To: The Institute for the Fiduciary Standard
From: Dick Purcell
Re: Comments on the Institute's January 2015 Proposed Best Practices
Date: March 9, 2015

In the introduction of the Institute's paper presenting its Proposed Best Practices for fiduciary investment advisors, these three points jump out:

1. **Clear communication that's understood** – Investment advisors' communication to clients must be clear to clients, understood by clients. In making this point, the Institute says investment guidance must be "understood by Main Street investors," delivered in "plain English." A companion Institute paper criticizes "failing to translate industry jargon into plain language"

2. **Expertise OK, ethics must be improved** -- The Institute says fiduciary investment advisors must meet two kinds of requirements: technical expertise, and ethical character. It says of these two it is ethical character that requires more rules and guidelines, and has focused its development of its Proposed Best Practices to meet that need.

3. **Involve the trainer-certifiers** -- To develop its Proposed Best Practices, the Institute has involved people with links to, and benefits from the "good work" of, four organizations that provide investment advisor training and certifications described as fiduciary or in investors' best interests. Those four are: fi360; the Personal Financial Planning Division of the AICPA: the CFP Board; and the CFA Institute.

With those points in mind, to define what new Best Practice rules are needed, consider current training of investment advisors. Consider the investment-advisor training offered by fi360, the first of the four trainer-certifiers cited above. Fi360 is the only one of the four that puts the word fiduciary right in the certifications it passes out – "Accredited Investment *Fiduciary*" (my italics). And fi360 also stands out in selling software and data to investment advisors for carrying out its teachings.

## "Investor, expect the unexpected"

For meeting an investor's goal, fi360 tells investment advisors to determine the "expected return" to meet the investor's goal.

Whoa. Wait a second. According to my BKM university investment textbook, which coauthor Professor Bodie calls "the market leader," actual returns will almost always be different from the "expected return." So of course, return is *not* expected to be so-called "expected return."

Of the vast majority of U.S. investors who are individual investors, 100 million of them, most expect the word "expect" to mean what the Merriam-Webster online dictionary offers as definition #1:

> **Expect:** to think that something will probably or certainly happen.

This "expected return" teaching from fi360 isn't exactly straight talk that will be "understood by Main Street investors," as called for by the Institute. Or straight talk that will be understood by Main Street investment advisors.

In fact, that term, "expected return," may be the most misleading term in all of financial history.

> The term "expected return" is professors' code for labeling a return that is *not* expected.
>
> It's worse than that. When professors use the term "expected return" for an investment, it standardly means there is *no such thing!* It means the investment's future return is unknown, is viewed in terms of probabilities, with *no* particular return likely enough to be expected.
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> For investors, it's even worse than that. As investment years go by, an investment's actual multi-year result is expected to fall further and further below what its so-called "expected return" would deliver. With increasing uncertainty as to how far below.

(Some professors will try to dispute that last point by talking about the per-year average of years' returns. Don't let them fool you. What counts for investors is the cumulative effect of all the years' deviations from so-called "expected return," and for more years the result is expected to be further below what they call "expected" with more uncertainty about how far below.)

So when an investment advisor follows that fi360 teaching for guiding an investor, he's leading the investor to expect a result for the investor's goal that the investor's investment is expected to fall short of. More years, further below – and more danger of way below.

That's not very fiduciary. But it's what fi360 teaches investment advisors to do. And fi360 gives those advisors certifications as "accredited investment fiduciaries," making them appear to investors to be experts doing the right thing. And making most of them think they are doing the right thing.

**The other trainer-certifiers do this too** – The other trainer-certifiers provide investment advisor training based on the same terribly misleading term: "expected return" (or just "return") for a return that is not expected.

The Personal Financial Planning division of the AICPA has provided technical review of the fi360 training system that features "expected return," and indicated to all of us that it approves that training by identifying itself as provider of technical review in the fi360 guidebooks that present that training.

Often the trainer-certifiers drop the word "expected" and call it just "return," as if there were no doubt at all, even though that return is not expected. Even though through years of investment, an investment's actual result is expected to fall further and further below what its so-called "return" would deliver. With increasing uncertainty as to how far below.

