Fiduciary Focus: Modern Prudent Fiduciary Investing (Part 2)

W. Scott Simon | 11-05-04 |

In last month's column, I discussed the meaning of investment risk within the context of modern prudent fiduciary investing. A key point made in that discussion is that fiduciaries ordinarily have the duty to diversify a portfolio in order to reduce the portfolio's uncompensated risk. This column continues and expands upon that discussion.

Because risk is the central factor at work in financial markets, investment advisors must think consciously about it when building client portfolios. It's probable, though, that most advisors (in fact, most investors) don't give much thought to investment risk. Only after a market has decimated their portfolios do they think about risk.

To the extent that investors even think about diversification of risk, most of them engage in what I have termed "naive diversification." That is, they hold some number of investments with the objective of maximizing expected return. The problem with this approach to diversification is that it not only doesn't account for risk but can actually be quite risky. Naive diversifiers tend to have a non-portfolio mindset, thinking in terms of "bits and pieces."

Those that engage in what I have termed "rational diversification" avoid stocks that have high covariance to each other in order to reduce portfolio risk--with the added bonus of possibly increasing return. It is this notion of diversification that is discussed extensively in Restatement Commentary, not naive diversification. Rational diversifiers tend to have a portfolio mindset, thinking in terms of "the whole."

These quite different approaches to diversification of risk lead Nobel Laureate Harry Markowitz to suggest that naive diversification tends to promote "speculative" behavior, while rational diversification tends to promote "investment" behavior. A recent case in which I appeared as an expert witness shows why.

The advisor that was sued in the case invested the client's portfolio in 24 individual stocks and 18 mutual funds that were concentrated primarily in a single market sector. Because "new economy" stocks were all the rage in the late 1990s and into 2000, due to what many thought was their nearly unlimited potential, the advisor responded by investing the client's portfolio heavily in them. Nowhere in the material provided to me could I detect that the advisor had given any thought to risk or portfolio diversification.

What the advisor did was what most investors (and probably most advisors) do: It sought to identify stocks believed to offer the best odds of maximizing expected return. Talk of this kind of investing is usually avoided in polite company since much of it really amounts to little more than "chasing return." To the extent that any notion of diversification enters the picture, the usual approach is to "diversify"--yup, you guessed it--among those stocks thought (often by "cheerleading" Wall Street investment analysts) to offer the best odds of maximizing expected return. That's naive diversification.

Naive diversifiers fail to make any effort to determine the appropriate level of risk for a portfolio. In effect, they let portfolio risk levels just happen. By selecting investments with significant expected returns, naive diversifiers allow the unconscious introduction of a significant amount of "bad" risk into their portfolios.

Bad, or "uncompensated," risk is not good for portfolios because financial markets don't reward investors for retaining that kind of risk. In fact, many investors that retain relatively large amounts of uncompensated risk in their portfolios are penalized with lower returns. And that's exactly what happened to the advisor's client.

The client's portfolio collapsed in value because the advisor concentrated much of it in only one market sector that, by definition, consisted of stocks that had high "covariance" to each other. When the bad news hit, the client's stocks all bit the dust since high covariance stocks react to news in similar ways at similar times. Nor did the advisor use collars or other risk management techniques that could have mitigated damage to the client's portfolio.

The advisor's defense was that it had thoroughly invested the client's portfolio in a sufficient number of stocks and mutual funds. The advisor explained its idea of diversification this way: "Holding 30 to 45 individual securities is well regarded as a completely diversified portfolio, even in the context of having some sectors that are more representative than others in that portfolio."

The advisor's explanation that such portfolios are "completely diversified" is demonstrably wrong. It reveals a basic lack of understanding of investment principles including those of Modern Portfolio Theory. It's simply not true that portfolios with relatively few stocks are well diversified. (The reasons for mistakenly thinking otherwise will be explored in a future column.)

In fact, the expected return of even a randomly selected portfolio of 50 stocks in any given year will be within a potentially large range of returns falling around the market return. For example, given a 10% annual market return there's a good chance statistically that the return of a 50-stock portfolio will fairly often differ as much as 4.5 percentage points above or below that market return. In this example, then, a 50-stock portfolio could return as little as 5.5% or as much as 15.5% in any given year. The range of potential returns on either side of the market return can thus vary substantially from year to year--and that can be quite risky.

A 100-stock portfolio contains 5% more risk than a 1,000-stock portfolio. Even a portfolio containing as many as 200 randomly selected stocks can deviate one percentage point on either side of the market's expected return. Although this differential certainly is not significant in any one year, when negatively compounded over long periods of time it can represent enormous differences in accumulated wealth.

In a world where two of the most successful investment gurus of all time--Sir John Templeton and John Neff--outperformed the market by an annual average of only 2 to 3 percentage points over 30-plus years of investing, the risk of underperforming the market by even one percentage point is obvious.

The difference between diversifying "some" risk and "all" risk is what the advisor "left on the table" in the form of uncompensated risk by investing in 24 individual stocks and 18 mutual funds that were concentrated primarily in a single market sector. That difference was like a ticking time bomb that went off when the market sector in which the client's portfolio was concentrated exploded. The result: catastrophic portfolio loss.

Merely investing in a lot of different stocks--without ensuring that such stocks have negative or low covariance to each other within a portfolio context--is not, on its face, prudent fiduciary conduct. I'm

not necessarily suggesting, of course, that advisors go out and invest in a Markowitzean mean-variance optimizer or any other software to determine the tradeoff between portfolio risk and return.

An informed assessment of portfolio risk, in many cases, can be based instead on simple common sense. After all, that's all you really need to avoid concentrating a portfolio in any single stock or asset class (or a relative few stocks or asset classes) such as, oh gee, high-tech stocks. It doesn't take a rocket scientist to know that such portfolios run the real risk of experiencing the "perfect storm" of disastrous losses.

Those that employ naive diversification in their investment practices incur compensated risk and uncompensated risk. The fact that naively diversified portfolios retain relatively significant amounts of uncompensated risk is directly contrary to how diversification is defined by modern prudent investing: reduction of uncompensated risk.

That's why Commentary to Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule) cautions: "Because market pricing cannot be expected to recognize and reward a particular investor's failure to diversify, a trustee's acceptance of [uncompensated] risk cannot, without more, be justified on grounds of enhancing expected return." This snippet of Restatement Commentary, which brilliantly integrates two essential principles of prudent fiduciary conduct, will be the subject of next month's column.

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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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