There’s No Getting Out Of Fiduciary Duties

Holding advisors to a fiduciary standard is in the best interest of investors.

David Trainer | Nov 22, 2016

Many expect that the president-elect will undo the regulations that would hold all brokers and advisers to a fiduciary standard, requiring them to act in the best interests of clients.

We think investors’ expectation for the fiduciary standard is here to stay no matter what the official rules say -- and those investors will increasingly demand that their advisers apply to their non-retirement accounts too.

Even if Trump did 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.

More importantly, the fight over the rule has brought to the surface some of the conflicts of interest involved in the investment management business. Clients know to ask if their adviser is a fiduciary now, and it’s going to be awfully hard to win new business if you can’t tell them you’re going to act in their best interests.

People should not be so quick to assume that a Trump administration will mean a return to the status quo in the wealth management industry. For one, killing the rule would actually take quite a bit of work and could face the threat of a Democratic filibuster in the Senate. While some of Trump’s top advisors are strongly opposed to the rule, it’s unclear whether Trump himself will want to spend political capital on a move that could hurt his populist image.

What Does Being A Fiduciary Mean?

In a nutshell, it means advisors should have competitively priced and transparent fee structures and investors should have confidence that advisers aren't giving them conflicted recommendations for commissions from another source.

Non-predatory fees and commissions are not the whole story. Bring a fiduciary means advisors must show they have performed proper diligence for investment recommendations.

While the Department of Labor has not provided specific guidance about exactly how advisors fulfill fiduciary duties while making investment recommendations, we think it means advisors need to rely on research that is (1) un-conflicted and (2) inarguably in the best interest of clients.

We also think the existence of this new rule means regulators are looking for improvement over existing research practices, which are based primarily on technical research and sell-side research.

Technical Analysis Does Not Hold Water In a Fiduciary Environment

In our meetings with key players across the wealth management industry, no one even attempts to argue that technical research comes close to being rigorous enough to satisfy fiduciary duties when making investment recommendations.

There is no evidence to suggest that technical analysis works on any sort of consistent basis. A 2008 study from New Zealand's Massey University tested over 5,000 technical trading strategies and found that not one of them added value in a statistically significant manner.

Any adviser that makes a recommendation based on technical analysis will have a hard time making a straight-faced argument to clients (or a court) that they fulfilled their fiduciary duties. There are too many risk factors and variables that are not incorporated into a stock chart.

Technical analysis at least avoids the conflict of interest concerns that plague sell-side research, but it lacks the requisite diligence to serve as the basis for an informed investing decision.

Sell-Side Research Remain Conflicted And Is On Downward Slide

If you have ever read the disclaimers at the back of every report published by a sell-side research firm, you need not read further. If you have not read any of those disclaimers you should. In the meantime, trust us when we say that every single report from a sell-side analyst contains the same disclaimers warning readers of the myriad ways in which the research could be in conflict with the actions (trading, advisory, underwriting, etc.) of the sell-side firm.

There are some incredibly smart and dedicated analysts on Wall Street that perform valuable research, and some of their research is un-conflicted. However, one never knows for sure which reports are or are not conflicted since the same disclaimers warn of conflicts in every single report.

Moreover, sell-side analysts have many responsibilities, whose importance increasingly supersedes that of writing research. They want to maintain access to management, drive trading volume, and give special attention to a handful of high-dollar clients. Providing accurate recommendations in their published reports is near the bottom on their list of priorities.

In trying to balance those different responsibilities, you end up with situations such as this one where a Deutsche Bank analyst told four hedge fund clients to sell a stock while maintaining a "Buy" rating

in his published report because he didn't want to harm his relationship with management. The stock lost 25% of its value a few weeks later after management lowered forecasts.

That situation, where an analyst keeps a buy rating to keep management happy and maintain access, is one of many false buys that crop up in sell side research. No wonder a study from last year found that sell-side analyst forecasts are still highly inaccurate.

As banks continue to cut back on research budgets, you end up with even less substantive research and more reports that exist only to drive trades or maintain profitable relationships. Advisers who use sell-side research as a basis for investment recommendations may not be conflicted themselves, but they're certainly not fulfilling a fiduciary obligation to clients.

How Do Advisors Fulfill Fiduciary Responsibilities and Stay Out Of Regulators' Cross Hairs

While the new DOL rules are principles based and do not provide discreet instructions as to what advisors should do to fulfill fiduciary duties, we think advisors cannot lose with clients or regulators by incorporating research into their practice that is:

1. Truly un-conflicted
2. Inarguably in the best interest of clients

The first item on the list above is straightforward. Research needs to come from sources that are 100% un-conflicted and can prove it.

The second item is a little tougher, but not impossible to nail down. "Inarguably in the best interest of clients" means research has to be:

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

The hard part here is that rarely, in the history of our capital markets, has there been research that meets all four of those requirements. But, we do not think that should mean investors do not get what they deserve.

Forget The Law—Clients Demand Diligence

No one can say at this point whether the DOL Fiduciary rule will be allowed to stand, or if it does how it will be interpreted. What we can say is that the push for this new rule in the first place shows that the status quo is not working for a large number of people. Clients demand higher-quality advice at a lower cost.

Ultimately, there's no perfect solution to this dilemma. Every client has different needs, so no one source of research will be perfect or complete for every client.

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% 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 advisers by providing insights that robos and self-directed traders can't match.

Think "robo analyst." Value investing research has often been overlooked in the past 20 years as it was too expensive and time-consuming. We think technology can make high-quality value investing research easily affordable and accessible.

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