Fiduciary Focus: It's Process, Stupid! (Part 2)

W. Scott Simon | 02-05-04 |

In last month's column, I described and explained some of the investment and management process found in the Uniform Prudent Investor Act. I emphasized the "central consideration" of fiduciaries under the act: making tradeoffs between portfolio risk and return.

In response to that column, John H. Langbein, the Reporter for the Uniform Prudent Investor Act and the Chancellor Kent Professor of Law and Legal History at Yale University Law School, wrote me: "In drafting the Uniform Prudent Investor Act, *we went to extraordinary lengths to remind courts that the standard of prudence is not outcome but process.*" (Emphasis added.)

And when noted attorney Fred Reish, the nation's foremost authority on the duties--and liabilities--of ERISA fiduciaries, was asked recently about what 401(k) plan sponsors should do with the scandal-tainted mutual funds in their 401(k) plans, his response was: "The answer is always the same--engage in a prudent process."

Given the importance of process in fiduciary investing, I thought that it would be useful in this month's column to touch upon two other major areas of the investment and management process found in the Uniform Prudent Investor Act: diversification and costs.

Diversification: The Antidote to Uncertainty

The word "diversification" is used a lot in investment articles and marketing literature. But what is its meaning within the context of the Uniform Prudent Investor Act and what implications does that hold for the investment conduct of fiduciaries?

Nobel Laureate Harry Markowitz, the father of Modern Portfolio Theory, identifies the fundamental problem all investors face: Selections of portfolio investments involve making decisions under uncertainty. This leads to the observation that uncertainty--or risk--is the central factor at

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work in financial markets. To see how true Markowitz's observation is, we need look no further than the plunge in value of many high-flying technology stocks in 2000, 2001, and 2002.

Restatement commentary acknowledges that there is no such thing as a "safe" investment or investment strategy. For example, *all* investments involve risk in the comprehensive sense of loss of inflation-adjusted value. Because it isn't possible to avoid risk, Restatement commentary requires fiduciaries to manage it. Modern Portfolio Theory posits that risk can be managed through diversification. (Stop-loss orders, collars, and other techniques can also be used to manage risk.)

The act ordinarily mandates diversification of risk. (Prudent fiduciary investing doesn't prohibit underdiversified portfolios. Instead, it shifts the burden of proof to the fiduciary to demonstrate its reasonable determination that "under the circumstances, it is prudent not to [diversify].") This enhanced duty is so central to modern concepts of prudence that the act integrates the diversification requirement into the very concept of prudent investing. Commentary to the Restatement 3rd of Trusts (Prudent Investor Rule) notes that the duty to diversify risk is based on principles of Modern Portfolio Theory.

As discussed in last month's column, principles of modern prudent investing don't require fiduciaries to predict future events. That is, a fiduciary isn't expected to have to forecast which financial markets and/or which investments within those markets will perform well or poorly. In short, fiduciaries aren't insurers of portfolio performances.

But wait, there's a "catch" to this. In return for the "pass" of excusing fiduciaries from having to forecast the performances of particular investments and/or particular financial markets, the standards of modern prudent investing require fiduciaries ordinarily to diversify portfolios--preferably broadly--as part of a prudent process.

If the law governing prudent conduct didn't provide for this "catch" to the "pass" given to fiduciaries, fiduciaries could always escape liability by arguing, for example, that declines in value of the stock market during 2000, 2001, and 2002 were unpredictable. Of course they were unpredictable! Financial markets and the investments that compose those markets are *always* unpredictable! That's what puts the "R" in "Risk!" Because of this, the law normally won't give a "pass" to a non-diversifying fiduciary that pleads the

unpredictability of financial markets.

The "catch" of requiring fiduciaries to ordinarily diversify broadly means that they should adopt a view of investment risk that's prospective.

A prospective view of risk obliges a fiduciary to recognize consciously--*before* the selection of any investment strategy--the fundamental problem identified by Markowitz: Selections of portfolio investments involve making decisions under uncertainty. Designing a portfolio's asset allocation and implementing it with an investment strategy requires that uncertainties be recognized and addressed *before* undertaking these tasks. Because uncertainty implies risk, a common way of managing the problem described by Markowitz and encountered by all investors is to diversify portfolios.

Even though fiduciaries cannot be second-guessed in hindsight about the performances of the portfolios under their care, that prohibition applies only if their conduct has been prudent. And prudent conduct, according to principles of modern fiduciary investing, ordinarily includes broad diversification of portfolios.

Restatement commentary emphasizes that broad diversification is preferred in trust investing--both *across* the asset classes that comprise a portfolio and *within* each such asset class. Edward C. Halbach, Jr., the Reporter for the Restatement and the Walter Perry Johnson Professor of Law at the University of California, Berkeley Law School, notes that diversification ordinarily applies even to specialized investment programs that are composed of assets such as real estate, venture capital, and foreign stocks.

Fiduciaries should diversify--preferably broadly--simply because they don't know what is going to happen to a particular stock (or a small group of stocks, or even an asset class) in the future. In *Discourse on Method*, the French philosopher and mathematician Rene Descartes said: "I think, therefore I am." And what does the prudent fiduciary say? "I cannot foretell the future--therefore I diversify." In this way, thorough portfolio diversification is like an "antidote to uncertainty."

Wasting Beneficiaries' Money Is Imprudent

Modern prudent investing takes a skeptical view of high cost investment strategies. The act allows fiduciaries to incur costs only that are " appropriate and reasonable."

Commentary to the act states succinctly: "Wasting beneficiaries' money is imprudent."

Before a fiduciary can ensure that it incurs only appropriate and reasonable costs, it must be able to identify those costs. It's not likely, though, that many fiduciaries understand the full range of the costs that are generated when investing and managing portfolios.

That's why fiduciaries need to a) have a good understanding of the meaning of "costs" and b) be able to identify the costs associated with the products it selects for a portfolio's investment strategy. This should force fiduciaries to, in the words of the Reporter for the Restatement, "pay attention to costs" and any opportunities to reduce them.

Many (perhaps most) of you probably use mutual fund investment products in your practices. Some of you are investment advisors to (and thus fiduciaries of) 401(k) plans and use mutual funds as investment options for these plans.

Fiduciaries of 401(k) plans (which may include you) have the duty to conduct an independent due-diligence process to ensure that the investment options offered to their plans by service providers such as insurance companies, banks, and mutual fund companies conform to specific criteria of prudence including cost control.

This is important because a far more insidious and widespread problem than the relatively few employees who lost everything in their 401(k) plans at, say, Enron is the exorbitant hidden (and even not so hidden) costs in 401(k) plans that siphon off the retirement savings of millions of workers invested in them. But that, as they say, is another story.

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.

For more information about Simon, please visit www.prudentinvestoract.com and www.prudentinvestoradvisors.com or you can e-mail him at wssimon@mindspring.com.

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