Modern Prudent Fiduciary Investing and Passive Investing

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The title of my speech today is "Modern Prudent Fiduciary Investing and Passive Investing."

The first part of the speech will be a brief introduction to modern prudent fiduciary investing as described in the Uniform Prudent Investor Act and the Restatement 3rd of Trusts.

The second part will be a discussion of why I think that passive investing is, in effect, the "default" standard of modern prudent fiduciary investing.

I will then finish up by discussing how you can use some of what I've imparted today to increase your chances of winning business from trustees of 401(k) plans, non-profit pools of money, public pension plans, private family trusts - and even from individuals.

My overall objective is to provide a clear and logical way for you to approach trustees and their trusted advisors such as attorneys to help give you a powerful marketing advantage over your competition in gathering assets.

I. A Brief Introduction to Modern Prudent Fiduciary Investing

A. Harvard College v. Amory (1830)

Any introduction to modern prudent fiduciary investing must begin with the 1830 Massachusetts case of *Harvard College v. Amory*. That case, which established the foundation of trust investment law in America, set forth the general and flexible Prudent Man Rule. Now, according to the Prudent Man

Rule, the goal of a fiduciary is to make the assets it manages productive by seeking the highest income possible while safeguarding the value of the principal.

The Prudent Man Rule and its fiduciary principles of care, skill and caution gradually became prevalent in most American jurisdictions through legislation and court opinions. As these principles were adopted in an effort to offer guidelines to trustees, the Rule eventually lost much of its generality and flexibility. Dissatisfaction with the Prudent Man Rule began to appear in legal and investment circles due to changes that were occurring in investment practices in the late 1960s.

Those investment practices consisted of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of financial markets - otherwise known as Modern Portfolio Theory.

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

It is rare in the history of human thought that the origin of an idea can be identified with any degree of precision, but in the case of Modern Portfolio Theory it can. Modern Portfolio Theory originated in the mind of a young Ph.D. candidate in economics as he sat in the library of the business school at the University of Chicago one day in 1950. That student, Harry Markowitz, was reading an influential book on finance called *The Theory of Investment Value*. The author of the book, John Burr Williams, maintained that an investor should invest in those stocks it thinks will produce maximum returns. Williams claimed that holding a large number of such stocks is "equivalent" to diversifying risk.

As he reads the book, it strikes the 23-year old Markowitz that Williams' approach to investing in those stocks that an investor thinks will produce maximum returns is nothing more than a one-dimensional focus on return. Markowitz thinks that the problem with Williams' notion of diversification is that it not only doesn't account for risk, but that it can actually be quite risky.

The "riskiness" of Williams' idea of holding a large number of stocks it is thought will produce maximum returns is that such stocks often have high covariance to each other. We know, of course, that "covariance" describes how the prices of stocks move relative to each other in reaction to new information about them. The prices of stocks that have high covariance to each other move in the same general direction, at the same general time. A recent - and relevant - example of this would be a portfolio of many High Technology stocks held by an investor at the start of 2000. John Burr Williams would say that such a portfolio was "equivalent" to diversifying risk.

Markowitz's notion of diversification is radically different from that of Williams. Markowitz seeks to diversify a portfolio with stocks that have low covariance to each other. The prices of low covariance stocks, of course, move in different directions, at different times. Markowitz concludes from this that Williams' idea of investing only in those stocks it is thought will produce maximum returns fails to imply the desirability of diversification.

This leads Markowitz to suggest in his seminal 14-page paper on portfolio theory published in March 1952 that Markowitz's notion of diversification tends to promote "investment" behavior, while Williams' notion of diversification tends to promote "speculative" behavior. The late Merton Miller - Nobel laureate and former member of the DFA Board of Directors - later called this paper the Big Bang of all modern finance.

More precisely, Markowitz suggests in that paper that investors who invest in each time period in those stocks believed to offer the best odds of producing maximum returns - *without taking risk into consideration* - are speculators, not investors. And it is for this reason that Markowitz shows us in a very compelling way why investors must *consciously think about risk as well as return*. This simple yet fundamental idea - *ranking as one of the most crucial investment insights of the 20th century* – will earn Markowitz a Nobel Prize in economic sciences in 1990 and universal acknowledgment as the "father of Modern Portfolio Theory."

Now it just so happens that Markowitz's crucial insight that day in 1950 which was the genesis of Modern Portfolio Theory was also the spark that ignited in the 1990s the revolution in the law that governs the investment and management of trust assets.

