FIDUCIARY – DO INVESTORS KNOW WHAT IT MEANS?

A Spectrem Group Whitepaper

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Voice of the Investor

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Picture this. Focus group facility in late 2014 with eight participants and a moderator. All of the participants have over $1 million of net worth. They include:

June – Retired. Mid-sixties. Graying. Spectacles. Formerly worked for the State licensing attorneys.

Ed –Contractor. Fifties. Dressed in cut-off shorts and a Harley Davidson t-shirt. Work boots. Scraggly beard.

Matthew – Thirtyish. Dressed in suit with loosened tie. Slicked hair. Works in the oil industry.

Vanessa- Mid-thirties. Brown hair. Stay-at-home mom married to a doctor. Two kids. Dressed in Lululemon.

Four additional group participants.

Moderator writes the word "Fiduciary" on a white board. Asks participants to pronounce it and then describe what they think it means.

Matthew: "Fie-duk-ee-airy? Isn't that some old guy that looks out for others?"
June: "It's Fie-doo-she-airy. It means being responsible for investments like in a trust or something."
Ed: "It means you can sue their…….**** if they screw up with your investments."

The participants had all previously acknowledged that they were using an advisor of some type to assist them in managing their money.

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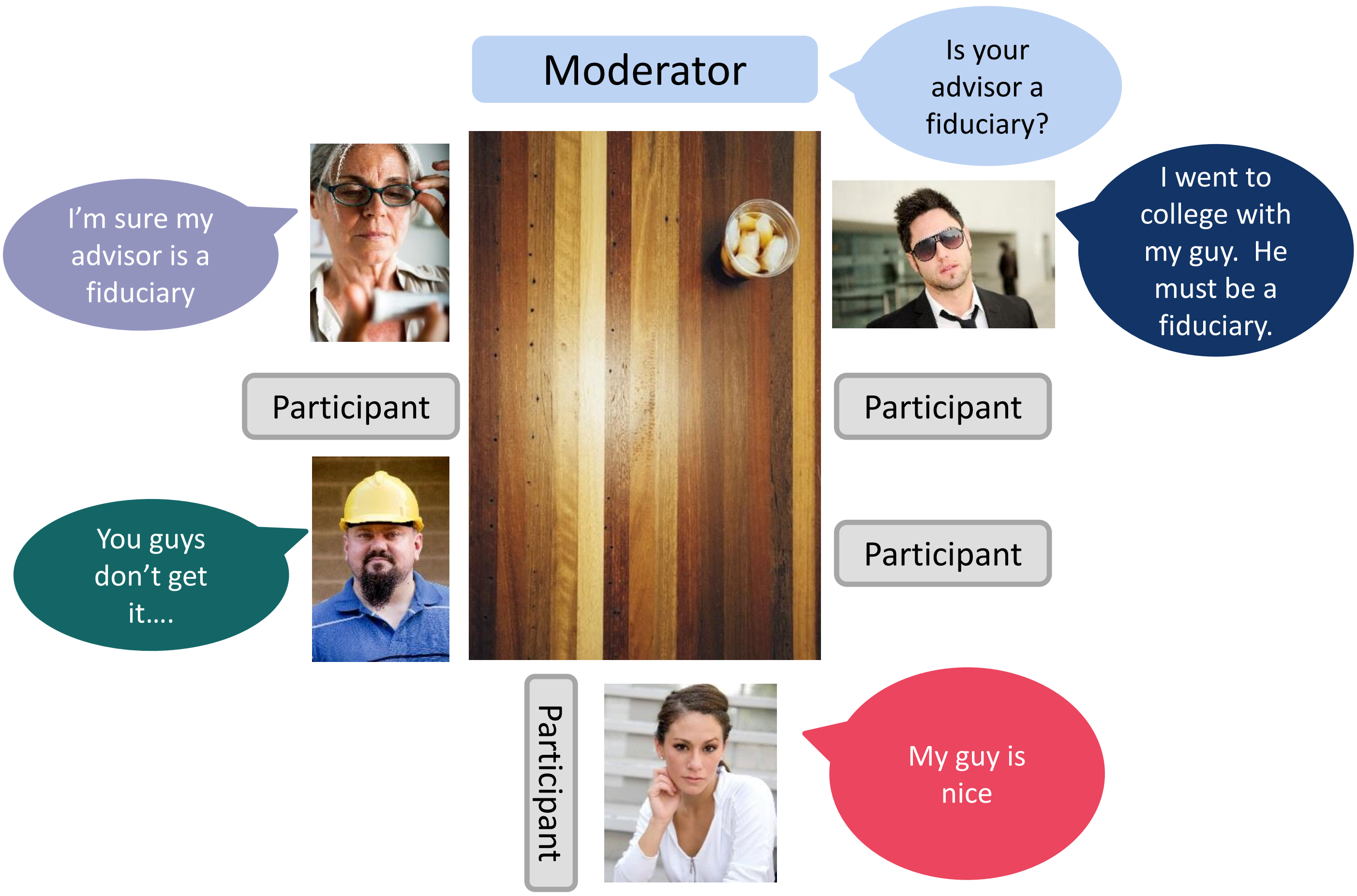
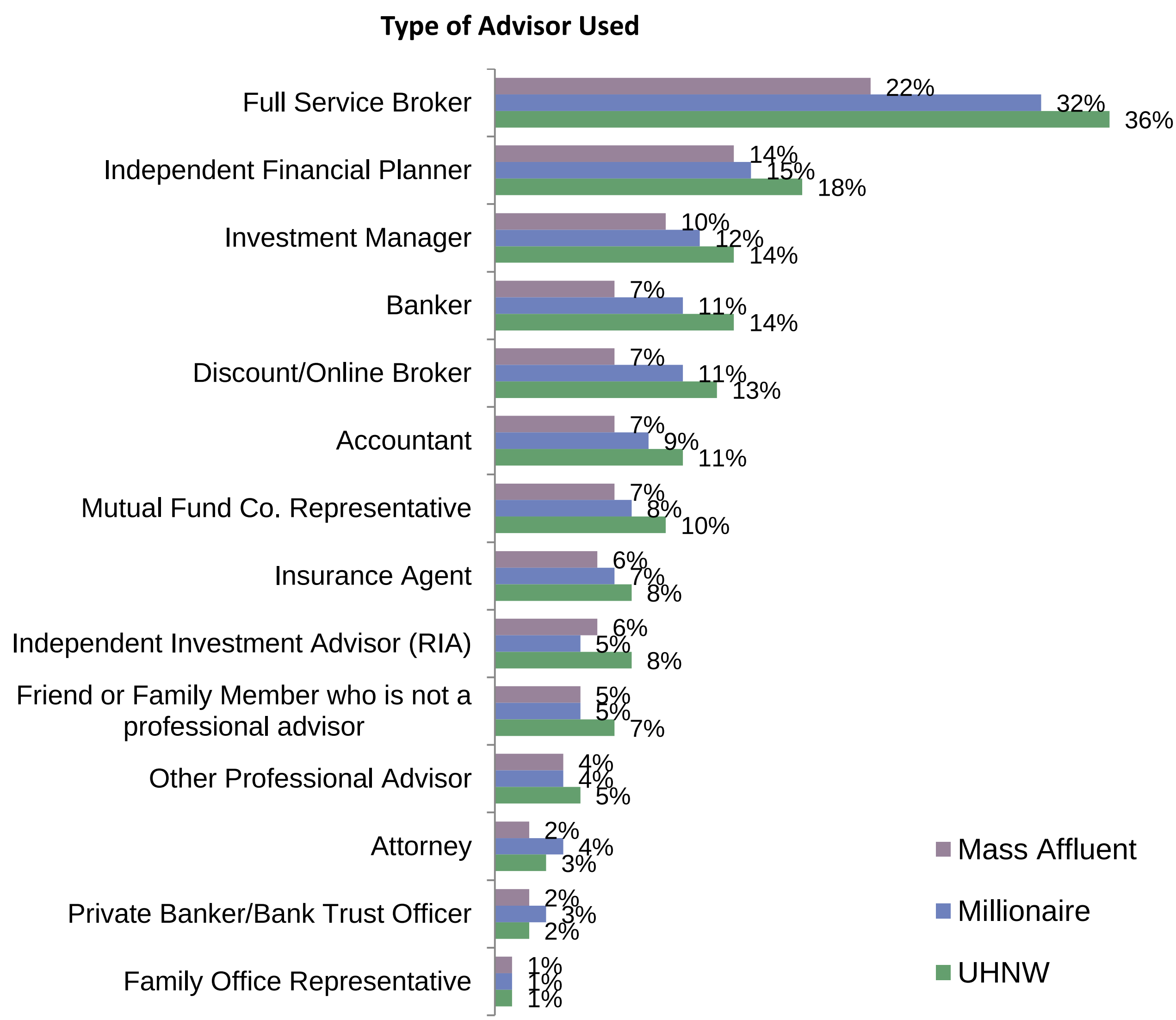
The moderator reads the definition of "fiduciary" and then asks , "Is your advisor a fiduciary?"



Vanessa: "Well, my guy is really nice, so he must be a fiduciary."
June: "I'm sure with all of the licensing he had to go through that he must be a fiduciary."
Matthew: "Yeah. My guy, I went to college with him. He's made a lot of money for me. He must be one of those, what do you call them, fiduciaries?"
Ed: "You guys don't get it. Unless he's signed agreements and admits he's a fiduciary …..he isn't one. He could be going for a bigger commission. A fiduciary has to act in your best interests, the others guys just have to act like they are."

Ed, of course, was correct. But the most interesting part of the conversation, and of the quantitative research that supports this discussion, is that most investors already believe that their advisor – regardless of the type of advisor that he or she might be using – is a fiduciary.

As you can see, the Full Service Broker remains the most commonly used type of advisor by investors regardless of their wealth segment.

