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How Does The Industry Win Back Investor Confidence? The Management Of Fiduciary Responsibility And Liability Is The Key Which, In Turn, Compels The Industry To Define Advice

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New York Attorney General Elliot Spitzer has established the cost of violating the public's trust is quite high. With a $1.4 billion lesson on conflicted advice fresh in our minds, the question of whether investment research is a means to win investment banking business or a guide for advisors and investors in making informed investment decisions is no longer in doubt. In ignoring the best interests of the financial advisor and the investor, and in firms deferring to the powerful allure of massive investment banking fees, the hard-won public trust in investment research has been lost; and the stature of the financial services industry has been greatly diminished. The financial advisor and the investor have paid a terrible price for there not being a reasonable number of countervailing sell recommendations to buy recommendations. A chorus of industry figures, led by Charles Schwab and former SEC Commissioners Harvey Pitt and Arthur Levitt, view this loss in investor confidence as an abrogation of industry leadership. This is not about the second worst capital market on record. The capital markets could recover to pre-millennium levels, and the loss of confidence would still persist.

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Joe Grano, CEO of UBS PaineWebber laments, "The people who have made this business great [financial advisors] are losing their self-confidence. We will never regain investor confidence if we lose our own self-confidence." Many share Joe Grano's sentiment, but for the financial advisor, who has had to personally bear the loss of investor confidence, there is the unsettling sense that their supporting firms are really saying they want to add value but only if it means they don't have to do anything different. The events of recent years weight heavily on the financial advisor and the investor, and strongly suggest the industry needs to chart a new course, where there is no question that the investors' best interests are first and foremost in the hearts and minds of the firms which are supporting the financial advisor.

Financial services organizations, which support the financial advisor, largely determine the range of investment and administrative values the advisor addresses and manages. These organizations, as a consequence, have a leading role to play in winning back investors' confidence. There has never been a greater need for leadership as the industry finds itself at a crossroad. Action must be taken to restore confidence, or the industry's stature will continue to erode and will be further diminished. There is a disconnect between the firm supporting the financial advisor and the financial advisor. The investing public is holding their advisors accountable for account performance, but the financial advisor cannot, in turn, hold their firms accountable as firms, by choice, have not provided the financial advisor with the processes, technology, methodology, infrastructure or support necessary to add value. This is a heavy burden for the financial advisor to bear alone. The advisor has the responsibility to add value but has little support from their firms to fulfill their fiduciary obligations. This must be resolved if we are to see investor confidence and the public's trust restored.

It is hard to believe that today no major supporting financial services firm has empowered their financial advisors to determine the precise rate of return generated on all their clients' assets, custodied both inside and outside the firm. Though every firm would like to

say they add value, until their advisors can make an investment recommendation in the context of all their clients' holdings, both assets and liabilities, it is not possible for that advisor to know if that recommendation improved overall portfolio return, reduced portfolio risk or enhanced the tax efficiency, liquidity and cost structure of all their clients' assets as a whole. By extension, no major firm has empowered their financial advisors to address and manage risk. Advisors are not empowered to determine whether their clients are taking 150% of the market's risk for 50% of its return. Advisors are not encouraged to act in the investor's best interests in managing the cost of the investment vehicles used in portfolio construction.

To this day, many advisors do not know that mutual funds are three times more expensive than managed accounts and that ETFs and folios are 40% less expensive than managed accounts. Because of the historically high cost of data storage, which has long since been resolved, most brokerage firms and mutual fund companies do not have tax lot accounting systems; thus it is not possible for most financial advisors, particularly those principally using mutual funds, to even consider the tax implications and/or tax efficiency of their recommendations. Tax planning is encouraged, but only in the context of insurance sales, which often creates more problems than it resolves by the crippling performance realized in the assets held within insurance contracts and the associated loss of liquidity and their terribly high cost structure. Wouldn't it be in the best interests of the investor for advisors to focus on non-investment procedural solutions for estate planning, using trusts which do not require an investment in insurance? With the exception of tax efficiency for tax exempt accounts, all these values (risk, return, tax efficiency, liquidity and cost structure) are required to be addressed and managed under regulatory mandate (UPIA for individuals, ERISA for qualified plans, MPERS for public funds and UMIFA for foundations and endowments). So, if firms are putting the investor's best interests first, why aren't financial services firms providing all the associated processes and technology necessary to add value as required under regulatory mandate? Isn't the financial advisor giving +60% of their gross revenues to their firms in return for all the support they may need?

