

# A New Era for Financial Advisors as Fiduciaries

## Do You Measure Up?

By Ron Surz, CIMA®

*Editor's Note: The opinions expressed in this article do not reflect the opinions of IMCA or the Investments & Wealth Monitor editorial advisory board.*

**Fiduciary:** An individual in whom another has placed the utmost trust and confidence to manage and protect property or money. The relationship wherein one person has an obligation to act for another's benefit.

—*West's Encyclopedia of American Law*

Financial advisors want the trust but not the liability that comes with the double-edged sword of managing money as a fiduciary. Surprisingly, the government has enabled this dual pursuit of professional responsibility. Thanks to a regulatory quirk, many advisors have found it convenient to hide behind exclusions outlined in a 1974 definition of who is a fiduciary. But the jig is up.

On October 21, 2010, the Department of Labor (DOL) proposed changes to the definition of fiduciary, as outlined by the Employee Retirement Income Security Act of 1974 (ERISA). If approved, the updates to ERISA section 3(21)(A)—the provision that defines fiduciary status—will dramatically alter the relationships between advisors and their clients.

At the heart of the proposal is a substantial expansion of the definition of individuals and entities that are considered fiduciaries. The modification will affect a wide array of financial institutions and advisors such as plan sponsors, broker-dealers, consultants, and investment managers. Notably, the proposal's definition of a fiduciary

includes anyone who provides advice about the selection of persons to manage investments.

Investment manager selection is a fiduciary act, such as the selection of mutual funds and exchange-traded funds (ETFs). If you provide any of these services, you are a fiduciary. That may be old news for some financial professionals, but the fact remains that the new rule removes exclusions that many advisors have used to escape fiduciary responsibility, such as providing services exclusively in manager-search consulting.

In other words, DOL has been frustrated in its enforcement actions and now is seeking to eliminate the escape clauses that have thwarted its regulatory oversight. A new era is dawning.

Reinforcing DOL's sharper regulatory focus is the recommendation of the Securities and Exchange Commission (SEC) for a Uniform Fiduciary Standard of Conduct for Broker-Dealers and Investment Advisers. The proposal, released in January 2011, would hold broker-dealers to the same fiduciary standard as advisors when they provide investment advice. In particular, the SEC

... recommends that when broker-dealers and investment advisers are performing the same or substantially similar functions, the Commission should consider whether to harmonize the regulatory protections applicable to such functions. Such harmonization should take into account the best elements of each regime and provide meaningful investor protection (SEC 2011, 165).

For additional perspective, consider this interpretation of fiduciary responsibilities from a leading law firm:

Becoming a fiduciary of a Plan carries with it substantial duties, including those of prudence, loyalty, diversification of plan assets, and compliance with a Plan's governing documents. In addition, fiduciaries of Plans are subject to broad anti-self dealing provisions. For example, a broker that seeks to provide products and services to a Plan on a commission basis generally could not do so if the broker were deemed to be a fiduciary with respect to the Plan's assets. Further, most of the exemptions from ERISA and the Code's prohibited transaction rules that counterparties rely upon to conduct ordinary course business with Plans require that the service provider or counterparty not be a fiduciary. Consequences of a violation of these prohibited transaction rules can result in rescission, excise taxes, restoration of losses and other penalties. *It is not surprising that service providers would seek to be deemed to be fiduciaries by design and not by circumstance* [emphasis added] (Strook & Strook & Lavin LLP 2010, 1).

Despite the consequences, it doesn't matter—until it does. The arrival of a lawsuit, for example, usually refocuses priorities in short order.

Pre-emptive action to sidestep a crisis is preferable, of course. That starts



by recognizing that fiduciaries are supposed to be the best that they can be. Accordingly, many financial advisors face critical decisions regarding investment manager due diligence.

The three basic choices are the following:

1. Stop selecting managers.
2. Take a chance that the same-old-same-old due diligence will “work.”
3. Get serious about real due diligence.

Keep in mind that outsourcing manager due diligence does not protect advisors, even if you’re outsourcing to your employer. The buck stops with you, which inspires caution when it comes to outsourced due diligence that is less than first-rate.

Fiduciaries also need to recognize the difference between procedural prudence and substantive prudence. There is some protection provided by doing what everyone else does, which is procedural prudence—but not if there is clearly a better way, which is substantive prudence. Fiduciaries should not follow the crowd if they can do better. It’s the distinction between common practices and best practices. Best practices ultimately become common practices, but this usually takes time.

