INVESTMENT FUNDAMENTALS

What is a fiduciary?

Newcomers to investing may have heard the term "fiduciary responsibility" in conversations with their advisors or retirement plan sponsors. But what is a fiduciary? And what are their responsibilities? At its most basic level, it comes down to trust. While the term is often associated with financial matters, broadly speaking, a fiduciary is a person in whom trust is placed.

Trust is a foundational pillar of financial services; it is essential to the world's financial systems. One can see the term applied to trust funds, banks and trusts, "In God We Trust" on U.S. currency, and even the push for so-called trustless transactions in the world of cryptocurrency. The world of finance is seemingly obsessed with trust—and rightly so. After all, clients are entrusting their assets, sometimes their life savings or the life savings of others, with another person; this leap of faith inherent to investing requires a degree of trust.

This is where fiduciary responsibility comes in. The phrase refers to one's legal and ethical responsibility to act in the best interest of another when the parties have entered into a relationship of trust. While this concept comes up a great deal in financial services, it is not exclusive to this domain. For example, a lawyer has a fiduciary responsibility to their client. A company's chief executive officer has a fiduciary responsibility to its shareholders. A legal guardian has a fiduciary responsibility to the child in their care. In and out of the world of finance, fiduciary responsibility revolves around trust.

In the domain of finance, a fiduciary is a person or entity that manages the finances of another and is legally bound to put the other person's best interests ahead of their own. This means that a fiduciary is not allowed to profit by putting their own interests ahead of those of their principal—the person they are meant to represent. There are a number of situations where this type of relationship may arise. A trustee has a fiduciary responsibility to the trust's beneficiaries. An agent, who has authority to transact on an account, has a responsibility to act in the principal's best interest. Investment committee members also have similar legal and ethical obligations.

A person or organization with a fiduciary responsibility is forbidden from profiting by acting against the interests of the party they are meant to represent. Even with the best intentions, if such a trusted party does not carry out their duties in an optimal fashion, this can still be considered a failure of their fiduciary responsibility. When acting in a fiduciary capacity, it is crucial to live up to this trust and act in a manner consistent with the principal's best interests. The legal and ethical guidelines around fiduciary responsibility are designed to improve outcomes for investors who have entrusted their assets to others. When fiduciaries act properly, the investors they represent are given a better chance of investment success; after all, being able to trust a financial professional may have advantages over trusting in luck.

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