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Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor

Following is my Comment on the Conflict of Interest Proposed Rule, RIN 1210-AB32.

Dick Purcell

From the Proposed Rule, the chief beneficiaries will be investment advisors instead of investors and for investors the situation will be worsened

Yes, brokers commonly provide investors advice that is not in investors' best interests, due to conflicts of interest, and this should be stopped.

But investment advisors have deeper conflicts of interest, created by the sellers of their training and certifications. By purporting to protect investors from conflicts of interest without confronting investment advisors' conflicts of interest, and instead implying that investment advisors are free of conflicts of interest, the purported rule will certainly enrich investment advisors. But for investors it will make the situation worse.

Investment-advisor conflict of interest #1

Sellers of investment-advisor training-and-certification claim that by collecting "fee-only" compensation, investment advisors are kept free of conflict of interest and thus pursue investors' best interests. But most investment advisors base their fees on assets under management, AUM. That gives investment advisors a most fundamental conflict of interest, in favor of investing clients' money subject to market risk to the exclusion of other deployments of client money that are very commonly better for clients' interests and deserve unbiased consideration.

Example A: Paying off the mortgage -- It's commonly better for a client to use savings first to pay off a mortgage instead of risking the money in the investment market; but the investment advisors' dominant fee-only compensation basis of AUM provides the investment advisor conflicting interest in guiding the client to risk his money in the investment market instead.

Example B: Purchasing a pension -- The overwhelming number one purpose of employee saving is to meet needs and goals of retirement years. For this it is widely agreed that the safest use of savings is "purchase of an insured lifetime pension" via lifetime SPIA or DIA. But here again, the dominant investment-advisor compensation method of fee-only, based on AUM, provides advisors conflicting interest in guiding the client to risk his savings in investments instead.

By focusing on broker conflicts of interest but failing to address this fundamental investment-advisor conflict of interest, the current proposed rule will have the effect of pushing investors from one conflict-of-interest to another. The chief beneficiaries will be investment advisors instead of investors.

Investment-advisor conflict of interest #2

In investment training of investment advisors, key concepts of modern portfolio theory are applied to identify a conservative-to-aggressive range of investment portfolios from which to make a selection. Along the range, each portfolio is a mix of asset classes, chosen for decades of return-rate history and widest diversification, to provide best grounds for estimating future-return-rate probabilities with least uncertainties. Modern portfolio theory presents a comparison of the portfolios in technical measures of return-rate probability for the individual year: return-rate arithmetic mean and return-rate standard deviation.

This is a good start. But the rest of the way, the sellers of investment-advisor training-and-certification teach investment advisors a process that amounts to avoiding pursuit of investors' best interests in favor of advisors' and other financial interests.

Avoiding pursuit of the investor's best interest

Through further analysis, those portfolios can be compared for an investor's best interest – compared in probabilities for dollar results for the investor's future needs and goals. This would inform investors and advisors for judging a best selection for the investor's best interest – his future dollar needs and goals.

But in investment-advisor training, this is not done! The portfolios are compared in measures of future-result probability -- *but not for the investor's best interest, dollars for his future needs and goals.*

Instead, the sellers of investment-advisor training-and-certification teach investment advisors a three-step process that omits pursuit of the investor's best interest in favor of the advisor interests and financial industry interests. That process, summarized below, has three major steps: **Mislabel, Divert, Switch**

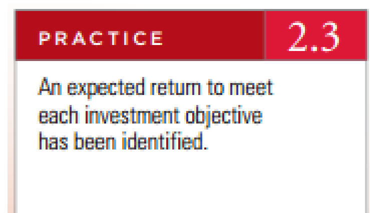
Step 1: Mislabel

For the two technical measures on which modern portfolio theory compares the portfolios, the trainer-certifiers of investment advisors base the training on labels that are fatally misleading:

"Expected return" or just "return" – For the technical measure of return-rate arithmetic mean for the individual year, the trainers teach use of the label "expected return" (or just "return") – even though that label is professors' code for a return that is *not expected!*

Worse, as investment years go by, an investment's actual result is expected to lag *further and further below* what the investment's "expected return" would deliver. With greater and greater uncertainty as to *how far below* the result may be.