In the meantime, it’s easy to identify what to avoid. Here are some common practices that are known to be flawed. Fiduciaries should see a clear red flag when they encounter the following situations.

### Bundled is Bungled

Target date funds (TDFs) are not being vetted. The common practice is to blindly select your bundled service provider for no reason other than familiarity and convenience. Almost 75 percent of the \$450 billion in TDFs is invested with the three largest bundled service providers, despite a plethora of competing products. This might suffice if the objectives for these TDFs were well-conceived, but a careful review of these funds suggests otherwise. TDFs

are packaged for profit. The ending equity allocations of the “Big 3” TDFs range from 55 percent to 75 percent. In sum, they are way too risky and likely to lead to loss-suits in the next 2008.

The critical objective of target date funds should be preservation of capital. Don’t lose participant money, especially near the target date. No guarantees, of course, but this is a much more realistic objective than replacing pay or managing longevity risk, which are the common objectives for TDFs, even though these objectives are never committed to writing. Furthermore, TDFs should have investment policy statements because, as default investments, they are employer-directed. Fiduciaries choose TDFs. Participants, by contrast, do not choose TDFs and so they have no idea what the products are or how they’re designed and managed. Investment policy statements for TDFs should cover the following:

- Objectives: Deliver at least accumulated contributions plus inflation at the target date
- Glide path details: Asset allocation through time in both graphic and tabular form
- Expense estimates
- Performance expectations
- Fiduciary signatures

### Peer Groups are Weird Groups

Most manager-screening processes employ peer groups, requiring good performance rankings over certain time periods. Attribution analysis, i.e., understanding why performance is good or bad, is not included, but it should be (more on attribution below.) All Certified Financial Analyst (CFA) charterholders learn of the serious problems with peer groups: survivorship, classification, and composition biases render peer groups useless, and no one can make these biases go away. But everyone, including CFA charterholders, ignores these biases because it’s easy to leave them unchallenged. Decades of use have led us to ignore well-documented deficiencies. Marketers exploit this vulnerability by

finding a peer group that makes them look good. Ever meet a manager whose performance is below median?

Peer groups should be replaced by unbiased portfolio simulations that create all of the portfolios the manager could have held, selecting stocks from a custom benchmark. This is classical hypothesis testing that compares the actual manager return to the universe of returns that could have been earned. There are no biases in these scientific peer group substitutes, and they’re available days after the reporting period ends. Portfolio simulations integrate custom benchmarks with brilliant statistics to provide accurate success assessments.

### Style Boxes are Vile Boxes

Manager due diligence always should consider the alternative of passive investing. Why pay more fees than necessary? Most managers can be replicated with a blend of passive ETFs or mutual funds, but only index huggers compete directly with style indexes. Only index huggers live in style boxes, and they have tricked you into believing that tracking error is risk. The truth is that tracking error measures conviction. Also, many talented managers are liberated, executing their strategies as they best see fit, unconstrained by style boxes.

Fiduciaries should use custom benchmarks. Indexes are barometers of performance in a market segment, such as utilities or large-value stocks. Benchmarks are passive alternatives to active management, capturing the people, process, and philosophy of the manager. Blended indexes can serve this need, but the best indexes for this purpose are mutually exclusive (no security is in more than one index) and exhaustive (the collection of indexes covers the entire market). These are criteria set forth by Dr. William F. Sharpe (1988) for returns-based style analysis—they apply even more for holdings-based analyses. The Russell, S&P, and MSCI indexes do not meet these criteria, but Surz Style Pure®


indexes and Morningstar Style Indexes do meet these criteria.

### Attributions are Convolutions

Attribution analysis—determining why a manager has succeeded or failed—is the most important and forward-looking tool in the consultant’s toolbox, yet it is commonly contaminated by benchmark misspecification. In attribution, if the benchmark is wrong all of the analytics are wrong, so the key to accuracy is getting the benchmark right. Most attribution systems do not support benchmark customization, so the benchmark is rarely right because you are limited to standard off-the-shelf indexes. Some of these flawed systems purport to be accurate because they use daily data and/or they incorporate transactions. This confuses precision

with accuracy. The most-precise return calculations are important for measuring performance, but they are not all that is necessary for measuring attribution. A reliable attribution analysis employs the most-precise return calculations and the most-accurate benchmark. Both are essential.

### Conclusion: Putting It All Together

By now you should be saying, “That’s a lot of changes.” The good news is that it’s easy to move from flawed antiquated common practices to 21st-century best practices, including attribution analyses. You won’t need to look very far to distance yourself from your competition. 

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