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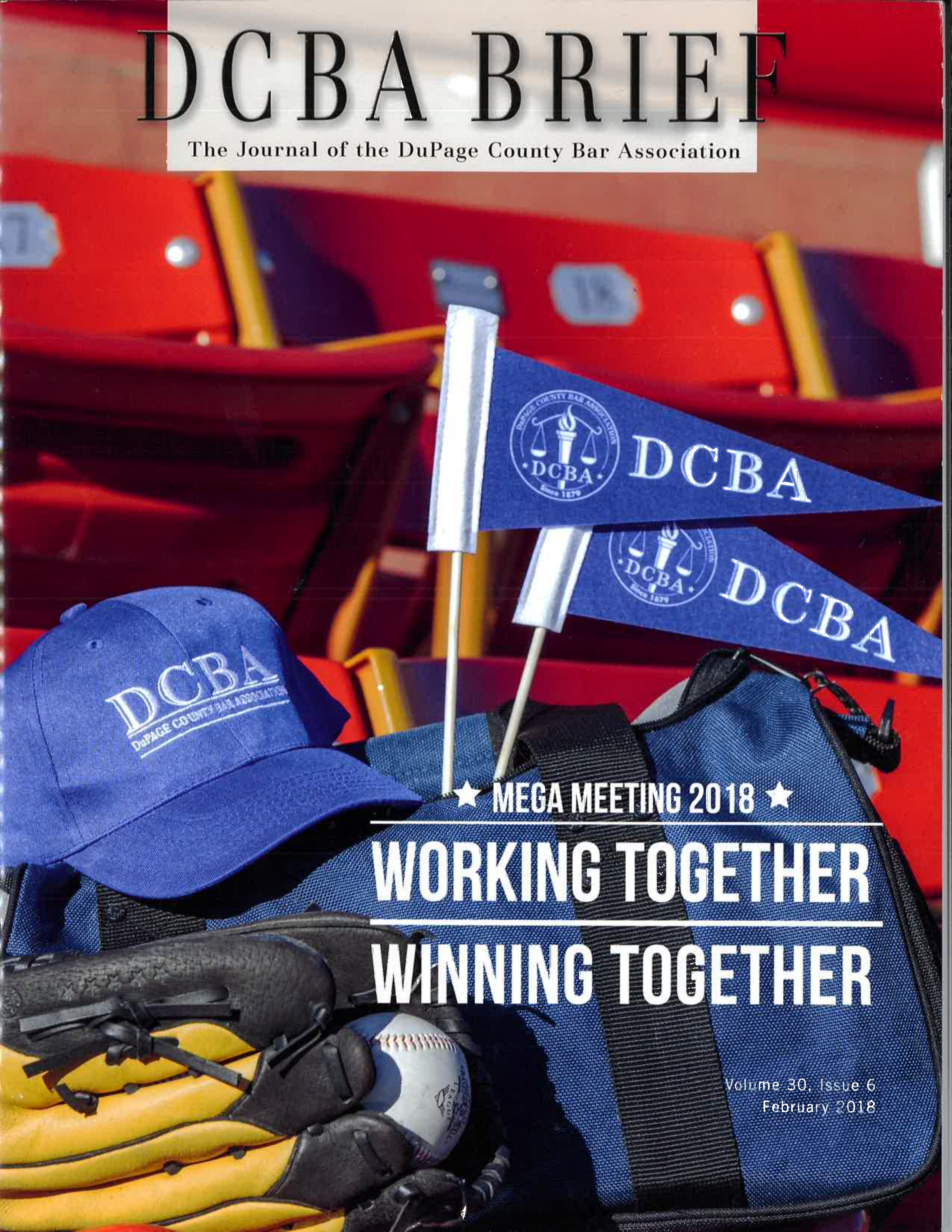

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FIDUCIARY INVESTING: SEEK PRUDENCE, NOT PERFORMANCE

By: William Hardesty

There is a significant volume of statistical data proving that no investor can consistently beat (out-perform) the returns of the stock market,[1] yet, individual investors and fiduciaries with investment responsibility continue to invest, or are advised to invest, in high-cost, actively managed mutual funds.[2] Often, those buying managed funds, directly or through a broker, unnecessarily and unknowingly pay fees and expenses that benefit the person who sold the fund. When brokers and other financial intermediaries, including corporate fiduciaries, benefit financially from using high-cost managed mutual funds, and fiduciaries commonly use those funds on behalf of beneficiaries, The U.S. Department of Labor, courts, and statistics say that a conflict exists and beneficiaries do not get what they are paying for.[3] If prudence truly guides fiduciary investment decisions, these issues must be addressed honestly and the warnings of the experts must be heeded.

