Fiduciary Focus: A Commonsense Approach to Investing

W. Scott Simon | 01-05-05 |

Among the first of my monthly columns for MorningstarAdvisor.com were two that focused on the notion that the prudence of a fiduciary is determined by its conduct, not the performance of the portfolio for which it is responsible. This is one of the fundamental, underlying principles of modern prudent fiduciary investing as discussed in the Restatement 3rd of Trusts (Prudent Investor Rule) and as codified in the Uniform Prudent Investor Act.

The Restatement was promulgated in 1992 and the Act in 1994. To date, the District of Columbia and 42 states, and the U.S. Virgin Islands, have adopted the Act into law. It is, therefore, jarring to hear that 13 years after the Restatement appeared and 11 years after the Act even highly sophisticated and knowledgeable investment professionals focus on portfolio performance. They completely ignore the bedrock standard by which they are judged as fiduciaries: their own conduct as reflected in their investment and management decision-making process that generates portfolio performance.

John H. Langbein, the Reporter for the Uniform Prudent Investor Act and Chancellor Kent Professor of Law and Legal History at Yale University Law School, has emphasized: "In drafting the Uniform Prudent Investor Act, we went to extraordinary lengths to remind courts that the standard of prudence is not [portfolio] outcome but [fiduciary] process." In short, as my earliest columns emphasized: "It's process, stupid!"

In a case where I was retained as an expert witness, the CFO of one of the largest, oldest, and most prestigious trust companies in America (nay, the world) was deposed to testify about the investment practices of his firm. His testimony centered on the fact that the performance of the plaintiff's portfolio was in the second decile. He tried (unsuccessfully) to keep the spotlight on portfolio performance rather than on his firm's failure to engage in a prudent investment and management process.

In another case where I was retained as an expert witness last year, yet another big, old, and prestigious trust company attempted to steer the inquiry away from fiduciary conduct. On direct examination at trial, I testified that I found little evidence that the trust company engaged in any process at all when investing and managing the plaintiff's portfolio, much less a prudent one.

I then referred to pertinent portions of the California Uniform Prudent Investor Act (the state in which the trial occurred) and testified that the trust company had not really complied with any of them. You would think that this firm which (according to its own website) manages hundreds of billions of dollars for tens of thousands of beneficiaries, custodies trillions of dollars and has thousands of fiduciaries on staff has the resources to implement at least some of the prudent process described in the Act--particularly now that the Act has been law in California for nine years.

Opposing counsel was clearly disconcerted by my testimony--not because it had any originality about it but because I simply went through some of a trustee's duties under the Act and noted the failure of the trust company to fulfill them. She deflated a bit in her cross examination, as a result, allowing me to escape relatively unscathed and live yet another day.

The following are some of those duties that I cited in my testimony. You may want to adapt the following discussion of them as a guide to help make sure that you are on the high road to fiduciary responsibility.

Breach of Duty to Engage in a Prudent Investment and Management Process

Much of the prudent investment and management process described in the California Uniform Prudent Investor Act is contained in Section 16047 (verbatim to Section 2 of the Uniform Prudent Investor Act).

Subsection (a) states:

"A trustee shall invest and manage trust assets as a prudent investor would, by [3] considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall [4] exercise reasonable care, skill, and caution."

Subsection (b) states:

"A trustee's investment and management [5] decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of [2] an overall investment strategy having [1] risk and return objectives reasonably suited to the trust."

I analyze the conduct of a fiduciary (that's you) beginning with this section, which is really the heart of the Act, in the following order (the preceding bracketed numbers are provided for easier reference):

1. Did the fiduciary define risk and return objectives reasonably suited to the trust (the "central consideration" of a trustee under the Act)?
2. Did the fiduciary establish an overall investment strategy?
3. Did the fiduciary consider the purposes, terms, distribution requirements, and other circumstances of the trust?
4. Did the fiduciary exercise reasonable care, skill, and caution?
5. Were the fiduciary's decisions respecting individual assets evaluated in the context of the trust portfolio as a whole?

I next review the circumstances described in Section 16047 (c) through (f) to determine which of them may be relevant to a case.

Breach of Duty to Invest in a Portfolio Context

Note that a fiduciary's decisions respecting individual assets must be evaluated in the context of the trust portfolio as a whole. Under the old Prudent Man Rule, each investment in a portfolio had to be prudent for the fiduciary to escape liability. If any one investment sustained a loss, the fiduciary could be found imprudent even though all the other investments in the trust portfolio registered gains.

Under the new Prudent Investor Rule, the portfolio is the all-important unit not the individual investments that comprise the portfolio. So ordinarily a fiduciary, when considering investments for a portfolio, must ensure that they are prudent within the context of the portfolio not if they are prudent standing alone outside a portfolio. Some investments may be regarded as risky on a stand-alone basis--that is, when considered outside a portfolio. But those very same investments when considered within a portfolio context can lose some of their perceived riskiness and actually reduce the risk of a portfolio.

The decisions of the trust company in the case were not made in a portfolio context but simply in an ad hoc way. The firm had a "guidance list" of all the stocks it "follows." (Such lists may be akin to Legal List statutes whose rationale has now been replaced by standards of modern prudent fiduciary investing.) It sold all the stocks in the portfolio that were not on that list which was nearly every one in the portfolio. Administrative convenience is all well and good but when it is invoked to the total exclusion of any required investment decisions within a portfolio context, it can constitute imprudent fiduciary conduct.

Breach of Duty to Diversify

Section 16048 of the California Uniform Prudent Investor Act (verbatim to Section 227(b) of the Restatement and substantially the same as Section 3 of the Act) states:

"In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."

The first of five "principles of prudence" identified in the Introduction to the Restatement is that "sound diversification is fundamental to risk management and is therefore ordinarily required of trustees." The crucial importance of the duty to diversify a trust portfolio is further underlined in Restatement Commentary, which cautions fact-finders to be careful before they absolve a fiduciary from fulfilling its duty of diversification since that duty is so basic to the very concept of prudent investing. There was no evidence that the trust company in the case conducted any sort of analysis as to how the portfolio should have been diversified.

Breach of Duty to Incur Only Appropriate and Reasonable Costs (and Taxes)

Section 16050 of the California Uniform Prudent Investor Act (substantially the same as Section 7 of the Act) states:

"In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust."

The prudence of any taxes generated as a result of an investment program should obviously be taken into consideration as well. The trust company gave no indication that it knew its conduct was bound by any of these basic standards of modern prudent fiduciary investing.

The CEO of Harvard Management Co., which manages Harvard University's $27 billion endowment fund, was asked recently, "Can private investors draw any lessons from what Harvard does?" Yes, he answered, such investors should be guided by four key principles: be well diversified, keep costs low, keep taxes low, and (when your investment time horizon is long) invest for the long term.

This commonsensical approach to investing reflects the standards of process, diversification, and low costs and taxes found in the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule).

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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