Buckingham Asset Management Annual Conference

Modern Prudent Fiduciary Investing
and
Passive Investing

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Modern Prudent Fiduciary Investing
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This presentation will discuss the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule), and why passive investing appears to be the "default" standard of modern prudent fiduciary investing. BAM advisors can use this knowledge to gain a powerful marketing advantage over their competition, thereby increasing the odds of winning business from trustees of 401(k) plans, non-profit pools of money, public pension plans, private family trusts as well as individuals.

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Modern Prudent Fiduciary Investing and Passive Investing

Presented to
Buckingham Asset Management
Annual Conference

Monday, October 23, 2006

Presented by
W. Scott Simon, J.D., CFP®, AIFA®
Prudent Investor Advisors, LLC

Outline of Presentation

I. A Brief Introduction to Modern Prudent Fiduciary Investing

A. Harvard College v. Amory (1830)

B. Harry Markowitz and the “Big Bang” of Modern Finance: Modern Portfolio Theory (1952)

C. Restatement 3rd of Trusts (Prudent Investor Rule) (1992)

D. Uniform Prudent Investor Act (1994)

E. The Relationship Between the prudent investor Act and the Restatement

F. The “Central Consideration” of Investment Fiduciaries: The Tradeoff Between Risk and Return

II. Passive Investing is, in effect, the Default Standard of Modern Prudent Fiduciary Investing

A. Modern Prudent Fiduciary Investing Permits Both Passive Investing and Active Investing

B. Active Investing

C. The Two-Pronged Test

D. Track Record Investing

E. Stock Picking and Market Timing

III. How to Increase Your Chances of Winning Business

A. modern prudent fiduciary investing

B. passive investing

C. dimensional fund advisors

IV. Conclusion

Two Visions of Diversification

- **John Burr Williams**
  - Invest in those stocks it is thought will produce maximum returns
  - Holding a large number of such stocks is “equivalent” to diversifying risk
  - Such portfolios often have high covariance to each other
  - This notion of diversification tends to promote “speculative” behavior

- **Harry Markowitz**
  - Invest in those stocks that achieve an optimal tradeoff between portfolio risk and return
  - Holding a large number of such stocks achieves optimal diversification
  - Such portfolios have low covariance to each other
  - This notion of diversification tends to promote “investment” behavior
  - Co-recipient of the 1990 Nobel Prize in economic sciences
  - Father of Modern Portfolio Theory

Restatement 3rd of Trusts (Prudent Investor Rule)

- Published by the American Law Institute in 1992
- Bible of trust investment law in America
- Legal treatise that examines the common law and state statutes in the field of trust law and restates them as broad legal principles
- Incorporates modern theories of investment and finance into the general language of the Prudent Investor Rule
- Revises and supersedes the Prudent Man Rule of the 1959 Restatement 2nd of Trusts

Uniform Prudent Investor Act – the “Octopus”

- Published by the National Conference of Commissioners on Uniform State Laws in 1994
- Sets forth prudent fiduciary standards governing the investment conduct of trustees of private family trusts
- Incorporated virtually verbatim into a number of other uniform acts, including:
- 1997 Uniform Management of Public Employee Retirement Systems Act
- 1997 Uniform Principal and Income Act
- 2000 Uniform Trust Code
- 2006 (July 13) Uniform Prudent Management of Institutional Funds Act
- 1974 Employee Retirement Income Security Act (ERISA)
- Uniform Prudent Investor Act now law in 44 states, the District of Columbia and the U.S. Virgin Islands
- American Bar Association endorsed the Uniform Prudent Investor Act in 1995, as has the American Bankers Association

The Link Between the Uniform Prudent Investor Act and ERISA

ERISA has always been interpreted with a strong eye on the common law, and it is therefore quite clear that the Uniform Prudent Investor Act will powerfully affect the federal courts in their interpretation of ERISA.

- **John H. Langbein, the Reporter for the Uniform Prudent Act and Chancellor Kent professor of law and legal history at Yale University law school, in "Prudent Experts: Can Not Using Derivatives to Achieve its Objectives Put a Plan Sponsor at Risk of a Lawsuit?" by Susan Arterian, *Plan Sponsor*, December/January 1997.**

The Relationship Between the Uniform Prudent Investor Act and the Restatement

- Restatement is the scholarly and authoritative forebear of the Uniform Prudent Investor Act
- Restatement is the “Godfather” of the Uniform Prudent Investor Act
- Uniform Prudent Investor Act and its commentary “draw upon” and “codify” the wording and principles of investment prudence laid down by the 300-plus page Restatement and its commentary
- Restatement sets forth the underlying rationale of the rules that are now part of the Uniform Prudent Investor Act
- Restatement provides numerous examples of prudent and imprudent investing
- Uniform Prudent Investor Act and Restatement stand together at the center of modern prudent fiduciary investing

The "Central Consideration" of all Investment Fiduciaries

Determine the *tradeoff between risk and return* in a portfolio

– **Prefatory Note to the Uniform Prudent Investor Act**

Different Forms of Active Investing

- **Track Record Investing**
  - Involves attempts to assess which superior performing investments from the past will continue to be superior in the future
  - Focuses on the past

- **Stock Picking and Market Timing**
  - Involves attempts to profitably forecast the future price movements of stocks (or bonds) so that an investor can predict which investments will be superior performers
  - Focuses on the future

All these forms of active investing lead to the widespread belief among investors that to be successful in maximizing investment performance, they must be able to “see” into the future or find a “skillful” investment advisor who can.

