

Trustee Investment Powers and the Higher Standards of Prudence

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INTRODUCTION

In 2002, the Province of Alberta modernized Trustee Investment Power legislation. The traditional legal list approach of “safe investments” was replaced with the Prudent Investor Rule and the application of Modern Portfolio Theory. Frequently, trustees both layperson and professional are in a position of exercising Investment Powers for pensions, endowments, charities, not for profits, formal trusts, family trusts and foundations. These trustees are now held to a new standard for determining liability, one which is based on a subjective evaluation of the prudence of their investment choices. It naturally begs the question, “Are some investment choices more prudent than others?” If so, “what are the higher standards and how can they be applied across provinces and across purposes?” In the context of trust portfolios consisting of liquid, public securities, this paper will illustrate the application of Modern Portfolio Theory, discuss the differences between Active and Passive portfolio management and establish the higher standards of prudent trustees.

THE DUTIES OF A TRUSTEE

The duties of a trustee are numerous and diverse. The Trustee Act states, a trustee must “...invest trust funds with a view to obtaining a reasonable return while avoiding undue risk”. The trust must be reviewed at “reasonable intervals” with a focus on “maintaining the real value” of the trust while remaining impartial “towards different classes of beneficiaries”. Trustees must also consider costs as well as the tax consequences of their investment decisions.¹ The Alberta Law Reform Institute describes the Prudent Investor Rule as “... the legal application of Modern Portfolio Theory”² and the goal of a trustee is not simply to minimize risk; it is to optimize the risk-expected return relationship. In the performance of their duties, the Prudent Investor Rule allows trustees to choose virtually any investment for a trust portfolio as long as each is considered within the context of the portfolio as a whole.

GUIDING A TRUSTEE

As pointed out by P. Renaud in The Alberta Prudent Investor Rule, “the difficulty with the common law standards of care is that they do not give the trustee much guidance concerning how to make investments and how they will be judged if there is a loss.”³ The Trustee Act offers this qualification, stating that a trustee “...is not liable for a loss in connection with the investment of trust funds that arises from a decision or course of action that a trustee exercising reasonable skill and prudence ... could reasonably have made or adopted.”⁴ The Alberta Law Reform Institute provided this absolution; “If the trustee has invested in accordance with prudent investment standards, there can be no liability, even if the trust has suffered a loss.”⁵

¹ Trustee Act, Province of Alberta, Section 3, current as of October 30, 2009. p.3

² Trustee Investment Powers, ALRI Report no. 80, February 2000, p.17

³ P. Renaud Q.C., the Alberta Prudent Investor Rule. p.31

⁴ Trustee Act, Province of Alberta, current as of October 30, 2009. p.4

⁵ Trustee Investment Power, ALRI Report no. 80 February 2000. p.72

Conversely, when quantifying the liability for a trustee that is judged imprudent, the Trustee Act states, “A court assessing the damages payable by a trustee for a loss to the trust arising from the investment of trust property may take into account the overall performance of the investments.”⁶ This statement implies that the performance of the trust portfolio may be measured against a benchmark return. It also raises the question, “does the definition of prudence include protecting the trust portfolio against underperformance risk?” None the less, for trustees the higher standards that ensure prudence remain unclear and open to interpretation.

MODERN PORTFOLIO THEORY: EFFICIENT DIVERSIFICATION

Proper diversification is not well understood and an accumulation of investments referred to as “not having all the eggs in one basket” is frequently confused with a diversified portfolio. In the 1930’s, the conventional wisdom was to analyze securities one by one using the Graham and Dodd method of security valuation. Competent stock research rendered broad diversification undesirable and the objective was to concentrate holdings in at most three or four undervalued securities to maximize returns. Some years later (1976), due to the increasingly competitive nature of the investment industry, Benjamin Graham offered these comments.

*“I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when our textbook “Graham and Dodd” was first published; but the situation has changed a great deal since then. In the old days any well-trained security analyst could do a professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost”.*⁷

In 1952 Harry Markowitz introduced Modern Portfolio Theory and an expanded view of diversification.⁸ This theory says that it is not enough to look at the expected risk and return of investments in isolation. Rather, an investor can reduce risk and improve returns by finding efficient combinations of securities and a rational investor will seek out combinations offering the highest return for the least amount of risk.

