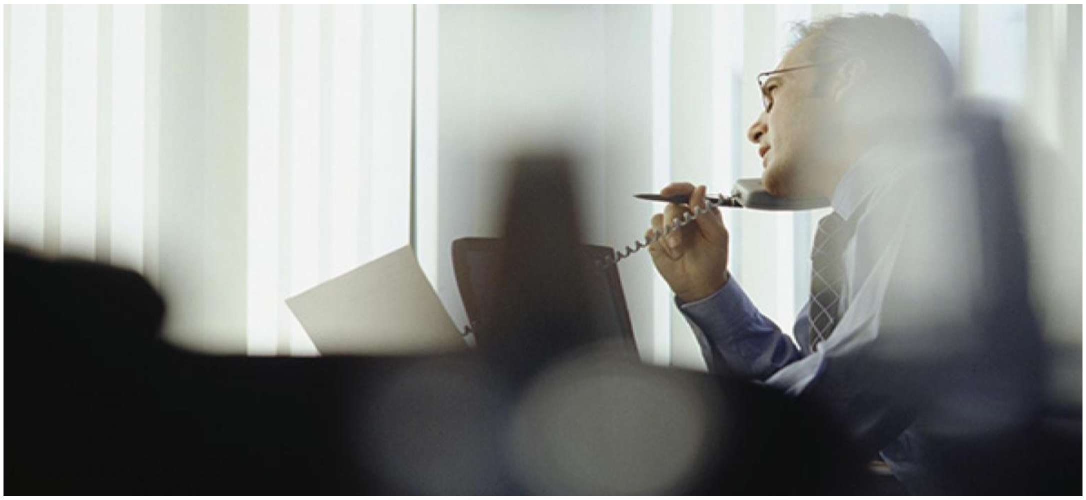

The 3 Rs of Fiduciary Practices

Three important reasons why investors should be working with a fiduciary

Feb 17, 2017

By Russ Hill

The ever-changing status of the Department of Labor’s fiduciary rule continues to garner mountains of press coverage—and with the President’s executive order to review and potentially quash the rule, there is more uncertainty than ever about how a repeal would affect the industry. Prior to the new administration, one complaint from critics of the rule was that Americans investing for their retirement didn’t need an enforced “babysitter.”

Those of us who embrace our role as fiduciaries applauded this ruling, and appreciate the light it’s casting on industry practices. What could possibly be unwelcome about requiring greater transparency concerning how investment transactions are priced? Or, requiring that professionals who invest on behalf of clients’ retirement security act in the best interests of those clients? That is why no matter what steps are recommended by the Department of Labor, we will continue acting as fiduciaries to our clients, as we have since 1989.

Thanks to this rule and the accompanying kerfuffle, American consumers are getting a great education on the diverse ways through which investment advice is delivered and priced in the United States.

Whether this ruling is eliminated or partially survives, investors always have a choice. Investment fiduciaries’ incentives are aligned with their clients, which is not the case with the standard broker/dealer model. For me, the most powerful advantages of working with a fiduciary are what I call the 3 R’s of investment fiduciary behavior: Requirements, Responsibility, and Results.

Requirements

At the heart of the current controversy lie the stringent but absolutely fundamental requirements of fiduciaries. Advisors working in a fiduciary relationship must place their clients’ interests above their own. They must do their best to ensure that their advice is based on accurate and complete information. They must both disclose and avoid conflicts of interest. As well, they are required to pursue a “best execution” standard—achieving the best combination of low cost and efficient execution in trading securities.

In contrast, a broker or “financial counselor,” is governed by a different set of standards, most prominently that of “suitability.” The suitability standard simply stipulates that b/d's must reasonably believe that any recommendations made are suitable in terms of clients’ financial needs, objectives and circumstances. Under the suitability standard, professionals buying or selling investments are not required to place clients’ interests first. Remarkably, they are not prohibited from buying investments that would garner them a higher fee or commission.

This can and not infrequently does incentivize brokers to sell their own products ahead of lower-cost competing products. “Suitability” also doesn’t prohibit brokers from selling classes of mutual fund shares that are saddled with high commissions and annual expenses to clients—despite the fact that identical, less fee-burdened classes of the same fund are readily available through other investment platforms.

Responsibility

To my mind, an equally vital aspect of the fiduciary argument is the moral case it makes, which harks back to this role’s origins as a trusted guardian of families and legacies. Acting as a fiduciary is “a duty of loyalty and care.” Acting in a fiduciary capacity isn’t just a matter of checking investment boxes and moving on to the next paying client. It’s a true responsibility.

Fiduciaries can’t hide behind legal lists of permissible investment securities. We’re tasked with having expert knowledge of the elements of portfolio construction, and how specific assets align with a client’s overall goals and financial plan. In the case of clients’ retirement accounts, allocating investments properly gives future retirees the best chance of seeing that their financial goals are realized. Now that people are living longer, keeping a steady eye on risk management practices—including diversifying assets—has never mattered more.

A true fiduciary is responsible for making the right trade-offs between risk and return, and analyzing the risks taken on by a portfolio as a whole, not just that of a proposed investment. In essence, the fiduciary is responsible for the processes he or she implements and oversees, which in turn has a decided impact on a given portfolio’s results.

