When Fiduciaries Control The Money

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Topics

- Foundational context for the fiduciary standard
  - Why it exists: Great expectations and long-held beliefs
  - How it is applied and governed
  - What it requires
- The evolution of capitalism
  - The rise of fiduciary capitalism
  - Implications for investing and for society
- Implications for you – the path forward for the professional advisor

Why the fiduciary standard exists?

"…[W]e cannot do everything ourselves; different people are more capable in different matters.

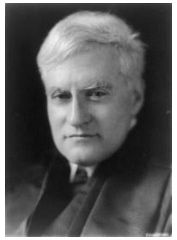
…[I]n cases where we ourselves cannot be present, the vicarious faith of friends is substituted; and he who impairs that confidence, attacks the common bulwark of all men, and as far as depends on him, disturbs the bonds of society…"

Cicero, 106-43 BC,
Oration For Sextus Roscius of Ameria

"A trustee is held to something stricter than the morals of the market place.

… Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

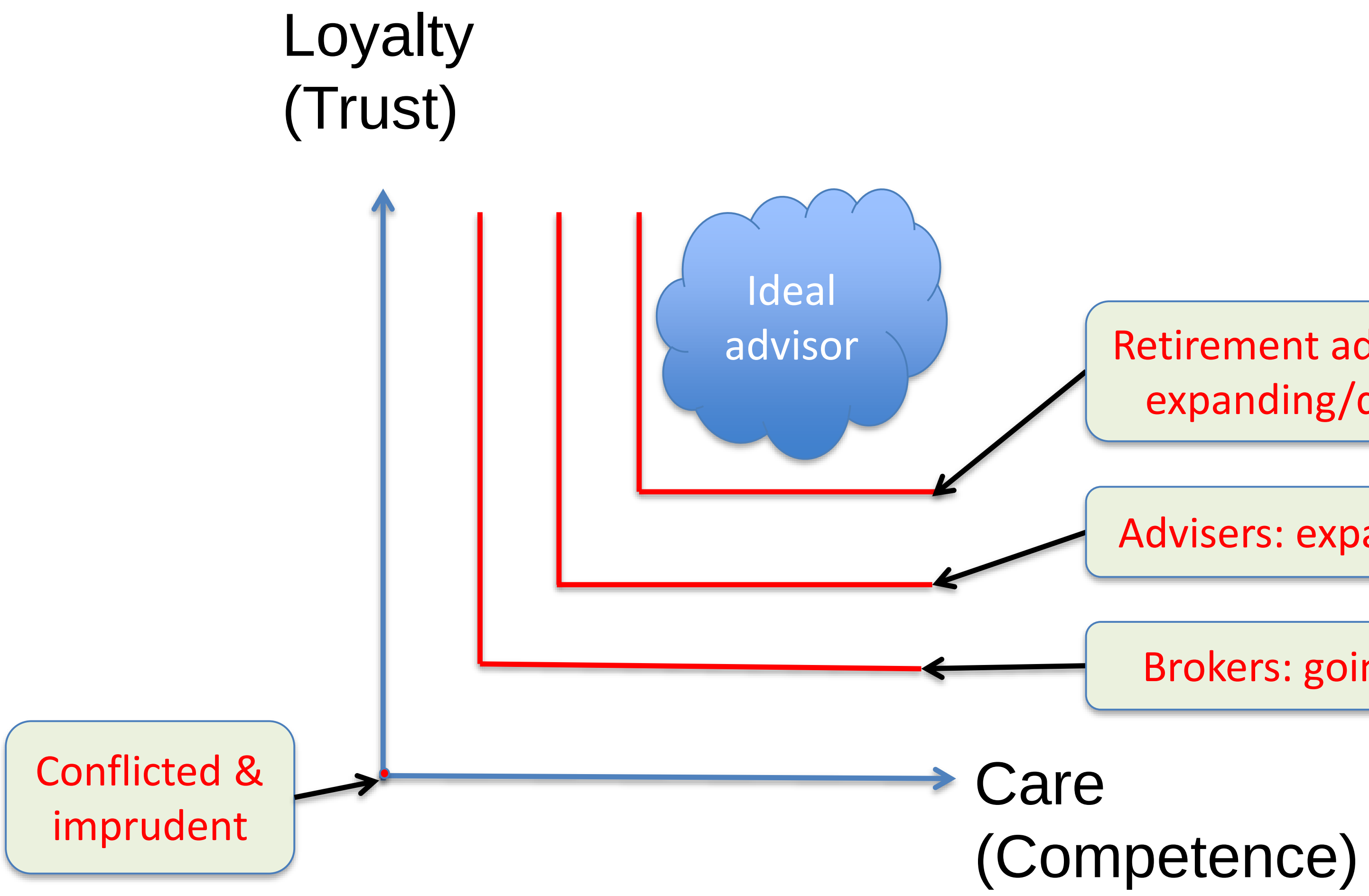
Justice Benjamin Cardozo,
Meinhard v. Salmon, 1929