[1] Lance Roberts, *Dalbar 2017: Investors Suck at Investing & Tips for Advisors* (September 26, 2017). "In 2016, the average equity mutual fund investor underperformed the S&P 500 by a margin of -4.70%. The bond market realized a return of 2.65% while the average fixed income fund investor earned 1.23%. In 2016, the 20-year annualized S&P return was 7.68% while the 20-year annualized return for the average equity fund investor was only 4.79%, a gap of -2.89% annualized." https://seekingalpha.com/article/4109442-dalbar-2017-investors-suck-investing-and-tips-advisors

[2] Most fund-invested assets are held in "managed" mutual funds. Managed funds use experts to pick the fund's investments. Managed funds charge investors for cost of those experts. Morningstar Direct (July 31, 2017) http://blog.spdrs.com/post/investing-is-never-passive-active-vs-passive-investing-series-part-1

[3] See Larson v. Allina Health Sys., D. Minn., No. 0:17-cv-03835, complaint filed 8/18/17. See also, Ajay Khorana, Henri Servaes and Peter Tufano, Mutual Funds Fees Around the World, Oxford University Press, The Society for Financial Studies v 22 n 3 (April 19, 2008) "In the United States, recent legal settlements have been accompanied by fee reductions, and a spate of lawsuits allege that fund managers and fund trustees breached fiduciary duties by approving fees to retail investors that are excessive."

BELLWETHERS EVERYWHERE

In light of the statistical evidence readily available to fiduciaries[4], prudent investment standards,[5] recent ERISA fiduciary fee litigation[6] and the Department of Labor's new "fiduciary rule"[7], it benefits fiduciaries, beneficiaries, and those who represent them both, to take a serious interest in how much managed investments cost beneficiaries and if managed fund costs are justified. While common in the ERISA universe,[8] suits for breach of fiduciary duty regarding investment fees and costs against individual or corporate fiduciaries are not so common. Investment related expense litigation may be concentrated in the ERISA world now, but the attention paid to standards of prudence and the mandates of best-interest investing will inevitably creep into the private fiduciary service world and result in suits. Excessive or unjustified investment fees and costs, at minimum, are more easily identified by beneficiaries today, leading to more informed beneficiaries. Informed beneficiaries sue.[9] Chances are, if the investor is using managed funds, the data will not justify the paying for managed investment.

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[4]All the performance and fee information used for this article is readily available to anyone concerned with fee erosion and paying too much for increased investment performance that statistically will never manifest. See: Jill Schlesinger, *You Can't Beat the Market, So Stop Trying,* CBS MoneyWatch (July 5, 2012). https://www.cbsnews.com/news/you-cant-beat-the-market-so-stop-trying/, see also, SEC Office of Investor Education and Advocacy, How Fees and Expenses Affect Your Investment Portfolio, SEC Pub. No. 164 (February 2014).

[5] 760 ILCS 5/5 (6) The trustee has a duty to invest and manage trust assets as a prudent investor would. "The circumstances that the trustee may consider in making investment decisions include the expected total return (including both income yield and appreciation of capital), and the duty to incur only reasonable and appropriate costs."*)*

[6] See *Larson v. Allina Health Sys., D. Minn., No. 0:17-cv-03835, complaint filed 8/18/17*. See also, Ajay Khorana, Henri Servaes and Peter Tufano, *Mutual Funds Fees Around the World,* Oxford University Press, The Society for Financial Studies v 22 n 3 (April 19, 2008) "In the United States, recent legal settlements have been accompanied by fee reductions, and a spate of lawsuits allege that fund managers and fund trustees breached fiduciary duties by approving fees to retail investors that are excessive."

[7] 29 C.F.R. 2509, 2510 and 2550. See also, 80 F.R. 21928. This "DOL rule" automatically makes fiduciaries out of financial professionals who work with retirement plans or who provide retirement plan advice. The Department of Labor's (DOL) definition of a 'fiduciary" requires advisors to put their clients' interests above their own and always act in the best interests of their clients. Advisors can no longer sell investments to benefit themselves unless they disclose the commission structure. Advisors did not have this duty before the rule. The rule was originally part of reforms proposed in 2010, but it was quickly shut down in 2011 due to strong opposition from the financial industry.