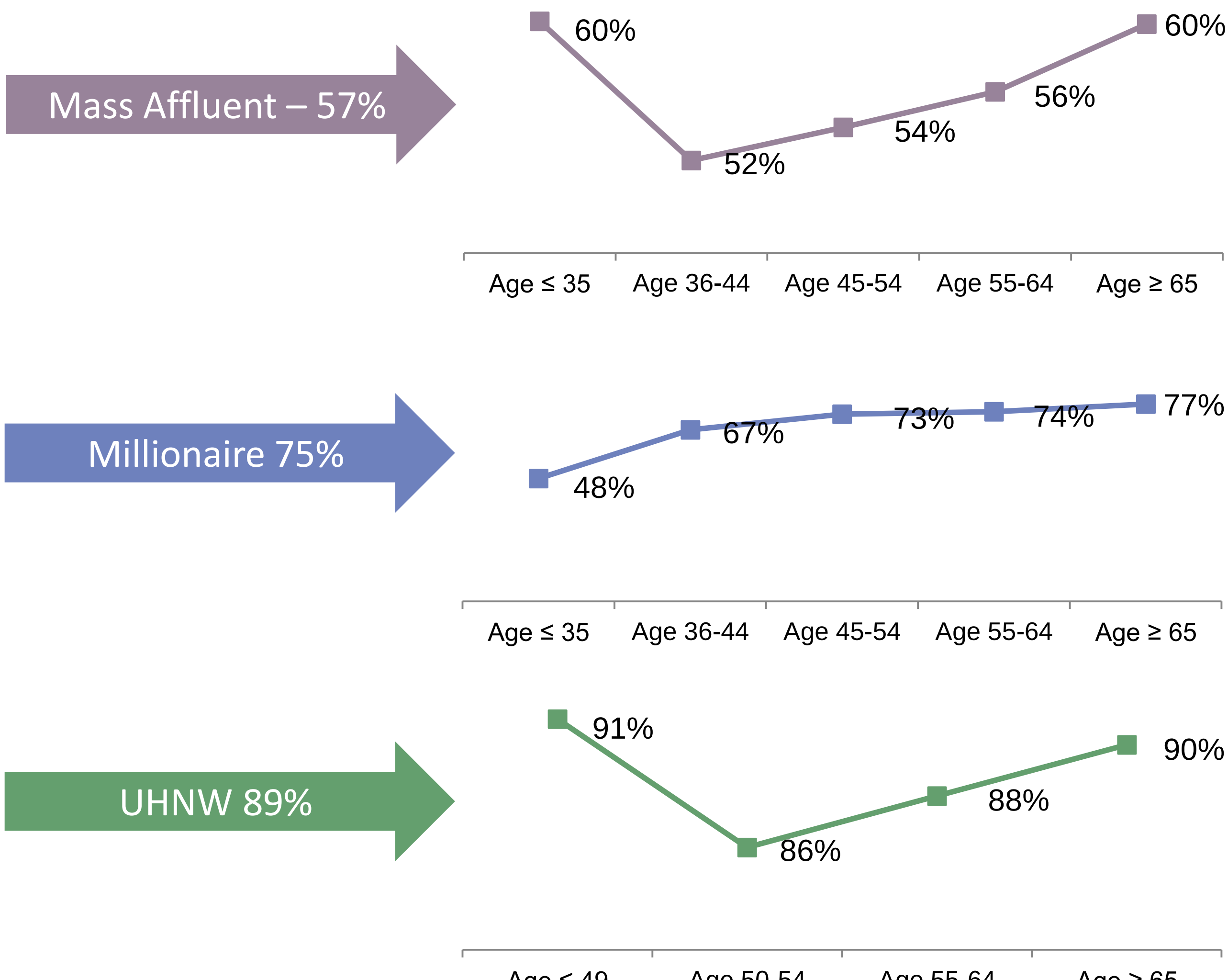


The advisors described above are chosen based upon the perceptions of investors of the type of advisor they are using. In many cases, investors don't really understand the difference between an investment manager, an RIA, and a financial planner. Additionally, an increasing number of full service brokerage firms have added financial planning capabilities to their service offerings, to further muddle the definition of "type of financial advisor".

While it is difficult to make a broad statement about whether a particular type of advisor is or is not a fiduciary, for the most part, many of those who are paid on a fee-only basis rather than a commission basis are more likely to be fiduciaries. The reality, however, is that most investors don't really know whether or not their advisor is a fiduciary or not.

