

PRUDENT WEALTH MANAGEMENT

Dear Prudence, won't you come out to play,

Dear Prudence, greet the brand new day.

John Lennon

Investment fiduciaries charged with prudent wealth management must develop and implement a decision making process that is:

- ⇒ Legally defensible;
- ⇒ Academically supportable; and
- ⇒ Administratively reasonable.

A Venn diagram showing the intersection of the legal, academic and administrative spaces appears on the cover of each *Fiduciary Forum*, graphically illustrating the importance of an coordinated, balanced and thoughtful approach to wealth management.

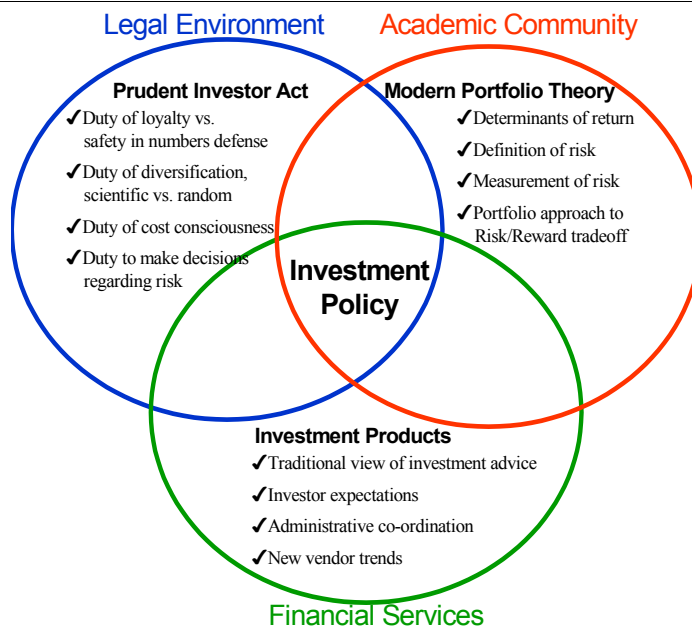
Over three decades ago, John Lennon invited Prudence to come out to play. Trustees and other investment fiduciaries should be aware that developments in trust law and financial economics have truly instituted a brand new day in defining how the concept of prudence applies to portfolio design.

A Brief History of Prudence

The history of the legal concept of 'prudence' is well documented. Bevis Longstreth, W. Scott Simon and other commentators provide a comprehensive body of work that outlines the development of the legal concept from its beginnings in the Prudent Man Rule (Harvard College v. Amory, 1830), through state Legal List statutes and their judicial underpinnings (e.g., King v. Talbot, New York State Court of Appeals 1869), through the American Bankers Association Model Investment Statute (1940) and Professor Scott's Second Restatement of Trusts, to the passage of ERISA (1974) and subsequent federal court interpretations establishing a standard of care, skill and caution known as the Prudent Expert Rule. Today, the common law of trusts draws heavily upon Professor Halbach's Third Restatement (ALI-ABA, 1992: "Prudent Investor Rule") as embodied in the Prudent Investor statutes adopted by most states.

Modern Portfolio Theory and Trust Law

Similarly, a rich set of research articles and commentaries in the field of financial economics known collectively as Modern Portfolio Theory [MPT] define the academic concept of 'prudence'. Modern trust law explicitly incorporates MPT into the standards for prudent asset management; and, therefore, fiduciaries must be able to justify investment decisions by reference to their academic soundness. Trustee actions based on mere opinion, past standards of practice, conventional wis-



dom, or good faith may be deemed imprudent if they are not soundly grounded in the principles of financial economics. Although economists and finance professors hold differing views of capital markets and possible investment strategies, trustees must be able to demonstrate that their asset management strategies have a reasonable expectation of adding value to rather than subtracting from the trust estate. Strategies that are, in the words of one court, merely "wishful hoping" are likely to be deemed imprudent. Modern trust law tends to interpret the requirements of care, skill and caution not merely as a set of conservative behavioral characteristics, but as a trustee duty to investigate and evaluate thoroughly the economic consequences of their decision making process.