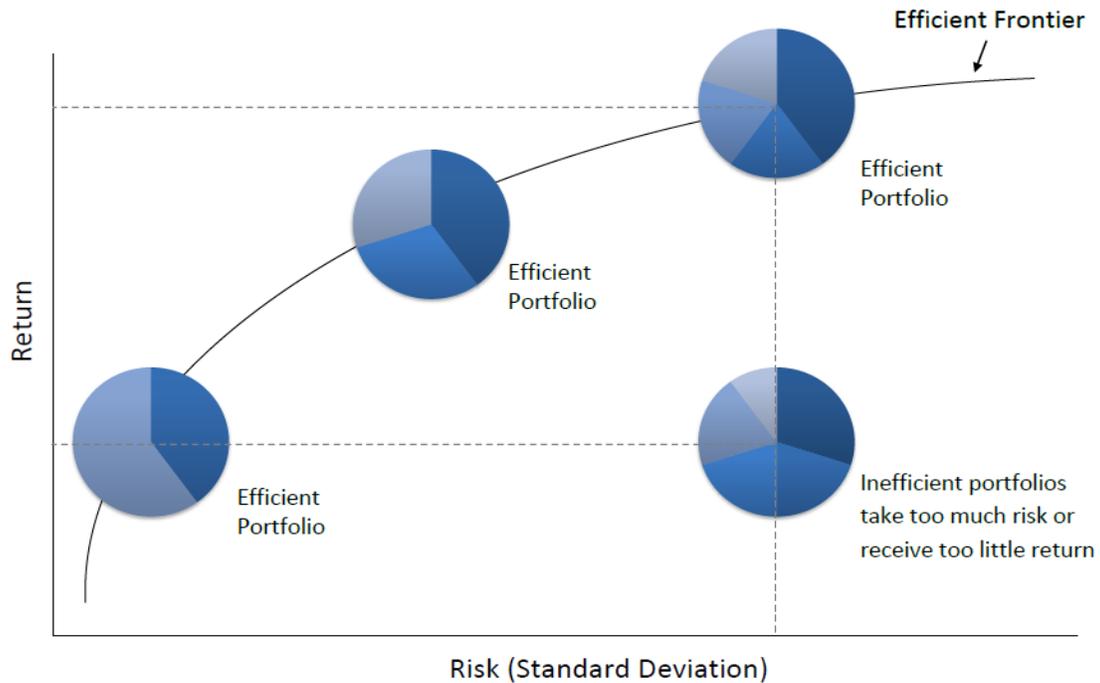
Efficient diversification is achieved by combining assets that are not perfectly correlated or are ideally, negatively correlated. Thus, if in the short term one asset were to decline in price another would rise, thereby mitigating portfolio risk. These optimal portfolios are found on the “Markowitz Efficient Frontier” shown below. Portfolios that fall below the efficient frontier provide less return for each level of risk.

⁶ Trustee Act, Province of Alberta, Section 5, current as of October 30, 2009. P.4

⁷ A Conversation with Benjamin Graham, Financial Analyst Journal 1976

⁸ Markowitz, Harry M. (1952) “Portfolio Selection”, Journal of Finance 77-91

MARKOWITZ EFFICIENT FRONTIER



A broad group of securities sharing similar economic or geographic traits is called an Asset Class. Asset classes include Canadian stocks, US stocks, International stocks, Value or Growth stocks, Emerging Markets stocks, Bonds and Real Estate to name a few. Asset classes are basic building blocks of well diversified portfolios.

Ideally, each asset class would be comprised of several hundred or several thousand similar securities. A trustee may hire an investment manager to research and choose individual securities to build each asset class or they can use commercially available pooled asset class securities constructed to achieve the same results. These readymade asset classes can be easily and efficiently combined into a properly diversified portfolio.