There are significant self-imposed, cultural, structural and technological impediments within brokerage, banking, planning and accounting firms that prevent the industry, as we know it today, from empowering the financial advisor to add value. Essentially, firms are afraid to acknowledge their advisors' fiduciary responsibility in making investment recommendations and have gone to great lengths to avoid any associated fiduciary liability that may accompany investment recommendations.

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Rather than assuming fiduciary responsibility, which would foster a much higher level of professional investment and administrative counsel, firms have chosen to absolve themselves from being responsible for any advice at all. This greatly diminishes the stature of the industry and role of the financial advisor.

Financial services firms maintain that any advice rendered by their financial advisors is incidental to their role in providing trade execution services. Thus, no advice is rendered, no fiduciary responsibility is assumed, and no fiduciary liability is incurred. Financial services firms are simply in the business of executing trades for a commission. Therefore, there is no associated obligation of the firm to help the financial advisor to add value through the purchase and sales of securities. Firms are not structured to help advisors address and manage overall portfolio values, like risk or return, which would incorporate all client holdings. Firms can help if an advisor wants to sell a specific product like a mutual fund or annuity, but they can't determine if it adds value. The entire resources of firms are marshaled to structure new account forms, contracts and arbitration procedures to avoid fiduciary liability. But in not assuming fiduciary responsibility, by extension, it is not possible for advisors to add value in the context of their fiduciary obligation mandated by public policy and thus, the haunting conundrum that the industry *must* resolve. The transparency of the internet is making account performance clear to the investor. The investor expects value to be added, but the industry's fear of fiduciary liability precludes the advisor from adding value, which has led to a loss of investor confidence that will continue to erode until the industry acknowledges and assumes its fiduciary obligations for its clients. Rather than managing fiduciary liability in a manner that would facilitate high level advice, it is being managed in a manner that denies advice is even being rendered. Adding value and fiduciary responsibility go hand-in-hand. Only by managing fiduciary liability is it possible for one to add value. Thus, depending upon how well a firm manages fiduciary liability, one can determine how well a firm is supporting their advisors. It is clear the industry is not structured to add value, but that is not because of a lack of investor interest or because advisors are not interested in their client's well-being, it is because firms have not acknowledged their fiduciary responsibility and have not marshaled their resources in support of the financial advisor adding value.

It is very easy for investors who are called by their broker and/or advisor and are sold a stock or a mutual fund, to actually believe that their advisor was recommending an investment. But, in fact, by virtue of all the documents governing the client relationship, the advisor was only executing a trade on an investment of which the advisor had made the investor aware. Essentially, the firm maintains no advice was rendered. Though the firm is

technically right, because of how it has structured the client relationship, the consequence of avoiding fiduciary responsibility and associated fiduciary liability is that no value can be added. The loss in investor confidence has occurred not because the industry was not vigilant in the protection of the integrity of investment research, it has occurred because the transparency of the internet has made it clear that brokerage firms are structured to facilitate trades in volume, not to add value. *Caveat emptor* ("buyer beware") is not a viable value proposition in the age of account transparency, particularly at a time when firms fuel a much higher level of client expectation with their advertising. Investors don't want to be their own investment counsel yet, the reality of the marketplace is that there is no process, technology or investment discipline in place that would foster the financial advisor addressing values in accordance to their fiduciary responsibilities. This is why commission brokerage rates are declining. If no counsel is being provided and no value is being added, then why would one pay retail brokerage commissions in the hundreds of dollars for trade execution that can be obtained for a flat fee of $10 or less? This is why financial advisors who have taken the initiative to create the processes and technology necessary to add value and who are engaging their professional investment counsel for an on-going advisory fee are fairing far better than those engaged in commission sales. The point of creating an investment policy statement is to manage fiduciary liability through defining the role and scope of responsibilities of the advisor, the client and the money manager. If the firms supporting financial advisors were to spend as much time, effort and resources managing fiduciary liability as they have in denying fiduciary responsibility, the industry and the advisor would be greatly elevated.