**It comes from professors in our universities** – Fi360 and the other trainer-certifiers did not create this terribly misleading thing, "expected return" that is not expected. It came from our universities and professors. It was spread in the investment advisor community by professors.

It was spread most directly by software backed by names of professors, software designed to enable and guide advisors in use of modern portfolio theory – software products such as Portfolio Strategist, designed and marketed to investment advisors by the firm of a professor beginning way back in the 1990s.

They're still doing it. In my copy of BKM, the same university investment textbook that says actual return almost always deviates from so-called "expected return," the term "expected return" appears over a thousand times. (I'm guessing, didn't count them.)

**For investment-advisor trainers, this is a technical-expertise problem** – The Institute says that in the world of fiduciary investment advisors, the need for improvement is in ethical character rather than technical expertise. But you can't convince me that the folks in charge at fi360 and the PFP Division of the AICPA are suffering from such an ethical problem that they *intend* to train investment advisors to mislead investors. No, they've been misled by the professors' irresponsible use of words and *don't know* they are training advisors to mislead investors. This is a terrible problem of lack of technical expertise right in the heart of the investment-advisor community, among the organizations that train and certify investment advisors.

***For this problem, generalities about plain talk for Main Street investors are not enough. We need a new specific best practice rule: fiduciary investment advisor trainers, certifiers, and practitioners should never use the term "expected return," nor ever use the term "return" for any particular future return that is not expected.***

**Some best investment advisors do *not* guide investors this way** – Some of the best investment advisors, and best investment software designers, are *not* fooled by the misleading "expected return" teachings from fi360 and the other trainer-certifiers. The best advisors and software providers guide investors in pursuit of the investors' best interests – best probabilities for dollar results for the investors' future goals. And they present this guidance not in the professors' doubletalk of "expected return" or "return" for return that is not expected, but in terms of probabilities for the future results that investors are investing for and understand: *dollars* and *years*.

For example: among financial planners who provide investment advice, by far the most widely used financial planning software is MoneyGuidePro, a product that produces meters showing assessments of various plans' and investments' probabilities for meeting an investor's future dollar goals in the years of those goals. The investor as well as the advisor can see how different plans and investments compare in likelihood of meeting his future dollar goals, so they are informed to make good decisions.

**Why don't the best investment advisors demand a stop to this "expected return" training?** – This terrible misuse of terms threatens the respectability of the entire investment-advisor community. Why haven't the best investment advisors stood up and stopped fi360 and other trainer-certifiers from teaching it?

Good question.

## "Investor, focus on your short-term fear for the individual year"

The investment advisor training provided and certified by the trainer-certifiers is based on *two* misleading terms. The first is "expected return" (or just "return"), exposed above. The second is "risk."

**Investor's real risk** – Of course, for anyone investing for dollar goals of future years, such as income for retirement years, the real risk is falling short of those future dollar goals, such as running short of money when you are too old to do much about it.

**Responsible risk assessment** -- In other fields that affect wellbeing of people, such as health, pollution control, engineering of transportation systems and products, professors and professionals have a well established approach for assessing risk, called risk assessment. Risk is assessed by considering adverse outcome in terms of probability.

**The investment-advisor trainer-certifiers use the term "risk" for something else** – In the investment-advisor training of fi360 and the other trainer-certifiers, the standard use of the word "risk" is not the investor's real risk of shortfall for his future dollar needs and goals. Instead, in their teaching "risk" is the label for a single-year technical measure of short-term return-rate variation.

**Exploiting investors' short-term fear** – By using the mighty scare-word risk for a measure of short-term return-rate variation, instead of the investor's real risk of shortfall for his future dollar goals, this training inflames and exploits investors' tendency to overreact to those short-term variations. This training further amplifies this diversion by drawing maximum investor attention to their fear of short-term return rate variation, by asking investors to answer questions on so-called "risk tolerance" questionnaires, in which the mighty scare-word "risk" means short-term variation and emphasis is placed on questions about investor fear of those variations.

**Selecting a portfolio of asset classes *blind*** – As the basis for investment selection, fi360 software provides the investment advisor a conservative-to-aggressive range of portfolio mixes of asset classes with decades of return-rate history and widest diversification, offering best grounds for future-performance estimates with least uncertainty. So far, so good. But from here on, it's all downhill.