Whereas, the legal list approach provided trustees with a pre-determined group of investment choices, Modern Portfolio Theory implies that a trustee is required to consider virtually any investment to find the best overall portfolio risk and return tradeoff. This raises the level of expertise that is required in a non-legal area.

COMBINING ASSET CLASSES; THE BENEFITS OF EFFICIENT DIVERSIFICATION

The following illustrations reveal the powerful effect of combining asset classes to reduce risk. From 1970 to 2009 a Canadian stock portfolio earned an average annual return of 9.70% with a standard deviation of 16.57%.⁹

Standard deviation is a statistical measure of volatility around an expected return and a lower standard deviation is representative of lower portfolio risk. Over the period of study, you would expect Canadian stocks to average 9.70% but in any given year returns could fall between -24% and +43%, 95% of the time. The goal of efficient diversification is to combine asset classes to reduce portfolio risk (standard deviation) such that the possible range of returns is tighter and more often you achieve the expected return, each year.

| Asset Class | Average Yearly Return | Standard Deviation (Risk) | Risk Reduction |
|------------------------|-----------------------|---------------------------|----------------|
| Canadian Stocks | 9.7% | 16.57% | -- |

95% Probability



A Balanced Portfolio consisting of 60% Canadian stocks and 40% Canadian bonds provides a substantial reduction in risk (standard deviation). Shifting 40% of the portfolio into bonds increased the Average Yearly Return and reduced portfolio standard deviation from 16.57% to 11.49%.¹⁰ Thus, portfolio risk has declined by 30% and yearly returns fall into a tighter range between -13% and +33%. Less risk and less downside are desirable portfolio traits.

| Asset Class | Average Yearly Return | Standard Deviation (Risk) | Risk Reduction |
|--|-----------------------|---------------------------|----------------|
| Canadian Stocks | 9.7% | 16.57% | -- |
| Balanced Portfolio 60% Cdn stocks, 40% bonds | 10% | 11.49% | 30% |

95% Probability



⁹ Asset class return statistics, S&P TSX Composite Index returns, January 1, 1970 – December 31, 2009, provided by S&P/TSX, TSX Inc. Rebalanced monthly.

¹⁰ Asset class return statistics, DEX Long-Term Bond Index return, January 1, 1970 – December 31, 2009, provided by PC-Bond, a business unit of TSX Inc. Rebalanced monthly.

A similar outcome is achieved by combining a Canadian stock and bond portfolio with foreign investments. If we diversify a portfolio of 40% bonds and 20% Canadian Equity to include 20% US Equity and 20% International Equity, the portfolio return rises to 10.34% per year while portfolio risk declines to 9.67%.¹¹

Adding bonds and foreign investments to a Canadian stock portfolio reduces risk by 40% and narrows the range of returns in a given year to between -9.0% and +30%. This is how adding riskier asset classes to a portfolio, such as emerging markets, can improve returns and reduce portfolio risk even though an asset class may be considered volatile on its own.

| Asset Class | Average Yearly Return | Standard Deviation (Risk) | Risk Reduction |
|---|-----------------------|---------------------------|----------------|
| Canadian Stocks | 9.7% | 16.57% | -- |
| Balanced Portfolio 60% Cdn stocks, 40% bonds | 10% | 11.49% | 30% |
| Globally Diversified Portfolio 20% Cdn stocks, 20% US stocks, 20% Intl stocks, 40% bonds | 10.34% | 9.67% | 40% |



A trustee's emphasis should be on finding the most efficient mix of asset classes; one that protects the value of the portfolio while producing the highest return. This represents a paradigm shift from a traditional approach of researching and picking investments one at a time, over time, to a portfolio constructed using modern investing techniques.

¹¹ Asset class return statistics, S&P 500 Index returns January 1, 1970 – December 31, 2009, provided by Standard & Poor's Index Services Group, MSCI EAFE Index (net div.) returns, January 1, 1970 – December 31, 2009. MSCI data copyright MSCI. Rebalanced monthly.

