The Truth Behind The Push To Delay The Fiduciary Rule

The Department of Labor's fiduciary rule is under fire again. Representative Joe Wilson (R-S.C.) has introduced a bill that would delay implementation of the rule for two years, with the ultimate goal of scrapping the regulation—which requires all brokers and advisors to act in the best interests of their clients—entirely.

Many industry groups have applauded Wilson's bill and argued that the costs to comply with the rule are too high, and that it places an undue burden on them to comply with those standards.

Essentially, those opposing the rule are saying that fulfilling a fiduciary standard—acting in the best interests of their clients—is too costly to work with their business model.

Josh Brown drives the point home in The Most Horrendous Lie on Wall Street:

> "Middle-class Americans are not worth serving if we can't charge them egregious fees and sell them products that they do not need."

Rather than lobbying against the new fiduciary rule, brokers should be looking for new ways to deliver cost-effective and high quality advice.

The Fiduciary Standard Is Here To Stay

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.

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.

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 can be a useful tool, and it avoids the conflict-of-interest concerns that plague sell-side research, but on its own it does not fulfill the requisite diligence to serve as the basis for a prudent investment decision.

Sell-Side Research Remains 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 and its recommendations could be in conflict with the interests and/or 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".

Truly diligent or "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. In turn, this can make it easier for advisors to deliver a fiduciary level of service to more middle-class Americans.

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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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