[8] See *Tussey v. ABB, Inc. 746 F.3d 327 (8th Cir. 2014)*. U.S. District Court found breaches in an ERISA case wherein higher expense classes of investments were chosen based on fees, the fund company was also paid for plan services at rates higher than market costs. See also *Gallus v. Ameriprise Financial, Inc., 561 F.3d 816 (8th Cir. 2009).* The court concluded that the plaintiffs failed to prove that Ameriprise's 12b-1 fees were too large. See also *Gartenberg v. Merrill Lynch Asset Management Inc., 694 F.2d 923 (2d Cir. 1982).* The court found fees were not ''disproportionately large.''

[9] *Daniels v. Morgan Asset Management, Inc., 743 F. Supp. 2d 730 (W.D. Tenn. 2010)* Plaintiffs alleged that fiduciary breached duties by investing trust and custodial assets in shares of expensive and poorly performing mutual funds and then failing to disclose fees and other compensation that the bank allegedly received from the funds. See also *Richek v. Bank of America, NA (N.D. Ill., 2011)* Plaintiff alleges that fiduciary transferred cash to shares of mutual funds that had undisclosed fee arrangements with the fiduciary that directly paid that fiduciary fees at a cost of 35 or 45 "basis points.".

“MANAGED” MUTUAL FUNDS

“Managed” mutual funds utilize one or more investment professionals (fund managers) who provide investment research, choose the investments held within the funds, and actively manage those investments over time. Fund managers are paid from the mutual fund for their efforts based upon a percentage of the fund's average assets under management. This means that the more investor dollars in the fund, the more they are paid. As a result, paying those managers for active fund management adds to the overall cost to own managed funds.[10] One professional has called active fund management fees the “last bastion of gluttony.”[11] Consider also that, even though there have been cost-reducing efficiencies created within the investment industry, investment advisor fees have remained as high as they were many years ago. “It’s as though the advisor industry has made no gains in productivity over the past 20 years.”[12]

“PASSIVE” INVESTMENTS

“Passive” investments, like exchange traded funds and mutual funds that track an index, do not use fund managers and simply hold assets that mirror the rise and fall of a market index. A benefit of not using managers to run investments in the passive fund is there is no one to pay. The result is a mutual fund that performs as well as the market itself and costs investors much less to own. Since passive fund performance does not vary wildly from the performance of the market it tracks, there is little potential for outperforming the market.

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[10] While individual investment in stocks and bonds may also be actively managed by paying for investment advice or allowing a professional to actively manage such a portfolio, the focus of this article is on managed or passive mutual funds and exchange traded funds (ETF). Mutual funds are staple in the fiduciary investment management and personal wealth management spheres. The data relied upon here is derived from mutual fund research and news articles regarding mutual funds. ETF funds are low -cost investments that track an index and perform similarly to passive index funds.

[11] JOHN F. WASIK, *The Erosive Effect of Expenses on a Portfolio’s Value.* New York Times (October 16, 2013) at Page F2. Quoting Rick Ferri, president of Portfolio Solutions in Troy, Michigan.

[12] Id.

It is important to note that there is always a need for investment advice from an investment professional when investing, so therefore, investing is never totally passive. "A decision on where to allocate capital always takes place, and that is an active one. What is lost in almost every 'active vs. passive' debate is that…the choice to seek the exposure [to passive investments] was not made on autopilot."[13] Advisors and other investment professionals add value when choosing the asset mix, via the asset allocation they use, using fundamental investment skills and acting as a guide to the uninitiated. The usefulness of picking investments in an effort to generate better than market performance, on the other hand, is not where these professionals fair well over time.