The conventional product management support infrastructure within financial services firms is designed to provide an unlimited stream of attractive sales stories that offer the promise of extraordinary returns. Yet, the conditions and circumstances in place that made those investment returns extraordinary can never be sustained. That is why, by definition, those returns were extraordinary. The result is the investor buys high on the promise of extraordinary returns, only to be disappointed when those returns do not materialize. The investor then sells low and repeats the cycle again and again. This is why there is a huge difference between investment returns and investor returns as documented by Dalbar and Morningstar research. In a bull market that generated +15% returns for +15 years, the average rate of return in a commission brokerage account was 6%, while investors with no professional assistance achieved a 5% return on their own. In a bull market those in commission sales provide their investors with far more exposure to the downside of price movement than the upside, which is only exacerbated in a bear market. Supporting firms assume no accountability for investment recommendations and are structured to facilitate trades in volume, not to add value. If firms are not keeping track of investor performance, it is very likely no value is being added. The advisor has been put in a situation where, if they were adding value, they wouldn't be able to determine it, as there is no infrastructure in place to discern the values added; and thus, the financial advisor's exposure to the loss of investor confidence is extremely high. All clients who expect value to be added, expect accountability. Is there anyone who doesn't want value to be added?

In order for the financial services industry to win back investor confidence, it must acknowledge and assume its fiduciary responsibility and empower the financial advisor to add value. Only in addressing and managing a broad range of investment and administrative values, as required under regulatory mandate, is it possible for the industry to add value and thus, manage fiduciary liability. There is no short cut – either you are or you are not fulfilling your fiduciary obligations. Today only a very small number of financial advisors are capable of working within the regulatory framework of UPIA, ERISA, MPERS and UMIFA in engaging their professional investment and administrative counsel for an on-going advisory fee. These senior investment management consultants constitute just 2% of the 250,000 active licensed financial advisors in the U.S. or about three-quarters of 1% of all 750,000 licensed advisors in the U.S., but they advise 25% of all U.S. assets. We have the good fortune to count many of these senior consultants as readers of this publication. Working primarily at the upper end of the high net worth and the institutional markets, where fiduciary responsibility is viewed more seriously, these 5,000 investment management consultants are the only constituency of financial advisors who continue to grow their business at a double-digit clip in today's challenging investment environment where commission sales are down 52%. Though it is clear to all that clients prefer value to be added, the reality of the marketplace is that the industry must find 140,000 advisors who are capable of adding value for the 14 million households who have more than $100,000 in investable assets, where fee-based professional investment counsel is economically viable (200 accounts averaging $250,000, with a fee of 1% – net of asset management cost – generates $500,000 in gross revenues). In order for the industry at-large to restore investor confidence, it must, in fact, be able to generally add value en mass. Investor confidence has been lost and the public's trust will be difficult to win back unless all firms and all advisors are legitimately prepared to add value. Anything less than a true world-class effort will only further erode public trust and further diminish the industry's stature. In an industry that has a long and storied history of terminating employees who would even suggest that advisors have a fiduciary obligation to their clients, there is little in place that fosters adding value and little understanding of what is entailed in adding value. This is particularly true if one is to go beyond what is required by regulatory mandate to qualitatively execute best practices. Thus, the financial advisor's conundrum: "Is it possible

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for institutions that are structured to avoid fiduciary responsibility to empower the financial advisor to add value, thus restoring public trust?" It is possible but not probable. An external catalyst is needed to simplify the complexity of the management of fiduciary liability that would lower the self-imposed, insurmountable hurdles within the industry that impede firms and their advisors from fulfilling their fiduciary responsibilities. We cannot rely on firms for this innovation because it is counter to their deeply entrenched culture, structure and technology. Yet this innovation must occur in order to restore public confidence. Thus, the innovation must occur outside of firms, with firms then having a simpler choice of deciding whether they wish to add value or not. We know that investors prefer that value be added and that enterprising advisors and firms will likely follow suit.

The key to regaining investor confidence is in managing fiduciary liability, and the key to managing fiduciary liability is creating standards for professional investment and administrative counsel. This would allow fiduciary liability to be effectively managed so fiduciary responsibility can be readily assumed, and a broad range of investment and administrative values can be addressed and managed as required under regulatory mandate. Assuming one's fiduciary responsibility means that one should elevate their professional investment and administrative counsel so that fiduciary liability can be managed. To that end, the Society of Senior Consultants (an affiliated group of this publication) in concert with our industry's most accomplished investment management consulting practitioners, leading technology development and venture capital firms, along with the Center for Fiduciary Studies and Dalbar, have created a high net worth standards initiative which will develop a standard for professional investment and administrative counsel for the high net worth and ultra high net worth market segments. The establishment of standards for professional investment and administrative counsel for the high net worth market segments will resolve many of the challenges associated with regaining the public's trust. The high net worth market starts at $1.3 million in assets, when estate taxation becomes an important financial consideration that must be managed. The ultra high net worth market starts with $25 million in assets, where client service supersedes financial service.

