay an upfront hourly fee. There is believed to be at least £30 billion<sup>4</sup> in portfolios of this type.

An even bigger potential market is the group of people who have never sought advice and never held a risk-based asset, but could benefit from doing so. Nearly £150 billion was invested in cash ISAs between April 2009 and April 2013 alone<sup>5</sup>. For many of these investors, a stocks and shares ISA would have been a better choice.

The changing regulations, including the merging of cash & stock ISAs into the New ISA (NISA), will reduce some of the barriers to risk-based investments and provide operators, able to offer appropriate guidance, a new potential market of 12 million<sup>6</sup> new investors.

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## 2.3 The Regulation of Social Investing & Social Media

Social investing shares many of the attributes that are currently being considered by the FCA in its review of social trading in the CFD/FX sector. A consultation paper is expected mid-2014, but a letter issued<sup>7</sup> on social trading in March 2014 outlines the FCA's initial thoughts.

The letter suggests that offering clients the opportunity to copy the investments of others could constitute 'Advising on Investments'. If the trades can be copied automatically, without being individually approved by the copier, then it constitutes 'Managing Investments'.

The regulations can be applied differently depending on the nature of the social investing business model and there are also a wide range of 'social investing' components, such as profiles, alerts and market sentiment that can be added to a financial company's services without the need for specific regulatory permissions.

It is clear that regulated operators can create suitable environments where investors can engage with each other about specific investments and to copy each other's investments, but if operating with Advisory or Investment Management permission, a company will need to have appropriate controls, for example processes and systems in place which prevent clients from making investments which are unsuitable for their personal circumstances.

The regulatory environment around social investing is evolving and the FCA is also scheduled to publish social media guidance for financial services firms in 2014.

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<sup>4</sup> Black Swan Partners estimate, based on IMA Asset Management Survey 2012

<sup>5</sup> & <sup>4</sup> <http://www.hmrc.gov.uk/statistics/isas/statistics.pdf>

<sup>7</sup> <http://www.ft.com/cms/s/0/fa905d08-a606-11e3-b9ed-00144feab7de.html#axzz2zuG9owD5>

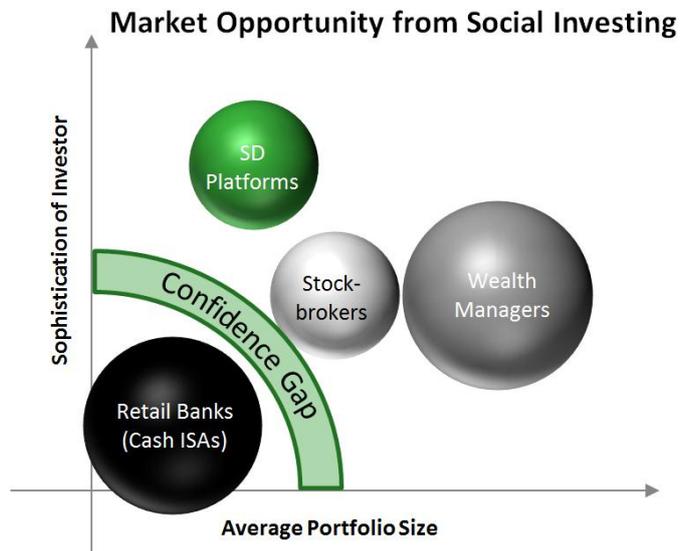
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## 2.4 The Opportunity for Existing Operators

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### 2.4.1 Addressing the Confidence Gap

**Graph 1: Illustrating the Confidence Gap between Retail Cash ISAs and Other Investments**



By addressing the confidence gap through social investing, retail banks can attract more sophisticated investors and increase portfolio sizes, self-directed platforms can attract less confident investors and wealth managers/stockbrokers can attract more mass-market investors. Marketing costs can be greatly reduced by building a referral mechanism into the business model.

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### 2.4.2 Core Influencers

Although a truly social investment platform is a new concept, designed particularly to help those who have little experience of investing to feel more comfortable doing so, it relies upon acquiring a core group of influencers who can provide the guidance that clients lack in the post RDR environment.

