Fiduciary Duty Can't Be Killed

"The fiduciary rule may fade away, but the fiduciary principle is eternal. The arc of investing is long, but it bends toward fiduciary duty."

- John C. Bogle, New York Times Op-Ed, February 9, 2017

"If you strike me down, I shall become more powerful than you can possibly imagine."

-Obi-Wan Kenobi, The Death Star, 3277 LY

It's looking more and more like the Department of Labor's fiduciary rule is on its last legs. President Trump recently signed an executive order directing the incoming Secretary of Labor (whoever that may be) to review the rule with an eye towards rescinding or revising it.

While the scrapping of the fiduciary rule may have a short-term impact on the types of investment advice out there, John Bogle correctly points out that investors have been and will continue to migrate to options that provide a fiduciary level of care.

In fact, the Trump administration's decision to kill the rule benefits advisors that hold to a fiduciary standard. The debate over the rule has shined a spotlight on the importance of the fiduciary standard and could lead to an exodus of clients away from advisors and brokers that choose not to meet it. It's only common sense that, when given the choice on the type of advice they get, clients will more often than not choose advice that they know to be in their best interests. Striking the fiduciary rule down could make it, in the words of Obi-Wan Kenobi, "more powerful than you can possibly imagine."

Clients Demand Fiduciary Duty

Even if Trump does 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.

With the industry already moving in the direction of fiduciary duty, one could argue that the DOL fiduciary rule is unnecessary. Assets are already overwhelmingly flowing to low-cost index funds and firms that hold to the fiduciary standard of care.

This rule may have been necessary in the past, but increased transparency and investor education makes it redundant today.

Clients Demand Diligence

While the debate around the fiduciary rule has focused on fees and conflicts of interest, too little has been said about the diligence required. As Michael Kitces pointed out, the rule's ambiguity over what constitutes a fiduciary level of diligence leaves the door wide open for countless lawsuits.

Such lawsuits would be counterproductive. It's becoming easier and easier for clients to identify good sources of investment advice and research. Clients are not only going to demand low fees, they are going to demand investment advice based on research that is:

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.

In the past, it has been almost impossible to provide this level of diligence at a scale and cost that is useful to most investors. We think robo-analyst technology enables a higher level of diligence at such a low cost that ignoring it is unethical.

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 robo-advisors and self-directed traders can't match. Recent developments such as leading robo-advisor Betterment LLC adding human advisors show that clients still want diligent advice that goes beyond, "stick your money in a low cost index fund."

With or without the fiduciary rule, the future of wealth management will belong to the firms and advisors that leverage technology to provide diligent, affordable, independent advice to a wide array of clients.

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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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