SELF-INTEREST FUELS AN "ACTIVE VS. PASSIVE" DEBATE

The loudest voices in favor of paying for active management are not statistical researchers or investment academics; but are the active fund managers, investment advisors/brokers, and professional fiduciaries who benefit from the sale or purchase of those managed funds.[14] Advisors want managed investments to thrive because they have an economic interest in the sale of those funds. Active fund managers argue that they earn the higher investment costs because of the higher returns they might produce. Corporate trustees can justify benefiting from managed fund ownership via statute.[15] Individual fiduciaries, who are often ignorant of the all-in costs,[16] might not be seeking to justify the costs at all. These positions would change if someone forced

[13] Matthew J. Bartolini, *Investing is Never Passive,* State Street Global Advisors (September 18, 2017) http://blog.spdrs.com/post/investing-is-never-passive-active-vs-passive-investing-series-part-1

[14] For example, trustees can take 12b1 fees paid to them by the fund, fund managers share in the fees charged the fund owner based on total assets in the funds, and advisors who sell the funds benefit from commissions and 12b1 fees. *See also* Doreen Martel, *How Do Stock Brokers Get Paid - By Whom?* (February 23, 2011). http://www.brighthub.com/money/investing/articles/107720.aspx "In all cases, those who are wondering how stock brokers get paid and who pays them should be aware that the customer is always paying the stock broker. While on the surface it may not appear this way…"

[15] 760 ILCS 5/5.2 "Neither a trustee nor its affiliate shall be required to reduce or waive its compensation for services provided in connection with the investment, management, and administration of the trust estate…a trustee may receive Rule 12b-1 fees equal to the amount of those fees that would be paid to any other party."

[16] Roger Edelen, Richard Evans and Gregory Kadlec, *Shedding Light on Invisible Costs: Trading Costs and Mutual Fund Performance*. (January-February 2013). Financial Analysts Journal. "[regarding expense ratios] it captures only the visible (i.e., reported) costs of mutual funds. Funds incur a host of 'invisible' costs that are less transparent to investors…"

investment professionals and fiduciaries to justify selling or buying a fund that carries high fees, yet does not produce better performance.[17]

According to Richard Ennis,[18] a Chartered Financial Analyst, the "potential payoff from active management has waned over the past 60 years, but the price of active management is at or near its all-time high."[19] Some estimate that investors lose around 1.50% of their investment return each year because of "mistiming" of the market.[20] John Bogle, the founder of Vanguard, has said "we're paying people to beat the market when they aren't doing it, and when you think about it, that doesn't make sense."[21] The debate has motivated research. That research has exposed the fact that people are paying for benefits that, statistically, will not materialize. Experts and academics have reported this data for years. Their findings are making their way to the consumer. The expert reports and consumer concerns are no longer falling on deaf ears.

THE TRUTH IS OUT THERE

The fund companies themselves are starting to recognize that high fees are under fire and word is getting out about lacking performance. The fee issue is significant enough to pressure fund companies to create new, cheaper mutual fund share classes for investors.[22] According to Credit Suisse, a world-wide investment management firm, Blackrock[23] stated that they do not expect their

[17] Richard M. Ennis, CFA, Are *Active Management Fees Too High?* Financial Analysts Journal Vol. 61 No. 5 (September 2005). Advisors for retirement plans are forced, per the new DOL fiduciary rule, are forced to disclose their financial interest and justify their investment choices and recommendations.
[18] Richard M. Ennis, CFA, founded Ennis, Knupp & Associates and has more than 30 years of experience as an investment consultant and is sought as an expert witness in fiduciary and investment litigation.
[19] *Id.*
[20] Steven Goldberg, *Investors Lose Big with Market Timing* (July 19, 2010) http://www.kiplinger.com/article/investing/T041-C007-S001-investors-lose-big-with-market-timing.html. Market-timing is a form of managed investment wherein investment buy or sell decisions are based on predicting future market prices.
[21] *We Asked an Investing Legend If Mutual Funds Are Doomed and His Answer Was Just Brutal* by Rachael Levy Jan. 25, 2017, available at http://www.businessinsider.com/vanguards-john-c-bogle-on-active-managers-going-out-of-business-2017-1 7
[22] Rebecca Lake, *Will the Fiduciary Rule Save Investors Money?* (May 19, 2017), https://money.usnews.com/investing/articles/2017-05-19/will-the-fiduciary-rule-save-investors-money
[23] BlackRock is a mutual fund company and is the world's largest investor with $5.1 trillion invested.

manager's past high performance to be replicated, and they are responding with a plan to cut $30 million in fees on some of their actively managed funds.[24] The mutual fund industry is also creating "clean share" funds that fee only for the management and operation of the fund, and will not pay compensation to the distributors, broker-dealers and retirement-plan providers selling the funds. Fund 12b-1 fees, which are ostensibly used for fund marketing expenses by the recipient, were also removed from these "clean" shares.[25] If these funds are now labeled "clean" by the fund company that created them, what would they label the remainder of their funds that have not addressed fees?