These influencers are likely to be experienced investors, and existing users of direct investment platforms. The challenge is to sufficiently motivate experienced investors to share their trading activities and to facilitate the sharing of investments and trade ideas through technology.

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### 2.4.3 The Potential Providers

The social investing functionality can be offered by start-ups or incorporated into existing financial services companies or established non-financial brands.

Established financial institutions have an existing group of customers and assets under management, but have struggled to attract clients whose confidence in the stock market has been shaken by the financial crisis. Social investing tools can be used to reassure this type of client and grow their client base.

New retail investing entrants can establish a trustworthy brand over time and have the technical flexibility to add new functionality quickly, which will help them grow from a small base. Established non-financial brands, in particular social media brands, with an established presence and large socially minded client-bases to target have an ideal target audience for a social investment service that addresses the perceived failings of existing investment services.

## 3. The Retail Investment Market

### 3.1 IFA Orphans & Lost Savers

#### 3.1.1 Advice Gap

The 'Advice Gap' refers primarily to IFA clients with portfolios of less than £100,000. It is not considered viable for investors with less than £100,000 to pay £500 a year for advice upfront, which represents in excess of 50 basis points a year. Of the £300 billion placed into funds by UK investors at the direction of IFAs before RDR, it is estimated that £30bn was in portfolios of less than £100,000<sup>8</sup>.

The alternative for these clients, 'IFA Orphans', representing 70% of IFA clients and 10% of their AUM, is a self-directed portfolio. Historically they may have shied away from self-directed investing, lacking the understanding or confidence to make investments without advice. However in many fields technology and culture are creating a shift away from the need for regular personal advice and establishing an environment where customers seek guidance. The most sought after guidance comes from friends, family or colleagues, and this will apply to investments as it does in other industries.

IFA Orphans will want to have some source of guidance for their investment decisions, but in a simple, transparent and above all cost-effective form. There is a gap in the direct to consumer market to provide IFA orphans, and others, with the confidence and reassurance they need to make self-directed investment decisions.

#### 3.1.2 Confidence Gap

Beyond IFA Orphans, there are significant numbers of people in the UK who have never sought financial advice and never owned a risk-based investment, despite being regular savers. The total value of Cash ISAs in the UK was £210 billion in April 2013<sup>9</sup>. While a cash ISA is an appropriate investment for some people, it is likely that the age, financial circumstances and risk profiles of many of these savers would have made a stocks and shares ISA a more appropriate option.

**Table 2: Comparison of £1,000 a Year Invested in Cash vs. FTSE All-Share ISAs Since 2004**

Year	Amount Invested Yearly	ISA Cash Value	Savings Interest %/Year	FTSE All-Share ISA Value	FTSE All-Share Total Return %*/Year
2004	1,000	1,000.00		1,000.00	
2005	1,000	2,049.20	4.92	2,215.40	21.54
2006	1,000	3,145.10	4.68	3,575.40	16.25
2007	1,000	4,319.65	5.55	4,747.73	4.82
2008	1,000	5,539.52	5.09	4,303.00	-30.43
2009	1,000	6,661.94	2.21	6,577.54	29.62
2010	1,000	7,848.48	2.8	8,499.06	14.01
2011	1,000	9,064.31	2.75	9,162.50	-3.96
2012	1,000	10,318.11	2.8	11,243.67	11.8
2013	1,000	<b>11,498.68</b>	1.75	<b>14,527.26</b>	20.31

Table courtesy of [www.swanlowpark.co.uk](http://www.swanlowpark.co.uk)

\* FTSE All-share return includes 0.5% management fees for tracker fund

<sup>8</sup> BSP estimate, based on IMA Asset Management Survey 2012

<sup>9</sup> HMRC ISA Statistics, <http://www.hmrc.gov.uk/statistics/isas/statistics.pdf>

The Government's amendment to the ISA rules will lower the boundaries for potential investors to enter the investment market. However, there are several reasons why these 'lost' savers - people who would benefit from risk-based investments but don't use them - choose not to. Above all is a lack of guidance as well as flexibility to move investments, which contributes to a lack of understanding or at least a lack of confidence in their understanding of the products. Marketing often doesn't reach them, and when it does the presentation and jargon of those warnings doesn't sufficiently tackle shortages in understanding and confidence.