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

One of the first shots in this revolution was publication of the Restatement 3rd of Trusts (Prudent Investor Rule) by the American Law Institute in 1992. The Restatement of Trusts is a legal treatise that examines the common law and state statutes in a particular field of law and restates them as broad legal principles.

The goal of the Restatement 3rd of Trusts was to revise and supersede the Prudent Man Rule – which was contained in the first Restatement of Trusts published in 1935 and the Restatement 2nd of Trusts published in 1959 - by incorporating modern theories of investment and finance into the general language of the Prudent Investor Rule.

Given the prestige of the American Law Institute, its pronouncements in other areas of law such as restatements of criminal law, remedies law or tort law often become a source of authority that is given great respect by courts and legislatures. In the field of law in which we're interested – trust law - the Restatement 3rd of Trusts is nothing less than the *Bible of trust investment law* in America today. Nonetheless, the American Law Institute is not a governmental body and no restatement of law has the sanction of any statute.

D. Uniform Prudent Investor Act (1994)

To help rectify this, the Uniform Prudent Investor Act was published by the National Conference of Commissioners on Uniform State Laws in 1994. The Act sets forth prudent fiduciary standards governing the investment conduct of trustees of private family trusts. Much of the language of the Prudent Investor Act has been incorporated virtually verbatim into a number of other uniform acts.

These include the 1997 Uniform Management of Public Employee Retirement Systems Act - now law in 2 states - which governs the conduct of trustees responsible for public employee retirement plans; the 1997 Uniform Principal and Income Act - now law in 41 states and the District of Columbia – which helps to coordinate the implementation of Modern Portfolio Theory and prudent investing with new rules pertaining to principal and income allocation; the 2000 Uniform Trust Code - now law in 16 states and the District of Columbia – which is a national codification of the law of trusts as well as an effort to reform that body of law by incorporating modern notions of fiduciary investment conduct; and, finally, the Uniform Prudent Management of Institutional Funds Act - published just three months ago in July – which governs the investment conduct of trustees responsible for charitable non-profits, including foundations and endowments.

The Prudent Investor Act even has a bearing on fiduciaries of private retirement plans governed by the ERISA such as 401(k) plans. John Langbein, the Reporter for the Uniform Prudent Investor Act and Chancellor Kent professor of law and legal history at Yale University law school, explains: "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."

I write a monthly column for Morningstar on fiduciary investment issues. In that column, I sometimes refer to the Uniform Prudent Investor Act as an "octopus" because of the way in which its tentacles have spread far and wide into virtually all areas of American trust investment law. That's why it's not a stretch to say that the fiduciary investment standards of the Uniform Prudent Investor Act govern, directly or indirectly, the conduct of a wide variety of trustees in the investment and management of hundreds of billions of dollars.

So far, the Uniform Prudent Investor Act has been enacted into law by 44 states, the District of Columbia and the U.S. Virgin Islands. The American Bar Association endorsed the Act in 1995, as has the American Bankers Association.

E. The Relationship Between the Prudent Investor Act and the Restatement

A number of people have asked me about the relationship between the Prudent Investor Act and the Restatement. I tell them to think of the Restatement as the "Godfather" of the Prudent Investor Act because the Restatement is the scholarly and authoritative forebear of the Act. The 23-page 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.

The Prudent Investor Act's tie to the Restatement is significant because it is the Restatement that sets forth the underlying rationale of the rules that are now part of the Prudent Investor Act while it also provides numerous examples of prudent and imprudent investing. The Prudent Investor Act and the Restatement stand together at the center of modern prudent fiduciary investing in America today.

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

The Prefatory Note to the Uniform Prudent Investor Act states that the "central consideration" of all investment fiduciaries is to *determine the tradeoff* *between risk and return* in a portfolio. It's no accident that this supreme duty required of a fiduciary when investing and managing trust assets is derived straight from Modern Portfolio Theory 101.

To help understand this better, let's refer back to Harry Markowitz's crucial insight that day in 1950. And what was that insight? *Investors must consciously think about risk as well as return.* And why did Markowitz conclude that? Because investors like John Burr Williams who don't take risk into consideration - and simply invest in those stocks it is thought will produce maximum returns - are speculators, not investors.

