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Modern Investment Management and the Prudent Man Rule

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MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE. By *Bevis Longstreth.* New York: Oxford University Press. 1986. Pp. xv, 275. $34.50.

In *Modern Investment Management and the Prudent Man Rule,*[1] Bevis Longstreth[2] asserts that legal standards of fiduciary prudence diverge from recognized modern investment management practices. The law, especially state law governing personal trusts, labels certain categories of assets as speculative per se[3] and inappropriate for retention in a prudent fiduciary's portfolio. The author argues that, by failing to consider an individual asset's risk in light of the portfolio's risk,[4]

[1] This book was done in collaboration with Salomon Brothers Center for the Study of Financial Institutions, New York University Graduate School of Business Administration, New York, N.Y.

[2] Partner, Debevoise & Plimpton, New York, N.Y. Mr. Longstreth also served as a Commissioner of the Securities and Exchange Commission from 1981-1984.

[3] *See, e.g.,* 3 A. SCOTT, SCOTT ON TRUSTS § 227.6 (3d ed. 1967) ("[C]ertain kinds of investments are universally condemned. . . . It is clear of course that a trustee cannot properly purchase securities on margin; nor can he properly purchase speculative shares of stock, or bonds selling at a large discount because of uncertainty as to whether they will be paid at maturity." (footnotes omitted)). The development of state trust case law has followed Scott's thinking. *See, e.g.,* First Ala. Bank v. Martin, 425 So. 2d 415 (Ala. 1982), *cert. denied.* 461 U.S. 938 (1983) (upholding surcharge of trustee for investing in and incurring losses in debentures of certain real estate investment trusts where those investments did not meet certain financial criteria). The *First Alabama* court cited SCOTT, *supra,* at § 227 as authority for the proposition that a trustee has a duty to preserve the trust property and make it productive. 425 So. 2d at 427. The common law concept of per se imprudent investments antedates SCOTT, *supra. See, e.g.,* King v. Talbot, 40 N.Y. 76 (1869).

Longstreth's work adds to a growing body of scholarship which takes issue with legal rules which consider investments per se imprudent. *See, e.g.,* H. BINES, THE LAW OF INVESTMENT MANAGEMENT ¶ 7.01 (1978). Like Longstreth, Bines believes that a critical determinant of the prudence of any individual investment is "the contribution of the commitment to the riskiness of the portfolio." *Id.* at ¶ 7.02[1].

Longstreth has provided an extensive illustration of real-world applications of nontraditional investments (e.g., securities lending, real estate, venture capital, options/futures, and repurchase agreements) in a prudent portfolio. Pp. 116-44. Another commentator has noted that anachronistic notions of prudence have chilled the use of such nontraditional investments and that the effect of these standards is to impose, effectively, a legal list regime. *See* Fleming, *Prudent Investments: The Varying Standards of Prudence,* 12 A.B.A. REAL PROP., PROB. & TR. J. 243, 251 (1977).

[4] For an explanation of how portfolio diversification invalidates the notion that the law should label an investment as per se speculative, see Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine,* 76 COLUM. L. REV. 721, 756 (1976)

the law deprives fiduciaries of opportunities to increase rates of return on invested capital and may actually add unnecessary risk.[5] Moreover, by stressing capital preservation and income, the law disregards risks posed by inflation.[6]

Longstreth traces state trust law beginning with the prudent man rule set out in *Harvard College v. Amory,*[7] through more restrictive legal list statutes, to the present standards of prudence. Juxtaposed against this legal development is a statistical sketch of the portfolio asset allocation habits of institutional investors.[8] While acknowledging that an inherently safe investment has never existed, Longstreth asserts that the proliferation of new investment vehicles and strategies, the increasingly sophisticated reporting wrought by federal securities laws, and the greater professionalism of investment managers, among other things, militate for a new legal concept of investment safety (pp. 61-72). That concept is one of risk management rather than risk avoidance.

To accomplish this, Longstreth proposes a process oriented stan-

("Because the capital asset pricing model makes the level of systematic risk the determining factor in the expected return of a portfolio, speculation becomes almost a trivial concept.").

To attribute traits of per se imprudence to an investment is the corollary of failure to consider that investment's risk in light of the entire portfolio. The law's failure to evaluate an investment's risk relative to the portfolio has been subjected to increasing criticism. *See, e.g.,* H. BINES, *supra* note 3, at ¶ 7.01; Note, *The Regulation of Risky Investments,* 83 HARV. L. REV. 603 (1970). The Note's author states that the primary determinant of prudence should not be the risk of each security, but "the marginal effect on total portfolio risk of acquiring each security." *Id.* at 617. Bines adds the caveat that there should not be a complete prohibition on investments which add incremental risk to the portfolio. Otherwise, a fiduciary would have to construct a portfolio by making the most risky commitments first. *See* H. BINES, *supra* note 3, at ¶ 7.02[1].

