

Managing Assets Under The New Prudent Investor Standard

A Presentation by
Bob Bannon, CFA
Chief Investment Officer

I. The Evolution of the Prudent Investor Standard

A. The Prudent MAN Standard

1. Harvard College v. Amory (1830)

- a. Relevant Standard – “men of ... intelligence managing their own affairs”
- b. Ironically, the ruling favored the trustee
- c. The case was more one of impartiality rather than imprudence

2. Codifying the Prudent Man Rule

- a. ABA’s Model Prudent Man Investment Statute (1942)
- b. Restatement of the Law, Trusts (Second) (1959)
- c. Uniform Management of Institutional Funds Act (1972)
- d. Various State Laws and Court Decisions

3. End Result – Unintended Restrictions and Results

- a. Certain investments were imprudent *per se*
- b. States issued lists of prudent and imprudent investments
- c. Anything non-income generating was speculative
- d. Investment Management became bond management only
- e. Trustees generally not permitted to delegate
- f. Mutual/index funds were improper delegations in some states
- g. Characteristics of the portfolio as a whole were irrelevant

B. Modifying the Prudent Man Rule

1. Industry tried to incorporate broader powers

- a. Lawyers drafted wills and trusts written to allow non-income producing investments (i.e., growth stocks)
- b. Banks drafted policies allowing use of investment rules in trusts that previously only governed agencies
- c. Some even authorized truly speculative investments

2. Some Laws Began to Change

- a. New York State's Prudent Man Rule (1970)
 - 1) Still focused on individual securities
 - 2) Allowed local discretion in defining powers
- b. Uniform Probate Code Prudent Man Rule (1974)
 - 1) Acknowledged that there were "special skills"
 - 2) Required them to be used if available

3. Along Comes ERISA (1974)

- a. "Under circumstances *then prevailing*"
- b. "like a prudent man...*familiar with such matters*"
- c. "*diversifying* the investments of the plan"
- d. "*Minimize risk* of large losses"

4. California Changes – Revised Prudent Man Rule (1987)

- a. Adopted as Probate Code Section 16040
- b. Derived from ERISA's Standard of Care
- c. Investments to be considered as part of overall strategy

C. The Prudent INVESTOR Rule

1. ALI's Restatement of the Law Third, Trusts (1992)

- a. Diversification is fundamental to risk minimization
- b. Risk and return are related and must be analyzed directly
- c. Duty to avoid unjustified fees and expenses
- d. Impartiality means balancing income vs. growth
- e. Trustees have authority, sometimes duty, to delegate

2. Uniform Prudent Investor Act (1994)

- a. Exercise reasonable care, skill, and caution
- b. Analyze investments as a whole, not in isolation
- c. Duty to diversify
- d. Incorporate risk and return analysis
- e. Still owe a duty of loyalty and impartiality
- f. Supervise and act with prudence in delegating
- g. Incur only reasonable costs
- h. Abide by the governing document and local law

3. California Uniform Prudent Investor Act (1996)

- a. Adopted as Probate Code Section 16054
- b. Must diversify unless prudent not to do so
- c. Contains a "prudent expert" clause
- d. Governing instrument may expand or narrow the prudent investor rule
- e. Trust property must be made "productive"
- f. Only incur "appropriate and reasonable" investment costs

D. Implications

1. So What Has Changed since Prudent Man?

- a. Acknowledgement that skill levels vary
- b. Recognition of Modern Portfolio Theory
- c. Legitimization of Delegation, esp. Investment Authority
- d. Elimination of lists of imprudent investments
- e. Allowance of mutual fund and index fund investing
- f. Focus on total return, tolerance for invasion of principal

2. So What HASN'T Changed since Prudent Man?

- a. Duty of Loyalty (avoid conflicts of interest)
- b. Duty of Impartiality
- c. Exercise Reasonable Care, skill, caution, and diligence
- d. In a word, PRUDENCE!!!

3. So What Protects Me? Look for Bob's 3 D's:

- a. **DIVERSIFICATION**
- b. **DOCUMENTATION**
- c. **DELEGATION**

So if you are a trustee, or an attorney, CPA, or other type of advisor to a trustee, you have "two D's" that you must do:

DUE DILIGENCE

To make sure that the "three D's":

**DIVERSIFICATION
DOCUMENTATION
DELEGATION**

are performed satisfactorily for assets to be managed in accordance with the Prudent Investor Rule.

II. Diversification

A. Some Definitions

1. Expected Return

- a. For a security, the expected total return (including income and dividends) over a specific period of time
- b. For a portfolio, the weighted average of the expected returns of all securities held, where weight is the % of portfolio value.

2. Expected Risk

- a. For a security, the degree to which the expected return should be expected to fluctuate over a given period of time.
- b. For a portfolio, a weighted combination of the expected risks of all securities held, tempered by the degree to which those securities “co-vary” with each other.

3. Diversification

- a. The expected returns of two securities might:
 - a. Tend to move in the same direction at the same time
 - b. Tend to move in opposite directions at the same time
 - c. Not have any relationship to each other
- b. Unless two securities have returns that move in perfect synchronicity, the total expected risk of holding both securities is less than their weighted sum
- c. Diversification is the amount by which a group of securities, held in a single portfolio, reduces the expected risk of that portfolio below the weighted-average risk of all the securities.

