



# Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*<sup>SM</sup>

## What the New Federal Fiduciary Rule Means to Investors

July 2016



In April, the U.S. Department of Labor (DOL) made headlines with its final rule covering conflicts of interest among investment advisers. Media coverage focused on the difference between a “fiduciary” standard and a “suitability” standard. Financial advisers and investment firms have been debating this issue—often heatedly—for years, and the DOL action probably will bring about changes within the industry.

The new rules also have a message for investors, especially those who rely upon an advisor. This lesson may not be astounding but it’s worth keeping in mind: You should know what investment advice is costing and whether you’re getting your money’s worth.

### Defining the terms

Investment advisers who are registered with the SEC are considered *fiduciaries*:

They have an obligation to act in a client’s best interest. Alternatively, registered representatives associated with a securities brokerage firm are required to make investment recommendations that are *suitable* for a particular client, given the client’s circumstances. (Registered investment advisers are fiduciaries under the Investment Advisors Act of 1940 but not under ERISA, the federal law covering retirement plans; ERISA is the DOL’s responsibility, so that agency issued the rule on retirement advice.)

When issuing its final rule in April, the DOL came down firmly in favor of the fiduciary standard, stating that “persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of a plan or IRA” will be treated “as fiduciaries in a wider array of advice relationships.”

### Digging deeper

Investors should keep in mind that the DOL rule covers retirement advice, not all investments. Therefore, this regulation applies to advisers’ recommendations for IRAs, 401(k)s, and other retirement accounts. When Wendy Jones seeks advice on how to invest in a regular (non-retirement) account, the DOL rule won’t apply, at least not directly. Advisers who

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## Benchmark-Based Investing

*From the beginning of 2015 to the second quarter of 2016, about \$250 billion has moved out of actively-managed mutual funds and into passively-managed index-tracking mutual funds and index-tracking exchange-traded funds.*

## Trusted Advice

### Learning Lessons

- ▶ The Department of Labor's final rule carves out educational information from the definition of retirement investment advice.
- ▶ Thus, advisors and plan sponsors can provide general financial and investment concepts on retirement saving with employment-based plans and IRAs without triggering fiduciary duties.
- ▶ For example, such education could consist of information about historic differences in rates of return among equities, bonds, or cash, based on standard market indexes.

adhere to a fiduciary standard for retirement advice may well follow the same approach for other client funds.

Moreover, the DOL clearly associates investors' best interests with low costs. The DOL repeatedly has mentioned "backdoor payments" and "hidden fees" as factors that harm American workers and their families. Lowering fees would boost returns, the DOL asserts.

### Investment implications

Some observers believe that the federal support of a fiduciary standard will result in more advisor

support of passive investment strategies and less emphasis on active management. Also, sales commissions may yield ground to fee-based advisory arrangements.

Both of those assertions may come to pass, but both trends are already well under way. Passive investing generally means holding funds that track a market index, such as the S&P 500. Such funds typically have relatively low costs, as there is no need to pay for research into security selection, and relatively low tax bills, because of infrequent trading.

Index-tracking mutual funds have been popular for some time, as finding fund managers who consistently outperform the indexes has proven to be challenging. In recent years, exchange-traded funds (ETFs) have taken market share from mutual funds; most ETFs track a specific market index. Thus, many advisors and clients have been moving towards such low-cost, tax-efficient approaches.

Similarly, fee-based investment arrangements also have been on the rise. Advocates assert that paying, say, an asset management fee puts a client "on the same side of the table" as an advisor, reducing conflicts of interest. If a client's investment assets grow through superior returns, so will the advisor's management fee.

### Assessing advisors

Given this background, what can you take away from the DOL's proposal? First off, don't focus solely on terminology. Whether you're getting the "best" investment or a "suitable"

investment for your needs, you will have to pay the advisor in some manner. Therefore, you should know how much you're actually paying, so read all contracts, engagement letters, and other documents carefully to find out the true cost.