This issue of 'lost' savers is particularly prevalent among women. Although women save a higher percentage of their income than men do, the number of male platform users is more than double the number of female users, and only 26% of women hold a risk-based investment at all compared with 32% of men.<sup>10</sup>

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### 3.2 What are the Lost Savers looking for?

Besides a return on their investments, in the simplest form, inexperienced, uncertain investors are looking for three things from investment providers – simplicity, transparency and trust.

**Table 3: Required Attributes of Investment Products**

Required Attribute	Description
1. Simplicity	Is the provider's website simply and clearly laid out, showing only the information they need to know but with any information they might want to know easily accessible?
2. Transparency	Is it very clear where your money will be invested, why, and how much it will cost?
3. Trust	Does the site inspire sufficient confidence to trust them with your life savings?

Examples of providers that best adhere to the principles of simplicity, transparency and trust are Nutmeg in the UK, and Wealthfront in the US.

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<sup>10</sup> The Platform

**Picture1: Screen grab of Nutmeg Portfolio**

The screenshot shows the Nutmeg website interface for a 'Wedding Fund' portfolio. The fund is named 'Wedding Fund' and has a total value of £1,000.00 as of 28/04/14. The performance section shows a 3.7% return over the last 30 days. The asset allocation is shown as a donut chart with the following breakdown: United States (33%), United Kingdom (25%), Japan (8%), Italy (7%), France (5%), Other (4%), Germany (3%), Spain (2%), Netherlands (1%), and Switzerland (1%). The fund is 10 months into a 30-year timeframe. The 'Fund Settings' section shows the goal type as 'Big Purchase / Event', the target as £10,000, the timeframe as 30 years, and the chosen risk level as 10. The 'Your investments' table lists the following holdings:

Ticker	Name	No. Shares	Price £	Value £	Percentage %
HSPX	HSBC S&P 500	46	11.1659	513.63	24.7%
MIDD	iShares FTSE 250	26	15.5300	403.78	19.5%
VUKE	Vanguard FTSE 100	10	30.3000	303.00	14.6%
DJMC	ISHARES EURO STOXX MID UCITS ETF	5	36.5760	182.88	8.8%
UC62	UBS ETF MSCI Japan 100% hedged to GBP UCITS ETF	10	15.8950	158.95	7.7%
ISPB	iShares S&P SmallCap 600	6	25.6700	154.02	7.4%
IEUX	iShares MSCI Europe ex-UK	6	21.8800	131.28	6.3%
IMIB	ISHARES FTSE MIB UCITS ETF	10	10.6320	106.32	5.1%
DJSC	ISHARES EURO STOXX SMALL UCITS ETF	3	23.6900	71.07	3.4%
CASH	Cash	0	0.0000	51.30	2.5%

Annotations on the screenshot include:

- Name your fund to add meaning to your goal:** Points to the 'Wedding Fund' title.
- Costs shown on additional tab:** Points to the 'Value' tab.
- Performance stats available:** Points to the 3.7% return section.
- Lots of ways to view asset allocation:** Points to the donut chart and the 'by country' dropdown menu.
- Asset allocation explained:** Points to the 'Tell me about this mix' button.
- Chosen timeframe affects asset allocation:** Points to the '30 years' timeframe selection.
- Simple questions to establish risk profile:** Points to the 'Chosen Risk Level' section.

The image above shows a sample Nutmeg portfolio, tailored to the circumstances of the client. A new user can view a tailored, sample portfolio with 5 clicks after reaching the website, choosing their investment goal, investment timeframe, investment amount (lump sum and monthly) and risk appetite.

Wealthfront has a very similar approach, though they also ask two questions on attitude to risk to assign clients a risk profile, rather than allowing clients to choose their own. Nutmeg asks these questions later, alerting the client if their answers do not match their chosen risk profile.