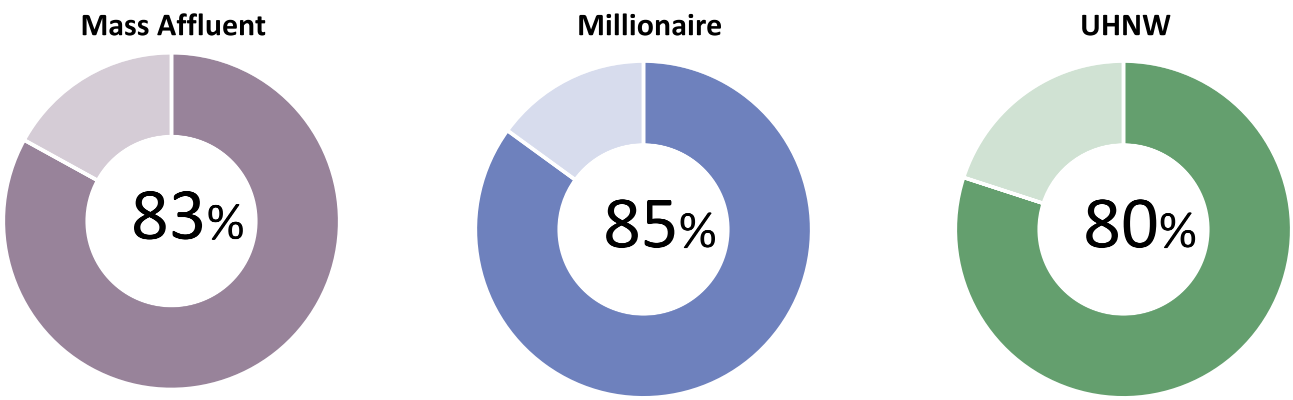
Similar to the results described in the focus group at the beginning of this report, a large percentage of investors claim to know what a "Fiduciary" is. In fact, 89 percent of households with more that $5 million of net worth (the Ultra High Net Worth or UHNW) indicate they understand what a fiduciary is and 75 percent of Millionaires, those with $1 to $5 million of net worth claim to know what a fiduciary is. This compares to 57 percent of households with $100,000 to $1 million of net worth (the Mass Affluent).

Percent that Feel They Know What a Fiduciary Is



In addition to indicating that they understand the concept of a fiduciary, most investors also believe that their advisor is a fiduciary. Eighty percent of UHNW investors feel their advisor is a fiduciary as do 85 percent of Millionaires and 83 percent of the Mass Affluent.

Feel Their Financial Advisor is a Fiduciary



Why does it matter if an investor believes his or her advisor is a fiduciary? Because, in general, Spectrem's qualitative and quantitative research throughout the years has indicated that most investors believe that their advisors are looking out for their best interests. There is, however, a legal difference between "best interests" and acting as a fiduciary. And based on proposed regulations by the DOL, the standards that most advisors are subject to (the "best interests" standard) may be about to change.

In the past, two different standards of behavior existed for advisors. The first standard was the "suitability" standard and the second the "fiduciary" standard. The SEC enforces the standards for fiduciaries, which tend to charge fees rather than commissions. In contrast, the Financial Industry Regulation Authority (FINRA) governs many types of advisors, including commission-based advisors. FINRA prefers the "suitability" standard, which is a laxer standard than the fiduciary standard.

Fiduciary Standard:

- Put the client's best interests first
- Act with prudence; that is, with the skill, care, diligence and good judgement of a professional
- Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts
- Avoid conflicts of interest
- Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.

Best Interests Standard:

- Suitable for client
- Consistent with the best interests of the client.

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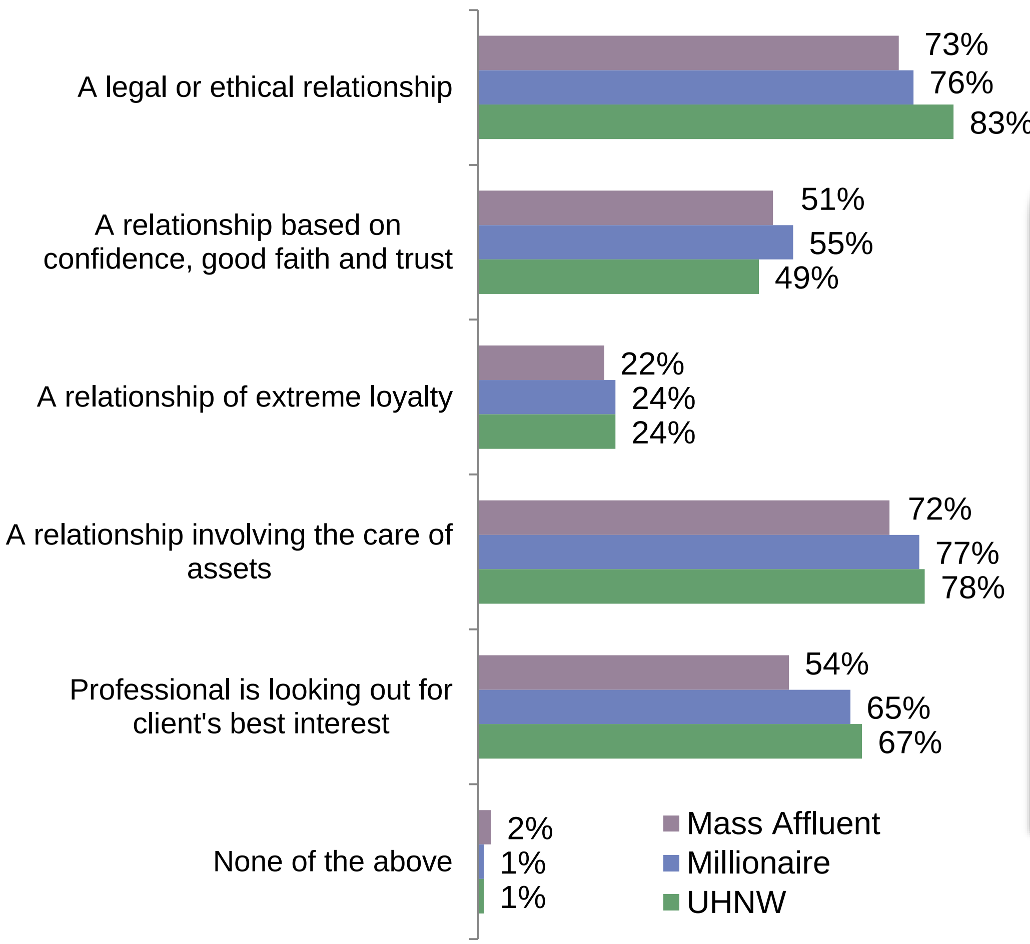
What do investors believe is included in a Fiduciary Relationship? Two-thirds of investors believe that the advisor is looking out for the client's best interests. An even greater percentage believe that it involves a legal or ethical relationship and more than three-quarters feel that it is a relationship involving the care of assets.

