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# Danger Zone: Advisers Who Don't Fulfill Fiduciary Duties

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and Marketwatch.com

In our recent op/ed "There's No Getting Our of Fiduciary Duties" (featured on Forbes, wealthmanagement.com and marketwatch.com), we explain how the DOL's new fiduciary rule has permanently impacted wealth management - no matter what Trump does. Echoing our op/eds is Josh Brown's "I Dare You" published about a week after ours. The Reformed Broker **strongly** supports our views - albeit with a bit more spice.

One of the effects of the DOL shining a bright light on that fact that not all advisers are required to act in the best interests of clients is that fewer advisers will be able to survive if they do not provide a fiduciary level of service. Accordingly, advisers who do not provide a fiduciary level of service are in the Danger Zone. Regardless of laws and regulations, advisers not providing a fiduciary level of service place their entire business at risk, as investors will naturally migrate toward advisers providing a higher and better level of service.

Clients are more educated than ever. There is more transparency into advisory practices than ever. It's going to be awfully hard for advisers to win new business if they cannot tell clients they will act in the clients' best interests.

### Impacts of the Fiduciary Expectation: Cut Commission-Driven Business & Better Research

Bank of America Merrill Lynch (BAC) is getting a jump on the competition and has announced plans to stop offering IRAs that charge commissions to clients who rely on brokers for advice. Choosing between a firm that has eliminated conflict of interest commissions and one that hasn't is pretty easy.

As a result, we see all the other wealth management firms following Merrill's lead. Morgan Stanley (MS), JP Morgan Chase (JPM), Prudential Financial (PRU), Goldman Sachs (GS), BlackRock (BLK) and Wells Fargo (WFC) among many more face significant risk of reputational damage and lost clients and assets under management if they do not follow suit. We think wealth management firms will also move in lockstep when it comes to bolstering their ability to show how their advisers fulfill fiduciary duties

### How To Fulfill The Fiduciary Duties When Making Investment Recommendations?

Getting rid of commission-driven revenues is the easy part. The harder part is defining exactly how advisers fulfill fiduciary duties when making investment recommendations. The new DOL rules are principle based and do not provide discreet instructions as to what advisers should do to fulfill fiduciary duties. However, we think there are some clear guidelines advisers can follow to ensure their investment recommendations fulfill fiduciary duties:

1. **Avoid Conflicted Research**

There's no denying that there are large conflicts of interest in most sell-side research. 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 high-dollar clients. Providing accurate recommendations in their published reports is near the bottom on their list of priorities.

Juggling these different responsibilities can lead to one of many false buys that occur in sell side research. In one instance a Deutsche Bank (DB) an analyst maintained a buy rating to keep management happy while informing hedge fund clients to sell the stock. We've covered other reasons why "buy" ratings cannot be trusted in our report "Are Buy Ratings Nearly Worthless?" It should come as no surprise then that a study from last year found that sell-side analyst forecasts are highly inaccurate.

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.

2. **Perform Proper Due Diligence on Fundamentals**

The only way for advisers to fulfill their fiduciary duties is to perform proper due diligence on the fundamentals of any investment recommendations. Exactly, how does one perform proper due diligence on the fundamentals of an investment? That's a question we think regulators and wealth management executives are asking themselves. Here's our answer on what constitutes research that performs real due diligence:

1. Complete – all relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including the footnotes and MD&A.
2. Objective – there must be quantifiable analysis that supports the recommendation
3. Transparent – advisers 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

To fill the void for research that meets this requirement, we see a new paradigm for research that elevates the rigor and diligence behind all advice while keeping costs to a minimum.

This new paradigm is not possible without new technology. This new technology will put power back in the hands of advisers by providing insights that robo advisers and self-directed platforms can't match. This technology is like a "robo-analyst" that does the grunt work (analyzing financials and footnotes in thousands of SEC filings and building models) and frees the adviser to service clients…with high-integrity, fiduciary-duty-fulfilling advice.

At New Constructs, our machine learning technology has processed over 120,000 filings since 2003. Recent advances in natural language processing (NLP) enable us to leverage machines to automatically parse 85%+ of filings and footnotes compared to just 30% a few years ago.

We provide detailed calculations on each of our 30+ adjustments to close GAAP loopholes to be as transparent as possible. We also calculate an accurate return on invested capital (ROIC), the driver of shareholder valuation, for 3000+ companies under coverage. One human alone cannot perform this type of diligence in a reasonable time frame. However, if the technology exists to bring new levels of diligence to all clients, why aren't wealth managers using it to give clients what they deserve?

**Background**

There is speculation that the president-elect will undo Department of Labor's changes to fiduciary regulations in an effort to "reform the regulatory code." However, we think investors' expectation for the fiduciary standard is here to stay no matter what the official rules say. Going forward, advisers and wealth management firms who choose to ignore fiduciary standards face serious risk of reputational damage and, ultimately, lost assets under management. Let's face it: how many advisers want to tell clients their retirement advice doesn't have the clients' best interests in mind?

**Before The Rule Change: Investors At a Disadvantage**

Prior to the rule change, brokers who gave investment advice were held to a suitability standard, which meant nothing stopped advisers and firms from steering clients into high fee, in house products. Such loose regulation opened the door for wealth management firms such to steer clients to products that helped line the pockets of the firm while costing clients millions.

With only a suitability standard, investors cannot be sure whether the adviser is prioritizing the interests of the advisers'. History shows that humans, when given a choice, put their interests first almost always. Look no further than our report on earnings manipulation, which documents how CFOs admitted they manipulate earnings to meet targets that triggered bonuses or incentive awards. Sales goals or commission bonuses have been shown to have the same effect, ultimately leaving clients on the losing end.

With conflicted advice costing families 1 percentage point in returns each year, and $1.7 trillion of IRA assets in products that generate conflicts of interest, the time to hold advisers to a fiduciary standard is long overdue.

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*Disclosure: David Trainer, Kyle Guske II, and Kyle Martone receive no compensation to write about any specific stock, sector, style, or theme.*

## New Constructs® – Profile

### How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?
ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

### Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

### Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

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