These portfolios offer vastly different combinations of future-performance upside potential and uncertainty. For selection among them, fi360 software compares them in its two misleading measures: "expected return" and "risk." For pursuit of the investor's best interest, this comparison is fatally deficient. It fails to reveal or even address how the portfolios compare for the investor's best interest, probabilities of dollar results for his future goals. In fact, this comparison gives no consideration to dollars, years, or effects of compounding along the way.

Yet this is how the advisor is trained to guide the investor in his selection of a portfolio mix of asset classes – selection largely based on inflammation of the investor's short-term fears, blind with respect to which portfolios are best or worst in pursuit of his best interests, probabilities for dollar results for his goal.

**A double anti-fiduciary effect** – This approach to portfolio selection has the anti-fiduciary effect of avoiding pursuit of the investor's best interest in favor of the investment advisor's interest, in two ways:

1. **Uninformed and dependent on the advisor** -- It leaves the investor focused on an individual-year portfolio comparison, from which he cannot see or make an informed judgment for himself on which portfolios are best or worst for his future, and thus is left blindly dependent on the investment advisor.

(Worse for the investor, from this comparison the advisor also cannot see what's best for the investor's future. The advisor is misled to inflame the investor's short-term fears and then base the investor's portfolio selection on an attempt to assess the investor's short-term fears.

2. **Unable to see the long-term cost of the advisor's fees** – Over the life of an individual's investment plan, annual fees and other deductions of only 1% or 2% can smother compound growth enough to reduce the investor's long-term dollar gain by a quarter, a third, even by half. But when the investor's focus is diverted to the individual year, he does not see that terrible long term cost of those fees, sees only the modest-looking 1% or 2%.

**It comes from professors in our universities** – Fi360 and the other trainer-certifiers did not create this misuse of the term "risk" and diversion of the investor's attention to his short-term fear and the individual year, where he cannot see what's best for his future or the long-term cost of financial fees. It came from our universities and professors.

It was spread in the investment advisor community, spread most directly by software backed by names of professors, software designed to enable and guide advisors in use of modern portfolio theory – software products such as Portfolio Strategist, designed and marketed to investment advisors by the firm of a professor.

**This is a problem of lack of technical expertise** – As we've mentioned, in its paper presenting its Proposed Best Practices for fiduciary investment advisors, the Institute says the need for improvement is in ethical character rather than technical expertise. But do you believe that fi360 and the other trainer-certifiers have such an ethical problem that they use the scare-word "risk" and single-year portfolio comparisons the way they do with the *intention* of diverting investor attention away from their own best interests in favor of investment advisors?

Of course not. This is a problem of technical expertise, the trainer-certifiers not understanding how professors' one-year analyses and labels, including "risk," are not right for guiding clients toward their best interests, best probabilities for dollar results for their goals of future years. It must be that the trainer-certifiers intend the best, but just don't know what they are doing. Instead of thinking through the mathematics of return-rate probabilities and compounding applied to an investor's cash flow plan and goals, they just say to themselves "It's Nobel prize winning theory, taught by our professors in our universities, and 'expected return' and 'risk' sound right – it must be right."

Well, for some purposes it may be right. But for individual investors, it is not right. It's all application of so-called modern portfolio theory, developed by Harry Markowitz. Right after he was given a Nobel Prize in Economics for his theory, Professor Markowitz had an article published in which he said that in developing that theory, he had in mind helping mutual funds, and for individual investors another approach should be used.

**New rule needed** – The Institute's Proposed Best Practices paper says investment advisors should provide a reasonable basis for guiding clients toward their best interests, and says that should include the analysis applied – but doesn't say what analysis should be applied. And somewhere it says serving clients' best interests requires "client risk profiles," a term in which the word "risk" means short-term return-rate variation instead of the client's real risk of running short of dollars for his goals of future years, such as running short of income when he's old.

