MarketWatch

Opinion: No matter what Trump decides on the fiduciary rule, the standard will only gain strength

By David Trainer and Sam McBride
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What financial adviser wants to be seen as not putting the client's interests first?

Paramount Pictures/courtesy Everett Collection
There's always Jordan Belfort, played by Leonardo DiCaprio, in "The Wolf of Wall Street."

Many expect President-elect Donald Trump will undo the regulations that would hold all brokers and advisers to a fiduciary standard, requiring them to act in the best interests of clients.

We think investors' expectations for the fiduciary standard are here to stay no matter what the official rules say — and those investors will increasingly demand their advisers apply to their non-retirement accounts too.

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.

Accordingly, big wealth management firms like Wells Fargo WFC, +0.63% Morgan Stanley MS, +0.32% and J.P. Morgan Chase JPM, +0.29% have spent months preparing to comply with the rule, even though it has yet to take effect. Bank of America Merrill Lynch BAC, +0.17% is eliminating all commission-based options for retirement accounts, transitioning clients to fee-only options.

Nor should people be quick to assume a Trump administration will push for a return to the old ways in the wealth management industry. For one, killing the rule would actually take quite a bit of work and could face the threat of a Democratic filibuster in the Senate. While some of Trump's top advisers are strongly opposed to the rule, it's unclear whether Trump himself will want to spend political capital on a move that could hurt his populist image.

Read: Dear President-elect Trump: Please do right by investors

What does being a fiduciary mean? In a nutshell, advisers 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 advisers must show they have performed proper diligence for investment recommendations.

Can robo advisers manage your money and emotions?

(2:41)
In investing, giving in to your emotions can cut your return by about 1.56 percentage points a year. Should you leave the job to an emotionless robo adviser instead?

While the Labor Department has not provided specific guidance about exactly how advisers fulfill fiduciary duties while making investment recommendations, we think it means advisers need to rely on research that is both unconflicted and 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 doesn't 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.

There is no evidence to suggest that technical analysis works on any sort of consistent basis. A 2008 study from New Zealand's Massey University tested over 5,000 technical trading strategies and found that not one of them added value in a statistically significant manner.

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 at least avoids the conflict-of-interest concerns that plague sell-side research, but it lacks the requisite diligence to serve as the basis for an informed investing decision.

Sell-side research remains conflicted

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 haven't read any of those disclaimers, you should. Meanwhile, 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 could be in conflict with the actions (trading, advisory, underwriting, etc.) of the sell-side firm.

There are some incredibly smart and dedicated analysts on Wall Street who perform valuable research, and some of their research is unconflicted. However, one never knows for sure which reports are or are not conflicted since the same disclaimers warn of conflicts in every single report.

How to get the best financial advice

(4:09)
And how to make sure your advisor is acting in your best interest, not his. John Nersesian of Nuveen explains all the questions you need to ask, in light of new rules for financial advisors.

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 in which 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.

So how do advisers fulfill their fiduciary responsibilities?

While the new rules are principles-based and don’t provide discreet instructions as to what advisers should do to fulfill fiduciary duties, we think advisers cannot lose with clients or regulators by incorporating research into their practice that is:

- Truly unconflicted
- Inarguably in the best interest of clients

The first item is straightforward. Research needs to come from sources that are 100% unconflicted 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:

- Complete. All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed.
- Objective. There must be quantifiable analysis that supports the recommendation.
- Transparent. Advisors need to be able to show how the analysis was performed and the data behind it.
- Relevant. There must be a tangible, quantifiable connection to stock performance.

The hard part is that rarely in the history of our capital markets has there been research that meets all four requirements. But we don’t think that should mean investors do not get what they deserve.

No one can say at this point whether the fiduciary rule will be allowed to stand and if it does, how it will be interpreted. What we can say is that the push for this new rule shows 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 advisers are projected to grow assets under management by 68% compounded annually over the next few years.

We think wealth management firms and advisers 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”. 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.

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