Second, realize that low costs aren't everything. Ascertain what value you're getting for what you pay. Is your advisor providing only investment advice? If so, what results have you received? Many financial professionals go beyond investments to insurance planning, education planning, estate planning, and other areas of wealth management. If you have such an advisor, does the total package provided to you justify the total amount of your outlays? If you are not comfortable with the answers, you may have to seek someone else to help you handle your financial matters. ■

## Did You Know?

In 2015, Atlanta's airport became the first to top 100 million passengers in a calendar year, serving over 101 million travelers. Beijing's airport was a distant second in the world, with nearly 90 million passengers last year. The next busiest U.S. airports were those serving Chicago (No. 4 in the world, 76.9 million), Los Angeles (7th, 74.9 million), and Dallas-Ft. Worth (10th, 63 million).

Source: Airports Council International

## ETFs Can Be Plain or Fancy

From virtually nowhere, exchange-traded products have grown to over \$3 trillion in assets. A small portion of these products are exchange-

traded notes (ETNs), but most are exchange-traded funds (ETFs): typically, pools of securities that trade like stocks.

A large amount of ETF assets, in turn, are in funds that track major stock market indexes such as the S&P 500 and the NASDAQ 100,

as well as small-company indexes, foreign stock indexes, and so on. These ETFs tend to be low cost and tax efficient, so many supporters of a fiduciary standard for advisors (see the article, “What the New Federal Fiduciary Rule Means to Investors” in this issue) believe that the new rules favor ETFs as being in the best interests of many investors. Indeed, one Morningstar analyst has asserted that an estimated \$1 trillion of investment assets will shift into ETFs.

### Outside the box

However, not every ETF is a low-priced proxy for a major index. As ETFs have proliferated, they’ve spread into what seems to be every nook and cranny an investor might want to explore. For example, there are ETFs that track an energy stock index, ETFs that track exploration and production companies, even ETFs that track crude oil futures. There are ETFs that track specific foreign currencies, high-yield foreign bonds, certain hedge fund strategies, and so on.

In recent years, leveraged and inverse ETFs have gained popularity. Leveraged ETFs may be known as 2x or 3x ETFs, meaning that they move two or three times as much as the underlying index or commodity price or some other baseline.

**Example 1:** Ann Benson buys a 2X ETF that tracks the S&P 500. If that index goes up 5%, Ann’s ETF goes up by 10%. If the S&P 500 drops by 5%, Ann’s ETF suffers a 10% price drop.

Inverse ETFs move in the opposite direction of their benchmark.

**Example 2:** Carl Davis buys an inverse ETF that tracks the NASDAQ 100. If that index goes up 5%, Carl’s ETF goes down by 5%. If the NASDAQ 100 drops by 5%, Carl’s ETF enjoys a 5% price gain.

Some ETFs are both leveraged and inverse. Thus, they move in the opposite direction of the benchmark and those moves are magnified two or three times.

**Example 3:** Eve Foster buys a 2X inverse ETF on the Russell 2000 index of small company stocks. If that index goes up 5%, Eve’s ETF goes down by 10%. If the Russell 2000 drops by 5%, Eve’s ETF enjoys a 10% price gain.

### Daily divergence

The preceding examples are simplified. In the real world, leveraged and inverse ETFs are more complex because these ETFs typically are reset daily. Over time, the results produced may vary widely from expectations.

**Example 4:** Suppose Eve Foster invests \$10,000 in a 2X inverse ETF

on the Russell 2000, as in example 3, and the index gains 5% on Monday, from 1100 to 1155. Eve’s 2X inverse ETF falls by 10%, from \$10,000 to \$9,000.

Now suppose the index falls back to 1100 on Tuesday. That’s a 4.76% drop, from 1155 to 1100, so Eve’s 2X inverse ETF gains twice as much—9.52%—from \$9,000 to \$9,857. In the two-day period, the underlying index is back to where it started, but Eve’s 2X inverse ETF has lost value.

