

Fiduciary Focus: Modern Prudent Fiduciary Investing and Investment Risk

W. Scott Simon | 10-05-04 |

Last month in this column, I made the (counterintuitive) point that the better way for advisors to increase portfolio wealth is to concentrate more on managing risk and less on trying to score big in the random game of identifying investment winners through stock-picking and market-timing.

Because I have been emphasizing return, I thought it might be worthwhile to spend some time discussing investment risk if for no other reason than that a fiduciary's "central consideration" under the Uniform Prudent Investor Act is to make tradeoffs between portfolio risk and return.

The Prefatory Note to the Act and the Restatement 3rd of Trusts (Prudent Investor Rule) emphasize the pervasive influence that Modern Portfolio Theory has had on prudent fiduciary investing. One of the essential tenets of Modern Portfolio Theory is that portfolio risk should be minimized given a certain level of expected portfolio return.

Any discussion of investment risk within the context of modern prudent fiduciary investing must begin with the fundamental observation made by the father of Modern Portfolio Theory, Nobel Laureate Harry Markowitz: Selections of portfolio investments involve making decisions under uncertainty.

This leads to the conclusion that risk (i.e., uncertainty) is the central factor at work in financial markets. Investment advisors must, therefore, think consciously about risk as they go about building portfolios for their clients.

Naive Diversification vs. Rational Diversification

Modern Portfolio Theory originated in the mind of Markowitz one day in 1950 as he was reading a well-known investment book called *The Theory of Investment Value* by John Burr Williams.

Williams maintained that investors should seek to maximize the expected returns of their portfolios. In Williams' view, diversification was equivalent to holding a large number of stocks that are anticipated to maximize expected return. It struck the 23-year-old Markowitz that Williams' approach was one-dimensional. Seeking only to maximize return didn't take into account the element of risk.

Indeed, Markowitz thought that Williams' notion of diversification--holding a large number of stocks with the objective of maximizing expected return--not only didn't account for risk but could actually be quite risky. Markowitz concluded that since Williams' approach didn't take risk into account, he failed to imply the desirability of diversification.

Williams seeks to diversify among stocks that are expected to maximize expected return. The "riskiness" of Williams' notion of diversification arises from the fact that stocks with maximum

expected return often have high covariance to each other. ("Covariance" describes how the market prices of investments move relative to each other in response to new information.)

An investor following Williams' approach to diversification might have, for example, in 1999 held many high tech stocks in its portfolio--stocks with maximum expected return. The ensuing collapse in value of many of these stocks readily demonstrates the risk that Markowitz identified in Williams' approach to diversification. In my book, *The Prudent Investor Act: A Guide to Understanding*, I have termed Williams' notion of diversification as "naive diversification."

Markowitz's notion of diversification is radically different from that of Williams'. Markowitz seeks to avoid stocks that have high covariance to each other in order to reduce portfolio risk (with the added bonus of possibly increasing return). Markowitz suggests that his notion of diversification tends to promote "investment" behavior, while Williams' notion tends to promote "speculative" behavior. In my book, I have termed Markowitz's notion of diversification as "rational diversification."

Total Portfolio Risk: Compensated Risk and Uncompensated Risk

According to Modern Portfolio Theory, risk can be managed through diversification. (Risk can also be managed through other techniques of risk management such as stop-loss orders and collars.) Section 3 of the Uniform Prudent Investor Act reads: "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."

As you can see, the act doesn't prohibit outright undiversified portfolios. Instead, it shifts the burden of proof to a fiduciary to demonstrate its reasonable determination that "under the circumstances, it is prudent not to [diversify]." But the message of the act and the Restatement 3rd of Trusts is that prudent fiduciary investing ordinarily mandates diversification of risk. Indeed, the duty to diversify risk is so central to modern concepts of prudence that the restatement integrates the diversification requirement into the basic text and commentary of the Prudent Investor Rule.

