Report for Fiduciaries

September 16, 2024

ERS asked:

> Should a fiduciary rely on Wall Street brokerage firms to provide fair, reliable and complete disclosures of the risks of investing in stocks they recommend, and do they provide estimates of how far the prices of stocks they recommend will fall if their earnings estimates or estimates of a company’s future p/s ratio is wrong? if not, why not and should fiduciaries buy stocks without a clear and reliable estimate of how much that stock may decline?

ChatGPT answered:

A fiduciary should not solely rely on Wall Street brokerage firms to provide fair, reliable, and complete disclosures of the risks associated with investing in the stocks they recommend. Here's why:

1. **Potential Conflicts of Interest**: Brokerage firms often have conflicts of interest because they may be involved in underwriting securities, providing corporate advisory services, or have other business relationships with the companies they cover. This can bias their research and recommendations, potentially leading them to downplay risks or emphasize the positive aspects of a stock to support other business interests.
2. **Lack of Comprehensive Risk Disclosures**: Wall Street firms typically provide buy, hold, or sell ratings and often focus on the potential upside of stocks they recommend. However, they rarely provide detailed, objective, or comprehensive estimates of how far the prices of these stocks may fall if their earnings estimates or assumptions about a company's future price-to-sales (P/S) or price-to-earnings (P/E) ratios are incorrect. Such potential downside scenarios are crucial for understanding the true risk of an investment.
3. **Insufficient Analysis of Downside Risk**: Even when risks are mentioned, the analysis tends to be qualitative rather than quantitative. It often lacks a rigorous statistical assessment of the probability and magnitude of potential declines. Investors need to know not just that a stock is "risky," but also the likelihood and extent of potential losses under different scenarios.
4. **Importance of Independent and Objective Analysis**: Fiduciaries are legally obligated to act in their clients' best interests, which means making investment decisions based on objective, thorough, and reliable information. They must go beyond relying on potentially biased brokerage reports and conduct their own due diligence or use independent third-party research that provides a clearer picture of both potential gains and losses.
5. **Risk Management and Fiduciary Duty**: Fiduciaries should not buy stocks without a clear and reliable estimate of how much that stock may decline. Without a thorough understanding of the downside risks, they could expose their clients to unnecessary or excessive losses, violating their duty to manage risk prudently. It is essential to assess both the potential upside and the

potential downside of an investment, particularly in scenarios where earnings projections or P/S ratio assumptions may be overly optimistic or incorrect.

6. **Need for Robust Risk Estimation**: A clear, robust, and quantitative estimate of potential declines helps fiduciaries prepare for adverse scenarios, implement appropriate risk management strategies, and maintain the trust of their clients. It also allows for better portfolio construction by balancing risk and return in line with the client's risk tolerance and financial goals.

In conclusion, fiduciaries should conduct independent research, utilize reliable third-party risk analysis tools, and ensure they have a clear understanding of both the potential gains and losses before making investment decisions. This approach aligns with their legal and ethical responsibilities to act in the best interest of their clients.

ERS asked:

> Is trading stocks based on momentum a strategy suitable for fiduciary responsibility and duty of care?

ChatGPT answered:

Trading stocks based on momentum is generally not considered a strategy that aligns well with a fiduciary's responsibility and duty of care. Here's why:

1. Lack of Fundamental Analysis:

Momentum trading relies on the premise that stocks that have performed well recently will continue to do so in the short term, and stocks that have performed poorly will continue to decline. This strategy often disregards a company's underlying fundamentals, such as financial health, revenue growth, earnings, or risk factors. Fiduciaries have a duty to conduct thorough and comprehensive analyses of investments to ensure they are in the best interest of their clients. Relying solely on momentum may overlook the risks and potential issues with a company's fundamentals.

2. Higher Volatility and Risk:

Momentum strategies are generally more volatile and involve higher risks than long-term investment strategies based on fundamental analysis. Stocks experiencing strong upward momentum can also reverse quickly, leading to sharp losses. This level of risk may not be appropriate for many clients, especially those with lower risk tolerances or those who are focused on capital preservation. Fiduciaries are obligated to manage risk prudently and in line with the client's risk profile.

3. Short-Term Focus:

Momentum trading typically involves a shorter-term focus and frequent trading, which may not align with the long-term goals of most clients, especially those focused on retirement, wealth preservation, or steady growth. Fiduciaries are often expected to prioritize long-term wealth management strategies that align with their clients' financial objectives.

4. Increased Transaction Costs:

Momentum trading involves frequent buying and selling of stocks, which can lead to higher transaction costs, including commissions, fees, and potential tax implications. These additional costs can eat into investment returns and may not serve the best interest of the client. Fiduciaries have a duty to minimize unnecessary costs and fees to protect their clients' assets.

5. Behavioral Biases and Market Timing Risks:

Momentum trading can be influenced by market sentiment, herd behavior, and emotional biases, which can lead to poor decision-making. Market timing is notoriously difficult to execute consistently, and even small misjudgments can lead to significant losses. Fiduciaries are responsible for ensuring investment decisions are made based on sound analysis and evidence, rather than speculative or emotionally-driven approaches.

6. Lack of Predictability and Reliability:

While momentum strategies may have periods of success, they are inherently unpredictable and may not provide reliable returns over the long term. They are often subject to rapid changes in market conditions and can lead to unpredictable outcomes. Fiduciaries have a duty of care to act with prudence and diligence, which typically involves selecting strategies that offer more predictable and stable outcomes.