And that's why there is no mention of John Burr Williams in either the 23 pages of the Prudent Investor Act or in the 300-plus pages of the Restatement. And that's a good thing because it is Williams and his ilk with their one dimensional focus on return that land themselves (or what's worse, their clients) in portfolios comprised of, oh gee, 80% High Technology stocks in the year 2000.

The standards of modern prudent fiduciary investing tell us that there is a better way. Modern Portfolio Theory focuses on *both* return *and risk* in order to reduce portfolio risk and, in so doing, enhances portfolio return. That's why Modern Portfolio Theory provides the theoretical underpinnings not only for the Uniform Prudent Investor Act but also for the Restatement – as well as ERISA. This underscores the central importance of Modern Portfolio Theory in investing and its tremendous influence in prompting and shaping the reform of American trust investment law.

You'll be happy to know that I've now gotten through the first of three parts of my speech. This part can be summarized by two main themes. The first: Modern Portfolio Theory requires that trustees think about *both risk and return* because if they don't, they are nothing more than speculators - not investors. The second theme: The "central consideration" of all investment fiduciaries under the Uniform Prudent Investor Act is to *determine the tradeoff between risk and return* in a portfolio.

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

Now let's turn to the second part of my speech today: my suggestion that 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

Some people have quoted me to the effect that modern prudent fiduciary investing *requires* passive investing. I'm here to tell you that it does no such thing. In fact, the Uniform Prudent Investor Act doesn't say a darn thing about active investing or passive investing. But the Restatement does; it clearly says that *both* passive investing *and* active investing are prudent. Nonetheless, I think that any careful assessment of the language of the Restatement would conclude, as I have, that passive investing is, in effect, the "default" standard of modern prudent fiduciary investing.

Before exploring that, let's turn again to the father of Modern Portfolio Theory. Dr. Markowitz identifies the fundamental problem all investors face: *decisions about portfolio investments are made under conditions of uncertainty*. A good part of this uncertainty arises from the fact that there is really no way to know today which investments will turn out to be superior performers and which ones will be inferior performers. This leads Dr. Markowitz to the conclusion that uncertainty (or risk) is the central factor at work in financial markets. That's why, as investment advisors, you must follow Dr. Markowitz's maxim to *think consciously about risk* as well as return as you go about building portfolios for your clients.

B. Active Investing

Many investment advisors - such as stockbrokerage firms, banks, RIAs, trust companies and others - who counsel fiduciaries on investing and managing trust assets, of course, believe that there *is* a way to know today which investments will turn out to be superior performers and which ones will be inferior performers. Such advisors believe that the best way to "know" this is through "active investing," the purpose of which is to "beat the market." Active investing takes a number of different forms.

One form of active investing - known as "track record investing" - focuses on the past. This involves attempts to assess which superior performing investments from the past will continue to be superior in the future.

Other forms of active investing - known as "stock picking" and "market timing" - focus on the future. They involve attempts to profitably forecast the future price movements of stocks (or bonds) so that an investor can predict which investments will be superior performers. John Burr Williams would be right at home here.

All such forms of active investing – whether track record investing, stock picking or market timing - 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 overwhelming majority of investors - including trustees - are active investors. The prevalence of such thinking leads many trustees to presume that active investment strategies are the best way to implement portfolio asset allocations.

C. The Two-Pronged Test

This presumption, I submit, appears to be turned on its head by the language of modern prudent fiduciary investing found in commentary to the Restatement. That commentary is not shy about coming right out and warning trustees of the dangers – that is, the added risk, costs and taxes - of stock picking and market timing:

> 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.

This commentary is significant because it states that a trustee proposing to implement a trust portfolio's asset allocation with a substantially costly (including taxes) and risky active investment strategy should *first* establish the prudence of the strategy.

Such prudence may be determined by means of a two-part test suggested by the commentary: First, are the extra costs, taxes and risks of the proposed active investment strategy "substantial" and second, even if they are substantial, can they be "justified by realistically evaluated return expectations?"

The Reporter for the Restatement, Edward C. Halbach, Jr., the Walter Perry Johnson professor of law emeritus at the University of California, Berkeley law school, restates the two-pronged test suggested by Restatement commentary in a more conversational way:

> 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].

The Reporter for the Restatement advises how notions of market efficiency can help guide trustees who employ the two-pronged test:

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

Reporter's General Note on Section 227 of the Restatement provides a cogent discussion of 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.

The Reporter for the Restatement further advises active investing trustees:

> 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].

Reporter's General Note on Restatement Section 227 sets forth a trustee's burden in 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].