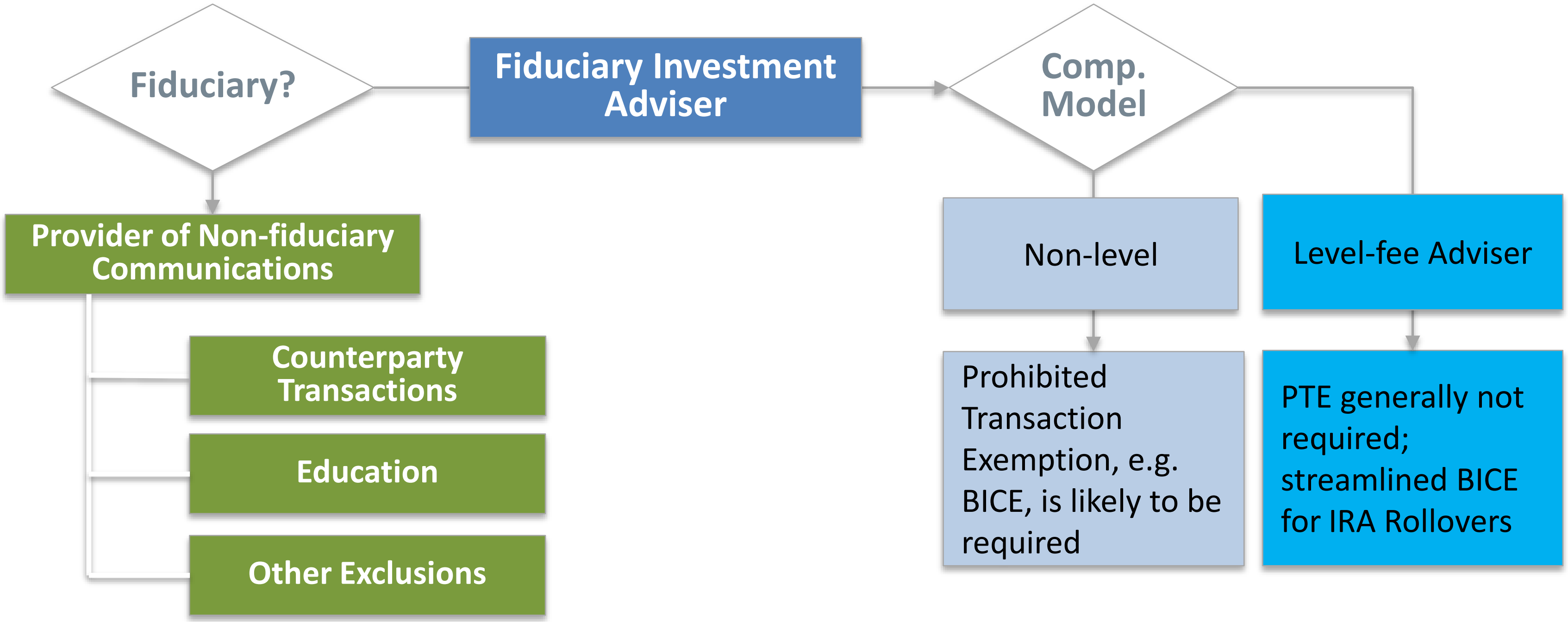
Counterparty transactions and advice are very different

Attributes	Counterparty Transactions	Personalized Advice
Relationship involved	“Arms-length”	“Trustee/entrustor”
Conflicts	Conflicts acknowledged; Parties serve self-interests	Conflicts must be resolved to serve the client’s interest
Information balance	“Sophistication gap” is narrow; buyer beware	Relationship of ceded control or reliance; high vulnerability
Standard of care	Rules of the marketplace; suitability	Fiduciary; suitability plus the Prudent Person Rule
Regulatory regime	Rules-based	Principles-based