THE IMPORTANCE OF ASSET MIX vs. STOCK PICKING and MARKET TIMING

Modern Portfolio Theory directs trustees to find an optimal portfolio asset mix. Investors commonly become focused on “Which stock or mutual fund should I buy and where is the market going?” What they should be asking is, over the long term, “how do I want to allocate my portfolio over the major asset classes to provide the greatest return for the least amount of risk?” These are asset mix decisions.

In fact, researchers Gary Brinson, Brian Singer and Gilbert Beebower reported in a paper titled Determinants of Portfolio Performance II: An Update, that approximately 91% of the difference in returns between two portfolios is attributed to asset mix and less than 9% of the difference is attributed to security selection (stock picking) or market timing.¹² Their study partitioned the returns between 1977 and 1987 of 82 large pension funds into the return attributed to being invested in the asset class versus the return that came from security selection (stock picking) and “active asset allocation” (a form of market timing). These results confirmed an earlier study that the allocation to various asset classes was significantly more important than the selection of individual securities or the timing of those investments.

The earlier study titled, Determinants of Portfolio Performance, looked at the returns from 1974 to 1983 of 91 large pension funds and found that on average 93.6% of the total variation in returns could be attributed to the asset mix decision. Less than 5% of the difference in returns was determined by security selection.

Very little time should be allocated to strategies that emphasize security selection or market timing. A prudent trustee will focus on determining the correct asset mix and implementing the asset mix. This modern portfolio approach offers simplicity in execution and the ability to standardize the approach across provinces and across purposes. Asset classes and how they can be combined according to a pre-determined asset mix to achieve a specific risk and return objective is a straightforward concept. Asset classes are easily benchmarked providing a mechanism for monitoring and evaluating portfolio performance. In contrast, it could be a challenging pursuit for trustees to fully understand the stock picking or market timing strategies of several independent money managers utilizing proprietary research or trading models. If the managers differ between provinces, it would not necessarily allow for legislated standards across regions.

¹² Performance 11: An Update, G. Brinson, B. Singer and G. Beebower, Financial Analysts Journal, May-June 1991.

ACTIVE PORTFOLIO MANAGEMENT VERSUS PASSIVE MANAGEMENT

Creating portfolio returns versus capturing returns.

A trustee can choose from two types of investment managers: Active or Passive. Active portfolio management is the traditional approach where managers research and choose a relatively small number of securities (20-60) per asset class that they believe will perform better than the market (asset class) return and better than their peers. This applies to stock investors as well as bond investors. Securities are chosen out of a universe of available stocks or bonds with the aim of creating a portfolio return better than the market. The implication is that through detailed research, the money manager will be able to produce extra returns.

Conversely, the goal of a Passive investor is to capture the returns available in a market by owning all, or substantially all, the securities in that market. A common form of Passive investing involves owning asset class indexes to replicate the returns of financial markets such as the S & P TSX Composite index, the Dow Jones index or the S & P 500 index. Building Passive asset class portfolios therefore, does not rely on analysts, brokers or research departments. The holdings aren't based on forecasts of the economy or predictions for stock markets. Passive portfolios capture the growth of companies that results from the hard work and good decisions of the employees and owners of each of the companies. This allows Passive strategies the advantage of lower fees, lower portfolio turnover and lower realized taxes. By investing in the market, the chance of underperforming the market return is minimized and single security risk is largely eliminated.

One critical question is, "Should a prudent trustee engage in strategies that attempt to beat the market return?" A second question would be, "Are Active managers successful at beating the market return after costs?" The published returns of Active managers compared to their index benchmark are illustrated below in the "Standard & Poor Indices Versus Active Funds Scorecard" (SPIVA).¹³

| <i>Percentage of Actively Managed Funds Outperforming Their Index SPIVA (as of December 31, 2008)</i> | | | |
|---|----------|------------|-----------|
| | One Year | Three Year | Five Year |
| Canadian Equity Mutual Funds | 41.94% | 21.05% | 11.22% |
| US Equity Mutual Funds | 26.14% | 13.98% | 8.75% |
| International Equity Mutual Funds | 18.00% | 17.78% | 10.35% |

Roughly 41% of actively managed Canadian mutual fund managers outperformed the S & P TSX Composite index return in 2008. Only 26% of actively managed US Equity funds outperformed the S&P 500 in Canadian dollar terms while 18% of actively managed International Equity funds outperformed their respective index return.

