

Trustee Investment Powers and the Higher Standards of Prudence

Chris Turnbull, CFA
Updated November 5, 2011

Trustee Investment Powers and the Higher Standards of Prudence

INTRODUCTION

In 2002, the Province of Alberta modernized its Trustee Act. The traditional legal list of “safe investments” was replaced by 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 entities such as, pensions, endowments, charities, not for profits, family trusts and foundations. In addition to more sophisticated investment guidelines, trustees are held to a new standard for determining liability, one which judges the prudence of their investment choices. This 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 states 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 offers 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 Albert, 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 of an imprudent trustee, the Trustee Act says, “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 implies the trust portfolio return 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.

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. As early as the 1930’s, the conventional investment industry wisdom was to analyze securities one by one using the Benjamin Graham and David Dodd method of security valuation. Competent stock research rendered broad diversification undesirable and the objective was to concentrate holdings in the three or four most 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 it is not enough to look at the expected risk and return of investments in isolation. Rather, a rational investor will seek out efficient combinations of securities offering the highest return for each level of risk. Modern Portfolio Theory has been referred to as the Big Bang of all modern finance and Professor Markowitz along with Merton Miller ultimately received the Nobel Prize in Economic Science for their work.

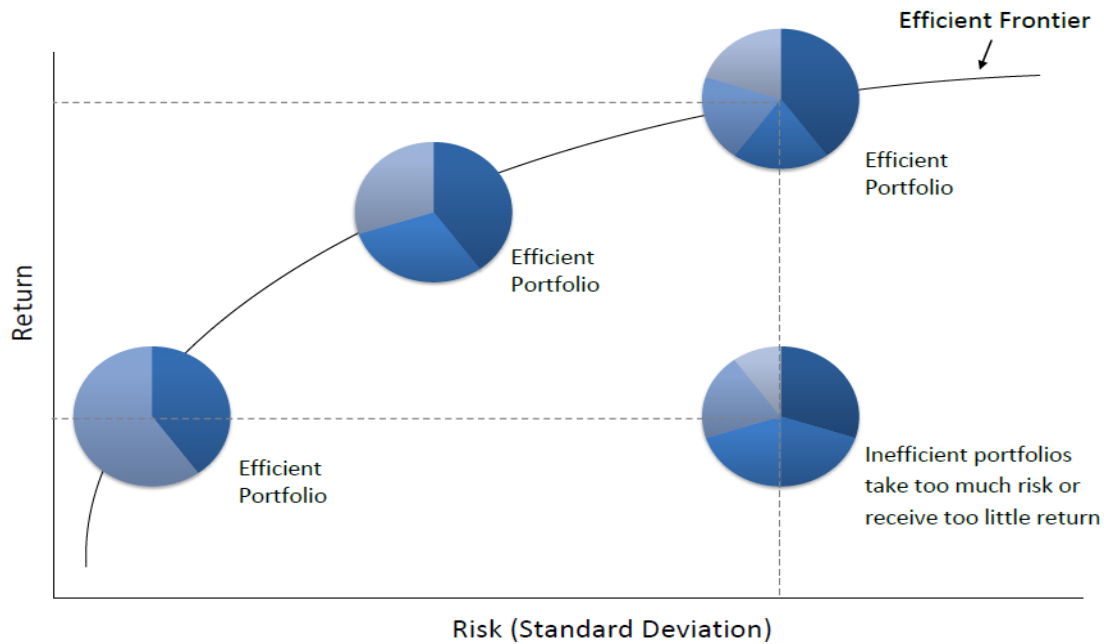
Efficient portfolio diversification is achieved by combining assets or asset classes that are not perfectly correlated or are ideally, negatively correlated. Thus, if in the short term one asset were to decline in price another would rise, thereby mitigating portfolio risk. These optimal portfolios are 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



Asset Classes are broad groups of securities sharing similar economic or geographic traits such as, Canadian stocks, US stocks, International stocks, Bonds, Real Estate Investment Trusts or Emerging Markets stocks. Each asset class normally consists of several hundred or several thousand similar securities. Trustees have traditionally hired investment manager(s) to research and choose a relatively small number of individual securities from their asset class of expertise for the portfolio. This is referred to as Active portfolio management and it is implied that astute research and selection will generate extra returns above the asset class market return.