***For this problem, that's not good enough. We need a new specific best practice rule: fiduciary investment advisor training and practice should be focused on guiding clients toward meeting their dollar needs and goals of future years. Analyses and the scare-word risk should be aimed at that purpose, not inflaming clients' short-term fears and diverting their attention to the individual year.***

**Some of the best investment advisors use analyses in another way, leading clients to see and reduce real risk** – The best investor-guidance software products, used by the best investment advisors, focus on probabilities of meeting clients' dollar goals of future years. This reveals assessments of their real risk -- risk of falling short of those future goals. An 80% probability of meeting those goals means 20% real risk of falling short. If that's too much risk, the client can consider adjusting his plan, for example increasing the amount he invests each working year, to increase the goal-meeting probability to 90%, reducing the real risk of shortfall to 10%.

**Why don't the best investment advisors stop the misuse of one-year analyses and the scare-word "risk," which inflames clients' short-term fears and divert their focus to the individual year?** – This terrible misuse of terms and analyses threatens the respectability of the entire investment-advisor community. Why haven't the best investment advisors stood up and stopped fi360 and other trainer-certifiers from teaching it?

Good question.

## While appearing to invest in asset classes, gamble the client's money *within* the asset classes

For the preceding steps, fi360 trains investment advisors to compare a conservative-to-aggressive range of portfolio mixes of asset classes, defined and assessed by indexes, and select a portfolio from that range. Across that range, asset classes have superior grounds for estimating future-performance probabilities: decades of return-rate history, as samples for calculating measures of past return-rate probabilities; and widest diversification, to minimize danger from any particular business or investment manager having future results below those of history or prediction.

Once that selection is made, there is *one* way to faithfully invest the client's money in his selected portfolio's asset classes: for each asset class, invest the client's money in an index fund or ETF designed to match the performance of the asset class.

**The switch** -- However, after selection of an investor's asset-class-mix portfolio selection, for actual placement of the investor's money fi360 leads investment advisors to *switch* – to select from a long list full of less-diversified, shorter-history, riskier gambles *within* the selected asset classes, such as actively managed mutual funds and investment managers that take out higher fees.

**The misrepresentation** -- And fi360 leads investment advisors to present such switches as if they were faithful investment in the selected asset classes.

**Selling stuff to try to make the switch appear responsible** – And to encourage investment advisors to switch, and help them try to justify it, fi360 sells advisors oceans of short-term-history "data" and gamble-rating "scores" for thousands of gambles within the asset classes.

**The wrong fees-and-expenses comparison** – Compared to investments in asset classes, via index funds or ETFs, most of the gambles within the asset classes have higher fees and expenses taken out of the investor's money, reducing the client's net returns and compound growth. The fair way to assess those fees and expenses is to compare them to the lower fees and expenses of investing in the asset classes. But in the fi360 floods of short-term "data" and "scores," fi360 instead compares those higher fees and expenses with higher fees and expenses of other gambles within the asset classes. This way, fi360 can present as "below average" fees and expenses that are higher than those of investing in the asset classes.

**This is so irresponsible, and dishonest, it makes a knowing observer gasp** – Consider:

1. Of course, it's blatantly dishonest to present a bet on an actively managed mutual fund or investment manager *within* an asset class as if it were faithful investment in the asset class. It is *not* the same as investing in the asset class. The fund or manager's *very purpose* is to *differ from* the asset class, in the odds-against hope of beating the asset class by enough to cover his higher fees. (Most don't.)

2. For the attempt to beat the asset class, the fund or manager standardly takes greater risk. In Professor Sharpe's investment textbook this is stated explicitly and called active risk.

3. The switch is de-diversification, increasing risk. The most acclaimed and valuable contribution of Professor Markowitz's modern portfolio theory is the mathematically proven risk-reducing advantage of diversification, spreading money among many investments to reduce danger from any particular investment's potential bad results. A switch from investment in a whole asset class to gamble on a particular investment manager is de-diversification, increasing risk.

4. Evidence of the increased risk is provided by a recent report from Vanguard, showing that over 15 years almost half of all equity funds disappeared. By contrast, whole major asset classes do not disappear.

5. For use of historical data to estimate investment return-rate probabilities, for statistically meaningful results a lot of years are required. For its asset classes, fi360 uses data for 40 years of history. But in the masses of data and ratings for bets within the asset classes that fi360 sells to investment advisors, attracting advisors to make the switch, the coverage is at most only ten

years and commonly only five years or three. And for the investment manager toward whom investment advisors are lured, to gamble the client's money, the fi360 scoring system says only two years on the job is enough for a perfect score. These numbers and scores are essentially floods of statistically meaningless nonsense.

