

Fiduciary Focus: Active vs. Passive Investing (Part4)

W. Scott Simon | 5-25-05 |

Many fiduciaries (as well as investors in general) are "active" investors. They believe that they (or someone they hire) can "beat the market" with an active investment strategy of stock-picking or market timing. The investment information system has a substantial interest in promoting and encouraging this belief. Such factors lead many fiduciaries to presume that active investment strategies are automatically the best way to implement portfolio asset allocations.

Reporter's General Note on Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule) appears to turn this presumption on its head: "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 the proposed active strategy] and also of continuous monitoring [of it]."

This language is similar to Restatement commentary that establishes the standard by which the conduct of a fiduciary will be measured when it's contemplating 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."

The preceding language, as well as the overall tenor of the Restatement and the Uniform Prudent Investor Act, which emphasize the virtues of broad diversification and low costs and taxes, suggests strongly that *passive investing is the "default standard" for investing and managing trust portfolios*. Passive investing involves investing in index mutual funds and asset class mutual funds.

Although (in the words of the Reporter for the Restatement) "[Restatement] commentary ... understandably tends to emphasize relatively passive investment ...", principles of modern prudent investing do permit fiduciaries to use active investment strategies as well. Reporter's General Note on Restatement Section 227 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 and risk involved."

The Reporter for the Restatement elaborates on this in the fourth generalization concerning prudent investment: "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 special circumstances or opportunities or in terms of a realistically evaluated prospect of enhanced return [from the strategy]."

Restatement commentary provides a helpful and practical two-part "burden of proof" test for a fiduciary to determine whether it can depart from a valid passive investment strategy and justify its active investment strategy: "Are the extra costs, taxes, and risks of the proposed active investment strategy 'substantial?'" Even if they are, can they be "justified by realistically evaluated return expectations?"

The two-part test provided by Restatement commentary makes clear that trustees have the affirmative duty to justify proposed active investment strategies. If the proposed active

investment strategy can be justified, then departure from a valid passive strategy is permitted.

The Extra Costs, Taxes, and Risks of Active Investing Are Usually Substantial

In many situations, the costs, taxes and risks of the proposed active investment strategy are "substantial" in comparison to those of a relevant passive strategy. For example, many active mutual funds bear commission loads, while passive funds rarely bear them. The annual operating expenses of a low cost passive fund are about one-eighth those of the average active fund. The trading costs of a low cost passive fund are about one-twentieth those of the average active fund. In addition, many active funds ordinarily generate higher taxes and, by definition, are riskier than comparable passive funds.

The Justification for Active Investing Is Problematic in Many Situations

Even if the extra costs, taxes, and risks of a proposed active investment strategy are "substantial," the second part of the two-part test provided by Restatement commentary still permits a fiduciary to proceed with the strategy if it can be "justified by realistically evaluated return expectations."

Actively investing fiduciaries, in many situations, will find it problematic that they can justify their selection of active strategies under the two-part test suggested by Restatement Commentary. Here's why.

The two basic ways by which investors justify adoption of active investment strategies are based on track records (whether investment managers or investment products) and identification of investment skill.

Track Records

"Track record investing" occurs when an investor identifies some investment with an outstanding track record and invests in it because the investor thinks that its historical performance will continue into the future. It appears that, in many situations, active investment strategies cannot be "justified by realistically evaluated return expectations" on the basis of track records.

At the outset, it should be noted that any investment 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. In fact, data show the perverse tendency for superior track records to be followed by inferior track records.

Virtually every reputable study of mutual fund performance over the last 40 years has confirmed that there's no reliable way to predict when--or which, or even if--winners from the past will win again in the future. Reporter's General Note on Restatement Section 227 reflects such findings: "[E]vidence shows that there is little correlation between [active] fund managers' earlier successes and their ability to produce above-market returns in subsequent periods." The SEC reveals its position on the subject by requiring that some version of "past performance is no indication of future results" must appear in all ads offering mutual funds for sale.

There are a number of other problems with using track records to justify active investing. For example, track records can be misleading. Although few fiduciaries (indeed, investors in general) know it, often the most important factors that separate a winning track record from a losing one are the starting dates and ending dates of the track records. The "art" of carefully selecting the time period for a track record that enhances its performance vis-à-vis some market benchmark is widespread in the mutual fund industry.

Another problem with an outstanding track record is that it is always riskier. According to a tenet of Modern Portfolio Theory, any portfolio (whatever its composition) that differs in kind or amount from the financial market (or market segment) in which it's invested must be underdiversified relative to that market (or market segment) portfolio. An outstanding track record is often nothing more than a reward for concentrated exposure to the compensated risk of a currently "hot" market segment or asset class. An underdiversified investment strategy that's riskier, of course, isn't perceived that way with 20/20 hindsight if it turns out to be a winner.

A track record also fails to reflect the effect of taxes or commission loads. For example, Fidelity Magellan generated an average annual pretax return of 18.3% over the 10-year period from mid-1985 to mid-1995. But once the reality of taxes (and commission loads) was taken into account, the after-tax return dropped to 12.7%. That turned a track record that apparently widely outperformed the market into one that came close to underperforming it.

Identification of Skill

The other way by which investors justify adoption of active investment strategies is based on identification of investment skill. It appears that, in many situations, active investment strategies cannot be "justified by realistically evaluated return expectations" on the basis of skill.

The reason why is that such managers are nearly always identified as "skillful" simply because they have superior track records. In fact, it is almost a law in the management consultant industry that the typical money manager recommended for hire by a consultant has a superior track record (i.e., in the top quartile) over a relatively short time period (i.e., the past three to five years).

If, as stated plainly by the preceding warnings from the Reporter's General Note and the SEC as well as the other factors cited, track records have little validity, then trustees may be acting irresponsibly in many situations when they equate investment skill with superior track records. That irresponsibility includes a waste of fiduciaries time and a waste of beneficiaries' money. Commentary to Section 7 of the Act states succinctly: "Wasting beneficiaries' money is imprudent."

Some people understandably may be uncomfortable, unhappy, or even outraged with the suggestion that passive investing is the "default standard" for investing and managing trust portfolios. Nonetheless, based on the two-part burden of proof test provided by Restatement commentary as well as the myriad of other factors noted, many fiduciaries are simply unable to offer sufficient justification for the active investment strategies they pursue. But don't blame me for that. I'm just the messenger.

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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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