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Danger Zone: Investors Who Don't Insist on Fiduciary Duties

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

"The DOL fiduciary really made the discussion of fiduciary for consumers mainstream. You can't un-ring that bell."

- Michael Kitces, Interview with Investment News, June 2, 2018

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

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

The DOL fiduciary rule is dead. After initially invalidating the rule in March, the Fifth Circuit Court of Appeals officially issued an order vacating the rule on June 21st. The SEC has proposed its own regulation to replace the DOL rule, but the proposed rule comes short of requiring a unified fiduciary standard.

While the scrapping of the fiduciary rule may have a short-term impact on the types of investment advice out there, Michael Kitces correctly points out that investors have been alerted to the potential shortcomings and conflicts of interest in the financial advice industry. It's now up to investors to make sure their advisor is held to a fiduciary standard.

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."

Demand Fiduciary Fulfillment from Your Advisors or Take Undue Risk

Even though the DOL rule has been killed, 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 by 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 no longer necessary. Increased transparency and investor education makes the rule redundant today. The mainstreaming of the debate around fiduciary duties means that investors are better able to make informed decisions about the financial advice they receive. In fact, assets are already overwhelmingly flowing to low-cost index funds and firms that hold to the fiduciary standard of care.

Clients Should 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 to fulfill fiduciary duties. Even the latest SEC proposal failed to put forward a clear definition of what fulfills 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, and Michael Kitces. They all agree that research the fulfills the Duty of Care should be:

- **Comprehensive**. It should reflect all relevant publicly available information (i.e. all 10-Ks and 10-Qs), including the footnotes and MD&A.
- **Objective**. Investors deserve unbiased research.
- **Transparent**. Investors should be able to see how the analysis was performed and the data behind it.

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The recipient of this report is directed to read these disclosures.

- **Relevant**. There must be some tangible, quantifiable connection to fundamentals.

In the past, it has been almost impossible to provide this level of diligence at a scale and cost that investors need. We think Robo-Analyst technology[1] enables a higher level of diligence at such a low cost that ignoring it is unethical.

As a result, we see a new paradigm for research, one that elevates the rigor and diligence behind all advice while keeping costs to a minimum.

The Conflicts of Using Traditional Research

This new paradigm for research contrasts with the existing model, which lacks transparency and leaves the door open for serious conflicts of interest.

In particular, sell-side analysts have an incentive to give positive ratings to companies with whom their employers do or want to do business. We recently highlighted how the significant cash burn at Netflix (NFLX) and Tesla (TSLA) leads the sell-side to issue positive ratings on those companies so they can underwrite bond deals for them in the future.

The sell-side also loves serial acquirers. Even though most acquisitions are overpriced and destroy value for shareholders, they provide lucrative fees the banks that work on them. As a result, it's in the best interest of sell-side analysts to stay in the good graces of companies that provide a steady stream of lucrative M&A work.

Investors that don't insist on a fiduciary level of service could find themselves pushed into flawed investments, such as the companies below, based on incomplete and conflicted research.

An Analyst Darling Investors Should Ignore

Abbott Laboratories (ABT) is one of the most prolific acquirers in the S&P 500, and the company considers these acquisitions to be a core part of its strategy. As ABT spokesman Scott Stoffel told the Chicago Tribune:

"Strategically shaping the company to compete and succeed through internal investment and M&A is part of our DNA."

ABT has spent ~$30 billion on acquisitions since 2013 – almost half of its invested capital. Unsurprisingly, the stock has almost universally bullish analyst coverage, with 16 of the 20 analysts covering the stock recommending it as a Strong Buy while just 3 rate it a Hold. No analysts have an Underperform or Sell rating on the stock.

The bullishness from analysts makes little sense when one considers the weak financial performance of ABT. The company's overpriced acquisitions have resulted in economic earnings falling from $125 million in 2013 to -$2 billion in 2017. Over that time, the company's total debt has increased from $8 billion to $23 billion.

It's even harder to make a straight-faced argument for ABT from a valuation standpoint. The stock has a P/E of 226, and the growth expectations embedded in the stock price don't look any better. To justify its valuation of $61/share, ABT must grow after-tax profit (NOPAT) by 21% compounded annually for 9 years. See the math behind this dynamic DCF scenario here.

Sell-side analysts have a consensus $70/share price target on ABT, but the fundamentals suggest a much lower valuation. If ABT can grow NOPAT by 10% compounded annually for the next decade, the stock is worth just $20/share today. See the math behind this dynamic DCF scenario here.

Another Highly Rated Stock with Red Flags

LogMeIn (LOGM) is another stock with questionable bullish analyst coverage. 9 of the 11 analysts covering the stock rate it a Strong Buy. Just 1 rates it a Hold, and none have an Underperform or Sell. The analysts have a consensus price target of $140/share, 36% above the current price.

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

LOGM takes the acquisition-driven growth strategy to an extreme. It acquired the GoTo business from Citrix (CTXS) for $3 billion in 2017. This acquisition accounts for over 90% of its invested capital. On top of this deal, LOGM continues to make smaller acquisitions, such as its $300 million acquisition of Jive Communications earlier this year.

These acquisitions have decreased LOGM's return on invested capital (ROIC) from 32% in 2015 to 2% over the trailing twelve months. Since ROIC is the primary driver of shareholder value,[2] it's clear that these deals have not been in the best interest of investors.

To justify its current valuation of $103/share, LOGM must grow NOPAT by 28% compounded annually for 14 years. To justify the analyst price target of $140, it must grow by the same rate for 17 years. See the math behind this dynamic DCF scenario here.

Despite the fact that LOGM's acquisition-driven strategy has been bad for shareholders and its valuation implies unrealistic growth expectations, sell-side analysts continue to support the stock. Any advisor that buys LOGM or ABT for their clients based on the conflicted recommendations of these analysts is not providing a fiduciary level of service.

Individual investors need to make sure their advisor is basing their decisions on diligent, unconflicted research that fulfills the Duty of Care.

This article originally published on July 2, 2018.

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

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[2] Ernst & Young's recent white paper "Getting ROIC Right" proves the link between an accurate calculation of ROIC and shareholder value.

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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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