6. The higher fees and expenses taken out of the client's account by gambles within asset classes can, over the life of an investment plan, reduce the client's net long-term gain by a quarter, or a third, or even by half.

**Anti-fiduciary** -- There can be cases where an investment advisor has valid reasons for switching from a selected asset class to an investment within the asset class.

But in general this switching is shockingly anti-fiduciary. Compared to investing in the asset classes, it places the client's investment at greater risk and subject to higher fees and expenses.

And in every case it is simply dishonest to present such switches as faithful investment in the client's selected asset classes, and dishonest to compare the fees-and-expenses of any such gamble with other gambles instead of with those of index funds or ETFs that represent investment in the asset classes.

On the other hand, it is certainly favorable to financial interests, including those of investment advisors. It results in lots of client money placed in gambles within their selected asset classes, from which the financial industry extracts client money for fees and expenses – much more than what's extracted from investments in the asset classes via index funds and ETFs. And the lists of thousands of those gambles, together with floods of "data" and "scores" for them, gives investment advisors lots of material for trying to justify their own fees taken from the clients' money.

**Again, the source is professors** – The investment-advisor trainer-certifiers did not originate this irresponsible and dishonest practice of appearing to invest in asset classes while instead placing investors' money in riskier higher-fee gambles within the asset classes. It was introduced by those software products backed by names of professors that introduced and enabled advisor application of modern portfolio theory, presenting this switch as if it were part of the Nobel Prize winning theory. Products such as Portfolio Strategist with its so-called Security Classifier, designed and marketed by the firm of a professor.

**It's colossal lack of technical expertise** – For anyone still thinking that in this field, technical expertise is fine, this one kills that notion. Anyone with a basic grasp of statistics would know that he could not get away with fi360's switch and supporting "data" and "scores." And yet after a decade, nobody has blown the whistle and stopped it – yet.

**The other trainer-certifiers do it too** – in teaching the switch, as if it were faithful investment in a client's selected asset classes, and misrepresentation that this is both responsible and honest, fi360 is not alone. The other trainer-certifiers teach it too.

**The Institute supports the switch** – In its Proposed Best Practices, the Institute says nothing about this problem of fi360 and the other trainer-certifiers encouraging the switch, and says nothing about the dishonesty of presenting the switch as if it were faithful investment in the client's selected asset classes.

Just the opposite. On the last page of its Proposed Best Practices paper the Institute simply says the investment advisor should have lots and lots of gambles within the asset classes. And regarding fees and expenses, the institute says the advisor should compare these gambles to other gambles, which in most cases have fees and expenses much higher than those of investment in the asset classes.

***For this problem new rules are necessary. In most cases, after selecting a client's asset classes the advisor should invest the client's money in those asset classes, which is done with index funds or ETFs. In the unusual case where the advisor has good reason to instead switch to a bet within an asset class, the advisor should present his reasoning, which should include comparison of the bet with the asset-class investment in length as well as performance of historical return-rate evidence, and in fees and expenses.***

# Conclusions and Recommendation

There are good investment advisors who inform and advise clients for pursuit of their best interests, best probabilities for best dollar results for their future dollar goals – instead of following training to base advice on misleadingly labeled deficient single-year

assessment in “expected return” (or just “return”) and “risk.” There are good investment advisors who guide clients to placement of their money in selected asset classes – instead of placing clients’ money in riskier, higher-fee gambles *within* the assets classes, under the false appearance of faithful investment in asset classes.

## The problem

But the prevailing system of investment education, advisor training, and certification, created and spread by professors, taught and certified by the trainer-certifiers, is so misdirected and so misleadingly presented that it mistrains most well-intentioned investment advisors to omit pursuit of client’s best interests in favor of the advisors’ own interests.