¹³ Index Versus Active Funds Scorecard for Canadian Funds, S&P Indices, Research Insights, February 2009, J. Bhandal, S. Dash. www.standardandpoors.com/indices/spiva/en/us

After three and five years, the percentage of out-performers drops significantly, indicating the out-performance cannot be repeated. Over a five-year period, about 10% of actively managed mutual funds outperform the market return. Put another way, the index return beats roughly 90% of actively managed mutual funds over the longer term. There's no way to identify the few out-performers in advance and the laggards could under-perform the index return by half a percent or five percent.

According to W. Scott Simon, in his book *Index Mutual Funds*, there are at least three requirements for Active managers to be successful:

- 1. They must consistently and accurately predict future security values to just overcome the cost of active management.*
- 2. Active managers must be able to interpret the same available information differently than all the other investors. Essentially, they're right and you're wrong.*
- 3. All other investors must be making mistakes in pricing securities that allows the active manager to buy "undervalued" and sell "overvalued".¹⁴*

Bill Miller, Chief Investment Officer at Legg Mason Capital Management, was named the "Greatest Money Manager of the 1990's" by Money Magazine. This, however, did not prevent the Massachusetts state pension fund from pulling nearly \$1.8 billion in assets from Legg Mason and four other firms in 2008 as part of a plan to shift all US equity assets away from managers who actively pick stocks to buy and sell. Of this, \$1.4 billion was transferred to a fund linked to the Russell 3000 index.¹⁵ Bill Miller himself had this to say,

"Well, first of all let me say that I think index funds ought to constitute, just from the broad standpoint of prudence, a significant portion of one's assets in equities. Because you know, the evidence is that over any substantial period of time - ten years, 15 years, 20 years - the odds that you will get a money manager who can outperform that period of time are about one in four.

So unless you're very lucky, or extremely skillful in the selection of managers, you're going to have a much better experience by going with the index fund. Your costs are lower, not just in management fees [but also in lower trading costs]. So there's a very significant case to be made for having your money in index funds."¹⁶

Investment research firm Greenwich and Associates reported that US Endowments and Foundations have "nearly 70% of their US stocks invested in indexed strategies."¹⁷ Both the Abu Dhabi Investment Authority, the largest Sovereign Wealth Fund in the world, and the California Public Employees' Retirement System, the largest US Pension fund, have the majority of their equities in index strategies. Remember, these funds that choose Passive portfolio management have access to the smartest financial minds and the best information and technology.

¹⁴ W. Scott Simon, in his book *Index Mutual Funds, Profiting From an Investment Revolution*, W, Scott Simon

¹⁵ M. Anantharaman, Massachusetts Pension Fund Axes Legg, 4 Others, Reuters, Aug, 2008

¹⁶ Bill Miller: By Jason Zweig, Money Magazine senior writer/columnist July 18 2007, What's Luck Got to do With it?

¹⁷ Lessons from the big guys, large funds using indexed strategies, Michael Nairne, Financial Post, March 29, 2010

MARKET EFFICIENCY

The primary reason professional money managers are unable to consistently outperform the market is due to market efficiency. According to the Efficient Market Hypothesis, new information is disseminated and reflected in security prices immediately, making it difficult to consistently identify overpriced or underpriced assets.

“...the securities market is an open, free, and competitive market in which large numbers of well-informed and price-sensitive investors and professional investment managers compete skillfully, vigorously, and continuously as both buyers and sellers.”¹⁸

Numerous studies have supported the efficiency of markets. One study of quarterly earnings announcements of 100 NYSE and 100 NASDAQ firms found that the majority of the price change occurred within a few trades at the market open. A similar study in 1998 of UK stock markets found that it took approximately “75 to 90 seconds or about 7 trades for stocks to adjust to the new data”.¹⁹

In a competitive and efficient market, trying to outperform becomes futile and costly. How can anyone systematically identify inefficiencies before everyone else to produce above market returns? Efficient markets marginalize analyst research and Active stock picking strategies contrived to beat the market and illustrate the value of Passive investment strategies that are designed to simply capture the market return in the safest and most efficient manner.