Included in a Fiduciary Relationship



For the most part, investors believe they can sue their advisor if the advisor is not working in the client's best interests. What investors don't understand is the difficulty they might have in proving that their advisors were not working in their best interests.

In April of 2015, the DOL released proposed regulations that would create a fiduciary standard for those advisors assisting investors with retirement plan assets. While not all advisors directly advise on retirement plans, advisors can still be deemed fiduciaries if they provide advice to plan participants or beneficiaries. This means that if an advisor is working with a plan participant regarding the rollover of his or her plan assets into an IRA account, he or she may be subject to a stricter standard than when dealing with other types of client assets.

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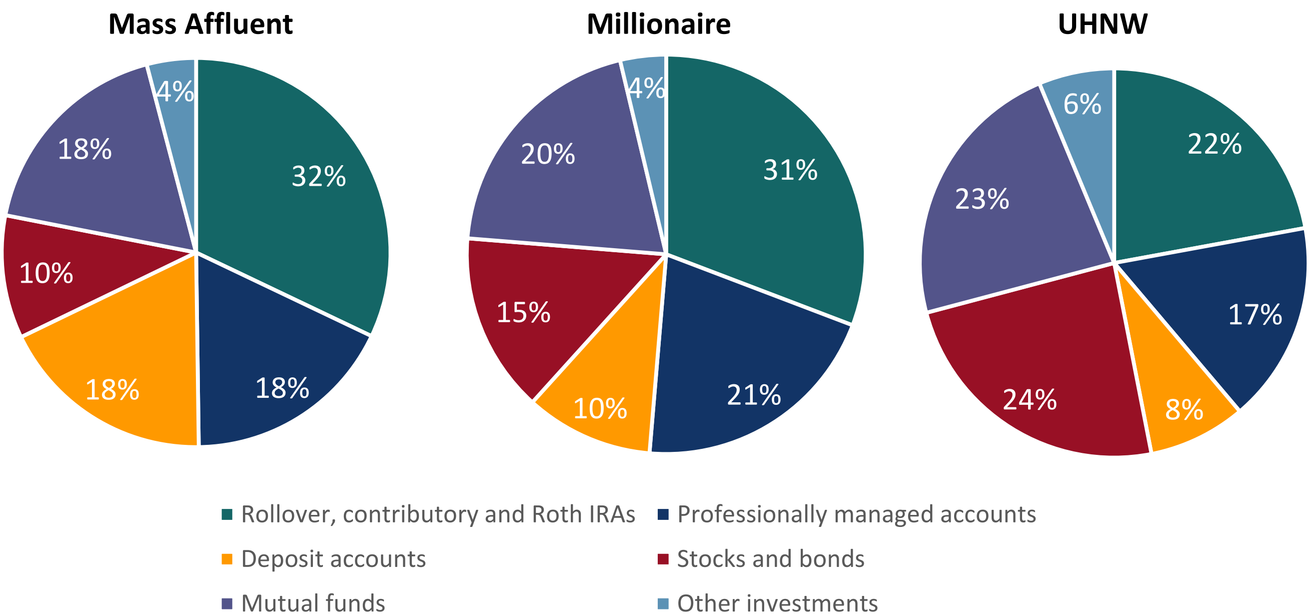
The IRA rollover is generally a significant piece of an investor's portfolio.

As you can see below, IRAs represent 32 percent of the portfolio of a Mass Affluent household, 31 percent of a Millionaire household and 22 percent of the investable assets of an UHNW household.

Distribution of Investable Assets



This becomes particularly tricky when advising a client to rollover assets from a plan into a proprietary investment offering of the advisor's firm. ERISA has rules prohibiting fiduciaries from receiving any consideration (fees) for their own personal account when dealing with assets of a retirement plan. The challenge is when a firm seeks to retain rollover assets and recommends a proprietary investment offering of any type, such as their own mutual funds. The new regulations allow for a disclosure of fees related to any conflict of interest, but will seem rather confusing to investors when multiple documents are shoved into their face. It is also likely to increase the perception that many investors have that advisors really aren't looking out for their best interests.