The affirmative duty to diversify portfolio holdings flows from a rule of law which evaluates the prudence of an investment relative to the portfolio. Although it is unreasonable and bad public policy for the prudent man rule to hold a fiduciary to be imprudent based on the performance of individual investments, the failure of the rule to require diversification is similarly an endemic flaw of the prudent man rule. Other law-reform-related works seem to support this proposition. *See, e.g.,* Fleming, *supra* note 3, at 250. The more modern fiduciary standard posed by the Employment Retirement Income Security Act (ERISA) imposes a duty to diversify. *Id.* ERISA requires the fiduciary to diversify "the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." 29 U.S.C. § 1104(a)(1)(c) (1982).

[5] In New York, for example, an investment must arguably be found faulty for some reason other than the percentage of the trust it constitutes. *See, e.g.,* Stark v. United States Trust Co., 445 F. Supp. 670, 682 (S.D.N.Y. 1978). Thus, a fiduciary who fails to diversify investments may add needless risk to the portfolio. Yet, in New York, there would arguably be no prohibition against this type of needless risk.

[6] Erosion of real rates of return by inflation places tension on the prudent man rule's prohibitions against nontraditional investments discussed at note 3, *supra. See* Hirsch, *Inflation and the Law of Trusts,* 18 A.B.A. REAL PROP., PROB. & TR. J. 601, 636 (1983). Longstreth's view that certain nontraditional investments (heretofore considered imprudent) such as real estate serve as a bulwark against inflation similarly supports modification of the prudent man rule to accommodate inflation hedges. Pp. 121-28.

[7] 26 Mass. (9 Pick.) 446 (1830).

[8] Among other statistics, Longstreth uses the portfolio asset allocations of the Harvard University and Princeton University endowment funds for the period of 1830-1984 as proxies for institutional asset allocations. Pp. 50-80.

dard as a "modern paradigm of prudence" (p. 110). Recognizing that an asset may possess a high statistical variance of return and only an average expected return,[9] and yet may still be a desirable investment if its returns are not highly correlated with returns of other portfolio assets, the paradigm would have jurists consider the prudence of the asset in light of other portfolio holdings. Longstreth argues that courts should scrutinize the competence of the fiduciary in employing an investment strategy, and the reasonableness of any delegation of management responsibilities, based upon the degree of specialization required to execute the strategy. In addition, courts should evaluate the strategy in light of the portfolio's purposes, including the need to make future cash available. The author wisely suggests that fiduciary standards across portfolio types (*e.g.*, pensions, foundations, endowments, and private trusts) be unified.[10] Longstreth then illustrates the application of the paradigm to certain nontraditional asset classes, with discussion of differing prudence criteria for each of those classes.[11]

Longstreth employs persuasive empirical data to support his thesis that present legal standards impose an undue constraint on investment options which, in light of the entire portfolio, are prudent. In 1985, the fifty largest bank trust departments, college and university endowments, private foundations, and corporate pension fund sponsors were queried concerning, among other things, the effect of the prudent man rule on the fiduciary's ability to hold certain asset classes (pp. 232-66). Consistent with the differing bodies of law to which the fiduciaries were subject, substantial differences in permitted investments were reported. As one would expect, bank trust departments were most constrained; pension fund sponsors showed virtually no constraints; and

[9] In common parlance, the variance of an investment's return is its risk. Variance is the degree of variation of possible returns around the investment's expected return. Expected return is simply the mean (average) rate of return. For example, an investment with a 50 percent chance of earning 20 percent and a 50 percent chance of earning nothing has an expected return of 10 percent, even though it will return either 20 percent or nothing. This investment would have a higher variance than an investment with a 100 percent chance of earning a 10 percent rate of return. Both investments have the same expected 10 percent rate of return, but the risk of the first investment is greater because its returns are more volatile.

[10] P. 112. Obviously, needs and objectives diverge widely among institutional portfolio types. For instance, a trust which must periodically raise cash must be managed differently from a trust which makes no periodic cash disbursements and which is to be distributed in a lump sum in the future. Longstreth explains the need for a unified standard as follows:

> Circumstances vary infinitely but the analytical process — careful and reasoned consideration of the suitability of an investment for the particular portfolio, taking into account the best available wisdom concerning portfolio management — is always the same.
>
> For this reason it seems fruitless to dwell on the differences between the private trust standard and the endowment standard, the endowment standard and the pension fund standard, and so forth.

