How the Fiduciary Rule Can Make You Money

The Post-DOL world is here. Despite delays, certain elements of the fiduciary rule are already in place.

With full implementation scheduled for July 2019, figuring out how to deal with the fiduciary rule is the top priority for many firms and advisors. Here's how you turn this regulatory bombshell to your advantage.

Don't Fight the Inevitable

Many of the largest investment managers have already made changes to comply with the fiduciary rule. For example, Bank of America Merrill Lynch (BAC) moved clients from commission-based accounts to fee-based ones. Fidelity has been aggressive in positioning itself as a fiduciary to retirement plan participants. The industry is moving towards a fiduciary standard, and soon a fiduciary level of service will be required to acquire and retain clients.

Win More Assets and Keep Them Longer

Most everyone is familiar with the Duty of Loyalty portion of the Fiduciary rule, while few understand the Duty of Care. Stand out versus your competition by showing expertise on the most important part of the Fiduciary Rule. Show clients that, despite the ambiguity surrounding the Duty of Care, you understand how to take care of them properly when it comes to investment advice.

Avoid Regulators' Scrutiny

In our meetings with wealth management executives and advisors across the country, the biggest concern we hear is:

> "When I/we get pulled in front of an arbitration panel, how will I/we justify my recommendations."

This concern is understandable given the conflicts endemic to sell-side research and the lack of rigor in technical research.

Now is the time to upgrade your practice to leverage research that can stand up to regulators' scrutiny and impress clients with your diligence.

Impress Clients with Thought Leadership on the Duty of Care

Despite the lack of regulatory guidance for fulfillment of the Duty of Care, there is plenty of common-sense guidance from thought leaders such as wealthmanagement.com, MarketWatch, Michael Kitces and Kim O'Brien, CEO of Americans for Annuity Protection. They all agree that research that fulfills the Duty of Care should be:

1. **Comprehensive:** Incorporate all relevant publicly available data from 10-Ks and 10-Qs, including the footnotes and MD&A.
2. **Un-Conflicted:** Provide unbiased research.
3. **Transparent:** Show how the analysis was performed and the data behind it.
4. **Relevant:** Show a tangible, quantifiable connection to fundamentals.

It's hard to find fault in providing clients with research that meets these standards. In fact, most average investors probably think today's research meets these standards, but it does not.

Impress Clients with the Latest in Technology

Research that meets these four standards can be hard to find. Not long ago, it did not exist with scale and consistency. Frankly, it's not been in the best interest of most Wall Street firms to make this kind of research available to the masses.

Fortunately, recent advances in technology make it possible to deliver research that meets the four standards in a cost-effective manner and at scale. Advisors now have access to the research they need to fulfill the Duty of Care without raising costs for their clients.

Accordingly, the advisors who delay embracing fulfilment of the fiduciary Duty of Care risk losing market share to those that do. Studies already show that advisors who embrace technology have higher AUM, serve more clients, and have greater job satisfaction.

Some of the largest wealth managers are already reaping rewards from investment in technology. For example, Morgan Stanley's (MS) wealth management division achieved record performance and propelled the stock to a $48 billion gain in market cap this year, which was driven, in part, by heavy investment in technology.

Swiss bank UBS (UBS) has also made technology and wealth management a focus. As a result, it has established itself as the top choice for high net worth individuals and ranks as the most valuable brand in the wealth management industry.

In July 2016, we estimated Morgan Stanley could enjoy a $28 billion boost to market cap from investing in wealth management technology, and we were too conservative by $20 billion. In our recent report on UBS, we estimate the firm could enjoy a $40 billion (60%) market cap boost from investing in wealth management technology.

Here's Why Regulators Like This Approach to the Duty of Care

For those that remain skeptical, we provide further explanation of each of the standards to underscore the self-evident nature of their importance to fulfillment of the Duty of Care.

1. **Comprehensive**

It's no secret[1] that corporate managers often exploit a large number of accounting loopholes to manipulate earnings per share (EPS). As a result, advisors have a fiduciary responsibility to analyze more than EPS. Only by reading through the financial footnotes and management discussion and analysis (MD&A) can advisors close accounting loopholes and assess the true profitability of a company.

Despite the importance of reading 10-K's and 10-Q's, many traditional research providers don't do this work. One sell-side analyst even recently admitted he hadn't realized that a bank he covered stopped filing reports with the SEC two months before. This lack of diligence is how you end up with 21 out of 23 sell-side analysts telling investors to buy or hold Valeant Pharmaceuticals (VRX) the day before it drops by 50%.

Don't clients deserve research that accounts for the entire financial picture of a company, not just a portion of it? Why settle for anything less than analysis of all financial information?

Warren Buffett says he reads 500 pages of 10-K's every day. Jim Chanos was able to spot the Enron fraud by looking at its 10-K's and 10-Q's. The most successful investors know that diligence matters.

2. **Un-Conflicted**

Not all sell-side research is conflicted, but how does one know what is or is not conflicted because of the disclaimers warning of a multitude of potential conflicts in every report.

The same concerns apply to fund research, where the research providers are often paid largely by the funds they cover.

Investors deserve truly unbiased research that is not influenced by relationships with the companies and funds under coverage.

3. **Transparent**

Advisors need to prove to clients and regulators that they're fulfilling fiduciary duties. Clients are in need of convincing since roughly two-thirds of investors don't trust the financial services industry to act in their best interest.

Client education is the key for advisors to overcome this mistrust. Advisors who help clients understand their decision-making process and are open about the data and analysis behind their recommendations can reap long-term rewards. By getting clients more engaged in the process, advisors increase the probability of keeping clients committed to their investment plan through good times and bad.

Fiduciaries need to be transparent enough to back up their investment research and recommendations with key details and the assumptions that drive them in real-time, not just when a regulator asks about them.

[1] In a 2015 survey, CFO's said they believe 20% of companies intentionally misrepresent their earnings.

4. Relevant

Take a hypothetical advisor that reads every 10-K and 10-Q and then only buys stock in the companies with the highest proportion of the letter "e" in their filings. This process would be comprehensive, objective, and transparent, but it would not be relevant to long or short-term performance of the investment.

Without a tangible, relevant link to long and short-term performance, an investment process is incomplete. With all the focus on sentiment, technical research, macro themes and other pure trading strategies, fundamentals can be overlooked. Advisors and investors that ignore fundamental research are doing themselves a disservice, as research has found that even technical-based strategies can improve with the use of fundamental analysis.

Though fundamentals need not represent 100% of the driver for investment decisions, they should not be 0%. Fundamentals matter, and investing without proper fundamental analysis puts clients at undue risk. Advisors that can back up their recommendations with relevant fundamental research will take clients from those that don't.

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

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To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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