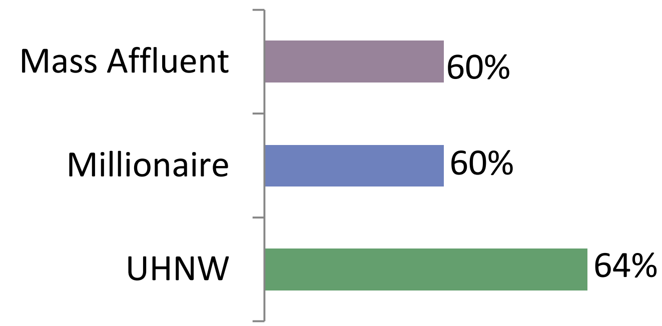
Spectrem's ongoing research with investors indicate that many investors feel that advisors aren't always looking out for their best interests.

Financial Advisors are More Concerned With Selling Products Than Helping Clients

Mass Affluent	Millionaire	UHNW
44%	43%	42%

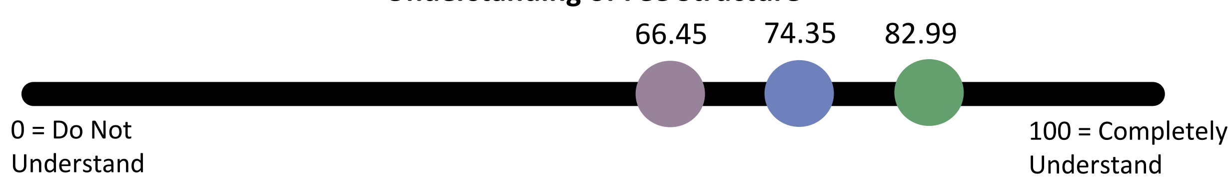
Additionally, even if investors don't necessarily think that advisors are disregarding the interests of their clients, they do feel that many financial advisors are biased towards a certain group or type of products.

Find Many Financial Advisors are Biased Towards Certain Group or Type of Products



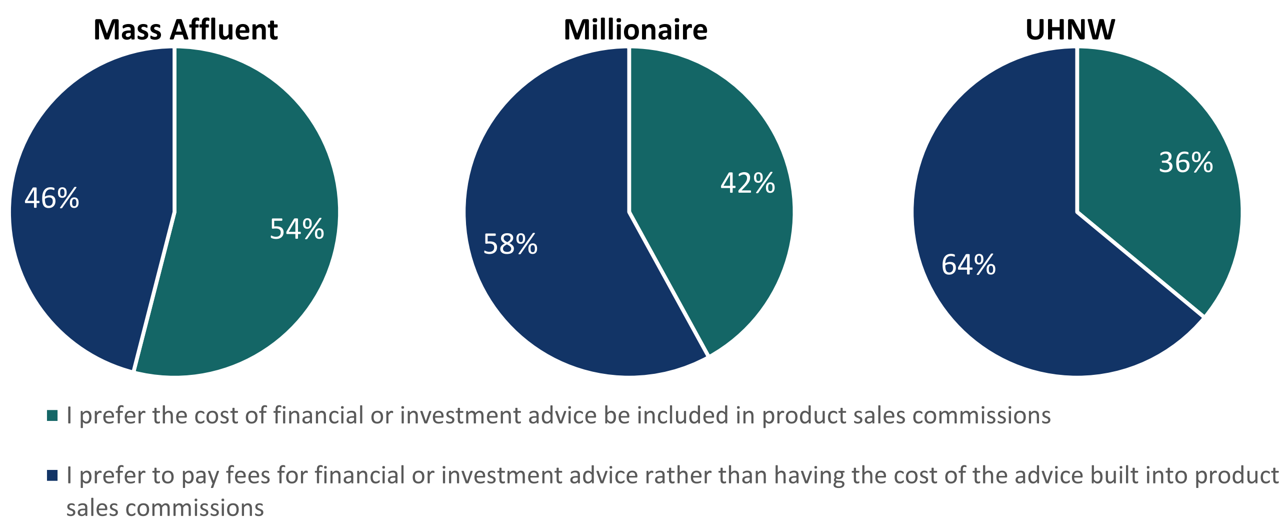
Investors probably believe that advisors are compensated more lucratively by some products than others (rightfully so!). But investors give mixed messages about fees. Overall, about three-quarters of investors indicate that they have a strong understanding of the fee structure they pay their advisors.

