Do you know of a place where you just feel good about being there? It just feels right, everyone feels at ease.

Near my home as a teen there was a place like that! A clear spring fed lake. Everyone wanted to be there. People came from all around to vacation there. Teenagers and families with small children spent their summer days there. Men spent the early mornings fishing in the deep cold water bringing up delicious meals of Walleye Pike; firm Bass and luscious Pan Fish. The water was clear and cool in contrast to the soft sandy beaches littered with large beach towels, girls trying to get that perfect tan and little children playing in the warm sand.

In contrast, on a farm where I grew up there was a river that ran through our property. Sometimes my brother and I would try to fish there. We would pull out bony Carp and wriggling slimy Bullheads. The fish smelled bad and no one really wanted to keep them. My sister went wading in the water and came out with muddy leeches stuck to her. Mom had to extract them with the hot end of a match. No one really wanted to spend a lot of time near that river.

Mud hides and deceives, the waters become unclear!

Conflicts of Interest Muddy the Investing Waters.

Clarity is important to help investors successfully reach financial goals!

When my partner and I left our broker dealer relationship it was for lack of clarity. At least to us it seemed, the message was the client’s financial goals were not first, the broker dealers financial goals were first! We feel there were often conflicts of interests. The public shareholders, the company, the production of revenue through selling product, the special relationships of revenue sharing, and our manager’s wishes for higher payouts were ahead of what was best for the client. Yes, we had to cover the company’s liability with all kinds of disclosure and legal language which “proved” the “client had agreed” that the investment product was “suitable” for them. Oh yes, protecting the company from the client was also put before the clients best interest.

This is the issue at hot debate now. Brokers and insurance sales persons are held to a “Suitability Standard”. Brokers and insurance sales people have an important place. Some people would rather have a sales relationship rather than a long term consultative adviser relationship.

The Investment Advisers Act of 1940 established a higher standard for those who would hold themselves out as investment advisers, a “Fiduciary Standard”. It is important to remain faithful in guarding the clarity of the fiduciary standard.
Our former company did not like the idea of us holding ourselves out as fiduciaries. In fact, they took great lengths to tell us in many ways we were not investment managers, we were purveyors of products, sales people!

I have no problem with companies distinguishing themselves with this difference. However, the waters were muddy. The broker dealer exception, advice that is only incidental and recent attempts to stir up changes to the Fiduciary Standard muddy the waters.

The fact is, commissioned brokers and insurance sales persons, want to be seen by the public as having their client’s best interest first, while working within a framework of suitability.

At least in outward appearance, everyone I know in the financial services industry wants to be seen that way. They see themselves as acting in their client’s best interest, yet not being able to hold themself out as a fiduciary. It’s Unclear! The waters are muddy! Confusing!

There needs to continue to be a clear distinction between acting as a fiduciary adviser and selling a suitable product!

Investment success is not found in product purchases or a series of suitable products. Investment success is found through faithful and vigilant choices made in the investor’s best interest throughout life.

Investing clarity is faithfully implemented through holding pure the fiduciary standard.

I want to illustrate this difference, between the fiduciary standard and the suitability standard, by talking through the four major contributors to investment return. These four factors are investor behavior, asset allocation, portfolio construction and manager selection.

**The Fiduciary Duty and Investor Behavior.**

With all respect to Harry Markowitz and William Sharpe, the client relationship and, holding the client to a long term investment strategy, is the most important contributor to investment return. You can read about this phenomenon through many studies. A good source is a paper written by Philip Z. Maymin and Gregg S. Fisher published in the spring 2011 Journal of Wealth Management. The title of the paper is; “Preventing Emotional Investing: An added value of an Investment Advisor”: [http://www.iijournals.com/doi/abs/10.3905/jwm.2011.13.4.034](http://www.iijournals.com/doi/abs/10.3905/jwm.2011.13.4.034). Building this type of a long term trusted relationship is easily and openly developed when you hold yourself out as an; Independent, Fee Only, Investment Adviser; or a Fee Only, Financial Planner.

The relationship becomes somewhat muddy and less clear when you are looking to offer a suitable product to sell. The sales person’s livelihood and their family’s wellbeing are tied to moving on to the next sale and the next person. Product sales by nature are an “on to the next person” arrangement. This works well in buying a car or a washing machine, it may not be the best option in making an investment. Most financial professionals I know have several hundreds of people to whom they have sold products, they are conscientious and well-meaning, but the relationship is clearly not one of a fiduciary nature.
They simply cannot spend hours and hours every year building the level of relational trust that it takes. Many of these conscientious financial representatives either burnout, neglect their families or are weeded out by the Broker Dealer for lack of production to the firm. I know this to be true by experience, my initial relationship with the firm I left was in teaching and training new financial representatives.

The clear need is for a fiduciary relationship where the investors pay a fee for the professional investment adviser who has dedicated themselves to put the client’s best interest in front of their own. A long term professional relationship that builds enough trust, where the client will act on the adviser’s recommendation, over and sometimes against their emotional reaction is needed. This kind of relationship adds value to the investor and increases odds of overall investor success. The benefit becomes clearer when the investor has given over in complete confidence and ease, giving that fiduciary adviser discretion over the investments. A fiduciary relationship allows for a sense of wellbeing and comfort.