Alternatively, a trustee may use commercially available asset class securities. These readymade asset classes can be easily combined into a properly diversified portfolio. Each is designed to earn the return of the asset class by owning the same or substantially all of the securities that trade in the asset class. This is referred to as Passive Index Investing.

While the theoretical underpinnings of Modern Portfolio Theory are complex there are two main objectives. The portfolio must capture the return of each asset class represented; nothing more and nothing less. Secondly, this must be done by taking compensated risks and diversifying away uncompensated risk.

“Passive investing is, however, the best way to rid a portfolio of as much uncompensated risk as possible (and the only way of eliminating the risk of underperforming a given financial market.)”⁹

⁹ Harry Markowitz, Fiduciary Focus: Active vs. Passive Investing (Part 5) Morningstar June 30, 2005

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 (single asset class) earned an average annual return of 9.70% with a standard deviation of 16.57%.¹⁰

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, Canadian stocks averaged 9.70% but, in any given year returns fell 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 annual returns are closer to the expected return each year.

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

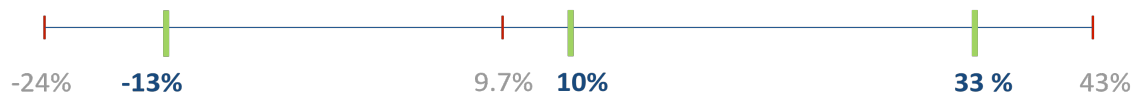
95% Probability



A Balanced Portfolio (two asset classes) 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%.¹¹ Portfolio risk declined by 30% and yearly returns fell 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



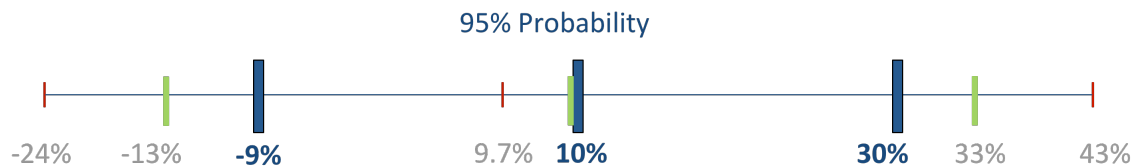
¹⁰ Asset class return statistics, S&P TSX Composite Index returns, January 1, 1970 – December 31, 2009, provided by S&P/TSX, TSX Inc. Rebalanced monthly.

¹¹ 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 add global diversification to our portfolio and include 20% US Equity and 20% International Equity, the four asset class portfolio return rises to 10.34% per year while portfolio risk declines to 9.67%.¹²

Adding asset classes such as, 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 riskier asset classes, 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 appropriate mix of asset classes for the trust; 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.

¹² 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. However, investors more commonly focus 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?”

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.¹³ Their study partitioned the returns of 82 large pension funds between 1977 and 1987 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 of 91 large pension funds from 1974 to 1983 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, implementing the asset mix by investing in asset class index funds and monitoring the portfolio. This modern method of managing portfolios offers simplicity and the ability to standardize the approach across provinces and across purposes. Asset class securities 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.

¹³ 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 main investment strategies: 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 they predict will perform better than the asset class market return and better than their peers. This applies to stocks as well as, bonds. 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 a skillful money manager will be able to produce extra returns.

Conversely, the goal of a passive investor is to capture returns by owning all, or substantially all, of the securities in that asset class. Passive investors often own asset class funds 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 research analysts, brokers or star rating systems. 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 efforts of the employees, owners and managers of each of the companies represented. This allows passive strategies the advantage of lower fees, lower portfolio turnover and lower realized taxes. By investing in asset class securities, 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 returns of active managers compared to their respective benchmark are illustrated below in the Standard & Poor Indices Versus Active Funds Scorecard (SPIVA).¹⁴

<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.

