DO FIDUCIARIES PRODUCE BETTER RETURNS?

By Louis S. Harvey

The legislative and regulatory activity since 2008 has been focused on increasing the fiduciary level of care to the investment market, motivated by the belief that investors are being injured - in spite of the protections that have been in place for decades. The superficial assumption is that investors will benefit from a fiduciary level of care.

While there has been extensive debate over the burden of proposed changes, the value of a shift to a universal fiduciary standard has barely been explored. The theory is that a fiduciary standard of care is simply better, but there has been very little discussion on the net effect such a standard will have on investor returns.

Certainly one could argue, if investment professionals put their clients' interests ahead of their own, the clients would be better off. The theory is simply that a fiduciary standard will lower the expense of investing and ensure that clients get the best recommendations. While the validity of this superficial hypothesis seems self-evident, there are a number of factors that will affect the real outcome for real people.

Consider first the construct into which the fiduciary standard is being introduced. The construct is that investments are sold, not bought. Unlike a car loan, mortgage or even a savings account or CD, investments are made after the investor is convinced to "buy". Very few investors actively seek and make investments without the motivation and urging of others through the selling process. Attempts at introducing fiduciary standards seek to draw a line between this urging of the investor to buy or sell (non-fiduciary) and making a recommendation to buy or sell (fiduciary). It is clearly unworkable to draw and enforce such a line.

A second consideration is the professional market. The pressure to lower expenses will make the business less attractive for professionals. If fiduciary standards are effective in lowering investor cost, it will also lower the compensation of professionals, making it less attractive to enter and remain in the field of work. This reduced supply of professionals will then cause prices to increase, thus undoing the initial lowering of expenses.

A third consideration is the compensation structure in use today. The structure in place today for fiduciaries is to use rates that vary based on portfolio value and are unaffected by the time or effort. A client that requires a high commitment of time is charged the same fee as a client who requires little attention. The current method of dealing with this problem is to require clients to have very high minimum balances in order to pay for the time involved, so that as fees decline, minimums increase. The result is that clients with lower balances remain un-served by fiduciaries.

An unsupported assumption is that lower expenses from a fiduciary standard of care will produce better investor returns. As with the preceding assumptions, this is highly flawed. In a practical sense, the threat of fiduciary breach leads professionals to be more risk averse and avoid investing in areas that produce the highest returns. While this movement to safety may not be in a client's best long term interest, it is virtually impossible to show a fiduciary breach of failing to make an aggressive recommendation.

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The four structural roadblocks of a) separating selling from recommending, b) the professional market, c) compensation limitations and d) professional risk aversion, must be addressed to have an effective fiduciary standard that increases returns for the investing community.

It is entirely unlikely that the legislative or regulatory community will address these structural issues, instead it is more probable that the blind force of regulation will continue to march forward and it will be up to the investment community to reform current practices to survive and thrive in the changing environment. The question is what can the investment community do to reform the structures that threaten business in a fiduciary environment.

a) Separating Selling and Recommending

While possible in theory, there is no practical way to establish processes that make a useful distinction between selling to an investor and recommending a security. Recognizing the futility of such a flawed approach, the reasonable course of action is to treat selling as a fiduciary act. This would apply the same standards of care to selling that regulators seek to apply to making recommendations. Universal application of a fiduciary protocol creates consistency in dealing with investors and protects the professional from fiduciary breach. The single fiduciary protocol reduces the growing complexity and cost of compliance and limits the professional's ability to build business.

b) The Professional Market

The number of available professionals may be severely limited by lowering compensation when a fiduciary level of care is used. Additionally, this lowering is clearly illogical and counter-intuitive. Investors would certainly be willing to pay a higher fee for the fiduciary. The solution to this hurdle is to revise compensation practices so that a premium is paid for a fiduciary relationship. This will require restructuring compensation to eliminate any potential conflict of interest while maintaining comparable payments. Several alternatives are available for such restructuring. The greater number of professionals will have the added benefit of serving more investors and will therefore eliminate shortages and the resulting price spikes.

c) Compensation Limitations

The irrational practice of setting prices independent of the service that professionals provide is another practice that makes a fiduciary protocol painful. In no other area of business is pricing disconnected from costs. Whether in manufacturing or service, consumers expect that the price of the goods and services covers the cost of providing them. The solution here is also quite simple. Use a pricing structure that reflects the time and skill level of the professional as well as the benefit derived by the investor. Rational pricing will reflect fees for services rendered in addition to compensation for achieving desired results. Results will depend on the investor's stated goals, whether they are asset preservation, stability or appreciation. Such a pricing arrangement will eliminate the need for minimums and permit investors to decide on the level and quality of support they need.

d) Professional Risk Aversion

The exposure to regulatory action, arbitration and litigation will limit the professional's willingness to introduce any but the lowest risk investment alternatives. Such a posture negates the value of the professional to create portfolios that reflect the investors' goals. The solution is to use a process in which the investor can make an informed decision, with full knowledge of the reasonable level of return and potential loss that can be expected. This decision- making process protects the professional and the investor when these critical factors are presented in a clear and concise way.

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An effective fiduciary protocol is not buried in arcane disclosures or complex mathematical formulas or buried in volumes of paperwork that very few investors bother to study. Effective protection is achieved through simple clear language that quantifies reasonable expectations in terms the investor can evaluate.

The Alternative

These four measures can reestablish the investment professional as a highly valued and well compensated contributor to the well-being of investors. With no need for regulatory changes, they remove the inefficiency of confusion, rationalize compensation and create the protection for risk-taking that is necessary to take advantage of market appreciation. The alternative is a growing conundrum of regulations, higher costs and diminished efforts to sell investments to the public.

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