This language is similar to Restatement commentary concerning a trustee who dares contemplate an underdiversified investment strategy:

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

And if there's any doubt about how the Reporter for the Restatement personally feels about passive investing, he lays it to rest:

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

All this language that I've just quoted from Restatement commentary, Reporter's General Note on Restatement Section 227 and Professor Halbach's law review articles about market efficiency is no doubt important and illuminating.

Nonetheless, we must still circle back to Restatement commentary's practical and empirical "burden of proof" two-pronged test required of a trustee contemplating active investment strategies and avoid reliance on notions such as market efficiency. As Professor Halbach explains:

> 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.

This offers those of us who believe in passive investing a huge advantage. Why? Because we get to avoid esoteric discussions about the Efficient Market Hypothesis, financial markets as zero sum games and the like. Instead, we can concentrate on the decided advantages of passive investing - including lower risk, costs and taxes – which all lead to higher return.

We know, of course, that nearly every active investment program has "extra costs, taxes and risks" that are "substantial." In such situations, based on the two-pronged test laid out by Restatement commentary, a trustee must first identify a viable passive investment strategy appropriate to the portfolio under consideration. It may depart from that position and employ a proposed active investment strategy. Before it can do that, though, it must demonstrate that - and document at the time - the substantial costs, taxes and risks of the strategy can be justified on the basis of a realistically evaluated prospect of enhanced return from the strategy. In short, such trustees must ask themselves: *Will I be getting enough bang for the buck*?

It seems to me that the added risks, and higher costs and taxes typically generated by stock picking, market timing and track record investing make it unlikely that trustees will be able to answer this question in the affirmative and therefore carry their burden of proof to justify many proposed active investment strategies. I think this is true whether a proposed active investment strategy is based on stock picking, market timing or track record investing.

D. Track Record Investing

For example, let's take a look at track record investing. Track record investing, which I've identified as one form of active investing, occurs when an investor identifies some investment such as a mutual fund with an outstanding track record and invests in it because the investor thinks that its historical performance - that is, its track record - will continue into the future. Here's what Reporter's General Note on Restatement Section 227 says about track record 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.

Other sources tell us that track record investing does not provide trustees with a reliable basis for justifying proposed active investment strategies. One source is the Securities and Exchange Commission. The SEC reiterates the warning raised by Reporter's General Note on Restatement Section 227 by requiring every mutual fund to carry the disclaimer that "past performance is no guarantee of future results." Another source telling us that track record investing is not a reliable basis for proposed active investment strategies are the findings of virtually every reputable study of mutual fund performance over the last 40 years. These studies show that there's no reliable way to predict when - or which - or even if - winners from the past will win again in the future.

In fact, the plain truth - for those willing to face it – is that any investment or investment manager that has performed well over a certain period in the past is just as likely to perform poorly in the future as it is to continue doing well. Indeed, data actually show the perverse tendency for many superior track records to be followed by inferior track records.

Another problem with track record investing is that it is little more than a one-dimensional focus on return. Didn't Harry Markowitz as a 23-year old figure out over a half-century ago that such thinking not only doesn't account for risk, but that it can actually be quite risky? And isn't that what led Markowitz to suggest that those engaged in such conduct are nothing more than speculators, not investors? ---- If you get nothing else out of my speech this afternoon, please remember that investment fiduciaries – *who are responsible for other people's money* – cannot be speculators! ----- And finally, doesn't track record investing violate the "central consideration" of a fiduciary under the Uniform Prudent Investor Act which is to "determine the tradeoff between return *and risk*?"

E. Stock Picking and Market Timing

What about the other two forms of active investing - stock picking and market timing? Do they provide trustees with a reliable basis for justifying proposed active investment strategies? Not in my book – and more relevantly, I don't think in the book of modern prudent fiduciary investing.

Just think about how a "skillful" money manager is identified. For example, many trustees responsible for large pools of money will hire an investment management consultant to search their databases for "the best" money managers. And who is always the winner at the end of these *always* long and expensive searches? The money manager with *a superior track record* – that is, one in the top quartile - over a relatively short time period – that is, the past three to five years. In short, the winning money manager is *deemed "skillful" if it has a superior track record*. In case you hadn't noticed, we have just circled back to the evils of track record investing.