P. 112.

[11] Pp. 116-44. For example, leveraged real estate investments create certain tax considerations not found in most other assets. P. 126.

endowments, foundations, and bank pension managers fell somewhere in between (p. 234).

Most interesting is the contrast between the relatively untrammeled investment posture of bank pension managers and the much more restricted stance taken by those same organizations when subjected to state trust law rather than ERISA.[12] This empirical finding presents strong evidence that the legal climate exerts a significant influence on the universe of prudent investments in which fiduciaries may invest. These empirical findings are particularly valuable because, although one may infer from the leading cases that Longstreth cites that these constraints affect fiduciary behavior, those cases in many instances are far from clear on such issues as whether individual investments should be evaluated in isolation,[13] whether inflation may be considered,[14] or whether there exists a duty to diversify.[15] Regardless of the actual state of the law, the survey lends much credence to the idea that fiduciaries perceive they are legally constrained from making certain investments, and they behave according to those perceptions (p. 153).

[12] 29 U.S.C. § 1104 (1982). The ERISA fiduciary must exercise "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B) (1982). While on its face this standard seems to differ little from the common law prudent man rule, ERISA, with its duty to diversify, does not consider the prudence of investments in isolation. Moreover, ERISA labels no investment per se imprudent. The result is virtually no restriction on the universe of possible investments available. Obviously, a particular selection of investments from that universe could be imprudent, but the universe itself is unrestricted.

[13] In Bank of New York v. Spitzer, 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S.2d 164 (1974), the court's recognition that "[t]he fact that this portfolio showed substantial overall increase in total value during the accounting period does not insulate the trustee from responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged" was dictum because the court did not surcharge the trustee and held that the investments were selected with due care. 364 N.Y.S.2d at 168. Moreover, the court went on to say that investment selections should not be reviewed as if the investment was in its own "water-tight compartment," arguably leaving open the consideration of the investment selection to the entire portfolio. 364 N.Y.S.2d at 168. *In re* Morgan Guar. Trust Co., 89 Misc. 2d 1088, 396 N.Y.S.2d 781 (Sur. Ct. 1977), which followed *Spitzer,* applied similar reasoning in dismissing an objection to certain securities purchases.

[14] The issue to be resolved in Hartzell v. Schuster (*In re* Trusteeship Under Agreement with Mayo, 259 Minn. 91, 105 N.W.2d 900 (1960)) was whether the trustee could deviate from the trust agreement (which forbade investment in certain real estate and stocks) in order to protect the trust corpus against inflation. The issue was not whether inflation could be considered as part of the trustee's investment process. A case which went the other way on a similar issue, Toledo Trust Co. v. Toledo Hosp., 174 Ohio St. 124, 187 N.E.2d 36 (1962), did so out of fidelity to the trust instrument in the absence of a showing of an emergency that would justify deviation from the instrument's terms.

[15] The duty to diversify would support evaluation of an investment selection in light of the rest of the portfolio. The leading case supporting a duty to diversify, Hamilton v. Nielsen, 678 F.2d 709 (7th Cir. 1982), identified a "generally recognized" duty to diversify trust assets. 678 F.2d at 712 (citing RESTATEMENT (SECOND) OF TRUSTS § 228 (1959)). But the court said that executors had no duty to diversify and, because the plaintiff was not complaining about a lack of diversification, the court did not need to decide that issue. 678 F.2d at 712-13.

In addition to the survey results contained in appendix C, the book includes separately authored appendices (pp. 161-231). Appendix A, *The Lessons of Modern Portfolio Theory,* by Edwin Elton[16] and Martin Gruber,[17] provides a theoretical model, based on modern portfolio theory or variants of that theory, which could support legal standards requiring diversification. The model could also support abandonment of the notion that any investment is *per se* imprudent (pp. 161-94). Thus, the model further supports Longstreth's thesis that the investment process, and not the individual investments themselves, should bear legal scrutiny. To comprehend this appendix, the reader will likely need some degree of familiarity with modern portfolio theory and the capital asset pricing model. Fortunately for the uninitiated, Longstreth's own text states comprehensible conclusions as to the implications of modern portfolio management for prudence standards (pp. 82-83) and illustrates the theory with examples.[18]

Appendix B, *The Puzzling Survival of the Constrained Prudent Man Rule,* by Jeffrey Gordon,[19] among other things reinterprets the key cases under a legal standard which applies a modern portfolio theory to prudence (pp. 195-231). Gordon believes that it is the rationale of the cases (following standards set out by the *First* and *Second Restatements of Trusts*[20] and *Scott on Trusts,*[21]) and not the results of the cases that would change under this reinterpretation (pp. 200-02). In cases where fiduciaries had been surcharged based on speculative individual investments, a portfolio theory would say that excessive weighting in one investment made the portfolio, rather than the individual investments themselves, too risky (p. 201).