Modern Portfolio Theory assumes that capital markets work, allowing investment capital to reach opportunity and investors to be rewarded with the appropriate returns. When you purchase a corporate bond or a common share you provide that company with your capital. The company uses all shareholder money to start, operate and grow their business. In return, stakeholders are provided with a return on investment commensurate with the level of risk that each has assumed. Bondholders have greater security and protection against loss versus common shareholders, who receive higher rates of return in exchange for potentially losing all of their investment. This return is the company’s cost of capital. While returns can be unpredictable each year or even over the course of several years, the table below illustrates the consistently positive returns that are achieved from taking stock market risk over time. These are the compensated returns that can be captured by Modern Portfolio Theory.

| <i>Average Annual Return by Decade</i> ²⁰ | | | | | | |
|--|--------|--------|--------|--------|--------|---------|
| | 1960’s | 1970’s | 1980’s | 1990’s | 2000’s | Average |
| S&P TSX Canadian Dollars | 10% | 10.4% | 12.2% | 10.6% | 5.6% | 9.7% |
| S&P 500 US Dollars | 7.8% | 5.9% | 17.5% | 18.2% | -1% | 9.5% |

¹⁸ C. D Ellis, *Winning the Losers Game*, 2002 p. 29

¹⁹ L. Swedroe, *What Wall Street Doesn’t Want You To Know* p 41-42, (Financial Management, Spring 1996 and *The Transaction-by-Transaction of Interest Rate and Equity Index Futures to Macroeconomic Announcements*, *Journal of Derivatives*, Winter 1998.

²⁰ Decade by Decade Returns, Data provided by S&P/TSX, and Standard & Poor’s Index Services Group.

The efficiency of investment markets has important implications for a trustee. If a trust's overall performance may be compared to a benchmark return would it be prudent for a trustee to seek out an investment strategy that attempts to beat the benchmark?

Consider two portfolio managers, A and B. Portfolio manager A acts prudently including protecting the portfolio against underperformance risk. Portfolio manager B performs his duties prudently, except that he attempts to beat the market return. If in fact B underperforms the market return, at what point does this constitute imprudence? The considerations here may be the potentially higher expense of Active management, any additional risks taken and the probability of successfully earning returns greater than the market return.

COMPENSATED RISK VERSUS UN-COMPENSATED RISK

Modern Portfolio Theory is also useful for differentiating between compensated and uncompensated risks. Trustees should choose investment strategies that take compensated risks and diversify away uncompensated risks.

Market risk is the chance that the actual return of the market will fall below its expected return. Market risk is a compensated risk that cannot be diversified away. For example, unanticipated events such as, a terrorist attack, a change in the monetary policy by a central bank, or a general economic downturn would likely affect the return of the market. These are examples of non-diversifiable market risk.

Non-market risks affect a specific asset or assets and can be diversified away. The risk that a company's chief executive officer dies unexpectedly, or the risk of a company becoming obsolete, losing a major customer or supplier, an unexpected shut down or a labor strike are all examples of firm-specific risks because they are unique to a particular company or industry. Non-market risk is uncompensated as it does not provide returns above the market return.

RISK ADJUSTED RETURNS

Not all risks are equal in the amount of return they provide and some risks do not add any return at all. If the objective is to choose the portfolio with the highest amount of return for the least amount of risk, we would be interested in the risk adjusted return of a portfolio. Critical to this process is eliminating or minimizing risks that do not compensate the investor with return.

Uncompensated risks that should be diversified away include:

- single security risk and stock picking
- holdings too few securities or concentrated holdings
- betting on industries or countries
- reliance on analysts research
- reliance on economic predictions
- reliance on ratings agencies

No one is going to pay you 'extra return' for taking these risks.