SPIVA®,[26] in a recent study looking at the statistical chances a managed fund can repeat benchmark-beating performance, found a tiny 4.03% of large-cap funds, 5.88% of mid-cap funds, and 5.75% of small-cap funds out-performed the market "over five consecutive 12-month periods. Random expectations would suggest a repeat rate of 6.25%."[27] This data reveals that anyone choosing a managed fund would have to find those exact high-performing funds in the vast sea of available investments to actually beat the market. If past performance is not a guarantee of future performance, how would an investor know what funds to choose? Even the Securities and Exchange Commission (SEC) has taken it upon themselves to publicly warn investors about fee erosion and investment performance.[28] With fees having such an impact on investment returns, a

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[24] Rachael Levy Mar, *The World's Largest Fund Manager Just Sent a Message to Investors Everywhere* (March 29, 2017). "Credit Suisse said in a research note: 'These changes reflect a lower confidence in the ability of human stock-picking in large-cap US equities, and also signal that the value proposition for US active equity funds with management fees…need to be adjusted lower to compete effectively with low-cost passive options in the retail channel'." http://www.businessinsider.com/blackrock-cuts-active-management-fees-and-moves-to-more-data-science-2017-3

[25] Daisy Maxey, *Clean Shares' Get a Boost from Fiduciary Rule*, The Wall Street Journal, (May 26, 2017) https://www.wsj.com/articles/clean-shares-get-a-boost-from-fiduciary-rule-1495808073. Corporate trustees and individual brokers benefit from 12b-1 fees.

[26] SPIVA stands for "Standard & Poor's Indices Versus Active" and are publicly available statistical comparison reports found here: https://us.spindices.com/search/?ContentType=SPIVA

[27] *Does Past Performance Matter?* - SPIVA ® The Persistence Scorecard - June 2017

[28] "As you might expect, fees and expenses vary from fund to fund. A fund with high costs must perform better than a low-cost fund to generate the same returns for you. Even small differences in fees can translate into large differences in returns over time." https://www.sec.gov/fast-answers/answersmffeeshtm.html

fiduciary, acting in the best interest of the beneficiary, not only has the duty to pick prudent mutual funds, but also understand and justify the costs associated with the investments chosen.

While it is common for a fiduciary to charge a conspicuous fee for services, it is not at all common for, say, a corporate trustee or investment agent to provide a robust investment-related cost disclosure or drill-down into the minutia of managed mutual fund expenses when meeting with attorneys, potential clients or beneficiaries. A significant amount of blame for this belongs with the individuals seeking fiduciary services. For individuals and fiduciaries alike, identifying the "true" cost of investing is often difficult due to the 'hidden" nature of those costs.[29] They simply do not know about the fees and do not ask the fiduciary about them.

Assume, for example, a fiduciary is required to invest $10,000.00 for a child who will receive the investment account after a 20-year period. If the fiduciary chooses a managed mutual fund portfolio that will produce, before expenses, a 10% annual rate of return and carries annual fund operating expenses of 1.5%, the account would grow to approximately $49,725.00. However, if the fund operating expenses could be reduced to .5%[30] by using passive investments, in 20 years, the beneficiary would ultimately receive approximately $60,850.00. Keep in mind the fiduciary may be charging an additional 1.00% fee for fiduciary services rendered for the beneficiary[31] and might also be receiving soft-dollars and 12b-1 fees as a direct result of holding managed funds.

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[29] Roger Edelen, Richard Evans and Gregory Kadlec, *Shedding Light on Invisible Costs: Trading Costs and Mutual Fund Performance*. (January-February 2013). Financial Analysts Journal *Shedding Light on Invisible Costs: Trading Costs and Mutual Fund Performance*, (January-February 2013). Financial Analysts Journal. "[regarding expense ratios] it captures only the visible (i.e., reported) costs of mutual funds. Funds incur a host of 'invisible' costs that are less transparent to investors—most notably, the transaction costs associated with implementing changes in portfolio positions."

[30] Passive portfolios can perform as well as the market for even less than illustrated. The Principal Global Investors Large Cap S&P 500 Index Inst Fund (PLFIX) carries a .16% investment expense, their mid-cap index fund (MPSIX) costs .21%, their small cap index (PSSIX) costs .20%, and their international index fund (PIDIX) costs .30% to own.