B. Modern Portfolio Theory

1. Risk and Return are Measurable ex Post

- a. Return is measurable as Total Return
- b. Risk is measured as Volatility or Standard Deviation

2. Not All Risk is Diversifiable

- a. Risk is composed of diversifiable and non-diversifiable risk
- b. “Market Risk” is non-diversifiable
- c. “Security Risk” is by and large diversifiable

3. Non-Diversifiable Risk and Return are Related

- a. Risk and return are positively associated – take more (non-diversifiable) risk, get more return (in the long-run)
- b. Empirically it appears to be true
- c. Theoretically it is believed to be true because:
 - 1) Individuals are often observed to be “risk averse”.
 - 2) Risk averse individuals are those who must be “compensated,” all else equal, to take on more risk.
 - 3) If greater compensation (i.e., more return) is required for someone to take on more risk, then we should observe a positive association between risk and return.

C. More Advanced Concepts on Diversification

1. Not all Diversification is by Stocks – It can come from:

- a. Asset Class Choices – How much in stocks, bonds, cash
- b. Economic Sector Choices – Utilities, energy, cyclicals, etc.
- c. Capitalization Choices – large stocks, mid-cap, small
- d. Geographic Diversification – international, country
- e. Credit Quality Choices - mainly of bonds but also stocks
- f. Style Choice - Value vs. Growth
- g. Maturity Choice – bills, notes, and bonds

2. Absolute vs. Relative Risk

- a. Absolute Risk is a Long-Term, Strategic Decision-Making
 - 1) Volatility of the Long-Term Strategic Asset Allocation
 - 2) Not Affected by short-term market expectations
 - 3) Measured by Total Volatility
- b. Relative Risk is Short-Term, Tactical Decision-Making
 - 1) Volatility of performance around a benchmark
 - 2) Driven by market outlook and security selection
 - 3) Measured by Tracking Error

3. Passive vs. Active Investing

- a. Modern Portfolio Theory (MPT) Widely Interpreted by Academics as Favoring Indexing
- b. MPT Interpreted by Market Practitioners as allowing Active Investment Management, i.e., adding value through:
 - 1) security selection
 - 2) tactical asset allocation
 - 3) sector rotation
 - 4) market timing
- c. The issue turns on whether Market Risk is the only non-diversifiable risk. Do securities contain some non-diversifiable risk as well?
 - 1) If yes, then Active Investment Management works
 - 2) If no, stick with indexing

D. Conclusions for Trustees (and Their Advisors)

- 1. Diversification is a must, but many different forms**
- 2. Risk and Return Must Be:**
 - Measured and Analyzed
 - Viewed as a Trade-off
- 3. A Professional Fiduciary with Specific Skills is a Must**
- 4. Diversification is Best Through Top-Down Investing**

III. Documentation

A. How Do You Document Prudent Investing? Document:

- 1. The Investment Evaluation**
- 2. The Investment Process**
- 3. The Investment Performance**
- 4. The Investment Communication**

B. Documenting The Investment Evaluation

1. Determine the Investment Objective

- a. Objective is a medium-to-long-term goal
- b. Most often expressed as a stock/bond/cash allocation
- c. Serves as a benchmark for performance
- d. Speaks directly to the balancing of growth vs. income
- e. Should not be determined by short-term market outlook
- f. Example: “Capital Preservation, 20% stocks/80% bonds”

2. Establish a Set of Investment Guidelines

- a. Contains two components: Objectives and Constraints
- b. Objective is articulated more specifically as:
 - 1) Return Expectations
 - 2) Risk Tolerance
- c. Investment Constraints – should include:
 - 1) Income Needs
 - 2) Tax Status (Tax Exempt? Tax Sensitive?)
 - 3) Liquidity Needs (distinct from income needs)
 - 4) Time Horizon to Achieve Objective
 - 5) Legal/Regulatory Constraints
 - 6) Other Unique Needs (Social Investing?)
- d. Maintenance of Guidelines:
 - 1) Should be written and maintained on file
 - 2) Prepared in advance of any investment activity
 - 3) Should be approved by client
 - 4) Reviewed regularly and allow for changing objectives

C. Documenting The Investment Process

1. The Investment Policy Statement (IPS)

- a. Often considered optional, but I recommend
- b. An IPS can be either:
 - 1) Specific to the client
 - 2) Specific to the firm (and thereby extend to the client)
 - 3) I recommend firm-wide IPS – ensures consistency
- c. An IPS defines the allowable:
 - 1) Security universes
 - 2) Investment strategies
 - 3) Bond maturities/credit qualities
 - 4) Trading practices (soft dollar usage, turnover)
 - 5) Frequency of account review
 - 6) Any other pertinent account management procedures

2. The Investment Review

- a. Documentation of the analysis taken for the account
 - 1) Economic/financial/market conditions reviewed
 - 2) Can be minimized if IPS defines a broad process
- b. Documentation of activity undertaken
 - 1) Securities transactions
 - 2) Cash inflows/outflows
- c. Documentation of compliance with Guidelines and IPS
 - 1) No less frequently than annual
 - 2) Review by committee or a compliance officer

