Opinion: The Labor Department still has to define the hardest part of the new fiduciary rule

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The next FAQ on the fiduciary rule should cover proper due diligence for investment recommendations

An open letter to the Department of Labor:

We applaud the Department of Labor for raising awareness of the importance of fiduciary standards. No matter the legalities, the new fiduciary rule is here to stay. Few would argue against the idea that all advisers should act in their clients’ best interests. Investors are better served, and the investing business has more integrity, when the fiduciary level of service is applied. Investors want advice that is aligned with their best interests. No adviser wants to be perceived as not having the clients’ best interests top of mind.

However, many people throughout the industry are still unclear as to how the fiduciary rule should be implemented. This uncertainty, at least in part, is behind many industry groups working hard to delay—or even scrap entirely—its implementation.

In its first two FAQs on the new fiduciary rule, the DOL covered key topics such as conflicts of interest, exemptions, and investor rights. In the third FAQ, we humbly suggest the DOL provide guidance on exactly how advisers apply proper due diligence and meet the fiduciary standard when making investment recommendations.

Defining diligence is probably the hardest part of implementing the fiduciary rule, but it brings important upside. It could alleviate significant compliance concerns from advisers and wealth management firms. It would also reassure investors that they are getting proper value for their fees, support the integrity of the markets, and promote the development of more high-quality investment research to better serve advisers and investors.
It’s important to note that diligence does not guarantee investors will always make money. Nor does requiring diligent research for investment recommendations guarantee that investors won’t get duped by advisors. It does, however, provide legal resource if the advisor acts contrary to the client’s best interests.

To the extent we can be helpful, we’d like to share what we’ve learned from our research and meetings with key constituents across the wealth management space.

**Defining diligent research**

To start, there is absolute agreement that research that meets the fiduciary standard should be 100% unconflicted and, inarguably, in the best interest of the client. To put a little more meat on that bone, we think truly diligent research should be:

- **Comprehensive.** All relevant publicly available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including the footnotes and the Management’s Discussion & Analysis (MD&A).

- **Objective.** There must be empirical analysis that supports the research and recommendation.

- **Transparent.** Users should be able to see how the analysis was performed and the data behind it.

- **Relevant.** There must be a tangible, quantifiable connection to stock, ETF or mutual-fund performance.

**Diversification isn’t a substitute for ‘diligence’**

By law, a fiduciary must act with “care, skill, prudence, and diligence.” The law also suggests diversification as a safety measure to avoid concentrated risk.

Certainly, diversification may reduce some risk, but, if we learned anything from the mortgage crisis, we know that investing in lots of bad securities can yield the same results as investing in a few bad securities. Diversification only shows diligence if an adviser has acted with “care, skill, prudence, and diligence” in his/her research of the securities into which he/she recommends investing.

**Can robo advisers manage your money and emotions?**

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In investing, giving in to your emotions can cut your return by about 1.56 percentage points a year. Should you leave the job to an emotionless robo adviser instead?

The same concept holds true for advice that relies on how other advisers or investors invest. Mass-market psychology should not be a substitute for diligence either. The fact that lots of other people are doing it doesn’t qualify as diligence even if it comes from robo advisers. We’ve learned that lesson from every stock market bubble.

Ultimately, we think there is no substitute for thorough, unbiased research that meets the criteria outlined above.

**Diligent research is hard to find**

We freely admit that doing proper diligence is easier said than done. If there were an obvious off-the-shelf source for diligent research, we’d likely not see the pushback we’ve seen for the new rule.

The DOL’s timing for this new rule couldn’t be better considering how hard it is get diligent research today. For starters, there’s the declining signal/noise ratio for investment research. Between CNBC, Fox Business News, and myriad online and offline publications, there are more opinions, research reports and articles than ever.

Relying on sell-side research can also be risky. While these reports often contain valuable information, the analysts/firms that write them may be compromised in myriad ways. If the DOL wants to discourage conflicts of interest (inarguably a
problem for the integrity of the investing business), then sell-side research should probably play a less prominent role in developing and justifying investment recommendations.

Doing diligence oneself isn’t a reasonable solution for most investors and advisers. Accounting rules and disclosures have become more complex and financial filings longer than ever. Who has time to read, analyze and model financial data from 10-K and 10-Q reports that are more than 200 pages on average?

Many traditional shortcuts like the P/E ratio and ROE have proven ineffective over time. Investors should also beware of research that claims to offer more sophisticated metrics as it is often plagued by inconsistencies and flawed methodologies.

**You know it when you see it**

While there may not be an obvious all-encompassing solution for diligent research, the DOL has already undoubtedly and meaningfully improved the integrity of the capital markets by shining a light into the dark corner of investment research.

The lack of a readily apparent solution shouldn’t deter the DOL’s advocacy for diligent research. We support the DOL’s approach to improving investment research thus far. We don’t see the need for new rules or regulations, rather enforcement and application of existing rules, like the fiduciary rule, will suffice. All grandstanding aside, who can argue against the merits of more closely aligning the best interests of investors with the wealth management industry?

The DOL need not provide prescriptive details on what diligent research is. We think guidelines like what we propose above will easily suffice.

Investors recognize diligent research when they see it. There are many research firms doing good work and providing diligent research, and our free-market economy will ensure their prosperity as long as diligence remains a priority. When diligent research thrives, so does the integrity and prosperity of the markets.

The DOL has an opportunity to give meaningful clarity to the investment community in its next set of FAQs. We hope it does so.

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**More on the fiduciary rule:**

- Answers to 17 questions you might have about the fiduciary rule
- How the fiduciary rule could change your relationship with your adviser
- Diana Furchgott-Roth: The Trump administration ought to target the fiduciary rule

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