¹⁴ 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 outperformed the market return. 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".¹⁵*

The Research Foundation of the CFA Institute published, *A Primer for Investment Trustees* to provide guidance in choosing between Active or Passive investment strategies. They say, "...the use of active managers is the assumption that the managers' investment processes can identify investment opportunities that will produce positive excess returns relative to their benchmarks."¹⁶

The use of active management requires the investment committee to believe that:

- Managers exist that can produce positive excess returns,
- The staff is able to identify and hire these superior managers,
- The trustees can endure periods of underperformance, and
- The investment committee is capable of coordinating these managers to achieve the objectives of the trust.

"A no answer to any of the statements implies that the Fund should not engage in active management. By implication then, passive management ought to be the default position where it is available."¹⁷

Investment research firm Greenwich and Associates reported that US Endowments and Foundations have "nearly 70% of their US stocks invested in indexed strategies."¹⁸ Both the largest Sovereign Wealth Fund in the world and the largest US Pension fund, have the majority of their equities in index strategies. Remember, these funds that choose passive portfolio management have the lowest costs, access to the smartest financial minds and the best information and technology.

¹⁵ W. Scott Simon, in his book *Index Mutual Funds*, Profiting from an Investment Revolution.

¹⁶ *A Primer for Investment Trustees*, Research Foundation of the CFA Institute, J. Bailey, J. Phillips, T. Richards, 2011.

¹⁷ *A Primer for Investment Trustees*, Research Foundation of the CFA Institute, J. Bailey, J. Phillips, T. Richards, 2011.

¹⁸ 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 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.”¹⁹

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”.²⁰

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 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 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 and passive index investing.

<i>Average Annual Return by Decade</i> ²¹						
	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%

¹⁹ C. D Ellis, *Winning the Losers Game*, 2002 p. 29

²⁰ 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.

²¹ Decade by Decade Returns, Data provided by S&P/TSX, and Standard & Poor’s Index Services Group.

Efficient investment markets have important implications for trustees. 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 if it has a greater chance of underperforming after fees?

In 2004, Canadian courts began recognizing the efficiency of investment markets. In the Ontario Superior Court of Justice, *Authorson (Litigation Guardian of) v. Canada (Attorney General)*, Canadian war veterans successfully sued the federal government making the case that investing their funds over many years in low interest bearing securities was insufficient and the appropriate portfolio should have consisted of 60% bonds, 35% equities and 5% cash. The court called several expert witnesses to quantify the return of the appropriate portfolio.

Professor Charette, a professor of Economics testified that, "...the possibility of trading profits or capital gains should be ignored based on the "efficient market hypothesis" which implies that on average, professional money managers can't generate returns much in excess of broad market averages."²²

David Yu, a fixed income expert with 29 years experience stated "...an attempt to outperform the market which would ultimately add no value to a bond portfolio, given the proven efficiencies of the marketplace."²³

William B. Solomon a professional actuary with 36 years of pension industry experience, "...concluded that active trading in a portfolio of equities rarely achieves much success and points to a 20 year survey of pooled funds invested in the TSX Composite Index where the return would have been 9.4%. If the portfolio had been actively traded, before fees, the return would be 9.9%. If fees were taken out the returns would be virtually identical."²⁴

In consideration of the expert testimony the judge accepted that markets are efficient and damages were calculated as the difference between the benchmark returns and what was earned from the actual interest bearing portfolio. No allowances were made for extra returns over the benchmarks.

UNDERPERFORMANCE RISK

Underperformance risk is the chance that the portfolio return will be less than the market or benchmark return. 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."²⁵ 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.

²² *Authorson (Litigation Guardian of) v. Canada (Attorney General)* Docket: 99-GD-45963

²³ *Authorson (Litigation Guardian of) v. Canada (Attorney General)* Docket: 99-GD-45963