Administrative Prudence: An Emerging Topic

Administrative prudence, however, is an area about which little has been written. In an era of incredibly opaque costs associated with wrap fee accounts, poorly disclosed investment expenses, payments for order flow, directed brokerage costs, soft-dollar compensation, and so forth, it is becoming increasingly important for investment fiduciaries to document that they have investigated and intelligently evaluated the administrative platforms and systems used to manage wealth. Therefore, Larry Harris's new text, Trading & Exchanges: Market Microstructure for Practitioners, is a welcome resource for fiduciaries. Harris is a Ph.D. economist from the University of Chicago, and is the Chief Economist for the SEC.

If you are an investment fiduciary, reading Harris' book may remind you of the story of the famous Comstock mine in

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There are always people who will give testimonials to market-timers because they have made money using a system. Under any market condition, there will be both bullish and bearish predictors. Someone is bound to make a sequence of correct predictions, if only as a matter of blind luck; and the widespread public exposure given to successful venders of market timing systems gives them a veneer of credibility.

...upon evaluating the professional management of 57 mutual funds over the period 1953 through 1962, the authors identify only one fund that exhibits statistically significant ability to time markets successfully.

Nevada. The story relates how the mine owners believed they had discovered a particularly good location for a gold mine. However, after extracting tons of seemingly promising ore, the assay analysis revealed no gold. Finally, frustrated and on the verge of bankruptcy, they hired a consulting geologist who, upon spying the huge hill of ore, exclaimed that he had never seen so much silver in his life! Like the early Nevada gold seekers, the reader of Harris' work, expecting tips on stock selection, market timing, and other market beating formulae, will be disappointed. Furthermore, Harris does not write specifically for investment fiduciaries. There is little discussion regarding standards of prudent investing throughout the 600+ pages of well-documented text. However, the book is a comprehensive overview of topics of critical concern to all investment fiduciaries.

Empirical Observation vs. Mathematical Rigor

Harris occupies an interesting intersection in the maze of intellectual currents through which several economic theories flow. With his Ph.D. and quantitative analysis background in economics (he is the research coordinator for the Institute for Quantitative Research in Finance), it is not surprising to find that he distinguishes between theories based solely on empirical observation and those grounded in mathematical rigor. Thus, for example, he disparages the theory that stocks beat bonds over horizons of 15 years or longer (the "stocks-for-the-long-term" theory) simply because it is based on the U.S. market; and is belied by data from other industrialized nations' markets. Furthermore, given his University of Chicago background, it is not surprising to discover that he is kindly disposed toward the efficient market hypothesis (which implies that current market prices impound all information that security buyers and sellers can acquire). However, he is not doctrinaire in his belief. Given his position as chief economist for the SEC, he is in a unique position to identify and evaluate the challenges and opportunities faced by those who elect to buy and sell securities (in Harris' terminology, buyers and sellers are called "traders").

Cost Control as Determinant of Success

Harris squarely places himself among the growing list of researchers that point to cost control as the primary determinant of investment success or failure ("For most active traders, transaction costs are the most significant determinants of their total returns."). He writes for the practitioner, not the academic; and he shines a bright spotlight on how unwitting investors (both individual and institutional investors) lose wealth not because their investment strategies lack merit, but because they do not

carefully investigate the administrative environment in which their ideas are executed. Here is the valuable "ore" for investment fiduciaries because Harris provides insight into the inquiries necessary to demonstrate the prudence of a trustee's delegation decisions or of his own investment decision-making process. That is to say, the fiduciary duty to assure that wealth is managed in a benign rather than virulent cost environment means something more than mere passive acquiescence to a sales pitch given by a commercial fiduciary or stock brokerage firm.