To illustrate how misleading that labeling is, consider the illustration at right. It is part of the teaching of Fiduciary360, the organization that sells investment advisors "investment fiduciary" credentials, along with training, guidebooks, and software.



But there is *no good reason* to do what that illustration teaches. It's terrible **mis**-training. An investment is expected to produce results further and further below what its so-called" expected return" would deliver, with increasing uncertainty as to how far below the result may be.

"Risk" -- . In other fields affecting people's wellbeing, such as health and transportation engineering, risk is measured responsibly, according to well-established methods of *risk assessment*: how likely and how bad an outcome may be. Of course, for anyone investing for retirement, the outcome for meeting the investor's best interest is dollar results for retirement years, and risk is danger of insufficient money for those retirement years. But instead, the sellers of

training-and-credentials for investment advisors teach use of the label “risk” in a very different way. They use it to label a technical measure of short-term return-rate variation for the individual year.

This misuse of the label “risk” inflames investors’ short-term fear and diverts their focus from their best interest for the future to those short-term fears.

And it can scare the investor into choices that increase his real risk of running out of money when he’s old. For most investors’ plans, the portfolios with least in this so-called “risk” have more real risk of falling short of the investor’s future dollar needs and goals.

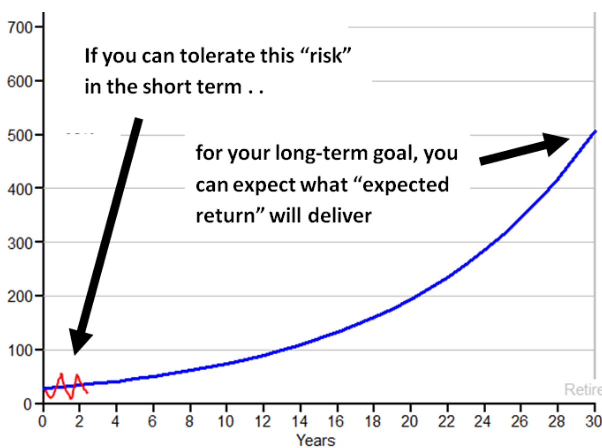
To illustrate how those labels provide the foundation for Step 2. Divert, consider the simple example of an investment of $100,000 with the goal of $500,000 30 years later for retirement. In this example the investor chooses a portfolio that modern portfolio theory shows to have return-rate arithmetic mean of 5.5% and return-rate standard deviation of 10%.

With the misleading labeling outlined above, the sellers of investment-advisor training-and-certification teach that the portfolio has “expected return” (or just “return”) of 5.5%, and “risk” of 10%.

That labeling leads to a prevailing view of the investment’s future outlook as illustrated in the graph at left below.

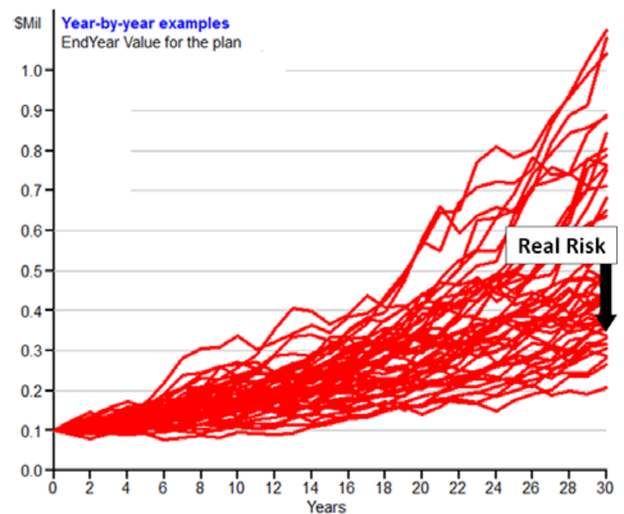
But a realistic view of the investment’s future outlook is radically different, as illustrated in the graph at right below.