D. Documenting the Investment Performance

1. For the Client Account

- a. Industry standards (AIMR, SEC) exist
- b. Performance is NOT just transactions and valuations
- c. Performance is total return, properly calculated, for:
 - 1) The total account
 - 2) Major asset classes of the account

2. For the Manager

- a. Managers should report performance across many clients
- b. Clients aggregated should be similar and fully discretionary
- c. Industry standards exist as to how to aggregate performance

3. What to look for in a good performance report

- a. Total return calculations
- b. Multiple time periods (1 month, 3 month, 1 year, since inception)
- c. Both absolute and benchmark relative performance
- d. Measures of risk
- e. For manager composites, measures of performance dispersion

E. Documenting the Client Communication

- 1. Regular account statements, no less than quarterly**
- 2. Discussions of Performance, no less than annually**
- 3. Reviews of Guidelines, every 3-5 years**

IV. Delegation

A. Two Types of Delegation

- 1. Selection of a Manager by a Non-Specialist Trustee**
- 2. Selection of manager(s) by a professional manager**

B. Delegation of Authority by the Non-Specialist

1. Traditional Trust Law Prohibited True Delegation

- a. The Restatement Second said:
 - 1) trustee was “under a duty to the beneficiary not to delegate to others the doing of acts the trustee can reasonably be required personally to perform.
 - 2) A “trustee cannot properly delegate to another power to select investments.”
- b. Delegation was nevertheless *de facto*:
 - 1) Outside Investment “Advisors” could be employed
 - 2) Advisors could consult and recommend
 - 3) Trustee was required to review, approve and implement
- c. There was also some confusion as to whether mutual funds or common trust funds represented improper delegation.
- d. Liability nevertheless existed for trustees, and investment advisors (and counsel?) if, under a “consultative nondiscretionary” relationship, the advisor is authorized by the trustee to act on his own.

2. The Prudent Investor Rule Allows Delegation

- a. New Legal Authority
 - 1) Restatement (Third) says “...except as a prudent person might delegate those responsibilities to others.”
 - 2) UPIA says “A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances.”
- b. Rules Regarding Delegation – trustee must exercise skill, care and caution:
 - 1) In selecting the delegated agent
 - 2) In establishing the scope and terms of the delegation
 - 3) In monitoring the scope and terms of the agent’s performance and compliance.

3. Thoughts/Recommendations Regarding Delegation

- a. A Question - Is delegation by the non-specialist trustee:
 - 1) Allowed? (Yes)
 - 2) Recommended? (Probably)
 - 3) Mandatory? (No, but case law may evolve that way)
- b. If the account size warrants:
 - 1) hire an investment management consultant to select the investment manager
 - 2) Consultant will independently review investment policy, select manager, review performance, issue RFP
 - 3) Manager selection is a far different skill set than security selection
- c. If non-specialist is to hire an investment manager directly:
 - 1) Ask for and receive a Form ADV (except from Banks)
 - 2) Ask for samples of all the "Documentation" items I described above:
 - Sample Investment Guidelines for Your Client
 - Recommended Hypothetical Portfolio for Your Client
 - Analysis of Your Client's Current Financial Condition
 - The Manager's Investment Policy Statement
 - Sample Performance Report for a Similar Client
 - Performance Composites for all Products
 - Sample Investment Review Form
 - Sample Client Statement
 - Sample Client Letter
- d. Word of Warning – think TWICE before hiring a broker as the Investment Advisor for a Trust Account
 - 1) Brokerage incentives are misaligned with your client's
 - 2) Brokerage fees are layered and excessive
 - 3) Brokerage fees (unlike true advisors) not tax deductible
 - 4) Brokers are often less experienced, educated

C. Delegation of Authority by the Specialist

1. Situation – Your Manager wants to hire other Managers

- a. They run a multi-manager program
- b. They run a “fund of funds” program
- c. They run a wrap program
- d. They primarily only use mutual funds or hedge funds

2. Comments and Recommendations

- a. Ensure that your manager is still the responsible party
 - 1) Review liability clause of investment agreement
 - 2) Refuse arbitration clauses
 - 3) Possibly avoid securities lending
- b. Look closely for added costs, especially
 - 1) wrap fees
 - 2) sub-advisory fees
 - 3) loads or commissions
 - 4) contingent fees or exit fees
- c. Scrutinize carefully for self-dealing
 - 1) Does the manager allocate to proprietary products?
 - 2) Are fees reduced for proprietary products?
 - 3) Are brokers or managers paying any fee to the manager of managers?
- d. Are multiple managers loyal to your client only?
 - 1) What are the tax consequences of the trust’s assets being managed to the broad needs of the fund, and not the trust?
 - 2) Are multiple managers buying the same securities for your client, thus unnecessarily incurring multiple fees on the same asset?

D. Conclusions for Trustees (and their Advisors)

- 1. Delegation by non-specialist to specialist may likely be in the best interests of the trust and the beneficiaries.**
- 2. Delegation by specialist to others warrants scrutiny**