A sense of caution is warranted, this trust must be earned over a long relationship, built over time, tested through transparency and demonstrated by verifiable result. This kind of trust cannot be handed over lightly or complacently, it must be developed. This benefit is an added value offered by a fiduciary relationship. This kind of relationship is clearly not able to be achieved through a product sales and purchase. This is only built through a long term advisory relationship.

The Fiduciary Duty and Asset Allocation

Modern Portfolio Theory tells us that our investment allocation is a major long term contributor to investment return. The problem comes in that asset allocation, by the very nature of investment environments and investor need, must be dynamic and not static in order to produce desired results. One simple variable like time to investment goal is in constant flux. Strategic Asset Allocations as well as possible accompanying Tactical Asset Allocations must be regularly monitored, reviewed and adjusted. The benefits of rebalancing or reallocation are documented through several different sources. See the following link: [http://www.qfinance.com/asset-management-best-practice/the-case-for-smart-rebalancing?page=1](http://www.qfinance.com/asset-management-best-practice/the-case-for-smart-rebalancing?page=1). Also, much of the benefit is derived from protecting the client’s portfolio from risk of large declines. See the following links from Research Affiliates: [http://www.researchaffiliates.com/Our%20Ideas/Insights/Fundamentals/Pages/S_2012_Oct_The_Role_of_Risk_in_Asset_Allocation.aspx](http://www.researchaffiliates.com/Our%20Ideas/Insights/Fundamentals/Pages/S_2012_Oct_The_Role_of_Risk_in_Asset_Allocation.aspx). And: [http://www.researchaffiliates.com/Our%20Ideas/Insights/Fundamentals/Pages/F_2012_July_Why_We_Dont_Rebalance.aspx](http://www.researchaffiliates.com/Our%20Ideas/Insights/Fundamentals/Pages/F_2012_July_Why_We_Dont_Rebalance.aspx).

In fact, beyond asset allocation strategies more and more research is pointing to the practice of risk budgeting or establishing a risk allocation. This process can even have more impact upon long term investment return results. The increasing use of risk allocation as a tool for helping investors achieve desired returns through taking less risk is highlighted in the July, 14th Wall Street Journal in a piece written by Ben Levisohn and Joe Light entitled “Same Return, Less Risk”: [http://online.wsj.com/article/SB10001424052702304821304577438361425353648.html](http://online.wsj.com/article/SB10001424052702304821304577438361425353648.html).
Risk must be measured in absolute terms as loss of purchasing power and not in the terms of relative measurements. Therefore risk to the investment advisor who takes on the role of a fiduciary must be viewed as real loss of principle; measured by sustainability of purchasing power. James Montier of GMO has written a white paper detailing the need for this view of risk in a white paper “The Seven Immutable Laws of Investing”: [http://av.r.ftdata.co.uk/files/2011/03/JM_SevenImmutableLaws_312.pdf](http://av.r.ftdata.co.uk/files/2011/03/JM_SevenImmutableLaws_312.pdf).

I have heard many times the quote attributed to Warren Buffett; “The number one rule of investing is, don’t lose money and the second rule is, always remember the first rule”!

An entire paper could be written on Asset Allocation and for that matter also on Behavioral Finance, Portfolio Construction and Manager Selection. Many such studies have been documented. So I will move on.

There is an inherent conflict in a one off or series of financial sales transactions based on a suitability standard. No matter how conscientious the sales person the long term basis for continual monitoring and adjusting risk is not built into the relationship of purchaser to sales person. Market Risk, Political Risk, Interest Rate Risk, Company Risk and a whole host of other considerations are pushed off to the side. The sales process is first, not the client’s best interest!

**The Fiduciary Duty and Portfolio Construction**

Portfolio construction is both an art and a science. Non-correlated investments are the building blocks of diversification and risk management. Consideration must be taken on how correlations contract and traditionally non-correlated assets become more closely correlated during extreme times of market stress. How the investment adviser constructs portfolios must be adjusted and readjusted to stress inputs. This is highlighted in a study by State Street entitled “Rethinking Asset Allocation”: [http://www.fwalliance.com/whitepapers/SSGA%20-%20Rethinking_Asset_Allocation_6.30.10.pdf](http://www.fwalliance.com/whitepapers/SSGA%20-%20Rethinking_Asset_Allocation_6.30.10.pdf).


Our firm put our model portfolio through a stress test of balance and performance by outside CFA analysts about a year ago. In their analysis, evenly one half of the portfolio diversification they classified as “Risk Reducing Investments”, the other half as “Return Enhancing Investments”. To our reassurance and confirmation, they did not advise much tweaking or change in the portfolio.