WRONG



The investor is led to expect that over the 30 years, the investment result will be what its “expected return” would produce, which is just about his goal of $500,000. The “risk” he is led to fear is scary short-term ups and downs just ahead. He’s led to think that if he can tolerate those short-term ups and downs, he can expect his $500,000 at the end.

RIGHT



But according to history, Monte Carlo mathematics, and common sense, the realistic view is that as investment years go by the return-rate deviations accumulate to spread the uncertainties of the result wider and wider. There’s major danger the 30-year result will be lower than $500,000, perhaps much lower. That is the investor’s real risk.

Of course, the investor’s best interest is best dollar result for the future goal, in this example dollar result at the end of the 30 years. As shown in the realistic graph above at right, what that future result at will be is highly uncertain. The real risk to be minimized is danger of a low, inadequate result for that future dollar goal.

The mislabelings that lead to the wrong view of an investment’s future, illustrated at left above, are used by academics as insider code words. But for the community of investment advisors guiding the general investing public, they are fatally misleading, creating the wrong view illustrated at left above. They provide the foundation for misguiding investors in favor of advisors and other financial interests, as outlined below.

Step 2: Divert

Instead of training investment advisors to compare the portfolios' probabilities for the investor's best interest, dollars for his future needs and goals, the sellers of investment-advisor training-and-certifications teach investment advisors to use the misleading labels to inflame the investor's short-term fears and divert his focus to the individual year. This is done in several ways:

Use the misleading label "expected return" or just "return," which gives the investor false comfort of reaching his long-term needs and goals.

Misuse the mighty fear-word "risk" for a measure of short-term return-rate variation, which inflames the investor's fear of those short-term return-rate variations.

Show the investor a graph that compares the investments for just the individual year, in which the measure of short-term return-rate variation mislabeled "risk" appears to be the dominant difference among the portfolios.

Ask the investor to provide answers in a "risk tolerance" questionnaire designed to focus his attention on his short-term fear for the individual year.

Develop a portfolio recommendation determined by theoretical mathematics based on an attempt to assess a measure of the investor's short-term fear, called "risk aversion" – without ever revealing or even considering which portfolios are best (or worst) in the investor's best interest, probabilities for dollar results for his future dollar needs and goals.

Anti-fiduciary! -- This diversion, from (a) the investor's best interest for his future to (b) his short-term fear for the individual year, has the anti-fiduciary effect of favoring investment advisors and other financial interests over investors' interests, in three major ways:

1. By failing to reveal to the investor how the portfolios compare and which are best for the investor's best interest, probabilities for dollar results for the investor's future needs and goals, it leaves the investor feeling more dependent on the investment advisor.

2. By failing to even consider how the portfolios compare and which are best for the investor's best interest, probabilities for dollar results for the investor's future needs and goals, it betrays the fiduciary obligation to do so.

3. By diverting investors' focus to the individual year, it diverts investors from seeing the long-term cost to them of fees taken out of their money by advisors and other financial interests.

   Total fees and deductions commonly total 1% to 2% of AUM per year, or more. Over an investment period of 30 years or more, these fees and deductions can take away a quarter, a third, or even half of what the investor's final dollar results would otherwise be. But when the investor is misfocused on the individual year, he does not see this effect. He sees just the 1% or 2% for the individual year.

For over a decade, regulators have permitted sellers of investment-advisor training-and-certifications to teach this anti-fiduciary diversion, and permitted them to call it "fiduciary" and in investors' "best interests." Any rule that purports to protect investors from conflicts of interest should have elimination of this conflict of interest as a principal target. The current proposed rule fails to do so, and instead suggests that investment advisors trained in this misguidance are meeting the fiduciary standard of pursuing investors' best interests. That will certainly benefit investment advisors, but for investors it will make the situation worse.

Step 3: Switch

To complete the process, sellers of investment-advisor training-and-certification teach a step that is so irresponsible and dishonest it makes anyone who understands the relevant investment probabilities gasp.

Instead of placing the investor's money in the chosen portfolio's asset classes, which can be done via index funds or ETFs designed to match the performance of the asset class, investment advisors are trained to place the investor's money in choices from long lists full of higher-cost higher-risk gambles **within** the asset classes, such as actively managed mutual funds – the Wall Street casino.