7. Alignment with Client Interests:

Fiduciaries must align their strategies with the specific goals, risk tolerance, and needs of their clients. Momentum trading, with its speculative nature, may not be suitable for most clients who seek steady growth, income, or capital preservation. Engaging in high-risk strategies without explicit client consent and a clear understanding of the potential downsides could be seen as a breach of fiduciary duty.

Conclusion:

While momentum trading can be profitable in certain market conditions and for specific types of investors, it generally does not meet the standards of prudence, diligence, and care required of fiduciaries. A fiduciary's duty is to prioritize their clients' best interests, focusing on long-term, fundamentally sound investment strategies that appropriately manage risk. Therefore, momentum trading is typically unsuitable for fiduciaries who must adhere to a high standard of care and accountability.

ERS asked:

> You suggest that "fiduciaries should conduct independent research, utilize reliable third-party risk analysis tools, and ensure they have a clear understanding of both the potential gains and losses before making investment decisions." What should fiduciaries do when they can't find third parties that have positive and accurate records of their past performance?

ChatGPT answered:

When fiduciaries cannot find third-party risk analysis tools or research providers with positive and accurate records of past performance, they face a significant challenge in fulfilling their duty to act in the best interest of their clients. In such situations, fiduciaries should consider the following steps to uphold their responsibilities:

1. Develop Internal Research Capabilities:

If reliable third-party sources are not available, fiduciaries may need to invest in building internal research capabilities. This could involve hiring experienced analysts, data scientists, or financial experts who can analyze the fundamental and technical aspects of potential investments. Developing proprietary models and using advanced statistical and data analysis techniques can provide more reliable insights tailored to the specific needs of their clients.

2. Utilize Multiple Data Sources and Independent Research Providers:

Instead of relying on a single source, fiduciaries can gather data and insights from a variety of independent sources, such as academic research, specialized research firms, economic reports, and even alternative data providers. Diversifying the sources of information can help reduce biases and provide a more balanced view of potential risks and rewards. By cross-referencing data from multiple perspectives, fiduciaries can develop a more comprehensive understanding of the investment landscape.

3. Focus on Transparent and Verifiable Methodologies:

Fiduciaries should prioritize research providers and tools that are transparent about their methodologies and data sources. When third-party providers disclose how they derive their conclusions, fiduciaries can better assess the validity and reliability of the information. Even if the track record isn't perfect, a transparent methodology allows fiduciaries to critically evaluate the data and make informed decisions.

4. Perform In-Depth Scenario and Sensitivity Analysis:

Fiduciaries should perform their own scenario analysis and stress testing to understand the potential impact of various risks, such as changes in economic conditions, market volatility, or company-specific events. By conducting sensitivity analyses on critical assumptions like earnings growth, price-to-earnings (P/E) ratios, or price-to-sales (P/S) ratios, fiduciaries can gauge how potential changes might affect an investment’s value.

5. Implement a Robust Risk Management Framework:

A strong risk management framework is crucial when reliable third-party risk analysis is lacking. This framework should include diversification strategies, position sizing, stop-loss orders, and other risk mitigation techniques that limit potential losses. This systematic approach allows fiduciaries to manage risk effectively even in the absence of perfect external analysis.

6. Adopt a Conservative Investment Approach:

When facing uncertainty due to a lack of reliable third-party performance records, a conservative approach may be more appropriate. This could involve focusing on well-established companies with strong financials, transparent business models, and a track record of stability. It might also mean avoiding high-risk investments or sectors with less predictability.

7. Engage with Independent Experts and Peer Networks:

Fiduciaries can consult independent experts, such as academics, industry professionals, or experienced investors, to gain additional insights into investment risks. Peer networks and professional associations can also provide valuable perspectives and best practices for evaluating investments when third-party data is limited or unreliable.

8. Prioritize Continuous Learning and Adaptation:

The investment landscape is constantly evolving, and fiduciaries must stay informed about new research methods, emerging risks, and market trends. Continuous education and adaptation to new information are crucial for making well-informed decisions. This may include training on advanced financial modeling, risk analysis techniques, and understanding emerging data science tools.

9. Document the Decision-Making Process and Rationale:

Transparency in the decision-making process is critical to fulfilling fiduciary duties. When relying on internal analysis or less-established third-party research, fiduciaries should thoroughly document their rationale, the sources consulted, the assumptions made, and the methodologies used. This documentation not only helps in regulatory compliance but also demonstrates a commitment to thorough and reasoned investment decision-making.

10. Seek Feedback and Independent Verification:

Where possible, fiduciaries should seek external verification of their findings. This could involve working with independent consultants or data scientists to audit the research and models used. Even if there aren't perfect records available, getting third-party feedback on the robustness of their internal processes can help ensure that their methods are sound and aligned with best practices.

Conclusion:

Fiduciaries have a duty to act prudently and in their clients' best interests, which includes thoroughly understanding investment risks and potential returns. When reliable third-party research is unavailable or lacks a positive track record, fiduciaries must adapt by enhancing their internal research capabilities, diversifying their sources of information, using transparent and verifiable methodologies, and applying a conservative and well-documented approach. This ensures they maintain a high standard of care and diligence in managing their clients' assets, regardless of external constraints.