Fiduciary Focus: It's Process, Stupid!

W. Scott Simon | 01-08-04 |

Last month in this column, I suggested how you may want to use the Uniform Prudent Investor Act to help build your practice. This month, I'll describe and explain some of the process found in the act.

Prudence as Process

During Bill Clinton's 1992 presidential campaign, his campaign workers were instructed to attack President Bush incessantly on an issue that he was most vulnerable to by chanting a simple mantra: "It's the economy, stupid!" In a similar vein, my advice (with all due respect) to investment fiduciaries and their advisors that really want to help and protect their beneficiaries (and themselves): "It's process, stupid!"

Prudence as process is one of the overarching themes that emerged from the landmark reformation of U.S. trust investment law in the 1990s. The standards of modern prudent investing require a fiduciary, in appropriate situations, to establish and follow a prudent investment and management decision-making process.

A fiduciary's conduct is reflected in its investment and management decision-making process. This is important to understand because the determination of prudence centers on *fiduciary conduct, not portfolio performance*. That is, the prudence of fiduciary investment decisions and actions is determined not by a portfolio's results but by the soundness of the decision-making process that led to those results.

While the loss of portfolio values is what usually triggers lawsuits and arbitrations, a fact-finder is not allowed under standards of modern prudent investing to focus on portfolio performance in determining whether a breach of fiduciary duty has occurred. When I am asked to provide consulting or expert witness services in a case, I don't even look at the portfolio's performance.

Instead, I focus on the fiduciary's conduct as it is reflected in its investment and management decision-making process to determine whether or not it was prudent. It could very well be that a fiduciary's conduct in managing a portfolio that lost 50% of its value was prudent as long as that conduct reflects a sound decision-making process.

A prudent process can immunize you against liability when you get into hot water for poor portfolio performance.

Sometimes portfolio performance *is* relevant--but only insofar as once a fiduciary's conduct is determined to be imprudent and liability ensues, the performance may be helpful in fixing monetary damages.

It is also impermissible under the Uniform Prudent Investor Act to judge a fiduciary's conduct with 20/20 hindsight. A fiduciary cannot be expected to predict future events; it is not an insurer of ensuing portfolio performance.

Instead, the prudence of fiduciary conduct is determined in light of the facts and circumstances existing at the time of the fiduciary's decisions or actions. This means that a fact-finder cannot look back in time and find a fiduciary imprudent solely because a portfolio's performance for, say, 2001 turned out to be minus 35%. On the other hand, a fact-finder cannot find a fiduciary prudent based solely on the defense that declines in values of the stock market during, say, 2000, 2001, and 2002 were unpredictable.

Risk and Return: The "Central Consideration" of Process

Plato observed in *The Republic*: "The most important part is the beginning." Any examination of the process described in the Uniform Prudent Investor Act should begin by citing certain language from its Prefatory Note: A fiduciary's *central consideration* when investing and managing the assets of a trust portfolio is to determine the tradeoff between portfolio risk and return. The following historical detour is necessary to provide the context of this duty.

It is rare in the history of human thought that the origin of an idea be identified with precision, but in this case it can. The notion of determining tradeoffs between portfolio risk and return emanated in the mind of a 23-year-old graduate student one day in 1950 as he was reading a book in the library at the University of Chicago graduate school of business. The book was *The Theory of Investment Value* by John Burr Williams.

Williams maintains that investors should seek to maximize the expected returns of their portfolios. In Williams' view, diversification is equivalent to holding a large number of stocks that are anticipated to maximize expected return. It strikes the student, Harry Markowitz, that Williams' approach is one-dimensional. Seeking only to maximize return doesn't take into account the element of *risk*.

Indeed, Markowitz thinks that Williams' notion of diversification--holding a large number of stocks with the objective of maximizing expected return--not only doesn't account for risk but can actually be quite risky. Markowitz concludes that Williams' approach fails to imply the desirability of *diversification*.

Two years later, Markowitz publishes a 14-page paper that stakes out the basic ideas of what eventually became known as Modern Portfolio Theory, a body of academic and empirical work concerning the behavior of financial markets. This paper was later identified as the Big Bang of all modern finance. For this and other work over the next 40 years, Markowitz received the Nobel Prize in Economic Sciences and designation as the father of Modern Portfolio Theory.

Modern Portfolio Theory and other notions of financial economics provided much of the impetus for the reformation of trust investment law in the 1990s. In fact, Modern Portfolio Theory provides the theoretical underpinnings of the Uniform Prudent Investor Act.

And now you know why a fiduciary's central consideration when investing and managing the assets of a trust portfolio under the Uniform Prudent Investor Act is to determine the tradeoff between portfolio risk and return.

Markowitz's idea that investors must *consciously think about risk as well as return* ranks as one of the most crucial investment insights of the 20th Century. And yet many fiduciaries (as well as investors in general) do not implement this very simple idea and, as a result, fail to discharge the central consideration they are charged with under the Uniform Prudent Investor Act.

For example, a fiduciary following Williams' approach to diversification in 1999 might have concentrated many high-tech stocks in its portfolio. These were stocks that "cheerleading" Wall Street investment analysts believed offered the best odds of maximizing expected return.

The ensuing collapse in value of many of these stocks readily demonstrates the problem with Williams' idea of diversification that Markowitz identified more than 50 years ago: Investors that invest in those stocks believed to offer the best odds of maximizing expected return--*without consciously taking risk into consideration*--are investing in an inferior way. In doing so, Markowitz suggests that they become *speculators not investors*. It goes without saying that fiduciaries, who manage money that's not theirs, cannot be speculators.

I see widespread evidence of such speculation in my consulting and expert witness work. This speculation is ingrained deeply in the culture of even many of the most prestigious and well-known wealth management firms in the country.

I have found that many of these firms fail to use any sort of formal (or informal) risk measurement such as standard deviation when building portfolios for their clients. They simply *ignore the existence of risk*. To any thinking person, it's clear that fiduciaries engaging in such conduct violate standards of modern prudent investing in a number of ways.

First, fiduciaries focusing solely on return violate standards of prudent fiduciary investing that require them to consciously take *both return and risk* into consideration when building portfolios.

Second, fiduciaries that focus solely on return define investment prudence in terms of portfolio performance not fiduciary conduct. This is *directly opposite* of how the Uniform Prudent Investor Act defines prudence: in terms of fiduciary conduct not portfolio performance.

Fiduciaries that focus solely on return think that if they achieve good performance, they're prudent. They also think that they're prudent if they turn in poor performance. It's not their fault, they say, that financial markets or the economy (or sunspots) interfered with their otherwise sound investment strategies. This reasoning is disingenuous--not to mention imprudent.

Please don't be one who violates the central consideration of a fiduciary under the Uniform Prudent Investor Act. Determinations of tradeoffs between portfolio return *and risk* must be made consciously--*you cannot just let them "happen."* Your beneficiaries will thank you for taking the time to make such determinations, as will your E&O insurance carrier.

A Brief Recap of Process

1. Prudence is process.
2. Conduct is reflected in a process.
3. Conduct not performance determines prudence.
4. Conduct cannot be judged with 20/20 hindsight.
5. A fiduciary's "central consideration": determine the tradeoff between portfolio risk and return.

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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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