

Russell Research

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Due care – the forgotten fiduciary duty

Issue: The fiduciary standard of conduct is generally considered the highest standard of conduct under the law. To conduct one's self as a fiduciary is to fulfill the duty of due care and the duty of loyalty. So much is made of independence and conflicts analysis (based on the duty of loyalty) that we often forget the real value of an advisor.

Response: This note is to call attention to due care, or what we consider the forgotten fiduciary duty. Beyond the need for disclosure, transparency, and management of conflicts of interest, due care is the need for seasoned expertise. Due care requires demonstrable good judgment, knowledge, and diligence in the advisory and fulfillment roles executed on the client's behalf.

Background

Imagine if you will, a licensed attorney who represents himself in court. Could there be a more perfect level of transparency, independence, and alignment of interests? No arrangement could be better in those regards, but all is not well: something important is missing. As the adage goes, an attorney who represents himself has a fool for a client. Under the duty of due care we recognize that the objectivity, expertise, and specialization best suited for counsel would most likely not be fulfilled by self representation. To receive due care, the attorney would fare better hiring outside counsel.

It is similar in the investment arena that independence, transparency, or alignment of interests are not guarantees of due care for a given role. The "prudent expert" standard codifies this with expectations of knowledge that is appropriate to the context and current with prevailing wisdom. [See sidebar]

The concept of the prudent expert is not limited to finance; indeed it exists throughout the law. A doctor has a higher duty of care walking by an injured person in a ditch than does the untrained person, for example. A certified dive master is held to a higher

The Prudent Expert standard under ERISA requires that a fiduciary manage a portfolio "with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent man 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."

standard of conduct than other divers in the open waters, even when joining a guided group as a paying customer. The legal ramifications in either case reflect the heightened expectations for expertise and knowledge. The implication is that even though an investment advisor may meet the fiduciary standard of care, it may still be a lower than desirable standard if the provider is unskilled.

Credential check; experience double-check

In this era of MBA and CFA credentials it is much easier to assess the levels of a professional's training than in times past. Credentials are useful in gauging the level of individual commitment to the profession, and of the organization's support for associate development. However it is also important to understand that expertise is bound and defined by the circumstances, including the experience and role that an advisor plays. Advice is highly contextual. Demonstrating that one knows what advice applies is a matter of track record, through different market cycles and across the relevant sectors of the financial industry. Credentials are a necessary condition, but experience and a track record of successful outcomes are what make the conditionality of expertise sufficient.

Seek the union of loyalty and due care

Some broker dealers will offer a "full fiduciary" approach to their implementation services, such as transition management, FX execution, or overlay programs. That they agree to ERISA codes of conduct may mean that they can't explicitly trade against their clients (although it is difficult to police what is done with the client's trade flow).

What "full fiduciary" does not mean is that they must be any better than an arm's length broker is at execution. They will remain free to execute through their own facilities and liquidity pools, whether or not these are the best for the client's portfolio. What Russell has found is that such assignments are most effectively done through an objective, multi-venue approach that's designed to identify who among the available choices has the knowledge and experience, and ultimately skill, to execute best in the particular market or type of transaction.

Today many large firms have access to multiple markets, through their own affiliates or strategic arrangements with other firms. But access doesn't necessarily mean expertise. The duty of loyalty merely requires them to structure their services and fees to avoid or manage conflicts of interest. It doesn't make them any smarter. And the duty of care – as defined by ERISA – means their expertise should be judged against "an enterprise of a like character and with like aims" in other words, another global broker. It's unlikely that a broker acting under this standard would be required to consider venues other than its own affiliates and strategic partners, regardless of whether they are best for the job. The result of all this may simply be that the client has hired a provider who is objectively less-skilled in some areas than others.

Finding loyalty and expert due care in a single agent can be difficult. Russell developed a multi-venue model over the last several decades based on our consultant's appreciation for expertise, and our years of experience with multi-manager funds. As we found with investment managers, we learned that no single broker can consistently be best in all markets for all transactions. Rather, we believe that our funds and our clients are best served by a disciplined process for finding the right brokers at the right time for the job. We have incorporated this approach into all the trading we manage. Dual registration and client engagement in both the Investment Advisor and Broker Dealer roles contributes to both levels of care clients need.

In the above cases, clients are better served by a real expert – held to the fiduciary standard – in choosing the right venue for execution & clearing, and for choosing the right instrument for the client’s strategy.

Good intentions = good outcomes?

In the Senate and House inquiries into the causes of the financial crisis, tremendous efforts were made to pin blame on bad actors and to find objects and practices of opprobrium. Alas for our duly elected and televised officials, precious little turned up in outright fraud, law breaking, or malfeasance. The majority of key players in government and the financial industry were operating within the boundaries of the law and acceptable market behavior.

As the world wakes up several trillion dollars poorer than it once thought it was, the real lesson of the great financial crisis is that more problems happen because of dumb decisions than conflicted ones, and that structural incentives and experiential perspectives (see the tales of those who shorted the US housing market) may have greater effect on outcomes than the morality or immorality of individual choices.

Due care is a higher standard of care that investors should demand from their advisors. Due care is driven by seasoned, expert advice, and is accompanied by a reputation for outcome driven excellence. Combined with duty of loyalty, the duty of due care fulfills the fiduciary standard of conduct.

RELATED READING

Michael Thomas, Pensions & Investments, May 2010

SIFMA’s “New Federal Fiduciary Standard” -

http://www.advisorperspectives.com/newsletters09/SIFMAs_Proposed_New_Federal_Fiduciary_Standard.php - the Restatement (Second) of Contracts provides that “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”

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