The Dangers of Active Investing

Active strategies…entail investigation and analysis expenses and tend to increase general transaction costs, including capital gains taxation. Additional risks also may result from the difficult judgments that may be involved and from the possible acceptance of a relatively high degree of diversifiable risk. These considerations are relevant to the trustee initially in deciding whether, to what extent, and in what manner to undertake an active investment strategy and then in the process of implementing any such decisions. If the extra costs and risks of an investment program are substantial, these added costs and risks must be justified by realistically evaluated return expectations.

- **Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), comment h, page 30.**

The Two-Pronged Test of Restatement Commentary

To the extent an investment strategy involves extra management, tax, and transaction costs or a departure from an efficiently diversified portfolio, that strategy should be justifiable in terms of…a realistically evaluated prospect of enhanced return [from the strategy].

- **Edward C. Halbach, Jr., the Reporter for the Restatement and Walter Perry Johnson professor of law emeritus at the University of California law school, in "Trust Investment Law in the Third Restatement,"** ***Real Property, Probate and Trust Journal*****, Volume 27, Fall 1992, pages 407-65; see Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), comment f, page 25.**

Market Efficiency Helps Trustees Apply the Two-Pronged Test

Market efficiency information is especially relevant in assessing [realistically evaluated return] expectations…

- **Edward C. Halbach, Jr., the Reporter for the Restatement and Walter Perry Johnson professor of law emeritus at the University of California law school, in "Trust Investment Law in the Third Restatement,"** ***Real Property, Probate and Trust Journal*****, Volume 27, Fall 1992, pages 407-65; see Reporter's General Note on Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), comments e through h, page 79.**

The Restatement Discusses Market Efficiency

Economic evidence shows that, from a typical investment perspective, the major capital markets of this country are highly efficient, in the sense that available information is rapidly digested and reflected in the market prices of securities. As a result, fiduciaries and other investors are confronted with potent evidence that the application of expertise, investigation, and diligence in efforts to “beat the market” in these publicly traded securities ordinarily promises little or no payoff, or even a negative payoff after taking account of research and transaction costs. Empirical research supporting the theory of efficient markets reveals that in such markets skilled professionals have rarely been able to identify underpriced securities (that is, to outguess the market with respect to future return) with any regularity.

– **Reporter’s General Note on Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), page 75.**

The Reporter for the Restatement Discusses Market Efficiency

When we think of the relative efficiency of our major central markets, we see compelling evidence that it's hard with any consistency or predictability to beat the market through stock picking. Therefore, one ought to be concerned about heavy expenditures for an undertaking unless it offers some realistic prospect of a corresponding payoff. [This] should be called to [the] attention [of trustees].

– **Edward C. Halbach, Jr., the Reporter for the Restatement and Walter Perry Johnson professor of law emeritus at the University of California law school, in "Redefining the 'Prudent Investor Rule' for Trustees,"** ***Trusts & Estates*****, December 1990, pages 14-22.**

The Burden of Justifying Active Investment Strategies

The greater the trustee's departure from one of the valid passive strategies, the greater is likely to be the burden of justification [for selecting an active investment strategy] and also of continuous monitoring [of it].

- **Reporter's General Note on Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), comments e through h, page 79.**

The Burden of Justifying Underdiversified Investment Strategies

The greater the departure [from a suitable, diversified portfolio], the heavier the trustee's burden to justify the strategy in question.

– **Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), comment f, page 25.**

How the Reporter for the Restatement Views Passive Investing

[Restatement]commentary…understandably tends to emphasize relatively passive investment…

- **Edward C. Halbach, Jr., the Reporter for the Restatement and Walter Perry Johnson professor of law emeritus at the University of California law school, in "Trust Investment Law in the Third Restatement,"** ***Real Property, Probate and Trust Journal*****, Volume 27, Fall 1992, pages 407-65.**

A Practical and Empirical Test

Drawing a defined and potentially arbitrary line between active and passive programs…can and ought to be avoided in legal doctrine by simply relating any special burdens of justification to the existence and degree of extra expense [including taxes] and risk involved.

- **Edward C. Halbach, Jr., the Reporter for the Restatement and Walter Perry Johnson professor of law emeritus at the University of California law school, in "Trust Investment Law in the Third Restatement,"** ***Real Property, Probate and Trust Journal*****, Volume 27, Fall 1992, pages 407-65; see Reporter's General Note on Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), comments e through h, page 79.**

Track Record Investing is not a Reliable Basis for Active Investing

[E]vidence shows that there is little correlation between fund managers' Earlier successes and their ability to produce above-market returns in Subsequent periods.