And investment advisors are taught to present this switch, from the chosen portfolio's asset classes to choices from the Wall Street casino, *as if it were faithful placement of the investor's money in his chosen portfolio's asset classes!*

Higher cost – This Switch step provides the payoff for the financial industry and for the investment advisors

> **Rewards for Wall Street** -- This Switch step provides the payoff for the financial industry. Choices such as actively managed mutual funds and investment managers standardly involve much higher fees and other deductions from the investor's money, compared to investment in the asset classes via index funds or ETFs.

> **Rewards for investment advisors** -- And this Switch step provides major reward for investment advisors too. Lists from which choices for the switch are made commonly include hundreds of even thousands of actively managed mutual funds and other investments within the asset classes. These lists present an appearance of lots of work for the investment advisor, enabling him to present a basis for charging the investor higher fees, compared to the simpler responsible step of just placing the investor's money in the asset classes.

This Switch step is widely criticized on the basis of higher costs to the investor. As previously stated, the higher costs are usually reported only on a basis of the individual year, but over the many years of an investor's plan can take away a quarter, a third, or even half of what the investor's long-term dollar results would otherwise be.

Higher risk -- But what's even more fundamentally bad for the investor, and seldom mentioned, is that almost without exception choices made for the switch involve much higher risk for the investor, compared to responsible placement of the investor's money in his portfolio's asset classes.

It's been known for centuries, since early development of the field of probabilities, that for meaningful estimates of typical investments return-rate probabilities based on actual return-rate evidence, considering the magnitudes of return-rate variations, **lots of years of return-rate history are required.** And it's long been known, and further shown by the mathematics of modern port folio theory, that to minimize risk of danger that any one business or investment manager may do very poorly in the future, **widest diversification is essential**.

It both of these characteristics, major asset classes have far better grounds for estimating future-performance probabilities than most other investments. They have **decades of history**, and **widest diversification**. That's why, back at the start of the process, the investments from which the portfolios were assembled were asset classes.

But for the switch, the choices in the casino lists come nowhere near these standards.

An example – To illustrate how badly the switch commonly abandons the standards of asset classes as grounds for estimates of investments' future probabilities, and thus greatly increases future-performance uncertainty and risk, consider how it investment advisors are led to carry out the switch by Fiduciary360, the organization that sells "investment fiduciary" credentials.

> **For the asset classes** used from the start all through the process of portfolio selection, Fiduciary360 applies high standards to provide best-grounded future-performance assumptions.

History -- Its asset-class estimates are based on **over forty years** of return-rate history.

