

## Investing as a Fiduciary

*In this paper we argue that fiduciaries (those overseeing personal trusts, not-for-profit endowments, foundations and retirement plans) regardless of their personal investment philosophy, should strongly consider the use of index funds. Using passive investment vehicles will help to greatly lower the risk of poor relative investment performance, reduce costs, minimize tax liability (for personal trusts), and maximize diversification.*

### The Challenge

Nobel Laureate Harry Markowitz, the father of Modern Portfolio Theory, identifies the problem investors face: decisions about portfolio selections are made under uncertainty. This uncertainty results from the fact that there is no way to predict today which investments will turn out to be superior performers and which will turn out to be inferior performers. Many investors and trustees, including stock brokerage firms, investment advisors, banks and trust companies, act as if this uncertainty does not exist. They claim that there is a way to know which investments will be superior and which ones will be inferior. Consequently, such investors believe that “active investing” (stock picking and market timing) can allow an investment portfolio to “beat the market”.

Attempts to find investment “winners” based on readings of the past or forecasts of the future do not, however, create ideal conditions for achieving investment success. Track records appear to be valid only insofar as they show what has happened in the past.

There is little correlation, though, between what happened before and what will happen in the future. In fact, empirical evidence shows the perverse tendency for superior track records to be followed by inferior track records (reversion to the mean).

Some trustees may not care about track records but simply want to find “skillful” money managers. It appears, however, that justifications for adoption of proposed active investment strategies based on the skill of their managers should also carry little, if any, weight. The reason is that such managers are nearly always identified as “skillful” simply because they have superior track records.

If, as stated plainly by the warnings of the Reporter’s General Note and the Securities & Exchange Commission (SEC), track records have little validity, then trustees may be acting irresponsibly in many situations where they equate investment skill with superior track records. Trustees are under a duty to know better.

In fact, long-term investment success is determined by the application of three major tenets of prudent fiduciary investing: proper asset allocation, broad diversification of risk and low costs and taxes. An emphasis on these investment principles gives trustees the best chance to effectively reduce portfolio risk and build long-term wealth.

### The Mandate

The responsibilities of fiduciaries are defined in the Uniform Prudent Investor Act (UPIA). The central tenets of UPIA can be summarized as follows:

1. The tradeoff in investing between risk and return is identified as the fiduciary’s central consideration.
2. The standards of prudence are applied to the investment portfolio as a whole, rather than to individual investments within the portfolio (as was the case in the “Prudent Man Rule”, which the UPIA replaced).
3. A trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.
4. The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.

Given these assumptions, it can be presumed that the greater a trustee’s departure from a valid passive investment strategy, the greater the likelihood that the trustee will have to justify the selection of the active strategy employed and ongoing monitoring of same.<sup>1</sup> Clearly there is no prohibition on deviating from an indexed approach, but it increases the level of risk to the fiduciary if active management fails to deliver on its promises, which happens frequently, as history has shown.

The arguments for indexing include market diversification, efficiency, low costs/taxes, and style consistency. These theories are supported by decades of empirical data that show active managers have been largely unsuccessful at beating their appropriate benchmarks.

The zero sum nature of the financial markets means that all passively managed money in a particular market will earn the market return. In contrast, over time, 50% of all actively managed moneys will always earn a return that is less than the market. This simple math is sobering. What makes it even more sobering is that these active investment managers are unpredictably underperforming. This compounds the uncertainty facing the trustee when selecting investment managers/products.



Furthermore, the Efficient Market Hypothesis, published in 1970,<sup>2</sup> posited that market prices of publicly traded securities quickly adjust to new information. Thus, analyzing past pricing trends or studying company financial information will not provide market-beating returns on a consistent basis. If the theory holds true, the best course of action is simply to participate in the returns of the market at a low cost with index funds.