Regulating marketplace conduct



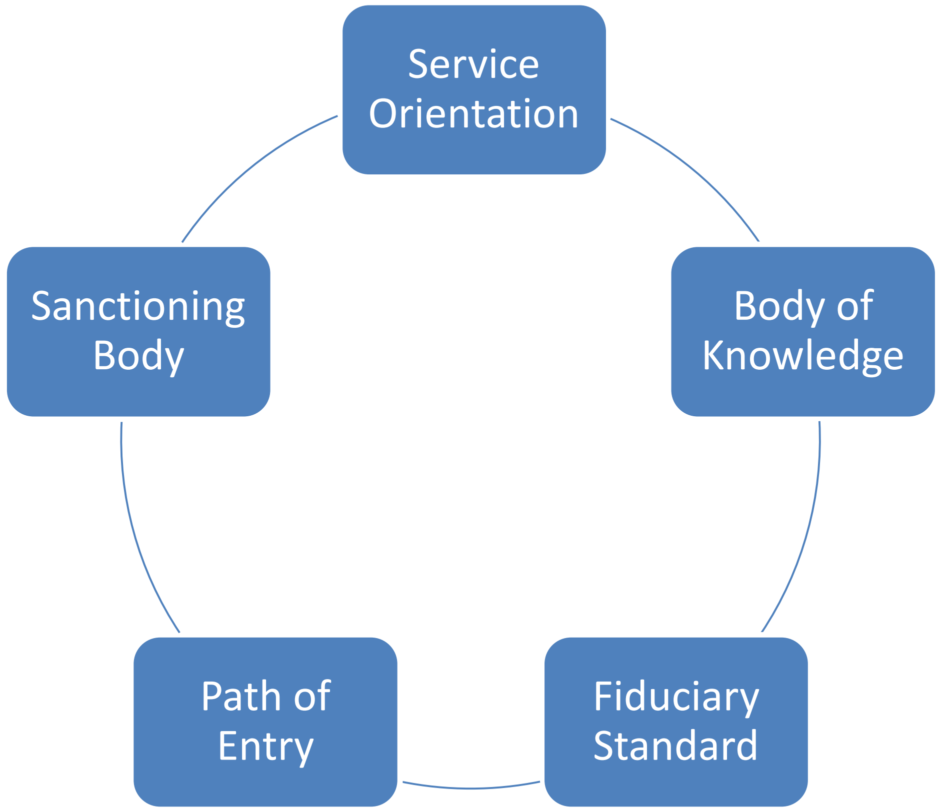
How the DOL Rule is structured



Looking beyond compliance

Defining Characteristics of a Profession

1. Service orientation to society and the profession
2. Defined body of knowledge
3. Code of Conduct that serves clients' best interests (fiduciary standard)
4. Path of entry to the profession
5. Sanctioning body



What does a “best interest” fiduciary standard require?

- ***Prudence*** “… the fiduciary acts with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims…”
- ***Individualization*** “…based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor…”
- ***Loyalty*** “…without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.”

Fulfilling a Best Interest Standard

Prudence	Individualization	Loyalty
• Apply generally accepted investment theories & practices • Diversify using appropriate asset allocation • Apply sound service provider & investment due diligence • Assure reasonable costs & compensation	• Know your client: — Investment objectives — Time horizon — Risk tolerance — Financial circumstances — Needs & expectations • Consider prevailing circumstances: — Economy & markets — Plan/account options — Other material facts & circumstances	• Avoid conflicts when possible • Mitigate unavoidable conflicts in the client's interest (e.g., BICE) • Disclose conflicts & other material facts • Monitor consistent with law, governing documents & terms of the engagement
Document all of the above as a record of procedural prudence.		

Prudent practices for fiduciaries – Impartial Conduct Standards

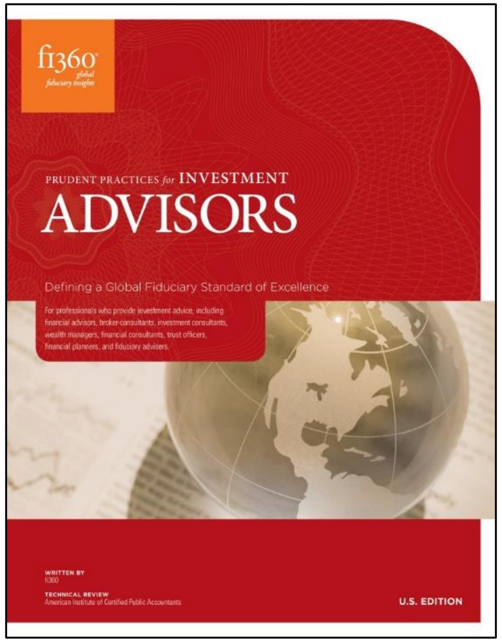
Four Step Prudent Investment Fiduciary Process