Understanding of Fee Structure



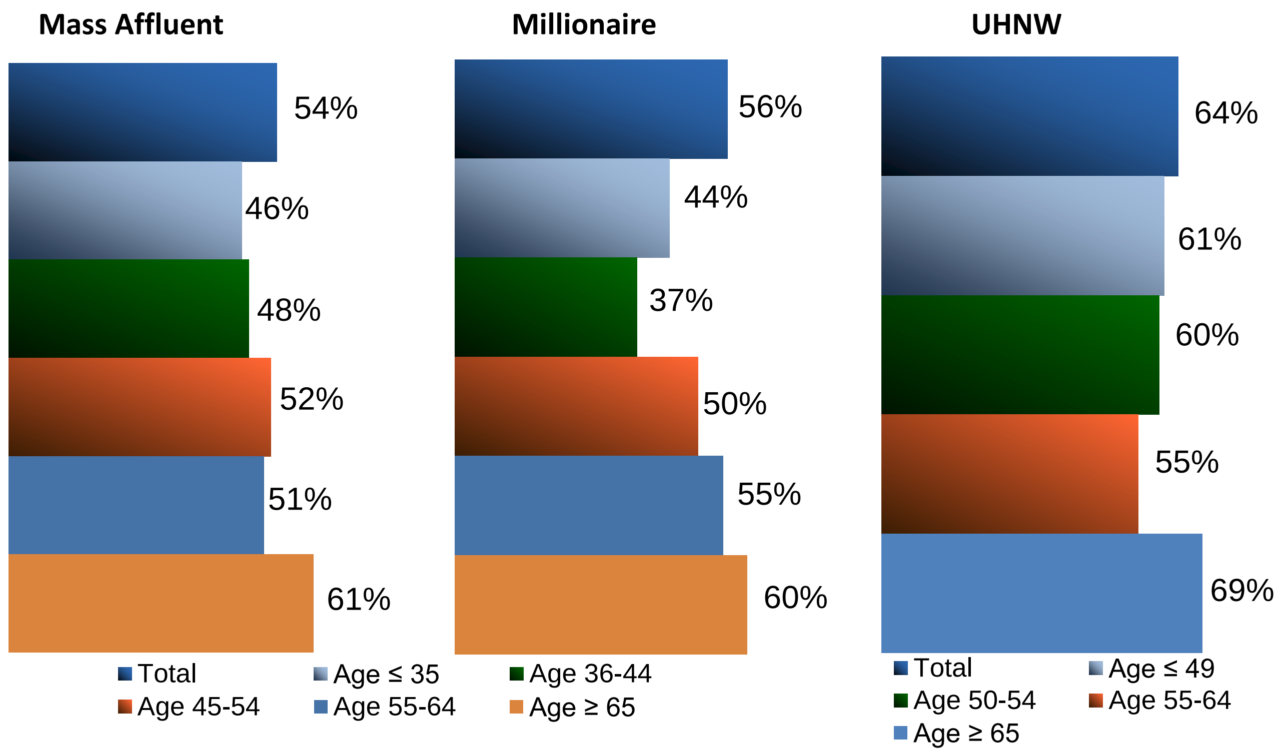
Keep in mind, as we discussed above, most investors believe that their advisor is a "fiduciary". If that is true, it is surprising to note that just under half prefer to pay commissions rather than fees for advice. In contrast, almost 60 percent prefer to pay a fee rather than a commission.

Commissions vs. Fees



Most importantly, more than half of investors are currently comfortable with the fees they pay their advisor. This comfort level, however, lessens significantly as age decreases. (Over the years, Spectrem has asked investors to indicate the amount of fees they are paying. The results have always been embarrassing – showing that despite what they indicate, investors have no clue about what they are really paying in fees.)

Very Comfortable With Fees Paid to Advisor



Why is this relevant? Not only do the potential changes to the standard of care hint at significant changes to the financial services industry of the future, the skepticism of the younger generation and their comfort in seeking out information may ultimately compress fees, making the balance of risk and reward harder to achieve. Is it worth it for a future advisor to work on building his or her practice, only to be subject to potential lawsuits and lower fees?

SUMMARY

While the fiduciary standard has not yet become a requirement for all types of advisors in all types of situations, the momentum is shifting. The regulatory requirements are increasing, but a balance remains. What do advisory firms need to do to plan for the future?

First, it's important to remember that the vast majority of advisors, regardless of whether they are commission-based or fee-based – whether they are "true fiduciaries" or just under a "suitability" standard – actually are trying to take care of their clients. They do look out for their client's "best interests". If clients didn't feel their advisor understood them and was looking out for them, they would leave. And turnover rates of investors changing advisors remains low, below 10 percent annually.

Secondly, the financial expertise provided by a financial advisor remains relevant despite the access to information available online today. Not only is it easy for an investor to get confused by all of the available content, the experience factor obtained by most advisors is important for clients to rely upon. The outside third party opinion provided by the advisor can be critical for an investor when making investment decisions, especially when emotions are involved.

Advisory firms need to be prepared for the future and develop the following policies and procedures regardless of the type of advisor they may be:

Write the "elevator" speech. Literally script out a discussion guide to use with clients describing the role of a fiduciary and what it means. You may want to point out that they may start hearing those words more frequently and it's important for them to understand what it means. Make it clear what standard you are held to while assuring them about how you care about their best interests, no matter to which standard you are officially held.