Longstreth's efforts to posit and illustrate a theory of prudence based on modern investment theories and practices are commendable. Indeed, the book presents compelling evidence that no investment should be labelled per se imprudent. The need for law reform follows from this conclusion. However, because under the new concept "prudence tolerates many alternative strategies while dictating none" (p. 83), the development of judicially cognizable standards will be difficult. Presumably, this problem could be addressed by the use of expert witnesses, in like fashion to controversies involving any standard of competence or care.

More troublesome is the possible disagreement over the assump-

[16] Professor of Banking and Finance, New York University Graduate School of Business Administration.

[17] Professor of Banking and Finance, New York University Graduate School of Business Administration.

[18] *See, e.g.,* pp. 122-23 ("The absence of covariance between real estate and stocks or bonds makes it a particularly good way to enhance the efficiency of a portfolio.").

[19] Associate Professor of Law, New York University.

[20] RESTATEMENT OF TRUSTS (1935); RESTATEMENT (SECOND) OF TRUSTS (1959).

[21] A. SCOTT, *supra* note 3.

tions which should underlie a modern prudence standard. Assuming Longstreth's survey represents the typical institutional fiduciary, there is evidence that fiduciaries do not embrace the efficient market theory, and rather often employ value-oriented fundamental analysis.[22] If fiduciaries in practice select assets based on an assessment of that asset's future return potential in isolation, and not in the context of a portfolio, should they be judged based on the risk of the asset in relation to the portfolio?

It is common knowledge that fiduciaries do employ diversification techniques or holdings limits, but they may not necessarily do so in relation to a portfolio. Suppose, for example, the manager's strategy is to rotate holdings among industry sectors which the manager perceives as presenting the best growth opportunities at any particular point in the economic cycle. Such a portfolio could be diversified by holdings, but because those holdings would be concentrated in a limited industry sector, there would be a large correlation between returns among individual holdings. Would such a strategy be imprudent if the risk of an individual asset is to be measured in relation to the entire portfolio? As Longstreth concedes, there is no one correct approach to investment strategies and the capital asset pricing model[23] is not universally accepted (p. 83). Again, this would seem to make legal standards difficult to formulate.

Finally, one may infer from the book that the greatest harm posed by anachronistic notions of the prudent man is the rule's effect on economic efficiency via substandard returns to those portfolios subject to the rule. There certainly is no liability crisis for fiduciaries, and Longstreth concedes that courts tend to be lenient toward trustees, and that decisions to surcharge trustees are rare (p. 17). Therefore, the problem with present standards is one of undue restraint. The policy argu-

[22] P. 233. Those who embrace value-oriented fundamental analysis believe that they can identify stocks (or other assets) with superior investment attributes. Accordingly, investments would be selected which fit that criteria. Though not completely inconsistent with modern portfolio theory, value-oriented fundamental analysis would view the "fundamentals" (earnings potential, and so forth) as paramount in making an investment selection. This school of thought places less emphasis on the correlation of returns between investments. In contrast, a modern portfolio theorist would search for investments which had returns which move in different directions irrespective of the "fundamentals" demonstrated by the investments themselves.

Value-oriented fundamental analysis is consistent with traditional state trust law standards of prudence: namely, that prudence is attained when the fiduciary selects *each asset* with due care. The investment research performed in determining each asset's qualities would typically satisfy standards of due care.

[23] For a challenge to the belief that capital markets are efficient, see Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research,* 60 N.Y.U. L. REV. 761 (1985). In appendix A, Elton and Gruber recognize that the capital asset pricing model is consistent with an efficient market. P. 180. Gordon and Kornhauser similarly recognize this assumption. Gordon & Kornhauser, *supra,* at 781. To them, this efficient market hypothesis "claims that informed participants (except for corporate insiders who possess unique access to certain information) cannot outperform other market participants." *Id.* at 786. Gordon and Kornhauser challenge this assumption of efficiency. *See id.*

ment that the prudent man rule hurts returns of those portfolios subject to the rule would have been better advanced by comparing risk-adjusted rates of return for portfolios not subject to the rule or subject to a more modern version of the rule (such as corporate pension funds), with those of portfolios which are subject to the rule. By so doing, the author could have better illustrated the detriment to beneficial owners flowing from the rule. Of course, such a study would probably constitute a topic for another book. Longstreth should be commended for his well-supported analysis of legal standards which often do not fit the realities of modern investment management.

— *Creighton R. Meland, Jr.*