How Trustees Operate under Prudent Investor and Principal and Income Rules

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I. RULES OF THE ROAD: MODERN PORTFOLIO THEORY AND PRUDENT INVESTOR

A. Modern Portfolio Theory ("MPT") seeks to reduce risk by diversifying investments across and within uncorrelated assets classes in investment portfolios.

B. Academics began applying MPT to trusts when the American Law Institute began a partial revision of the Restatement of Trusts in 1987. The revision was completed and approved by the ALI in 1990 and issued in 1992. Change to prudent investor rule noted in Section 227 of the Third Restatement of Trusts. Rule allows investment in anything and everything available in financial community (still subject to trustee's duty of prudence and other fiduciary duties).

C. The National Conference of Commissioners on Uniform State Laws (NCCUSL) began drafting a new Uniform Prudent Investor Act in 1991 to make statutes conform to the new Restatement of Trusts. NCCUSL released the new Act in 1994. It facilitates the adoption of MPT. Key elements are:

1. A standard of prudence is applied to any investment as part of the total portfolio rather than to individual investments. Uniform Prudent Investor Act § 2(b).

2. The tradeoff between risk and return is identified as the fiduciary's central consideration. Uniform Prudent Investor Act § 2(b).

3. All restrictions on categories of investment for a fiduciary are eliminated. Uniform Prudent Investor Act § 2(e).

4. Fiduciaries need to diversify assets under their care. Uniform Prudent Investor Act § 3.

5. Trustees can delegate investment and management functions. Uniform Prudent Investor Act § 9.

D. California adopted the new Prudent Investor Act in 1995, with modifications. Cal. Prob. C. §§ 16045-16054. California statute follows Uniform Act approach of unrestricted use of any and all investments available in financial community (subject to prudence and other fiduciary duties).

1. Prudent investor rule requires consideration of "purposes, terms, distribution requirements, and other circumstances of the trust" to be exercised with "reasonable care, skill, and caution." Cal. Prob. C. § 16047(a).

2. Provides that fiduciary's investment decisions "…evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Cal. Prob. C. § 16047(b).

3. Factors listed that are appropriate for trustee to consider when investing, to extent relevant to trust and beneficiaries, include general economic conditions, tax consequences, role of investment within portfolio, expected portfolio total return, and needs for liquidity, income , preservation or appreciation of capital. Cal. Prob. C. § 16047(c).

4. Allows fiduciaries to "…invest in any kind of property or type of investment or engage in any course of action or investment strategy consistent with the requirements of [the California Trust Law statutes governing fiduciary duties]." Cal. Prob. C. § 16047(e).

5. Directs fiduciary "to diversify the investments of the trust, unless, under the circumstances, it is prudent not to do so." Cal. Prob. C. § 16048.

6. Trustees may incur costs only "…that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust." Cal. Prob. C. § 16050

7. Allows fiduciaries to "delegate investment and management functions as prudent under the circumstances." Cal. Prob. C. § 16052(a).

E. An excellent discussion of Modern Portfolio Theory (MPT) and its relationship to the prudent investor rules can be found in the ACTEC Journal, published by the American College of Trust and Estate Counsel (ACTEC).

1. The first two installments appeared in the Winter 2004 and Spring 2005 editions. Moses, Singleton and Marshall III, *Modern Portfolio Theory and the Prudent Investor Act*, 30 ACTEC Journal 161 (Fall 2004) (referred to hereafter as "the ACTEC Journal MPT article"); Moses, Singleton and Marshall III, *Using a Trust's Investment Policy Statement to Develop the Portfolio's Appropriate Risk Level*, 30 ACTEC Journal 161 (Fall 2004). The remaining two installments will be published in the Summer and Fall 2005 editions. They will be entitled: *"Computing Market Adjusted Damages in Fiduciary Surcharge Cases Using Modern Portfolio Theory,"* and *"The Appropriate Withdrawal Rate: Comparing a Total Return Trust to a Principal and Income Trust."* Trust and estate attorneys and other professionals who are not ACTEC Fellows can order copies of these articles from ACTEC, 3415 Sepulveda Blvd., Suite 330, Los Angeles, CA 90034, 310 398-1888 (ph), 310 572-7280, www.actec.org.