– **Restatement 3rd of Trusts (Prudent Investor Rule), page 75**

Past performance is no guarantee of future results

– **Securities and Exchange Commission**

There's no reliable way to predict when - or which - or even if – winners From the past will win again in the future

– **Studies of mutual fund performance over the last 40 years**

Some Notable Quotations

Every departure from indexing that you hope will put you ahead - as when you give eight money managers with different styles one-eighth each of your portfolio to manage - when the resultant ends far from diversification agreement with the overall index, your risk-corrected long-run performance is in jeopardy to a degree that you are not able even to estimate.

– **Paul Samuelson, the second (and first American) recipient of the Nobel Prize in economic sciences (1970), in "The Long-Term Case for Equities,"** ***The Journal of Portfolio Management*****, Fall 1994, pages 15-24.**

Some Notable Quotations

[A]ny pension fund manager who doesn't have the vast majority - and I mean 70% or 80% of his or her portfolio - in passive investments is guilty of malfeasance, non-feasance or some other kind of bad feasance! There's just no sense for most of them to have anything but a passive investment strategy … Most pension fund managers cannot even reasonably hope to do any better than a passive fund. And on a risk adjusted basis they don't!

– **The late Merton Miller, co-recipient of the 1990 Nobel Prize in economic sciences and former member of the DFA Board of Directors, in *Investment Gurus* by Peter J. Tanous (Paramus, NJ: New York Institute of Finance, 1997), pages 225-26.**

Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees.

– **Warren Buffet, legendary disciple of Benjamin Graham, in the Chairman's Letter, 1996 Berkshire Hathaway Corp. Annual Report.**

Some Notable Quotations

[Most investors would] be better off in an index mutual fund.

- **Peter Lynch, legendary (former) manager of Fidelity Magellan, in "Is There Life After Babe Ruth?", *Barron's*, April 2, 1990, page 15.**

I wouldn't be displeased at all if many trustees are encouraged to index portions of their portfolios, as may fit their return objectives and duties of impartiality. I hope that attention to costs might invite indexing when and as suitable because, based on current understandings of performance, index funds look very good as a potential element of trust portfolios.

- **Edward C. Halbach, Jr., the Reporter for the Restatement and Walter Perry Johnson professor of law emeritus at the University of California law school, in "Redefining the 'Prudent Investor Rule' for Trustees," *Trusts & Estates*, December 1990, pages 14-22.**

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Some Notable Quotations

- **Q**: How can individuals find managers who can beat the street?
- **A**: Most people think they can find managers who can outperform, but most people are wrong. I will say that 85% to 90% of managers fail to match their benchmarks, if you properly specify their benchmarks.
- **Q**: That's pretty pessimistic.
- **A**: Yes. But because managers have fees and incur transaction costs, you know that in the aggregate they are deleting value. The investment business is a giant scam. It deletes billions of dollars every year in transaction costs and fees.
- **Q**: So what should individuals do?
- **A**: Most people should simply have index funds to keep their fees low and their tax down. No doubt about it.
  - **Jack R. Meyer, Former CEO of Harvard Management Co., who was responsible for Harvard University's multi-billion dollar endowment fund, in *Business Week*, Dec. 27, 2004.**

Some Notable Quotations

One of the central findings of Modern Portfolio Theory [is] that … huge and essentially costless gains [can be obtained by] diversifying [a] portfolio thoroughly.

- **John H. Langbein, the Reporter for the Uniform Prudent Act and Chancellor Kent professor of law and legal history at Yale University law school, in "The Uniform Prudent Investor Act and the Future of Trust Investing," *Iowa Law Review*, Volume 81, 1996, pages 641-69.**

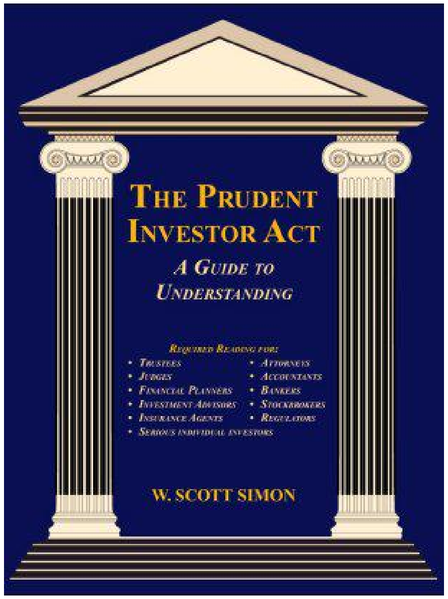
A Copernican Revolution…the most fundamental thing that has happened to the investment process - the development of Modern Portfolio Theory, the Theory of Efficient Markets, the scientific understanding of risk/return relationships and the importance of diversification in portfolios.

- **John H. Langbein, the Reporter for the Uniform Prudent Act and Chancellor Kent professor of law and legal history at Yale University law school, in a telephone conversation with W. Scott Simon.**

Resources

The Prudent Investor Act: A Guide to Understanding

by W. Scott Simon



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