Active vs. Passive Management

Harris notes that fiduciaries are not required to engage active managers. In fact, he suggests that fiduciaries should only consider hiring an active manager when they are reasonably certain that the manager will be successful:

You also must be able to predict performance if you employ active investment managers to speculate on your behalf. Active investment managers speculate with their clients' money. They are active, as opposed to passive, because they actively try to identify and exploit speculative opportunities. Accordingly, they often trade frequently. You can hire their services by employing them as investment advisers or you can obtain their services indirectly by buying the mutual funds and commodity pools that they manage. In either event, when managers speculate on your behalf, you speculate on their success. To select good active investment managers, you must predict which ones will speculate successfully. If you cannot predict which managers will be successful, you should not employ active investment managers. The most important decision investment sponsors make is whether to employ active managers.

Although there are many important and recurring themes in Harris' book, this *Fiduciary Forum* selects just a few that are particularly important for fiduciaries and other investors. One of the text's most noteworthy characteristics is Harris' ability to state basic, seemingly mundane, questions or observations, followed by a wonderful, almost breathtaking, depth of analysis. Here are a few examples:

Why do People Trade ?

Why do people trade (i.e. buy and sell assets)? Harris contends that much trading is done by *Utilitarian Traders*. These are traders who use the markets to obtain benefits that

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“...the future market return is more likely to be positive after decreases in recommended ...equity weights. The mean annualized six-month return is 12.7%, while the mean excess return following decreased equity weights is 16.2%. This is the opposite to what we expect if newsletters appropriately time the market.”

are external to the trading process itself. Utilitarian traders are faced with problems that, in their opinion, can be solved, all or in part, by participating in market related activities. The farmer with his net worth invested in a wheat crop participates in the futures market, not to profit, but to hedge risk; the tax-trader executes orders that will generate deductible losses; the asset exchanger will trade one asset for another that is of better use. A classic example is the foreign traveler who exchanges money on the international currency markets; indeed, most financial transactions exchange cash assets for another type of asset that is, at the moment of exchange, of better use (valued more highly) than cash. *Utilitarian traders* are uninformed traders in the sense that they do not seek to exploit information to earn abnormal profits (“beat the market”).

What’s an Investor?

One of the more interesting categories of utilitarian traders is *Investors*. *Investors* use the market to solve intertemporal cash flow problems like saving for education or retirement: *Investors* exchange money for assets that allow them to move money from the present to the future:

Investors expect to get a fair rate of return when using the markets to move money into the future. Indeed, many investors will defer their consumption only because of the investment returns that they expect to receive. Since investors are uninformed traders, the rate of return that they expect to receive does not depend on any private information that they may have. The fair rate of return is therefore an unconditional expected return.

Although *Investors* may hope for spectacular returns (abnormal profits), they are motivated to move money through time (borrowers move money from the future to the present) based on the expectation (not the guarantee) of receiving fair rates of returns given the risks of the assets they choose to purchase (borrowers, of course, pay prevailing interest rates to move future money into the present).

Spectacular Speculators

Harris designates profit-motivated traders as *Speculators*: “Speculators attempt to profit by predicting how prices will change in the future.” Speculators must understand fundamental asset values better than other market participants; they must have better access to data and they must be able to analyze data better than other traders. Speculators believe that they can predict future asset price changes more accurately than other market participants.

A CURRENT RESEARCH PROJECT

Patrick Collins and Scott Simon are currently co-authoring an article that draws (in part) from the material in Harris’ book. Among the issues discussed are:

- 1) Must a trustee seeking to delegate investment management responsibilities investigate and evaluate the administrative platforms used to manage wealth? For example, how should a trustee evaluate the true costs (as opposed to the advertised “all-in” fee) of a brokerage house Wrap Fee account?
- 2) Is a commercial investment fiduciary (advertising a high level of expertise) obliged to perform and document internal diagnostics to confirm that their investment approach and buy/sell strategies add value?