SINGLE SECURITY RISK

A trustee who chooses the traditional approach of building a portfolio security by security leaves that portfolio vulnerable to poor decisions or the unfortunate occurrence when good companies fail. Think of all the investors that owned the common shares, preferred shares or bonds of one of these formerly great companies; Enron, Lehman Brothers, Citigroup, WorldCom, or Nortel? This is called single security risk. It is uncompensated risk that should be diversified away.

Investment losses are different than market declines. Losses don't come back.

Uncompensated risks are more often associated with active portfolio strategies and portfolios with a fewer number of holdings. Trustees who choose Passive asset class portfolio strategies will largely avoid single security risk.

UNDERPERFORMANCE RISK

When a portfolio earns less than the market or benchmark return we call this Underperformance Risk. When quantifying liability for an investment strategy that is deemed imprudent, the Trustee Act states, "A court assessing the damages payable by a trustee for a loss to the trust arising from the investment of trust property may take into account the overall performance of the investments."²¹ This statement implies that the performance of the trust portfolio will be measured against a benchmark return.

The market return often comes from a handful of stocks or industries. When a money manager picks a relatively small number of favored stocks out of the market, their portfolio will not only look different than the market portfolio, but it will provide different returns as well. These differences can be dramatic.

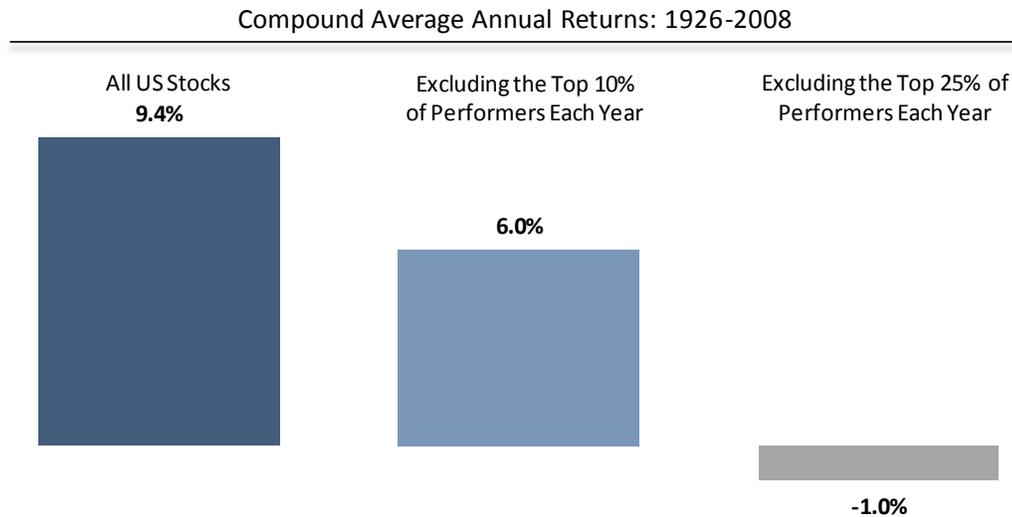
In 2007 for example, Canadian stock investors earned investment returns vastly different than the return of the S & P TSX Composite Index. Many were asking why? According to RBC Capital Markets, RIM, Potash and Alcan accounted for 105% of the 2007 S & P TSX Composite Index return, meaning that outside of these three stocks, the market was down on the year.²²

Individual and professional investors tended to hold a greater percentage of blue chip, high dividend stocks such as banks in their portfolio than these companies represented in the market portfolio. However, four out of the top ten worst performing securities were bank stocks: CIBC, Bank of Montreal, Royal Bank and National Bank. Thus, if an Active manager did not own the same weighting in RIM, Potash and Alcan as the TSX Composite Index then they did not benefit from the strength of these few securities and as a result their active stock-picking portfolios dramatically underperformed the Passive market return.