It’s true that stock market indexes seldom move 5% on a single day. However, moves of 1% or more occur with some frequency, and the principle is the same. Especially if such an ETF is held for an extended time period, the daily resets can cause the result from holding a leveraged or inverse ETF to diverge widely from the performance of the underlying benchmark.

### Proceed with caution

Leveraged and inverse ETFs pose risks, but there are reasons that they have grown in popularity. Used astutely, these ETFs might enable you to increase investment returns or hedge certain portfolio risks. If you work with a skilled advisor who is familiar with leveraged and inverse ETFs, you may be able to gain more control over your investments while boosting upside potential. ■

## Disaster Planning Versus Succession Planning

Business owners should have an exit strategy: a plan for the time when they’re either unwilling or unable to keep running their company. Often, that planning can include a current disaster plan for relatively young business owners and a future long-

term succession plan for a smooth path to retirement.

### Worst case scenarios

No matter how young or how healthy you are, you’re not immune to tragedy. Therefore,



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business owners should have a disaster plan, which might be called a catastrophe plan or a continuity plan or something similar. Such a plan can protect you or your family in case of death or disability.

To understand why such a plan is vital, consider what might happen in its absence.

**Example:** John Smith, age 45, is the sole shareholder of the successful John Smith Co. After a fatal auto accident, his widow Jane inherits John's shares. At such a time, Jane will have to find a buyer and negotiate the terms of the sale. Jane may have a difficult time getting full value for this profitable business.

Alternatively, John might suffer a stroke and lose his ability to work full-time. In the absence of a disaster plan, John (or someone representing him) will have to relinquish control of the company and find some way to realize the value of the business he has built.

### Buy-sell benefits

To provide protection against such possible disasters, business owners and co-owners of all ages should have a buy-sell agreement in place. Such an

agreement should identify the buyer, in case a sale becomes necessary, and specified events that will trigger the buyout. The agreement also should spell out how the price will be determined—it could be a multiple of cash flow or revenue, for instance.

If a company has two or more co-owners, a mutual buy-sell can be effective. For sole shareholders, such as John Smith in our example, finding a buyer may require some creativity. A key employee might be named, or even a competitor. Funding for a possible buyout might be provided through life and disability insurance.

### Happier ending

If all goes well, our hypothetical John Smith will remain healthy and active throughout his 40s and 50s. His company will continue to prosper. In his 60s, though, John might start to think about stepping down—or at least slowing down. At some point, John should begin working on a long-term succession plan for his retirement or semi-retirement.

Note that John should not ignore the chance of a catastrophe, at any age. Therefore, his succession plan

should include disaster planning. For the long-term plan, John may prefer to have a different buyer than the buyer for the catastrophe plan. (The initial catastrophe plan can contain language allowing for cancellation of the agreement with written notice from the buyer or seller.)

In addition to catastrophe coverage, the long-term succession plan might have a schedule for John's future participation in the company. Will John leave altogether, as of a certain date? Will he continue to work at the company for a certain or an indefinite time period? If he stays on, what responsibilities will he have? In some cases, the purchase price might be reduced, if John leaves the company altogether; a higher price might be agreed upon if John agrees to stay for a while, helping the company make the transition to new ownership.

A long-term succession plan also should cover taxes because certain deal structures can be more or less favorable to the seller. Our office can help you work out the terms of a fair agreement, for disaster protection as well as for a satisfactory exit. ■

## TAX CALENDAR

### JULY 2016

#### July 15

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies.

### AUGUST 2016

#### August 1

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2016. Deposit any undeposited tax. If your tax liability is less than \$2,500, you can pay it in full with a timely filed return. If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than \$500.

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2015.

#### August 10

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2016. This due date applies only if you deposited the tax for the quarter in full and on time.

#### August 15

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.