You will no doubt be happy to know that I've now gotten through the second of three parts of my speech. This part can be summarized by two main themes. The first: Passive investing is, in effect, the default standard for modern prudent fiduciary investing. The second theme: The three forms of active investing - stock picking, market timing and track record investing - are not a reliable way for trustees to justify proposed active investment strategies.

III. How to Increase Your Chances of Winning Business

I now turn to the last part of my speech: how you can increase your chances of winning business. I suggest that you may want to consider a three-pronged marketing strategy. The first one involves modern prudent fiduciary investing, the second one involves passive investing and the third one involves Dimensional Fund Advisors. Here's what I mean by that.

Let's say that you're marketing "wholesale" – that is, to referral sources such as attorneys. Although many attorneys have read about the Uniform Prudent Investor Act, Modern Portfolio Theory, etc., etc., they really don't work with, or understand, these notions. Few legal people get the investment side but then, few investment people get the legal side.

A. Modern Prudent Fiduciary Investing

You can fill this information void by being one of the few that gets both sides and, as a result, enhance your asset-gathering abilities. So I suggest that part of your marketing message should be along the lines of the following:

> We are one of the few advisory firms in the country that invests and manages assets according to the requirements of the Uniform Prudent Investor Act and the Restatement.

Although the financial services industry is an increasingly highly competitive profession, that kind of message will differentiate you from just about all your competitors out there. As part of your message, you may want to speak to attorneys in the language they understand: *"liability" and "fiduciary duties*." For example, trustee liability is not judged according to a portfolio's performance, but the prudence of the trustee's conduct. In short, liability hinges on the *trustee's conduct, not the portfolio's performance*.

Using this kind of message as a lead-in means that your approach is more educational and collaborative – not to mention less threatening to attorneys - in comparison to someone pushing a product – even a wonderful product like DFA funds. Remember, attorneys see product pushers all day long and you do not want to get lumped in with them.

B. Passive Investing

Bearing in mind that the primary emphasis of your marketing message should be on modern prudent fiduciary investing, the second prong of that message should be passive investing. I suggest that you keep your message about passive investing simple - along the lines of the following:

> The asset classes that make up financial markets increase in value over the long run. This growth is simply a reflection of the enormous vitality of an ever-expanding capitalistic economy. Asset class funds virtually duplicate the investment performances of these asset classes. The most risk, cost and tax efficient way of achieving the returns offered by the asset classes that make up financial markets is to invest passively.

Your emphasis should be that passive investing goes *hand in glove* with modern prudent fiduciary investing. Indeed, you can say that prudent investing is passive investing and passive investing is prudent investing.

Then conclude this part of your message by noting that although both passive investing and active investing are permitted, passive investing is, in effect, the "default standard" of modern prudent fiduciary investing based on strong legal and academic evidence. Trustees may depart from that standard and invest actively, but only with careful justification that's well documented. The language of modern prudent fiduciary investing makes such justifications problematic.

C. Dimensional Fund Advisors

The message that prudent investing is passive investing and passive investing is prudent investing provides a very convenient and natural way for you to lead into a discussion about Dimensional Fund Advisors. DFA offers investment in broadly diversified and low cost portfolios of institutional asset class funds earning market-level returns at market-level risk. Modern prudent fiduciary investing *literally demands this product.*

The approach that I have suggested today will, in my opinion, appeal not only to attorneys and other trusted advisors that immediately "get it," but also to those who will take some more convincing.

IV. Conclusion

I'd like to conclude my remarks this afternoon by describing the paradox that confronts all investors.

That paradox is this: investors are heavily exposed to, and focus on, a superficial investment approach. This approach – which involves stock picking, market timing and track record investing - is actually *contrary to* the best interests of investors because it tends to encourage speculative investing. No trustee of any pool of money - whether it is 401(k) money, non-profit money, public pension plan money or private trust money - should be engaged in speculative investing for the very simple fact that it is imprudent conduct, per se.

Yet many investors remain unaware of a profound fact that is actually very much *in line with* their best interests: a prudent and commonsensical approach to investing that is legally sound, academically grounded and cost efficient. That approach involves investing in portfolios of broadly diversified, low cost, low tax insitutional level asset class mutual funds that efficiently and effectively capture the returns offered by financial markets at market-level risk.

Once trustees and other investors are exposed to information such as that presented here that allows them to truly understand this paradox and its far-reaching implications, they recognize immediately the compelling logic of investing in portfolios of asset class funds that fit hand in glove with principles of modern prudent fiduciary investing.