A Reminder to the SEC: Disclosure Is Not Enough

As the SEC gets set to propose its advice standard (similar to the Department of Labor's Fiduciary Rule) on April 18, we believe it is important to note that disclosure alone is not enough to protect investors.

Simply adding more information to disclosures will only overwhelm clients, many of whom already struggle to make sense of the disclosure that exists today. More importantly, more disclosures don't address the central concern of advisors, which is how to prove they are fulfilling the Fiduciary Duty of Care.

The SEC should attempt to alleviate this concern by clearly outlining its view of how advisors can fulfill the Fiduciary Duty of Care.

More Disclosures Are Not a Solution

The current SEC standards regulating advisors focus heavily on disclosure, and a disclosure document for registered investment advisers is expected to be part of the proposal unveiled on April 18.

Few people in the industry believe that a disclosure standard is enough to ensure that brokers and advisors act in the best interests of their clients. SIFMA managing director Kevin Carroll recently told Investment News:

"We don't think a best-interest standard would be satisfied by disclosure alone."

History proves that, while disclosure is important, it's not enough on its own. There was plenty of disclosure revealing the issues with credit default swaps and CDOs in the lead up to the financial crisis, but almost no one identified them because they were buried in prospectuses running in the hundreds of pages.

A disclosure-only standard perpetuates the same needle in the haystack problem plaguing the status-quo. Investors shouldn't have to plow through long and complicated filings just to ensure that their advisors are obligated to fulfill the fiduciary duties of care and loyalty.

Setting Standards That Are the Solution

There is agreement from thought leaders such as wealthmanagement.com, MarketWatch, Michael Kitces and Kim O'Brien, CEO of Americans for Annuity Protection, 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**: considers all relevant publicly available data from 10-Ks and 10-Qs, including the footnotes and MD&A
- **Objective**: unbiased advice using unbiased research
- **Transparent**: clients can see all aspects of the investment process, including analysis performed and the data behind it
- **Relevant**: investments have a clear connection to the client's financial goals and the research behind advice has a tangible, quantifiable connection to stock or fund performance.

If the SEC wants to make changes that help investors, then it should require that all investment recommendations be backed by research that meets the criteria above.

New Standards Should Raise the Bar for the Industry

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 financial media provides a deluge of noise with little value, and sell-side research is highly conflicted.

Doing diligence oneself is not a reasonable solution for most investors/advisors either. 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? Enter the Robo-Analyst.[1]

The Robo-Analyst uses machine learning technology to automate significant portions of the data gathering and modeling process while flagging complex items in the footnotes for review by expert analysts. This technology makes it possible to provide accurate fundamental models of return on invested capital (ROIC) at scale.[2]

Any research that does not provide this level of diligence should not be considered comprehensive or relevant enough to meet the Duty of Care. Many traditional short-cuts like the P/E ratio and ROE have proven ineffective over time. Meanwhile, there is a clear correlation between improving ROIC and increasing shareholder value. Investors should also beware of research that claims to offer more sophisticated metrics as it is often plagued by inconsistencies and flawed methodologies.

Diligent Research Practices Improve the Integrity of the Capital Markets

The lack of a readily apparent solution should not deter the SEC's advocacy of investors beyond additional disclosures. We support the SEC'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 SEC 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.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

[2] Ernst & Young's Recent white paper "Getting ROIC Right" proves the importance of a diligent calculation of ROIC and the superiority of our data and metrics.

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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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