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Economic Commentary

The New “Fiduciary Rule”

On June 9, 2017 the Labor Department put in place new regulations affecting the relationship between investment professionals and their clients who have assets in retirement portfolios. The essence of the regulation is that advisors must put their clients’ interests first, ahead of their own interests. This is a higher standard than the previous Securities and Exchange Commission (SEC) requirement that investments must be “suitable” for the clients. This upgrade in standards is welcome, in my view, and the compliance manual at my firm has conformed to this standard since the inception of the firm in 2010.

The reason these regulations are being instituted by the Labor Department and not by the SEC is based on the Labor Department’s jurisdiction over these issues. The Employee Retirement Income Security Act (ERISA) became law on Labor Day 1974. This law affects the pension and profit sharing plans of corporations, union health and welfare funds, and state and local pension funds. Among other things it sets forth the requirement that individuals will have a vested interest in their pension benefit after ten years of creditable service. Later that vesting period was reduced to five years.

The key to understanding the requirements under ERISA are in the definitions. For instance, how many hours of work are necessary to qualify for a year of creditable service? The answer is 1,000 hours, about 125 (8 hour) workdays, or roughly six months. Another example, what is the definition of a fiduciary? The answer under ERISA, is almost anyone who has a connection to the pension plan. Corporate trustees such as banks, are obviously fiduciaries. Brokers who sell securities to pension funds are also defined as fiduciaries, even though their relationship is purely transactional. In some cases the actuary who develops the investment returns needed to fund the future liabilities of the pension funds can also be viewed as a fiduciary.

In the 43 years since ERISA became law, the retirement funding environment has changed significantly. Previously most retirement plans were of a defined benefit nature, meaning the sponsor, or employer, assumed the risks associated with guaranteeing a fully funded plan that could meet all its prospective obligations. At present, most retirement plans are 401-K type defined contribution plans where the individual participant selects the investments and thus bears the risks associated with those choices. At retirement, many of these 401-K plans are rolled over into individual IRA type plans. For many people, an individual IRA is their only retirement savings account, as they are not covered by their employer.

As a result of this change in the retirement investment environment, there are a great number of relatively small accounts coming into existence, attested to by the fact that 10,000 “baby boomers” turn 65 each day. The retail brokerage industry has operated in this market for decades and has learned how to profitably service this market segment.

In a typical case, an individual contacts a local broker who has passed SEC mandated examinations to prove his or her competency in the area of investments. There is a

meeting and the customer may be asked to fill out a questionnaire to assess his or her financial objectives, and tolerance for risk in the form of volatility of the value of the person's portfolio. The broker listens to the customer and utilizes his or her firm's "model" for selecting investments for this type of customer. Up to this point, the process is both sensible and appropriate. However, the selection of investments is where the upgrade to a fiduciary standard is necessary.

Assume the broker and the customer agree that a mix of 50% in common stock mutual funds covering the full range of possible investments, and 50% in bond mutual funds is appropriate. The question becomes which class of stock should be utilized to fulfill the agreed upon objective. Class "A" shares for most mutual funds carry a sales charge of 5-7%. Other classes may have no sales charge but charge a higher annual fee. Some mutual funds have charges to principal, so called "12b-1 fees," that pay for promotion of the mutual fund through advertising.

I have reviewed IRA type portfolios for prospective clients for decades prior to opening my own firm. What I have invariably found is that the mix of mutual funds in these IRA portfolios are all Class "A" shares. In almost every case, the portfolio mix has not been adjusted from the inception of the account. This leads to the conclusion that a customer with a $300,000 mutual fund portfolio at inception, in effect paid his broker/advisor $15,000 to provide the initial structure, and nothing since then. In a few cases I have seen brokers charge an ongoing "monitoring" fee, usually a fixed amount per month, and payable from funds outside the IRA portfolio.

The defense for this approach is that the investment choices are "suitable" for the customer, and that is clearly the case in most instances. However, when "suitable" investments result in a substantial up front payday for the broker/advisor, it is appropriate to ask whose interests are primarily being met.

A fiduciary standard would require that, at least in some cases, the broker/advisor would choose a no-load option, an index based mutual fund, or an index based Exchange Traded Fund. The broker/advisor in this case would thereby demonstrate a higher standard of conduct in which he puts his customers' interests first.

That is how we invest for clients at Beplat Asset Management and we welcome the rest of the investment community in joining us in fulfilling this standard of practice.

Raymond A. Beplat, CFA
President