Review your fee disclosure documents. While the DOL will probably issue standards regarding which types of documents and disclosures are required…and your own compliance departments will have similar documents…see if those documents can merely act as backup to one really clear document that sets out the fees that will be charged to their account. Not only will you increase the trust of your investors, you will attract younger clients who are open to "sound-bites", as long as the backup exists.

Create a quarterly committee meeting to review client accounts. Trust companies have acted under the "prudent man rule" and fiduciary guidelines for centuries. As such, they have incorporated numerous procedures to document how they fulfill their fiduciary duties. One

SUMMARY

of these guidelines was regularly scheduled meetings within the office to discuss an account, any changes to the family needs as well as any investment policy changes within the firm. This meeting and discussion would be documented and ultimately provided protection to the trustee. Most advisory firms are a little more ad hoc. Additionally, sometimes decisions are kept only between the advisor and the family. It may be time to broaden the number of individuals involved with an account, not only to lessen the liability, but to ensure that the right decisions are being made for a family.

Document decisions and changes. While most firms have these protections in place, it is never wrong to reinforce the importance of ensuring that transactions, approvals, and other communications with investors must be retained. But it is also necessary to deal with the 21st century communication changes. Make sure your firm knows how to encrypt text messages and social media. While it's easy to ignore, it will become increasingly important in the future.

Most investors already believe their advisor is a good fit and is helping them to make the right investment decisions. New guidelines and proposals are helping to formalize those standards. Keep in mind, that while the markets are up, most investors aren't as critical of their advisor as they might be should the market crash. That's why it is important to formalize your procedures and communications during a time when investors are relatively upbeat. Don't wait for the next market crash. Determine whether or not you plan on becoming a fiduciary and begin to work towards that goal.

METHODOLOGY:
This report provides a summary of respondents' views of new investment opportunities to assist financial institutions in developing these products as well as assisting existing financial advisors in retaining and growing their businesses. Those who participated had between $100K and $25MM net worth, not including primary residence (NIPR).
The surveys were completed by the person primarily responsible for making the day–to–day financial decisions within the household. All respondents in this report have net worth, not including their primary residence, of $100,000 to $25,000,000.
Spectrem conducted this survey through an online panel that is generally representative of the affluent investors throughout the United States. However, some age–based weighting of the data was performed to insure a more representative sample.

Net Worth, NIPR, includes all assets except primary residence, less all liabilities. We examine three distinct segments:
- Mass Affluent - $100,000 - $999,999
- Millionaire - $1,000,000 - $4,999,999
- Ultra High Net Worth (UHNW) - $5,000,000 - $25,000,000

You might also be interested in…

2015 Personal Trust Update
Spectrem's annual trust report reviews the growth of the trust industry, including the number of trust assets and accounts held by major financial institutions. It reviews the growth and usage of collective investment funds as well as amount of assets managed by institutional trustees.
Available Q3, 2015. $3,500

Investor Perceptions of Socially Responsible and Impact Investing
New investment opportunities continue to emerge that provide affluent investors the opportunity to generate healthy returns while also making a positive impact on the environment, society or their community. This Spectrem Perspective will analyze Socially Responsible and Impact Investing, how wealthy investors currently perceive these investments, how they currently use them in their portfolios, and their intentions for use in the future
Available Q2, 2015. $3,500

Lost Without an Advisor: How to Attract Advisor–less Investors
Many investors across the U.S. are managing their own assets because they lack knowledge about how to work with an advisor. These "lost investors" are a hidden opportunity for the financial services industry, if advisors and providers could overcome some of the concerns and confusion of these investors. Are they afraid of the fees charged by an advisor? Why do they believe they lack the assets to work with an advisor? Are they concerned about the security of their information? Embarrassed by their lack of knowledge?
Available Now. $5,000

High Income Women Investors
What differentiates high net worth women from their male counterparts? How do women who earn over $150,000 in annual income want to work with a financial advisor? What type of advisor do they prefer? How are they planning for retirement? How are they currently invested and what changes do they anticipate in the future? These questions and more will be answered in this Spectrem report, which will survey women who are currently working and have incomes of at least $150,000 annually.
Available Q4 2014. $5,000

DC Participants: Advisor Relationships and Changing Advice Requirements
Research shows that there are a multitude of driving factors regarding advisor usage among the general population, including age, wealth level, occupation and gender; but what about advisor usage among retirement plan participants? What factors affect the way they utilize the expertise and planning skill of financial advisors? Who are they most likely to turn to for advice? Are the advisors they use associated with their retirement plan, or do they use an outside advisor? If so, what type of advisors do they use? What reasons were involved in making these decisions? What services have they received from an advisor? What do they need? Financial planning? Long–term care? Available October 2015. $6,000

Wealthy Investors and Their Perceptions of Virtual Advisors
As the number of online investment platforms begin to multiply, the future of the financial advisory business is being questioned. Will investors of the future prefer online investment platforms rather than a financial advisor? How many investors have or might consider using one of these platforms? What do they consider the strengths and weaknesses of this approach? How likely are they to rely upon one of these platforms in the future?
Available Now. $7,500