1. Organize
2. Formalize
3. Implement
4. Monitor

Seven global fiduciary precepts

1. Follow laws & governing documents
2. Diversify, manage risk
3. Prepare & follow an IPS
4. Use prudent experts
5. Control costs
6. Avoid conflicts
7. Monitor

20+ Prudent Investment Practices (Handbooks)



Evolution of capitalism

Industrial or Managerial Capitalism 1945 - 1980

Corporate debt and equity issuers are the dominant forces	Dispersed securities ownership

Financial Capitalism 1980-2015

Banks, asset managers, and brokerage firms are dominant	Financial services sector grows through financial engineering

Fiduciary Capitalism 2015 - ?

Institutions hold ever larger share of world capital (>50%) as fiduciaries	Fiduciaries (universal owners) apply long-term stewardship perspective

Key traits of institutional investors

- Institutional investors include:
  - Pension/retirement plans
  - Foundations and endowments
  - Mutual funds, collective trusts, etc.
  - Sovereign wealth funds
- Long (generally perpetual) time horizon
- “Universal owners” – large and broadly diversified portfolios
- Cost conscious and conflict averse
- Less worried about benchmarks than long-term results
- Fiduciary accountability
- Professional management – deep in talent and resources

Concerns of universal owners

- Marketplace transparency
- Market price impact of buying and selling
- Externalities – how the actions of one company impacts others
- Mitigating micro and macro risks
- Fiduciary liability
- Ability to influence management when selling is impractical
  - Proxy voting
  - Shareholder activism, confrontation and collaboration
  - Attaining directorships
- The passive investing paradox – indexing undermines market efficiency, making active management more attractive

Marketplace impacts

- Ongoing pressure to improve transparency and reduce conflicts
- Due diligence drives down product costs and drives up quality
- Rapidly growing interest in Sustainable, Responsible, Impact (SRI) investing using Environmental, Social, and Governance (ESG) factors
- Active investing to mitigate risk and promote long-term alpha
  - Shareholder activism
  - ESG strategies
  - Penalize negative externalities (e.g. embedded carbon price)
  - Reward positive externalities (e.g. support innovation in companies working to address climate change)
- Increasing alignment of investor, professional, and societal objectives

Growing acceptance of SRI investing

- “For investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions.”*
- “Sustainability is an important factor in the long-term success of a business. Therefore, as with any other issue related to the prudent management of capital, considering sustainability is not only important to upholding fiduciary duty, it is obligatory.”**
- DOL Interpretive Bulleting 2015-01 acknowledges that consideration of ESG issues may yield economic benefits for investors and be used proactively in due diligence

* CFA Institute “Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals” (2015)

** UN PRI “Fiduciary Duty in the 21st Century” (2015)

Evolving practicality of SRI Investing

- Morningstar's new ESG factor scoring system for 20,000+ funds
  - Through partnership with Sustainalytics
  - 5-Globe system, by asset class
- Harvard Business School Study – Companies that differentiate material sustainability factors can enjoy 6%+ relative-to-market performance (found 80% of data points were immaterial)
- SEC is seeking comments now on Regulation S-K (disclosures required by public companies)
  - Comments about ESG disclosures specifically requested
  - CFA Institute is urging investors to comment

Performance implications of SRI

- “88% of the research shows that solid ESG practices result in better operational performance of firms and 80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices” *
- “Early findings provide no evidence to suggest that these mission-aligned [private equity] exits draw depressed financial outcomes. In fact, the data show that mission-aligned exits…can provide strong returns.”**
- “ESG Tilt” and “ESG Momentum” strategies outperformed the global (MSCI World) index

* Report by the University of Oxford and Arabesque Partners (Clark, Feiner, and Viehs 2014) quoted from CFA Institute “Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals” (2015)

** Wharton, University of Pennsylvania, Social Impact Initiative study “Great Expectations: Mission Preservation and Financial Performance in Impact Investing” (2015)

*** MSCI “Can ESG Add Alpha: An Analysis of ESG Tilt and Momentum Strategies (2015)

Risk mitigation implications of SRI

- Reputational (Nike, Gates Foundation)
- Operational/financial (insurance companies)
- Legal/regulatory (Enron)
- Competitive (ASICS, Linde)
- Physical (BP)
- Stranded assets (coal mining)

Why Consider ESG Issues?