## Diversification

It is now broadly accepted that asset allocation drives much of the investment return of an investment portfolio. Academic studies have concluded that fully 80% or more of the return characteristics of a portfolio are determined by the allocation to stocks, bonds, cash and alternative asset class investments.<sup>3</sup>

The implementation of this conclusion has been evolutionary, as investors who 10 years ago focused on holding a portfolio of 30-50 individual stocks, now have adopted the risk/return benefits of broader diversification.

In fact, one major focus of Modern Portfolio Theory is the portfolio diversification effect and the measurement of security risk in a portfolio context. Modern Portfolio Theory decomposes risk into two components: the diversifiable risk and the non-diversifiable risk. The risk that can be diversified is referred to as firm-specific, or unsystematic, risk, and includes such things as lawsuits, labor disputes, poor management decisions, etc. that are unique to a particular corporation. Modern Portfolio Theory contends that the capital markets will not reward any single security or portfolio that has diversifiable risk. If a portfolio is properly diversified through the use of index funds, then all unsystematic risk can be eliminated.

## Costs/Taxes

In investing and managing assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. The UPIA states that “wasting beneficiaries’ money is imprudent. In devising and implementing strategies for investment and management of trust assets, trustees are obligated to minimize costs.” Considering that the majority of active managers will underperform their benchmarks net of fees, it is reasonable to question the prudence of the additional cost of an active money manager.

Also, actively traded portfolios could produce a large level of realized gains, increasing the level of taxes paid over time. Taxes can significantly affect net investment returns. Index funds, in contrast, are inherently very tax efficient.

## Portfolio Turnover

It is also important to gauge the efficiency of a portfolio and to make sure that costs are minimized by evaluating portfolio turnover. Turnover is generally presented in the form of a percentage and measures the portion of the portfolio that is traded each year. For example, if a \$10 million stock portfolio trades securities with a principal value of \$5 million, the turnover that year would be 50%. The average turnover rate for actively managed investment portfolios currently exceeds 100%. Every time a trade is executed,

brokerage commissions must be paid and bid/ask spreads and market impact costs are incurred. Simply by implementing a well-executed, long-term buy-and-hold philosophy using index-based products, turnover can be reduced, costs can be minimized, and returns will improve.

## Style Purity

Style purity involves making sure a manager invests only in securities that represent their stated strategy. For example, a domestic large-cap stock manager should only buy domestic large-cap stocks. This may sound obvious, but “style drift” is very common. According to data provided by Morningstar, the average domestic, large-cap stock investment manager held 4.0% of the portfolio in cash and 8.2% in international stocks at the end of 2007. What this means is that an investment committee, or trustee, specifies a 35% target for domestic large-cap stocks, the portfolio will likely be overweight cash and international stocks, and underweight large-cap stocks relative to target. Over time this could have a significant adverse impact on achieving the investment objectives.

Active managers argue they are less constrained than index funds and are able to move into cash before market corrections. However, the evidence shows the contrary.<sup>4</sup> Since active portfolio managers have career risk if they make the wrong call, they are likely to be fully invested at market tops and often have significant cash holdings at market bottoms.

Index fund investing, however, ensures style purity which helps avoid mistakes or errors in a manager’s judgment. Using an index fund strategy, the portfolio will always be optimally invested, resulting in returns commensurate with the market while minimizing the chances of significant underperformance.

## The Conclusion

At the end of 2007, only 11% of all registered investment company assets were invested in indexed investment vehicles,<sup>5</sup> the remainder invested in funds managed actively, or in pursuit of market-beating returns. Ironically, there is data going back almost 100 years showing that professional investors have been largely unsuccessful in generating returns in excess of the market return. John Bogle, the founder of The Vanguard Group, terms this phenomenon the triumph of hope over experience.

Actions taken to reduce risk and lower costs (and taxes) promote prudent investing, while attempts to pick stocks or time the market tend to encourage speculative investing. Fiduciaries are specifically charged NOT to engage in speculative investing. In choosing an “active” strategy, fiduciaries are under pressure to always choose the “right” manager. Apart from the fact that fiduciaries, responsible for managing money on behalf of others, should not engage in speculative investing, the selection of active managers requires a trustee to always be right. But fiduciaries cannot always be right when it comes to portfolio performance. They can however be prudent when it comes to their fiduciary conduct.