Traditional measurements of Alpha Ratios, Sharpe Ratios, Correlations, Sortino Ratios, Standard Deviation, Beta and other measurements within the tool box of Modern Portfolio Theory can add clarity. These tools must measure the effectiveness of piecing the entire portfolio together, as well as each individual piece of the investment portfolio picture.
My partner compares portfolio construction to making salsa. The tomatoes, peppers, onions, herbs and spices alone probably aren’t going to leave a good taste in your mouth. Blended together the ingredients really leave a good taste and a sense of comfort and ease.

Portfolio Construction is a process not a product. Financial product sales people cannot be placed in the boat with the adviser who adheres to a fiduciary standard. The waters are already muddy as brokers and insurance sales people hold themselves out as financial advisors. The fiduciary standard must, for the sake of the investing public, be held with clarity, unmixed without mixing from the mud of exceptions and change. The high standard of doing the best thing for the investor above the adviser’s best interest needs strong defense.

**The Fiduciary Duty and Manager Selection**

The Investment Adviser acting as a fiduciary to the investor, as we have detailed, must go through a complex process. This process is not a sales process or learning to overcome buying objections. It is an investment management process; the next step is choosing and monitoring the investment managers.

In the process of choosing a manager, even if using a passive management, there are considerations to be made.

Whether you sit on one side of the passive and active debate the investment adviser acting as a fiduciary must stay informed of how the investor’s portfolio is performing and the risk involved in that performance.

If you stand in the conviction that passive investments are optimal, is there a place where fundamental weighting, equal weighting or a quantitative index modeling might add value? Whatever your choice there is analysis to be done. If you are choosing a capitalization weighted index product realize your exposure is dominated by very few, probably highly correlated investments.


In the active management space, is the manager truly exhibiting an active process that adds to risk adjusted benefits over an appropriate benchmark?

Recent studies show many people paying for active management are over paying for passive management. In a paper entitled, “The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance” written by Martijn Cremers, Miguel Ferreira, Pedro Mato and Laura Starks, the


A second measurement to help in identifying the benefit an active manager may be providing is highlighted by Martijn Cremers and Antti Petajisto is called “Active Share”: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=891719.

Fi360, Lipper, Morningstar and others give scores and analysis to investments that are publicly traded, more due diligence may be needed for private and non-traded investment management options. There is a need for numerous checks and balances. This is a start, however manager selection must move beyond counting stars and past performance. These are simple measures and help to sell products but do little to tell us if we should use that manager to complete our portfolio construction.

Again, at the danger of being redundant, risk measures must be employed. These measures must be stress tested within extreme market conditions to highlight this see the article in Index Universe, written by Bruno Monnier and Ksenya Rulik “Risk Efficiency In Bull and Bear Markets”: http://www.indexuniverse.eu/europe/publications/journal-of-indexes/articles/8017-risk-efficiency-in-bull-and-bear-markets.html?fullart=1&start=6.

**Filter Investment Advice through a Clear Fiduciary Standard**

Even if the financial sales person is well trained and has advanced professional designations our experience is they are discouraged from acting as a fiduciary or an investment adviser. The water is muddied with promotional products which the broker dealer highlights for sales. The incentives might be from contests to receive some personal financial gain, in the added adjustment in payouts tallied on a scorecard, to maintain an approved title such as Wealth Manager or impact of these incentives to recognition. All these promotional financial products, of course, must appear suitable to the client. In addition when one investment product offers a more favorable payout than another product to the financial sales person the waters are muddied.

Both the spring fed lake and the muddy river from my past were needed and useful in different ways. The two should not and never will be confused with one another. They both received water from somewhere else; they were a receptacle like the investor. It is important to distinguish what is received. The fiduciary investment advisor and the financial sales person who looks to suitability are conduits to investments, the filters are quite different.
The muddy river, which ran through our farm, received run off from farm fields, dirty trenches and ditches. The water was not filtered. This water gathered whatever it could of impurities. Eventually it ran into deep enough rivers that the silt and dirt were deposited and finally into a lake.

The cool clear lake, which everyone flocked to, received water from a deep underground spring. The water had been filtered time and again by forcing through rock, stone and sand. It was a rigorous trip but the water came out clear and clean. There is a constant clear flow into the lake feeding other lakes and rivers. I wouldn’t want to see those waters become muddy and lose clarity. It would be tragic. It would be an irretrievable loss.

It would be even more tragic if the fiduciary standard became muddied and unclear. It is hard work and it takes a lot of skill and experience at filtering the silt out of investments and investment portfolios in order to do what is best for the investor. I wouldn’t want there to be additional confusion to what the difference is between an investment process built upon the fiduciary standard and an, invest product sales transaction based on a suitability standard. The loss to the reputation of the investment industry would be irretrievable! I would not feel right or at ease in those muddied waters.

Roger Willroth is a Principal at Marrs Wealth Management LLC. We are located in Ames, Iowa. Marrs Wealth Management is an Independent Fee Only Registered Investment Advisory Firm. We custody investor assets at multiple custodians including Charles Schwab, TD Ameritrade, TIAA CREF and an Independent Trust Company.