The purpose of the high net worth standards initiative is threefold. First, it provides a framework for fiduciary liability to be effectively managed, which will foster firms and advisors to assume their fiduciary responsibility, greatly elevating the level of professional investment and administrative counsel provided. Second, it defines best practices and delineates the enabling technologies necessary to address and manage a broad range of investment and administrative values, providing an invaluable context for firms and advisors to understand how all these technologies work together in one cohesive process. The technological blueprint is invaluable for technologists and venture capitalists alike. This funding of worthy technology has been extremely inefficient. The industry doesn't need yet another $20 million managed account wrap fee program platform; it needs an electronic asset/liability study, etc. There have been many excellent technologies that have not fully realized their commercial potential because the marketplace either did not fully appreciate their application and/or uncommon sophistication was required to use the technology, which was not manifested in the marketplace. Yet these technologies, when integrated into one easy-to-use process, are essential to one fulfilling their fiduciary responsibilities, adding value and reducing the labor intensity of professional investment counsel. Third, it creates a parallel group of venture capital and technology firms that are interested/engaged in developing/integrating the technologies necessary to add value and manage fiduciary liability. This makes the concept of standards less abstract as there is a practical technological application that will result, which facilitates the execution of high level professional investment counsel.

The Society of Senior Consultants, Dalbar, leading consultants and industry authorities have previously created standards for the foundation and endowment and the defined contribution market segments. Yet, by not directly tying those initiatives to managing fiduciary liability, and by not including leading technologists who would foster the development of enabling technology that would make high level counsel possible to execute for all financial advisors, those earlier standards just reflect high level counsel for those who were already capable of executing at a high level. The high net worth standards initiative is designed to empower all financial advisors through expert systems to address and manage values that would otherwise not be humanly possible to manage by virtue of either the technical skills required and/or the extraordinary administrative detail that is required to be managed. Leveraging the financial advisor through technology is the key for the industry to assume its fiduciary responsibility, manage its fiduciary liability and regain public trust.

If this were the medical industry, the order of magnitude of this innovation, taking the industry from it not being possible to add value to adding value, would be widely applauded because the focus of the medical industry is the patient. The hope is that the financial services industry is equally concerned about the investor's well-being and that this standards initiative will be equally well received. If not, the same self-interests that caused the loss in investor confidence will only further erode the industry's stature.

We understand the challenge. The product management organizational structure firmly entrenched within financial services support organizations is very difficult to change. Subordinating all the product and service areas to an objective investment process that empowers the financial advisor to manage fiduciary liability and add value is culturally, structurally and technologically disruptive. Money, power and status are at risk for the product constituencies that drive the industry. Thus, it is far from certain that the investors' and advisors' best interests will prevail. This is why advisors feel their firms are saying they are all for advice and adding value, but only if it means they don't have to do anything different. This takes us back to the root cause of loss in public trust: the firm's interests supersede that of the investor. Yet, the investor doesn't care how disruptive adding value may be culturally, structurally or technologically. They just want their advisors to add value.

The high net worth standards initiative aligns the interests of the investor, financial advisor, technologist, venture capitalist and the financial services industry. The investor will always prefer value to be added than not, and the financial advisor, who has worked so hard to establish relationships and build credibility with investors, are best served by aligning their interests with investors. The missing link has been the technology and support infrastructure that would support the financial advisor in their efforts to address and manage a broad range of investment and administrative values as required by their fiduciary responsibilities to the investor. By the high net worth standards initiative establishing best practices in defining advice for the high net worth market segments, it creates a means to manage fiduciary liability, reduce the labor intensity of advice and importantly, provides a blueprint for technologists and venture capitalists that would foster the technology (electronic asset/liability study, investment policy statement, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation) necessary for all financial advisors to fulfill their fiduciary responsibilities. This greatly elevates the counsel and professional stature of the financial advisor, wins back investor confidence and restores faith in the financial services industry. We invite all financial advisors, all financial advisor support organizations, all financial service technology development firms and supporting venture capitalists to join us in elevating the financial advisor and the counsel they provide.

The evolution of the financial services industry toward adding value and the financial advisor engaging their professional investment and administrative counsel for an on-going advisory fee is irreversible because adding value and fulfilling one's fiduciary obligations is far superior value proposition than one not doing so. The firms and advisors who are early adopters (see "Crossing the Chasm," *Senior Consultant,* Sept/Oct 2002) clearly have a competitive edge. In today's difficult investment environment are the seeds that will allow the financial services industry to again grow and prosper. Let's all work toward that end. ■