[31] All investment costs referred to in this article should be considered as additional expenses to any fiduciary or advisory fees charged.

When a 1.00% fiduciary fee[32] is added to the 1.5% (per the example) investment expenses, the result is that a portfolio would have to generate a 2.5% return just to break even.

PERFORMANCE IS NOT ALWAYS PRUDENT

While better investment performance can offset the impact of mutual fund fees and expenses, performance is a very difficult factor for a fiduciary to research and control. In addition, it is arguable that performance should not be driving the decision at all.[33] To illustrate the point, consider that a fund producing a 6% return, carrying a 2% cost to own it, will produce a net 4% return, while a "lesser performing" index fund may return 5% but costs only .5% to own, netting the owner 4.5%. The beneficiary in the example, or a court, might find fault, not in the "performance" of the underlying investments, but the impact fund fees had on the resulting portfolio. In other words, the beneficiary might argue that to act in the best interest of a beneficiary, a trustee must endeavor reduce the costs related to the investment of the assets or be able to justify the investment costs incurred. The beneficiary's position is not far-fetched.[34]

[32] PRICECOMPARE ™ Pohl Consulting and Training, Inc. May 30, 2017. Fiduciary service providers, like trust companies acting as trustee or investment agent, commonly charge fees based on the market value of the assets under management. Fees for services range from 1% to 1.30%, with large market fiduciaries charging the highest fees. In a metropolitan market, a $5 million portfolio, on average, suffers a .97% fee. Small-market and rural fiduciary fees average a .67% fiduciary fee for the same $5 million. Fees are commonly reduced as the portfolio market value increases.

[33] 760 ILCS 5/5 (2) "The prudent investor rule is a test of conduct and not of resulting performance."

[34] *Larson v. Allina Health Sys., D. Minn., No. 0:17-cv-03835, (complaint filed 8/18/1).* This is an ERISA complaint for breach of fiduciary duty due to: the choice to use higher cost investment options in the ERISA plan were damaging to participants; allowing the use of proprietary funds in the plan; failing to replace poor-performing, higher cost investment options with nearly identical, lower-cost, better- performing options readily available in the marketplace; and failing to provide proper disclosures of fees and expenses paid to others.

WHAT TO DO

With greater public attention focused on investment costs, and the tremendous amount of evidence that paying for managed investments is futile, it is time for investment advisors, trustees, investment agents and other fiduciaries with investment powers, to take hard look at "all-in" investment costs. Fiduciaries acting in the best interest of their beneficiaries need to be ready to walk away from high-cost managed investments or be ready to justify their investment choices and disclose everything. It is advisable that fiduciaries utilize a benchmarked process, comparing managed and passive investments, to ensure they use prudent investment choices. The benchmarking process benefits the fiduciary and the beneficiary by providing a transparent way to document and communicate fees and expenses. The "process" is often more important than the result when it comes to prudent investment analysis anyway.[35]

Beneficiaries and those advising them should look deeper into the true costs of investing, ask fiduciaries if they have a vested interest in the investments chosen, and actively seek fiduciaries who invest only in the beneficiary's best interest. Not many fiduciaries will volunteer this information because they are not required to do so. Not taking these steps can be detrimental to the financial self-interest of both beneficiary and fiduciary. After all, the DOL is already making retirement advisors do just about all of this,[36] beneficiaries are now more informed than ever, relevant ERISA fiduciary litigation is prevalent, fund companies are acquiescing to their consumers and the performance data, and, most-importantly, prudence has always required it.

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[35] 760 ILCS 5/5 (2) "The prudent investor rule is a test of conduct and not of resulting performance."

[36] 81 FR 21002. The Department of Labor's (DOL) definition of a 'fiduciary" requires advisors to put their clients' interests above their own and always act in the best interests of their clients as a condition of receiving compensation that would otherwise be prohibited under ERISA and the Code. Advisers must adhere to enforceable fiduciary conduct and fair dealing with respect to advice. "The exemption is designed to cover a wide variety of current compensation practices, which would otherwise be prohibited as a result of the Department's Regulation extending fiduciary status to many investment professionals who formerly were not treated as fiduciaries." Advisors to plans must adopt policies and procedures that reasonably mitigate harmful conflicts of interest, and disclose their conflicts of interest and the true expense of their advice.