The process starts with mixes of asset classes, which is good. But all the rest of the way it is anti-fiduciary:

> For selection of a mix of asset classes, use the misleading label “expected return” or just “return” to give the client false expectation of result for his future goals that his investment is expected to fall short of. Then add irresponsible use of the term “risk” to divert the client’s focus to the individual year where he cannot see what’s best for his future and thus is dependent on the advisor, and cannot see the long-term cost of the advisor’s and financial industry fees;
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> Then for placement of the investor’s money, switch from the client’s chosen asset classes to choose from thousands of riskier gambles with higher fees, under the false appearance of faithful investment in the client’s selected asset classes, thus giving the advisor the appearance of lots of work sifting through the gambles which he can point to as justification for his fees.

## Twisting the fiduciary standard to benefit advisors instead of investors

This process is so warped against the best interests of clients, in favor of investment advisors, that if it is covered by a blanket labeled “fiduciary,” the beneficiaries of increased promotion and enforcement of the fiduciary standard will not be the investing public but an empire of fee-enriched investment advisors, whom the trainer-certifiers have (a) trained to misguide investors in favor of the advisors’ receipt of fees and (b) given certifications that make the advisors appear to be, and in most cases think they are, fiduciaries.

## The exposure

For two decades this kind of investment education and investment advisor training-and-certification has prevailed. But it may not last much longer. Increasing attention to and debate about the fiduciary standard will attract increasing scrutiny. Venture capital is financing startups looking for new approaches that leave the current investment advisor community in the dust. For people looking for openings to beat the investor-guidance competition, the misconceptions and misleading labels on which the current investment advisor training in based are not hard to spot.

Exposure from outside could become a mega-scandal – “investorgate” – bringing the whole investment advisor community down, turning certifications from fi360 and the other trainer-certifiers into badges of shame, hurting the best investment advisors along with the rest.

## The Institute

The Institute for the Fiduciary Standard has a wonderful opportunity: fix the problem, now. Change investment advisor training so instead of just being *called* fiduciary, it *is* fiduciary.

**Mr. Bogle** – In the towering figure of John Bogle, the Institute has an ideal, superb leader for defining what’s right and for winning support. For four decades now, he has been the dominant missionary for true fiduciary investor guidance. Relentlessly, in creating and marketing asset-class index-fund offerings from Vanguard, in books, speeches, articles, interviews, he has pushed for financial

interests to offer and investors to choose investments best suited for pursuit of investors' best interests. The very core of his message has been:

Invest in asset classes, via index funds, to minimize growth-choking fees and other deductions (and minimize risk).

Focus on the longer term, out to your goals, to see the advantages of minimizing those fees, deductions, and risks.

**Others involved in the Institute** – But what the trainers-certifiers are teaching, and the Institute's Best Practices Board has failed to expose, and instead to a large extent endorses, is in essence the opposite:

Divert investor focus to the single year, where he cannot see what's best for his future or the long-term cost of fees.

Then while appearing to invest in asset classes, switch to choose from a swamp of riskier gambles with higher fees.

## My recommendation

My recommendation to the Institute is, other than Mr. Bogle, change the people involved so they represent technical expertise in investment mathematics, including probabilities and statistics, rather than investment in the current trainer-certifiers and their teachings.

With such a change, the Institute can rescue the investment-advisor community from two decades of blind acceptance of misapplied and mislabeled theory from professors, that avoids pursuit of investors' best interests in favor of financial industry and advisors' interests, and instead advance investment advisor training to fulfill the fiduciary standard.

Without such a change, continuing on the path indicated by the Proposed Best Practices, the Institute will just help put a fiduciary blanket over the current mistraining and mis-certification that makes the beneficiaries of the fiduciary standard not the investing public but a growing population of investment advisors misguiding investors while gorging on fees. They won't have to think up ways to mislead their clients in favor of their own fees – the trainer-certifiers will do it for them and label it "fiduciary."

Until it's exposed.

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Mr. Purcell does *not hold any* of the following certifications:
the certification of AIF awarded by fi360
the certification of CPA/PFS awarded by the PFP Division of the AICPA
the certification of CFP awarded by the CFP Board
the certification of CFA awarded by the CFA Institute

Mr. Purcell is currently authoring a book citing words of professors in support of his contention that university investment education has corrupted fiduciary investor guidance.

Full disclosure: Mr. Purcell is designer of and holds a financial interest in a software product for investment advisors' guidance of individual investors named Portfolio Pathfinder.