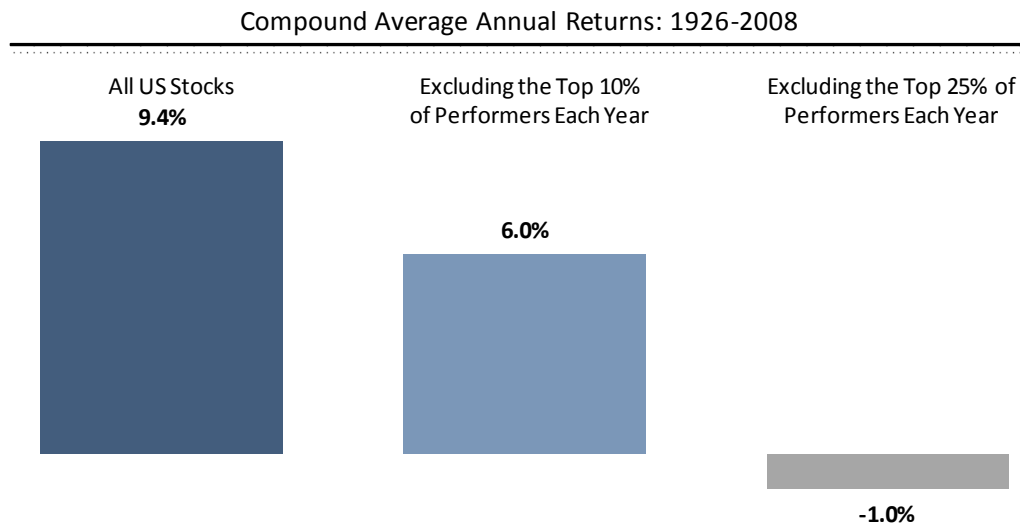
²⁴ *Authorson (Litigation Guardian of) v. Canada (Attorney General)* Docket: 99-GD-45963

²⁵ Trustee Act, Province of Alberta, Section 5, current as of October 30, 2009. P.4

In 2007 for example, Canadian stock investors earned investment returns vastly different than the return of the S&P TSX Composite Index. 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.²⁶

Individual and professional investors tended to hold a greater percentage of blue chip 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 investor 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 portfolios dramatically underperformed the passive market return.

Jim Davis of Dimensional Fund Advisors²⁷ 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 can account 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.

²⁶ 2007 – Painful Year for Bank Investors in Canada, RBC Capital Markets, Dec.12, 2007

²⁷ 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.

COMPENSATED RISK VERSUS UN-COMPENSATED RISK

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.

Uncompensated risks that should be diversified away include:

- single security risk
- 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.

THE HIGHER STANDARDS OF PRUDENCE

Establishing the higher standards of *Prudent Investor Rule Compliant Portfolios* will help trustees ensure their investment decisions are considered prudent. Modern Portfolio Theory and passive asset class portfolio management 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. It has been suggested that the overall performance of a trust portfolio will be measured against similar benchmarks. Trustees could adopt strategies that attempt to beat the market (benchmark) return. However, if they underperform they are vulnerable to criticism. Passive portfolios are specifically designed to capture the return of the asset classes and markets in which they are invested. This offers a Trustee 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 securities per asset class they predict will perform better than the market and 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 fund containing several hundred or several thousand securities. This approach is designed to accept risk that compensates investors with return and diversifies away risks that do not, as is required by Modern Portfolio Theory. Thus, the return of the portfolio will approximate the return of the asset classes with better managed risk.

To judge a trustee's prudence, I propose the higher standards of portfolios that comply with Modern Portfolio Theory, hold more securities, take less underperformance risk, less single security risk and that are protected against the bias and error of human predictions. 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!”*²⁸

²⁸ Merton Miller, co-recipient of the 1990 Nobel Prize in Economic Science.

CONCLUSION

Passive portfolio management provides trustees with a 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 will establish an appropriate asset mix for the trust, implement the asset mix by investing in asset class index funds and monitor the portfolio. 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.

Disclaimer

The information contained herein is for information purposes only and does not constitute specific investment advice. The information provided is based on asset class, security, and investment data and projections that are generated using 3rd party sources, assumptions, models, and methods that are consistent with investment industry standards. Although the author takes all steps to ensure that it presents information for which it has reasonable basis and grounds, there can be no warranty, guarantee, or assurance, implicit or otherwise, that the projections contained within this presentation will occur exactly as stated. Where historical statistics are used, they are used for illustrative purposes only. Historical performance is not to be construed as being indicative of future performance. Historical statistics use publicly available index or mutual fund returns (where appropriate) and may not include all fees or taxes associated with implementing an equivalent strategy.