Results

The White House Council of Economic Advisers has stated that advice on retirement accounts from non-fiduciaries costs American families $17 billion a year due to the conflicts of interest posed. This results, on average, in 1 percent lower annual returns on families’ retirement savings.

Working with a fiduciary won’t necessarily promise an individual better investment results. But, I would argue that the discipline, objective analysis, and lack of self-interest required of an investment fiduciary should lead to investment portfolios that will have a good chance of outperforming those brokered by conflicted advice and inflated fees. While an investment fiduciary is properly and legally evaluated on process, the experienced results from correctly following a fiduciary process are likely to be quite good.

Incentives Matter

Almost two decades ago, our firm chose to follow an independent advisor model to work with our clients in a fiduciary capacity. At the time, this was something of a radical move—away from the practices and fee structures of traditional brokerage firms. Today, in many cases, when we roll over clients' outside retirement plans to our fiduciary model, extra paperwork and compliance issues may be required to demonstrate that investment allocations are appropriate and we're implementing a strategy in their best interests. But, the strenuous documentation and due diligence are worth it.

As a fiduciary, we place our clients at the very center of our practice. We do this because it's a good fit with our worldview—both in terms of investment management and ethical responsibility. As a fee-only fiduciary and advisor, our success is based wholly on our clients' success: financial incentives are aligned.

It's a model that has an almost elegant inner logic and integrity. Although it looks like the fiduciary ruling will be rolled back, I hope its ideologies and tenets become more widely embraced by all financial firms.

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Fiduciary Duty Can't Be Killed

Striking the fiduciary rule down could make it, in the words of Obi-Wan Kenobi, "more powerful than you can possibly imagine."

Feb 21, 2017

By David Trainer

"The fiduciary rule may fade away, but the fiduciary principle is eternal. The arc of investing is long, but it bends toward fiduciary duty."

- John C. Bogle, New York Times Op-Ed, February 9, 2017

"If you strike me down, I shall become more powerful than you can possibly imagine."

-Obi-Wan Kenobi, The Death Star, 3277 LY

It's looking more and more like the Department of Labor's fiduciary rule is on its last legs. President Trump recently signed an executive order directing the incoming Secretary of Labor (whoever that may be) to review the rule with an eye towards rescinding or revising it.

While the scrapping of the fiduciary rule may have a short-term impact on the types of investment advice out there, John Bogle correctly points out that investors have been and will continue to migrate to options that provide a fiduciary level of care.

In fact, the Trump administration's decision to try to kill the rule benefits advisors that hold to a fiduciary standard. The debate over the rule has shined a spotlight on the importance of the fiduciary standard and could lead to an exodus of clients away from advisors and brokers that choose not to meet it. It's only common sense that, when given the choice on the type of advice they get, clients will more often than not choose advice that they know to be in their best interests. Striking the fiduciary rule down could make it, in the words of Obi-Wan Kenobi, "more powerful than you can possibly imagine."

Clients Demand Fiduciary Duty

Even if Trump does kill the rule, do wealth managers want to risk reputational damage for reverting to pre-fiduciary practices?

Holding advisors to a fiduciary standard is in the best interest of investors. Who wants to get caught arguing against providing that level of service? Accordingly, big wealth management firms like Wells Fargo (WFC), Morgan Stanley (MS) and JP Morgan Chase (JPM) have spent months preparing to comply with the rule. Bank of America Merrill Lynch (BAC) went so far as to eliminate all commission-based options for retirement accounts, transitioning all its clients to fee-only options.

With the industry already moving in the direction of fiduciary duty, one could argue that the DOL fiduciary rule is unnecessary. Assets are already overwhelmingly flowing to low-cost index funds and firms that hold to the fiduciary standard of care.

This rule may have been necessary in the past, but increased transparency and investor education makes it redundant today.

Clients Demand Diligence

While the debate around the fiduciary rule has focused on fees and conflicts of interest, too little has been said about the diligence required. As Michael Kitces pointed out, the rule's ambiguity over what constitutes a fiduciary level of diligence leaves the door wide open for countless lawsuits.

Such lawsuits would be counterproductive. It's becoming easier and easier for clients to identify good sources of investment advice and research. Clients are not only going to demand low fees, they are going to demand investment advice based on research that is:

1. *Complete – all relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed.*
2. *Objective – there must be quantifiable analysis that supports the recommendation.*
3. *Transparent – advisors need to be able to show how the analysis was performed and the data behind it.*
4. *Relevant – there must be a tangible, quantifiable connection to stock performance.*

In the past, it has been almost impossible to provide this level of diligence at a scale and cost that is useful to most investors. We think robo analyst technology enables a higher level of diligence at a such a low cost that ignoring it is unethical.

As a result, we look for a new, different paradigm for research, one that elevates the rigor and diligence behind all advice while keeping costs to a minimum.

Technology is already disrupting the wealth management industry in a profound way. Robo advisors are projected to grow AUM by 68 percent compounded annually over the next few years.

We think wealth management firms and advisor should look for technology that puts power back in the hands of advisors by providing insights that robo advisors and self-directed traders can't match. Recent developments such as leading robo advisor Betterment LLC adding human advisors show that clients still want diligent advice that goes beyond, "stick your money in a low-cost index fund."

With or without the fiduciary rule, the future of wealth management will belong to the firms and advisors that leverage technology to provide diligent, affordable, independent advice to a wide array of clients.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.