General questions include:

- ⇒ Is an investment fiduciary obliged to periodically run credible self-diagnostics, prior to implementing portfolios?
- ⇒ Does administrative prudence dictate that the investment fiduciary offer something more than a "best efforts" / "good faith" standard?
- ⇒ Should financial engineering activities, such as portfolio design, be subject to standards that apply to other engineering activities, which require diagnostics where the system is inter-actively complex or closely knit?
- ⇒ Without a credible self-diagnostic performance evaluation system, can a commercial fiduciary legitimately advertise above average investment expertise?

They trade because they expect to profit.” Harris also describes *Futile Traders*. *Futile traders* expect to profit, but they do not. They are, in fact, merely pseudo-informed traders that believe they are well informed. According to Harris, “...they lack the skills, analytic resources, and access to information necessary to trade profitably. They may do everything that profit-motivated traders do, but they do not do it well enough to trade profitably.”

Know When to Hold ‘Em, When to Fold ‘Em

Finally, Harris identifies a segment of traders that he characterizes as *Gamblers*. Unlike

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Unfortunately, the ability to identify relatively superior newsletters is not particularly helpful to investors looking for asset management guidance. Even the best newsletters have abysmal performance.

“bank trust department portfolio managers are unable to time the market successfully by changing their portfolio betas in anticipation of differential market conditions and, thus, are unable to outperform a passive buy and hold investment strategy.”

investors who move money through time, with the unconditional expectation of a fair return, or speculators who buy and sell securities with the conditional expectation that they will earn superior (“market beating”) returns, gamblers are traders that “focus more attention on favorable outcomes than on losing outcomes.” *Gamblers* often believe they are *Speculators*, but are, in fact, uninformed treasure hunters.

Aligning Objectives With Approach

Shortly, we will consider Harris’ contention that successful speculators exist; and we will examine why they succeed and why they are very rare (and, why their continued success often depends on keeping their identity anonymous in the trading environment. Who wants to take the other side of a Warren Buffet trade?). For the moment, however, it may be useful to investigate the meaning of the term “stewardship of wealth” that characterizes trustee’s duty. Is a trust settlor looking for an asset management platform that emphasizes one investment approach over another? According to Harris, “many people confuse investing, speculating, and gambling.” Indeed, many traders enter the market realizing they have multiple motives. If grantors prefer wealth management strategies characteristic of gamblers and speculators, it is reasonable:

- 1) To include broad-scope exculpatory provisions in the enabling documents; and,
- 2) To expect courts to enforce such provisions.

If, however, grantors are *Investors* (according to Harris’ definition of the term), seeking to move money through time with an unconditional expectation of a fair return for beneficiaries, they probably prefer a very different investment approach. How many grantors approved the insertion of exculpatory provisions because they thought that the “blue-chip,” “old-line,” “conservative” trust company or wealth management firm that they retained was actually an investment *Speculator* or pseudo-informed *Speculator (Gambler)*. As Harris remarks, “Speculators expect higher returns from their positions than do investors.” Banks and brokerage trust operations, in fact, often promote their services based on returns-based marketing and on claims of expertise in asset valuation. Leaving aside, for the moment, the fact that such claims are testable hypotheses (and, if not true, may leave the claimants subject to charges of deceptive trade practice), grantor expectations are clearly relevant factors to be identified prior to committing wealth to an intergenerational (dynasty trust) management. Is the *Speculator’s* approach, even when shown

to be economically successful at a statistically significant confidence level, the most suitable for long-term stability of principal and production of income? Are grantors paying for an *Investor* approach and receiving a *Speculator* approach? Using Harris’ terminology, since *Investors* can expect, on average, to lose money to well-informed *Speculators*, is this a bad thing?