²¹ Trustee Act, Province of Alberta, Section 5, current as of October 30, 2009. P.4

²² 2007 – Painful Year for Bank Investors in Canada, RBC Capital Markets, Dec.12, 2007

Jim Davis of Dimensional Fund Advisors²³ recently analyzed all US stocks going back to 1926. He concluded that the best-performing stocks each year had a pronounced effect on the overall market return. The compound return on all US stocks from 1926-2008 was 9.4% per year. If you eliminate the top 10% of performers each year, the compound return drops to 6%. If you eliminate the top 25% of performers, your compound return goes down even further to an astonishing -1% per year. Simply put, if your stock picking portfolio excluded the very best performing quartile of stocks each year, you would have lost money investing in equities over a period of more than eighty years.



Results based on the CRSP 1-10 Index. CRSP data provided by the Center for Research in Security Prices, University of Chicago. In USD.

Every year the market portfolio will hold the best performing stocks; this is an unlikely feat for a stock picking portfolio. If strong performance from a few stocks accounts for much of the market's return each year and there is no evidence that managers can identify these few stocks in advance – then any attempt to pick stocks may result in missed opportunity. Trustees should be increasingly concerned with managing trust portfolios to minimize the risk of underperformance.

²³ Missing Opportunity, Jim Davis, Dimensional Fund Advisors, 2010. Results based on the CRSP 1-10 Index. CRSP data provided by the Center for Research in Security Prices, University of Chicago. In USD.

THE HIGHER STANDARDS OF PRUDENCE

Establishing standards for *Prudent Investor Rule Compliant Portfolios* would help trustees ensure their investment decisions are considered prudent. Passive asset class portfolio management and Modern Portfolio Theory provide these higher standards. These standards offer simplicity in execution and the ability to standardize across provinces and across purposes.

In the field of portfolio management, portfolio returns are measured against a benchmark return. For example, the performance of a Canadian stock portfolio is compared to the return of the S&P TSX Composite Index. It has been suggested that the overall performance of a trust portfolio will be measured against a similar benchmark. Trustees could adopt strategies that attempt to beat the market (benchmark) return and not receive any recognition. Providing a lower return leaves them vulnerable to criticism. Passive portfolios are specifically designed to capture the return of the markets in which they are invested. This offers better protection against underperformance risk than Active strategies that are designed to beat the market, but rarely do.

Passive asset class portfolios also offer trustees a higher standard for diversification than Active strategies. Active managers build portfolios by researching and picking relatively few stocks per asset class that they believe will perform better than the market and better than their peer group. This is the antithesis of diversification.

Passive portfolios, conversely, are efficient combinations of major asset classes such as, Canadian Equity, US Equity, International Equity, Emerging Markets Equity, Real Estate and Fixed Income with each asset class containing several hundred or several thousand securities. This approach is designed to accept risk that compensates investors with return and to diversify away risks that do not. Thus, the return of the portfolio will approximate the return of the market (asset class) with better managed risk.

To judge a trustee's duty to diversify, I propose a higher standard of portfolios that hold more securities, take less underperformance risk, less single security risk and that are protected against the bias and error of human decisions. This is the essence of *Prudent Investor Rule Compliant Portfolios* and Passive portfolio management.

*“Any pension fund manager who doesn't have the vast majority – and I mean 70 percent or 80 percent of his or her portfolio in indexed investments is guilty of malfeasance, non-feasance or some other kind of bad feasance!”*²⁴

²⁴ Merton Miller, co-recipient of the 1990 Nobel Prize in Economic Science.

CONCLUSION

Passive portfolio management provides trustees with the prudent investment process and the higher standards required by the Trustee Act's Prudent Investor Rule. Competitive and efficient markets render efforts to beat the market return futile. A prudent trustee would choose portfolios comprised of asset class index funds that capture market performance. Combining asset classes, as directed by Modern Portfolio Theory, provides high-level diversification and returns that can be benchmarked against common indices with minimal chance of underperformance. Prudent Investor Rule compliant portfolios can be structured to focus on compensated market risks and protect against uncompensated risks to fulfill the trustee's responsibility to diversify. Passive investing is also associated with lower levels of portfolio turnover, lower operating costs and lower taxes. Passive portfolio management offers a standardized approach that could be applied across provinces and in a wide variety of trust portfolios. A trustee who chooses a Passive asset class portfolio strategy will ensure their investment decisions meet the higher standards required by the Prudent Investor Rule.

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