Fiduciaries, as well as attorneys and other financial advisors who are concerned with issues of legal liability and fiduciary obligation,

should understand this crucial difference. Modern prudent investment principles suggest that passive investing is the “default” strategy for investing and managing trust assets.

For individual investors, failing to earn market returns may prove costly, but they have only themselves to blame for falling prey to Wall Street’s marketing machine. In a fiduciary setting, however, underperformance may lead to trustee criticism, liability and even litigation. Tools to assist fiduciaries in making smart investment decisions and to protect them from lawsuits have been available for some time, but the evidence suggests the majority of fiduciaries still adhere to Wall Street’s party line that investors can add incremental net return through stock picking and market timing activities.

“All relevant fiduciary standards including the 1974 Employee Retirement Income Security Act (ERISA), the 1994 Uniform Prudent Investor Act (UPIA), the 1997 Uniform Management of Public Employee Retirement Systems Act (MPERS), the 2006 Uniform Prudent Management of Institutional Funds Act, and the Restatement 3rd of Trusts (Prudent Investor Rule) have imbedded language suggesting that Passive Investment Strategies should be the appropriate implementation of a fund’s investment policy. Fiduciaries ignore this at their peril.”<sup>6</sup>

## Addendum

The evidence in support of this paper is compelling for a number of reasons:

- A)** The costs and taxes associated with passive funds are lower than those associated with many active investing programs. When costs and taxes are taken into account, significantly more than 50% of active money managers fail to beat their respective benchmarks.
- B)** Passive funds are broadly diversified and are characterized as having relatively lower risk. Actively managed portfolios, in contrast, are not as well diversified because they’re comprised of investments from the market portfolio. By definition, this creates portfolios with relatively higher risk.
- C)** Passive funds do not experience style drift. A passive fund ordinarily reflects the components of an asset class or index quite accurately. Style drift, in contrast, is present in actively managed portfolios. This can lead to a number of problems for a trustee holding active funds in portfolios. Monitoring can be difficult. Style drift can by itself lead to underperformance relative to a benchmark. Style drift can also lead to imprecise implementation of a portfolio asset allocation strategy.
- D)** Passive funds are not subject to “manager risk” like active investment products. This can occur when a manager is hired based on “superior past performance” and it’s discovered later

that the manager’s performance was due to luck, not skill. Even when the performance results from skill, the risk continues because it’s not known when it can be repeated.

- E)** In the last few years, we have seen an increase in the number of lawsuits against fiduciaries. In our litigious society, this trend is likely to continue. Interestingly, litigation awards have focused on Beta (often performance relative to the S&P 500) to calculate damages. A trustee needs to be aware that deviating from the market’s return may lead to performance that is less than what the courts have expected.
- F)** It is often asserted that passive investing is a mediocre way of investing because it earns the market return. The theory of financial economics suggests, and empirical data confirms, that passive investing actually results in long-term performance that is, in reality, superior to active investing programs. This is achieved, ironically, with no focus on “beating the market” and with a lower risk profile.

1) American Law Institute

2) Eugene Fama, “Efficient Capital Markets: A Review of Theory and Empirical Work”, *Journal of Finance* (May 1970).

3) Brinson, Hood & Beebower, 1986, *Determinants of Portfolio Performance*

4) “Aggregate cash holdings do not forecast future market returns, suggesting that equity funds as a whole do not have market timing skills” Xuemin Yan, “The Determinants and Implications of Mutual Funds Cash Holdings: Theory and Evidence” Sept 2005

5) *Investment Company Institute*

6) Frank Armstrong, “Index Funds Provide a Substantial Measure of Safe Harbor for Fiduciaries”, August 2008

Thesis and conclusion credit to Scott Simon, author of the book “The Prudent Investor Act-A Guide to Understanding”



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