Q2 2016 Market Commentary

In recent weeks, two events have struck at the heart of the financial industry – one you have probably heard about and the other possibly not.

The first was the release of millions of documents from the Panama-based law firm Mossack Fonseca, related to tax-avoidance schemes that the firm developed for interested clients. The leak of these "Panama Papers" may have already cost one Prime Minister his position and promises to make life uncomfortable for another as the world looks askance at the financial affairs of dozens of high profile politicians, celebrities and business leaders.

While some of those exposed are likely in real legal trouble, not all are guilty of a crime – like corporate tax inversions, the tax-arbitrage strategy of off-shoring accounts is a legal way to reduce your expenses. But when public officials and well-respected role-models (or large, well-known corporations) engage these strategies, there can be a sense of public betrayal. As with high-frequency trading and currency hedging, tax-avoidance schemes simmer in the minds of those who have no access to these strategies as yet more proof that the game is rigged.

This makes the shining light of attention most unwelcome for the banks and other institutions involved, many of which have already seen a series of investigations and high profile lawsuits on pay-to-play policies, mortgage-backed securities fraud, LIBOR rate rigging, and money-laundering clients. The leak will spark new investigations, and re-energize old ones that have been flailing – which may benefit customers for a little while as banks race to behave better under the microscope.

But inevitably, whatever good intentions surround the leak and the subsequent investigations they will be lost in the haze of daily headlines. Any lasting effects of the leak will likely be in the form of a raft of new regulations meant to deter such activity in the future, even as the well-connected hunt for a new firm to help in their tax-avoidance aspirations – one with better security.

Such regulatory reaction to a public disapproval is the crux of the second event, which is the release of the Department of Labor's new "Conflict of Interest rule." The rule, brought about in part by the financial crisis and the perception that it continued an ongoing cycle of harm to small investors that began during the tech bubble of 2000, essentially expands the Employee Retirement Income Security Act (ERISA) definition of an investment fiduciary, and covers IRAs and Coverdell accounts in addition to traditional pension plans and 401Ks. The broader brush is intended to ensure that those who are tasked with handling retirement funds are all meeting the higher "best-interest" standard of fiduciary care.

On the surface and in theory, it is a change that we at Northstar applaud as advisors, having come across too many clients with investments that clearly do not serve their best interest, even if they do pass muster against the lower "suitability" standard. But we all know that a promise to act with honesty and integrity doesn't mean much if it's coerced – and that despite all the rules and regulations against behavior that harms clients, such harm still happens with appalling regularity. Imposing a fiduciary standard of care upon someone that doesn't really care won't suddenly make that person more honest or compel them to act with integrity, but it might make them more careful.

Those who do care, and have always cared, will now need to work harder to shoulder the burden of fiduciary duty, and make no mistake it is a weighty charge. The term fiduciary is not simply a title, but a position that comes attached to an increased level of responsibility and expectation as well as greater exposure to liability as a result of that higher standard.

Current fiduciary advisors know that their duty entails an in-depth and thorough understanding of not just a wide variety of investment strategies and products, but also of each client's financial lives – budgets and risk tolerances, definitely, but also aspirations, fears and financial behaviors as well. This kind of professional and personal expertise requires a great deal of time and effort on the part of the advisor and a greater financial commitment on the part of the client. This is one reason many financial planning firms have bifurcated their services to provide for both advisory (financial planning and investment management) and non-advisory (investment placement and service ) clients.

Fiduciary compliance also requires a lot of time and effort, for record keeping and documentation and a myriad of annual audits and various reporting requirements. Many of these requirements depend upon independent legal counsel, as well as sizable technology infrastructure. There is high probability that the extra time and resources required to act as a fiduciary will inevitably force consolidation in the industry, as smaller firms try to remain competitive against established giants whose economies of scale and access to policy-makers provide some protection against the disruption that sweeping regulatory change can create.

It is our opinion that, though well intentioned, the new regulations will effectively raise the barriers to entry at multiple levels, for both investors and advisors, through more stringent rules. All for the sake of weeding out those not inclined to follow any rules. The weight of these rules, like mistrust toward banks, will fall mostly on those least-prepared to cope; smaller, transactional advisors with decent intentions and no legal department to speak of.

Indeed, though the rule will have little direct impact on many of a firm's clients there will be an increased mandate placed on advisors from clients who are affected. And while most firms such as ours are familiar with and have infrastructure in place for record-keeping and reporting requirements, systems may need to be altered and strengthened to adequately monitor a large and sudden shift of clients from an "as-needed" service schedule to one in which we are, at the very least, actively analyzing investments and communicating findings on a quarterly basis.

Thus, the rule may necessitate some form of change in the way firms operate in general and provide services to non-advisory clients specifically. Ideally, such a change will result in less of an advisors time spent on record-keeping tasks and regulatory filings and more spent on conversations with clients and the management of their financial plans, because at the end of the day that's what we at Northstar feel we are here to do.

In any case, neither the Panama Papers nor the conflict of interest rule should have much of an impact on the markets as they are more structural in nature than catalysts for a change in growth and earnings. Tax-arbitrage and the subsequent off-shoring of capital is a very specialized area of finance, and the amount of money involved is small compared to the size of total trading. And the fiduciary rule doesn't affect stock and bond pricing but without a doubt it will alter the design and offering of future investment products, insurance contracts and the methodology and pricing of investment advice and service.

Indeed while the major indexes have yet to break through their prior highs, stock prices generally remain solidly range bound just below those levels. Economic trends continue to improve, though at their current glacial pace there isn't quite enough improvement to push stocks out of the current range. Nor are conditions deteriorating, which has helped to keep prices from falling out of this range for very long.

With such subdued levels of growth the market will be paying very close attention to earnings this season. The results will very likely break the trading range, but it is anyone's guess what the direction of that break will be. Earnings expectations are pretty low, so even meeting those expectations could spark another downturn – but an upside surprise in a number of key industries (particularly energy) could set off another solid rally. Investors will likewise be more focused on where those earnings are coming from, financial statement manipulation such as stock buy backs and accounting strategies or true top line revenue increases.

All this indecision makes this market fragile and a very difficult one to trade. As we saw in February the news of falling oil prices was deemed to be an indicator of demand, not production, and the stock market fell in lock step to the falling price of oil. Since then, as oil has slowly rebounded and investors started asking questions first before reacting, we have seen the S+P 500 come back to where it had been before the correction and small and mid-cap stocks regain a sizeable portion of their decline.

Fortunately we are not traders and so we can avoid getting mired in short-term thinking. Looking too closely at each day's data can cause you to walk headlong into a bad decision because you missed the larger, more long-term trend. Sometimes the market reacts to specific events, but it does so at the same time (if not before) anyone sees it on the news. That means trying to trade an event will inevitably fail, as most people will simply be too late to catch the rally or prevent the fall.

More often, the market is looking ahead by a few months, if not a year or so, and successful investors focus even further out into the future. As planners, we are in the habit of considering our clients' lifetimes, which can mean decades of investment. This most recent downturn will be one of several over that period, but none will have the power to permanently derail a plan that has been carefully created, maintained and amended, through advice and counsel, that is truly built for that length of time.

Should you have any questions regarding your planning, your portfolio or the new fiduciary rule, Julia and I are always available to talk things through with you. We can be reached by email at julia@nstarfinco.com and steve@nstarfinco.com or by phone at 800.220.2161.

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