Commentary to the restatement notes that the duty to diversify risk is based on principles of Modern Portfolio Theory. A principle central to Modern Portfolio Theory is that total portfolio risk is composed of two kinds of risk: compensated risk and uncompensated risk.

"Compensated risk," which composes about 30% of total portfolio risk, reflects how the market prices of many (or all) stocks are affected relatively the same by economic (and non-economic) news. For example, nearly all stocks decreased in value in the immediate aftermath of Sept. 11, 2001.

Compensated risk is unavoidable by an investor that invests in the stock market because the prices of individual stocks are affected, more or less, by the risk of a general rise or fall in the value of the stock market itself. Compensated risk can be thought of as the "price of admission" that must be paid by an investor that wishes to enter the stock market in exchange for (possibly) securing the relatively higher returns offered by the stock market (as opposed to the relatively lower returns offered by fixed-income investments).

Compensated risk ordinarily is "good" as long as an investor has a realistic prospect of realizing gain commensurate with the risk assumed. Financial markets reward investors for retaining this kind of risk in their portfolios. A fiduciary is therefore under no duty to reduce compensated risk, but to manage it. Edward C. Halbach, Jr., the reporter for the Restatement and professor emeritus of law at the University of California, Berkeley Law School, explains: "The primary means of increasing a diversified portfolio's expected return is to raise its degree of [compensated] risk. Because [compensated] risk is [rewarded], [trustees] are under no [duty] to minimize it, but [instead] are to

make conscious decisions about the suitable level of [compensated] risk for the particular [trust portfolios] under their management."

"Uncompensated risk," which composes about 70% of total portfolio risk, reflects how the market price of a particular stock is impacted uniquely by economic and non-economic news. For example, the price of Microsoft stock may go down as a result of the departure of a key Microsoft executive.

Uncompensated risk is avoidable by an investor that invests in the stock market. The investor holding only Microsoft stock can protect himself against this risk by also owning stock in companies that are unaffected by the departure of Microsoft executives. John H. Langbein, the reporter for the Act and professor of law at Yale University Law School, observes: "One of the central findings of Modern Portfolio Theory [is] that ... huge and essentially costless gains [can be obtained by] diversifying [a] portfolio thoroughly."

Uncompensated risk ordinarily is "bad" for portfolios because financial markets don't reward investors for retaining this kind of risk. In fact, many investors are penalized with lower returns for retaining uncompensated risk. They simply don't have a realistic prospect of realizing gain commensurate with the risk assumed.

As business school students all over the world are taught in Modern Portfolio Theory 101, the most efficient and effective way to minimize risk in a portfolio is to eliminate as much uncompensated risk from it as possible. Restatement Commentary even defines the broadest possible diversification: "The ultimate goal of diversification would be to [completely eliminate uncompensated risk and thus] achieve a portfolio with only the [compensated]...element of risk." Commentary to Section 3 of the Act adds: "The object of diversification is to minimize [the] uncompensated risk of having too few investments." Such language is derived from fundamental principles of Modern Portfolio Theory.

A fiduciary, then, ordinarily has the duty to wring out as much uncompensated risk from a portfolio as possible. Restatement Commentary describes the penalty for not doing this: "Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill."

A Special Place Called "Imprudence Hell"

These three duties of caution, care, and skill are defined in Commentary to the Act as the very elements of "prudence." The breach of even one of these three duties can make the conduct of a fiduciary imprudent and subject it to liability. But a fiduciary's breach of all three duties--as in the case of failing to reasonably diversify a portfolio's uncompensated risk--reserves the fiduciary a special place in "Imprudence Hell." Being cast into such a place is (very) bad (legal) karma.

It's important to note that the language of the Act and the Restatement describes Markowitz's notion of diversification of portfolio risk by which the uncompensated risk in a portfolio can be virtually eliminated. There is no mention of John Burr Williams or of his notion of diversification. Unfortunately, many fiduciaries--including those that should (and do) know better--employ Williams' notion of diversification.

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