

Fiduciary Focus: Modern Prudent Fiduciary Investing (Part 3)

W. Scott Simon | 12-15-04 |

My column last month ended by quoting from Commentary to Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule): "Because market pricing cannot be expected to recognize and reward a particular investor's failure to diversify, a trustee's acceptance of [uncompensated] risk cannot, without more, be justified on grounds of enhancing expected return."

I observed that this snippet of Restatement Commentary brilliantly integrates two essential principles of prudent fiduciary conduct: 1) the duty ordinarily to diversify a portfolio to reduce its uncompensated risk and 2) a fiduciary's "central consideration" under the Uniform Prudent Investor Act: to make the tradeoff between a portfolio's risk and return.

To help explain this, let's examine what each part of the quoted Restatement Commentary means, beginning with: "Market pricing cannot be expected to recognize and reward a particular investor's failure to diversify."

I have explained previously that "uncompensated risk" reflects how the market price of a particular stock is impacted uniquely by economic and non-economic news. For example, the price of General Electric stock may go down as a result of the destruction of a key G.E. manufacturing plant in Ireland.

The bad news is that uncompensated risk comprises about 70% of total portfolio risk. The good news for an investor holding only G.E. stock is that some uncompensated risk can be eliminated from its portfolio if it diversifies by also holding stocks in companies that are unaffected by the destruction of G.E. manufacturing plants. (The even better good news for investors is that they can eliminate virtually all uncompensated risk from their portfolios by owning the market portfolio, but that's another story for another column.)

The fact that any investor has the ability to eliminate some uncompensated risk from his or her portfolio (or virtually all uncompensated risk by owning the market portfolio) is precisely the reason why financial markets won't reward these investors for retaining this kind of risk.

What the market is really saying to such investors is this: "Hey, dummy! If you don't have the smarts to hold the market portfolio, then all bets are off." In fact, holding a portfolio that differs in composition from the market portfolio is (by definition) riskier than the market portfolio. That's why many investors are penalized with lower returns for retaining uncompensated risk.

As a way to understand this, consider an investor that holds Best Candy Co. stock and Sugar Cane Co. stock in its portfolio. Because sugar is a critical ingredient of candy, the value of Best Candy stock decreases significantly and the value of Sugar Cane stock increases significantly when the price of sugar rises. Holding these two investments together in a portfolio generates (not surprisingly) higher return but (surprisingly!) lower risk than a portfolio of Best Candy stock--or Sugar Cane stock--and a

Treasury bill.

Why, in this example, is a portfolio with two stocks less risky than a portfolio with one stock and a Treasury bill? The answer lies in the fact that financial markets are sophisticated and effective mechanisms for pricing investments. In our example, Best Candy stock and Sugar Cane stock are natural complements because the two stocks have negative or low "covariance" to each other. That is, the market price of one stock moves differently in relation to the price of the other stock when the price of sugar rises or falls.

The market "realizes" that the risk of holding only Best Candy stock (the risk being that the price of sugar will soar) can be "hedged" (i.e., offset) by also holding Sugar Cane stock since Sugar Cane stock will benefit when the price of sugar soars. As a result, the market "decides" that Best Candy stock should be priced in a way that generates a certain expected return, given its risk.

Likewise, Sugar Cane stock is priced by the market in a way that generates a certain expected return, given its risk. If Sugar Cane stock suddenly ceased to exist, the market price of Best Candy stock would plummet because new buyers of Best Candy stock would require a higher return for a stock whose risk (expressed as an increase in the price of sugar) could no longer be hedged.

By holding complementary stocks whose prices are affected in different ways by the same event (e.g., a change in the price of sugar), overall portfolio risk is reduced. This demonstrates how a portfolio can become more "efficient" by application of what I have termed "rational" diversification. Such portfolios provide "more bang for the buck."

An investor that holds only Best Candy stock (or Sugar Cane stock) in its portfolio has "overpaid" for that stock because it failed to acquire the very risk-reducing (i.e., hedging) instrument available in the market to price Best Candy stock (or Sugar Cane stock): Sugar Cane stock (or Best Candy stock). This "overpayment" by the investor takes the form of not getting enough return for the amount of risk it assumed or assuming too much risk for the amount of return it got.

"Mr. Market" (a term coined by legendary stock-picker Benjamin Graham, one of whose disciples is the legendary Warren Buffett) can be merciless in punishing investors for this overpayment as amply demonstrated by all those portfolios concentrated in "can't miss" high tech stocks in, say, 2000. Such underdiversified portfolios with excessive uncompensated risk were simply "ticking time bombs" that went off when the market sector in which they were concentrated exploded, thereby producing catastrophic losses.

And this brings us to the other part of the quoted Restatement Commentary: "A trustee's acceptance of [uncompensated] risk cannot, without more, be justified on grounds of enhancing expected return." (Emphasis added.)

What does the word "more" mean in this context? To me, it clearly indicates the need for a fiduciary to make a conscious assessment of the risks (as well as the costs and taxes) of a portfolio's proposed investment strategy so that it can make a rational tradeoff against the expected return of that strategy. This is nothing less than a description of the "central consideration" that fiduciaries are charged with under the Uniform Prudent Investor Act.

It therefore seems that a fiduciary's conduct is imprudent if its sole justification--i.e., absent the "more"--for making portfolio investments is simply the potential for higher returns.

This means that a fiduciary cannot justify its portfolio selections merely by citing the possibility of higher returns for investments that it believes, for example, "have exceptional promise" or "are poised

to outperform."

Selecting potentially higher return portfolio investments without consciously taking risks (as well as costs and taxes) into consideration, then, cannot be justified. Such fiduciary conduct isn't in accord with the standards of prudent fiduciary investing.

Even when a fiduciary concentrates, say, high tech stocks in a trust portfolio, ordinarily it must still diversify the risk among those stocks. Edward C. Halbach, Jr., the Reporter for the Restatement and the Walter Perry Johnson Professor Emeritus of Law at the University of California, Berkeley Law School, observes: "[T]he goal of diminishing uncompensated risk through diversification should be a pervasive consideration in prudent investment management and ordinarily applies even within specialized programs [i.e., those limited to assets of a particular type or having special characteristics such as real estate, venture capital and foreign stocks] that may be incorporated into [the overall investment strategy of a portfolio]."

Of course, not all portfolios heavy with uncompensated risk and concentrated in a few stocks--or even one stock--wind up exploding. For example, concentrated ownership of founders' stock sometimes conveys fabulous riches on a fortunate few such as Microsoft's Bill Gates. Nonetheless, it's very difficult (more like impossible) to divine which firms will grow from unseasoned startups to Fortune 500 behemoths.

In fact, it's much more reasonable to expect that a great percentage of unseasoned firms will outright fail. While it's difficult to think so today, the odds were Super Lotto-like in 1978 when Bill Gates and others who founded Microsoft (many of whom at the time looked like time-warped refugees from a 1960s hippie commune) that they would ever be a success at all--much less amass such tremendous wealth. Sometimes, though, as noted, even portfolios that are ticking time bombs don't explode.

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Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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