On Wealthfront, the prospect can open an account and invest with 10 more clicks by entering their name, address, birthday, phone number, social security number and amount they wish to invest. Deposits are then completed electronically and the securities purchased as soon as funds are cleared. In all, a portfolio can be selected and an account opened and funded within 10 minutes. The only disappointing element is that the account cannot be funded with a real-time deposit, meaning that clients cannot view their live portfolios as soon as they have been opened.

This approach is catching on – as at April 30<sup>th</sup> 2014 Wealthfront has \$800,000,000 under management, up from \$100,000,000 in January 2013 and \$538,000,000 in mid-January 2014, yet when compared to the largest asset management firms there remains significant potential for further growth. With fees at 0.25% (0% on first \$10,000) Wealthfront needs to manage costs and one key area is marketing expense - as of August 2013, Wealthfront had no advertising or paid marketing spend<sup>11</sup> with growth coming through referrals.

### 3.3 Track Record & Referrals

One of the biggest issues is a lack of a track record. Nutmeg has not yet been in operation for long enough to have a meaningful track record<sup>12</sup>, and Wealthfront uses the historical performance of ETFs it offers to illustrate potential returns. Both companies are relying on trailblazers and early adopters spreading the word. The advantage for existing operators is the opportunity to combine an existing track record with social investing components.

For Wealthfront, in the absence of a long-term track record and minimal marketing spend, the source of growth over the last 12 months has been referrals from existing clients, of which a lot are employees of tech firms in Silicon Valley, which is its own close-knit network. It leverages this network by featuring some of its well-known tech clients on the homepage.

**Picture 2: Wealthfront Clients as shown on its website**



<sup>11</sup> <http://pando.com/2013/08/12/hungry-index-ventures-cashes-out-3-5m-in-early-wealthfront-employees-stock/>

<sup>12</sup> <http://www.nutmeg.com/how-we-invest#portfolio-performance> & <https://www.wealthfront.com/questions>

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### 3.4 The Missing Element

Existing and emerging platforms have so far failed to create meaningful social functionality within their platforms.

For example on one of the emerging platforms, the prospects cannot easily see which of their contacts are already clients, and they can't see which portfolio their peers have chosen to invest in.

This lack of effective social investing mechanism built into the product is impacting the chance to bridge the existing investment confidence gap.

For example established and emerging companies all use suitability questions to determine a customer's risk profile, which ultimately leads to a numerical score. Online customers want more – they want to get a feel for what other users with similar circumstances are doing.

Combine the social element with the track record and platform functionality of an established player or the low cost simplicity of emerging providers and you have the perfect combination; customers being given the confidence to invest in products at the appropriate risk level and being guided to invest in suitable investment products.

In Social Investing Part II we will examine the components that make up a good social investing offering and how operators can address this market. To receive a copy of Social Investing Part II, please email [stuart@blackswanpartners.co.uk](mailto:stuart@blackswanpartners.co.uk).

## 4. Black Swan Partners

Black Swan Partners specialises in innovation in the retail investment and trading sectors. We marry a hard-nosed commercial framework to innovative thinking and have the expertise to bring your vision of the future to reality. We can assist operators and new entrants develop a social investing product that will help attract new clients and reduce an operator's cost per acquisition.

Our consulting approach puts the client experience at the centre of everything we do. Optimising and understanding every stage of aspect of the client experience enhances the customer acquisition process, lowers the cost per account, improves client satisfaction and increases revenue and profit margins. With social investing, our aim is to build elements into the client lifecycle that help inexperienced investors overcome the barriers currently dissuading them from investing and experienced investors invest more.

Black Swan Partners have completed projects advising operators in this space, as well as presenting to the FCA about the social trading sector and their approach to this market.

We are excited about the opportunities that social investing offers, especially the prospect of opening risk-based investments to a wider-audience, and would be happy to meet with any operators to discuss in more detail.

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### 4.1 Contact Details

For further information, please contact:

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