Open Letter To The Department of Labor: What Does "Diligence" Mean For Fiduciaries?

We applaud the DOL 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 advisors 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 advisor 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.

Calm The Markets

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 advisors 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 advisors 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 advisors and investors.

To the extent we can be helpful, we'd like to share what we've learned on this front 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% un-conflicted 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 Is Not 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 advisor has acted with "care, skill, prudence, and diligence" in his/her research of the securities into which he/she recommends investing.

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

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The recipient of this report is directed to read these disclosures.

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 could not 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 a myriad of online and offline publications, there are more opinions and research reports/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 a myriad of 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 is not a reasonable solution for most investors/advisors either. 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 short-cuts 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 should not deter the DOL's advocacy for diligent research. We support the DOL's approach to improving investment research thus far. We do not 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 proscriptive 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.

There Are No Guarantees

It's important to note that diligence does not guarantee investors will always make money. There are no such guarantees because investing is a very competitive business. Hordes of professional money managers spend millions of dollars on research and work 60+ hour weeks to try and get an edge. Most of them, e.g. 75%, fail. Requiring diligent research for investment recommendations does not guarantee that investors will not get duped by advisors, either. It does, however, provide legal resource to investors to recoup losses and prosecute bad actors in the advisory business if the advisor acts contrary to the client's best interests. Doctors and lawyers are required to act in the best interests of their clients though the results of their services are not guaranteed. So, why shouldn't we hold advisors to the same standard?

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

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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.

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