2. The editor's note describing the ACTEC Journal articles is telling: "Modern Portfolio Theory has become a customary tool used by investment professionals and, as such, constitutes an industry standard that prudent fiduciaries cannot ignore." The ACTEC Journal MPT article at 166.

3. The authors summarize the impact of MPT and prudent investor on a trustee's fiduciary duty succinctly:

> The Prudent Investor Rule incorporates Modern Portfolio Theory. Fiduciaries are thus bound to consider MPT in constructing the portfolios under their control. To do otherwise exposes the fiduciary to claims of misconduct and the resulting potential assessment of damages and surcharges. … The Rule is a test of conduct, not performance. Thus, if the fiduciary chooses a risk level that is appropriate under the terms of the trust and constructs a portfolio that is ex ante efficient and the resulting portfolio suffers losses, the fiduciary should not be liable for damages. … The tools to develop these portfolios are readily available to investment practitioners and should pose no barrier to the conscientious fiduciary. To ignore these tools places the fiduciary in a precarious position. The ACTEC Journal MPT article at 174.

II. THE KEY AND TOUBLESOME DUTY TO DIVERSIFY

A. A key duty under prudent investor is to diversify away the investment risk inherent in concentrated positions in a particular asset or asset class.

1. The Uniform Prudent Investor Act provides: "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." Uniform Prudent Investor Act § 3.
2. Under California's version of the Uniform Prudent Investor Act, trustees are directed "to diversify the investments of the trust, unless, under the circumstances, it is prudent not to do so." Cal. Prob. C. § 16048

B. Investment risk is inherent in concentrated positions in single assets. One of the tenets of MPT, adopted in prudent investor, is to use diversification of investments to efficiently balance investment risk and return. The NCCUSL commentary to Section 3 of the Uniform Prudent Investor Act provides:

1. Rationale for diversification. "Diversification reduces risk . . . [because] stock price movements are not uniform. They are imperfectly correlated. This means that if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another." Jonathan R. Macey, An Introduction to Modern Financial Theory 20 (American College of Trust and Estate Counsel Foundation, 1991). For example, during the Arab oil embargo of 1973, international oil stocks suffered declines, but the shares of domestic oil producers and coal companies benefited. Holding a broad enough portfolio allowed the investor to set off, to some extent, the losses associated with the embargo.

2. Modern portfolio theory divides risk into the categories of "compensated" and "uncompensated" risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk - the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks. The investor who owned only international oils in 1973 was running a risk that could have been reduced by having configured the portfolio differently - to include investments in different industries. This is uncompensated risk - nobody pays the investor for owning shares in too few industries and too few companies. Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk of having too few investments. "As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings." R.A. Brealey, An Introduction to Risk and Return from Common Stocks 103 (2d ed. 1983).

3. This is intuitive – don't keep all of your eggs in one basket. Importantly, financial data supports theory and statutes. For example, see the J. P. Morgan Private Bank (JPM) study in 2002 on risks of concentrated positions of U. S. large cap public stock held in portfolios. Excerpts follow:

CONCENTRATED STOCK PORTFOLIOS REQUIRE A UNIQUE PERSPECTIVE AND ANALYSIS OF THEIR OWN

- JPM looked at three metrics in analyzing negative events in concentrated portfolios
  - **severity:** the worst quarterly return an investor is subject to
  - **frequency:** the number of times that the portfolio's negative return goes below a specified level
- Private client-oriented research is necessary to complete the picture
  - standard equity research is useful as a backdrop, but more work is needed to define the potential for event risk since the cost of being wrong is often not manageable
  - event risk is more disruptive for concentrated equity holders; no insurance when things go wrong, like the PBGC for pensioners
  - **shortfall**: the amount by which the concentrated position under-performs the total return of the broad market

SEVERITY: LOOKING AT WORST-CASE RETURNS

- From January 1990 to December 2001, the worst quarterly total return on the S&P was 15.0% in the third quarter of 2001
  - JPM analyzed each stock in the S&P over the same time period
- Few investors own all their exposure in a single name, so JPM created hypothetical portfolios with a concentrated single stock and a broader basket of other stocks
  - result: 450* concentrated stock portfolios ("**CSPs**") composed of **60%** of an individual stock, and **40%** of the S&P itself**

* CSP = each stock weighted at 60%, with residual in the S&P, quarterly price returns from 1/31/1990–12/31/2001
Source: FactSet Research database, JPMorgan Chase