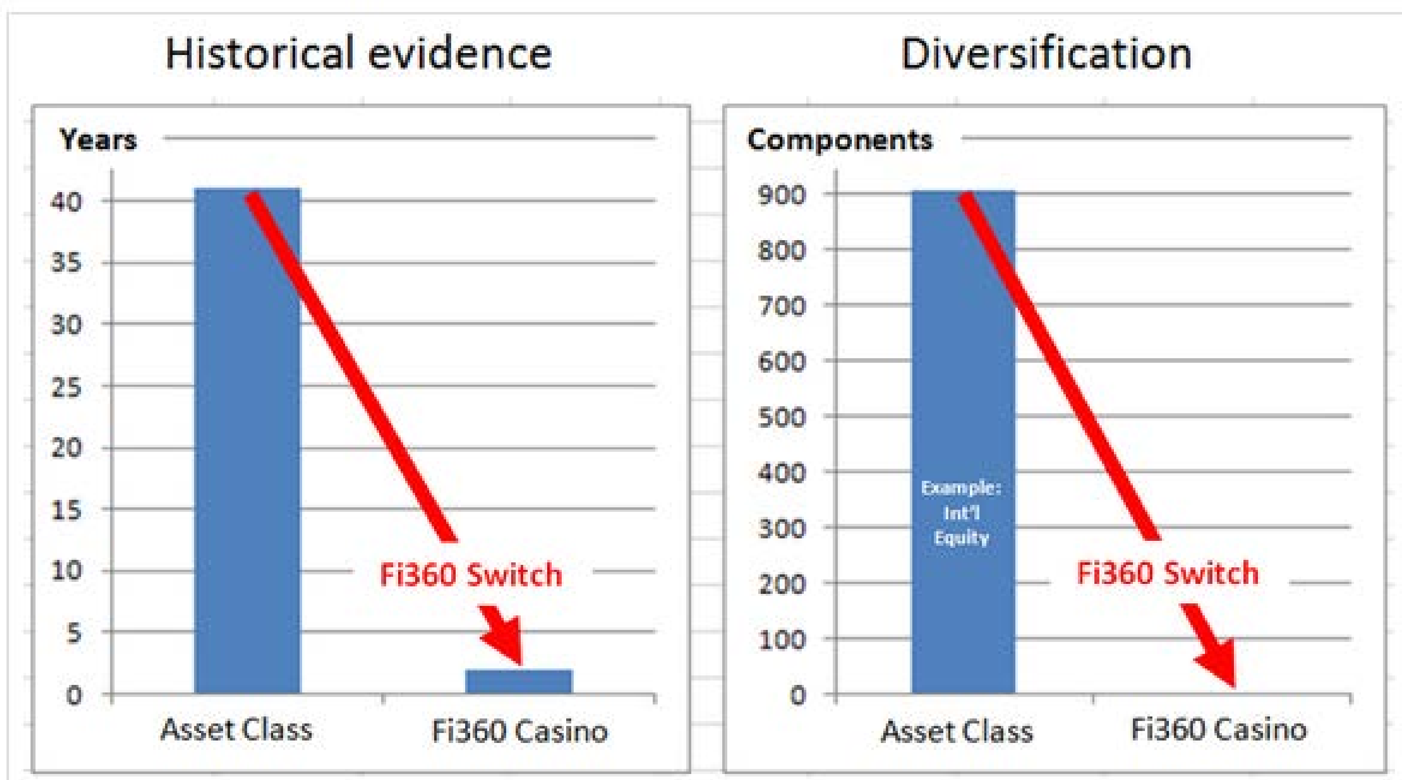
Diversification -- While the number of separate investments within an asset class varies from class to class, they are generally in the **hundreds**. For example, the asset class of International Equity includes investments in over **nine hundred** companies.

But for the casino, for actual placement of investors' money, Fiduciary360 simply abandons those standards. It tells investment advisors that for placement of an investor's money,

Diversification -- A gamble within an asset class can get a perfect rating even if it is a gamble on **only one** "investment manager"

History – The investment manager can have as few years on the job of **only two**.

This total abandonment of its asset-class standards can be exposed visually:



And Fiduciary360 leads investment advisors to present this switch, from asset classes to casino, *as if it were faithful investment in the asset classes.* This is not only *irresponsible misguidance* – it's also **blatantly dishonest**.

This is as bad as any conflict of interest in the broker community. In fact, in two respects it's even worse. It isn't just individual brokers – it's an entire population of investors trained this way. And advisors trained this way are sold the credential of "investment fiduciary."

For years the trainer-certifiers of investment advisors have shaped the investment advisor community this way, with double conflict of interest:

1. They claim that investment advisors' fee-only compensation is conflict-of-interest free, despite the fact that its being based on AUM gives advisors powerful incentive to guide people into the market risk of investment even though other uses of their money such as purchase of a pension may better meet people's best interests.

2. They train investment advisors to guide people's investment in the way outlined in this paper: avoid pursuit of investor's best interest, instead guiding them in the process of Mislabel-Divert-Switch that better serves investment advisor and financial industry interests.

To protect investors from conflict of interest, it's necessary to stop misguidance based on conflicts of interest in the investment advisor community as well as in the broker community. The current Proposed Rule addresses conflicts of interest for brokers but not for investment advisors. Its effect will not be protection of investors but enrichment of a larger and larger community of investment advisors, enriched at the expense of investors.

To overcome the conflicts of interest in the investment advisor community, it's necessary to reach beyond individual investment advisors and establish regulations for the sellers of investment-advisor training-and credentials, which are the source of the problem.

Dick Purcell