• Help manage investment risks	63%
• Clients/investors demand it	44%
• ESG performance is a proxy for management quality	38%
• It’s my fiduciary duty	37%
• To help identify investment opportunities	37%
• My firm derives reputational benefit	30%
• Regulation requires it	7%
• Other	5%

* CFA Institute “Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals” (2015)

Client Demand and Growth of SRI

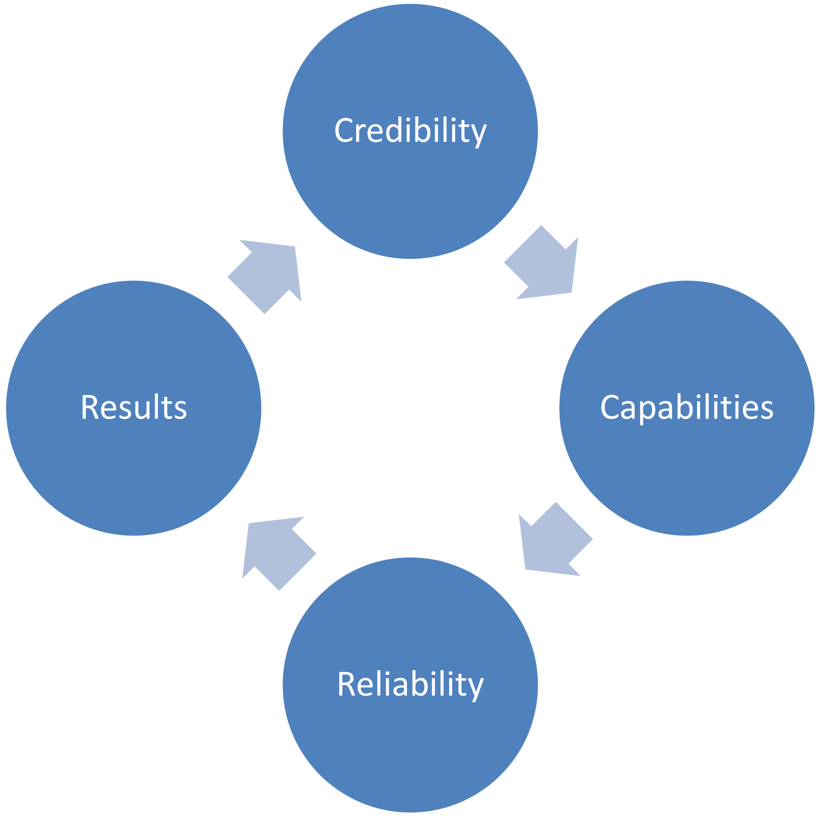
- Ten-fold increase in SRI assets from 1995 through 2014*
- $6.2 trillion U.S.-domiciled assets held by institutions that apply ESG factors at the start of 2014*
- 76% increase in assets between 2012 and the start of 2014*
- 73% of CFA designees working as portfolio managers and research analysts use ESG in their research and decision-making**
- SRI using ESG has gone mainstream – represents application of generally accepted investment principles

* US SIF Forum for Sustainable and Responsible Investing

** CFA Institute "Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals" (2015)

Competing in a transformed world

- Credibility
  - Personal/Professional
  - Company
- Capabilities
  - Skills
  - Tools
- Reliability
  - Process-driven
  - Professional practice design
- Results
  - Set goals and milestones
  - Benchmark success for your clients and your business



The Professional Advisor’s Mandate

- Do what is right for the client (loyalty)
- Exercise professional skills (care)
- Run a sustainable business without comprising fiduciary principles

Fi360’s mission is to help you fulfil your professional mandate.

Gather, grow, and protect investor assets through better investment and business decision-making.

Questions and further discussion

Useful resources:

- All about the DOL Fiduciary Rule – https://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2
- All about fi360, including Prudent Investment Practices: www.fi360.com
- Fi360 National Account Manager, Jeff Hladun – Jeff.Hladun@fi360.com

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