Winning a Zero Sum Game

What makes an informed *Speculator* successful; or, how can traders make profits in a relatively efficient market? This topic is of central importance given Harris’ thesis that:

- ⇒ Trading is a zero-sum game;
- ⇒ Informed traders, on average, cannot generate profits when trading with other informed traders;
- ⇒ Predicting profitability based on past performance is not reliable;
- ⇒ If the trading strategies of informed traders prove profitable, other informed traders will compete for market liquidity (i.e. drive up the cost of trading) as they rush to establish their positions; and,
- ⇒ The more informed traders trade, the more efficient the market becomes.

Harris describes several approaches used by informed speculators including investment methods followed by *Value Traders* and by *News Traders*. Value traders estimate fundamental values based either on private or publicly available information. But this is not easy:

Since informed traders can profit only if they trade when prices differ significantly from values, they must complete their trades while they still know values better than other traders do.”

Generally, value traders estimate justified asset prices, while news traders estimate changes in justified asset prices. Value traders sacrifice trading speed for information collection and financial analysis.

Value Traders

Successful value traders must have pyramid-shaped organizations and must collect information from numerous sources, including economists, financial analysts, statisticians, actuaries, computer programmers, engineers, accountants, scientists, etc. Senior decision makers must assure that the inputs are consistent with respect to their assumptions:

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Otherwise, the firm will buy securities analyzed by optimistic analysts and sell securities analyzed by pessimistic analysts. They must also ensure that their analysts have not ignored important information. Otherwise, they will buy securities for which they failed to identify negative information and sell securities for which they failed to identify positive information."

News Traders

News traders, must have relatively flat organizations. News traders must trade before the news impacts security prices. They decentralize control and allow great freedom to individual portfolio managers. Decisions must be made with little time for deliberation. News traders must have efficient, real-time communications with news and database sources.

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Return maximization strategies are rarely employed because they create irrational asset weightings and unfavorable reward/risk tradeoffs. The return maximizing investors that placed their investment capital with Enron, Global Crossing, WorldCom and other "new economy" firms confirm this point.

THE PARADOX OF THE EFFICIENT MARKET HYPOTHESIS

True to his academic roots, Harris acknowledges the power and elegance of the Efficient Market Hypothesis [EMH]. Markets are efficient when they fail to provide systematic opportunities for trading strategies that yield consistent and persistent abnormal risk-adjusted returns. The theory of market efficiency holds that competing, rational, profit-maximizing investors will rapidly analyze all available information. They will refuse to buy overvalued assets and will refuse to sell assets at less than their justified price; and, furthermore, will quickly take advantage of investors foolish enough to buy or sell at prices that deviate from intrinsic value. Therefore, in an efficient market, the price of any security remains close to its fundamental value. Price changes are the result of new information coming to market participants. Because new information may be either favorable or unfavorable; and, because it cannot be known ahead of time, it is very difficult to accurately predict security price changes, and even more difficult to develop trading strategies to exploit future price changes.

The early expressions of the EMH draw upon the mathematics of random motion and nonstationary processes (the Random Walk theory) in which "fully informative prices seem to follow random walks because no one can predict future price changes from past information when prices fully reflect that information. When price changes are unpredictable, they appear random." Later expressions of the EMH draw upon the mathematics of game theory developed in the 1930s by von Neumann and Morgenstern at Princeton University. Efficient markets are an example of a "zero-sum game" in which the gains of one player can only be measured in terms of the relative losses of another. Market returns are the aggregated and averaged results realized by all participants. Therefore, for every player that beats the market, there must be a corresponding player that generates a loss—it is impossible (except at Lake Wobegon where all of the children are above average) for the majority of players to win. Unfortunately, in the investment world,

there is no persistency in superior performance—the best funds of one year are just as likely to end up as the worst performers in the next year as they are to continue their success. As Harris states: "These results are very robust. They are true for equity funds, bond funds, and commodity pools. The results are uniform across years and across countries. The results are similar when performance is measured by quarter or by month....Past performance poorly predicts future returns primarily because past performance generally is due more to luck than to skill." Most of the factors that influence portfolio returns are fiendishly difficult to predict. Therefore, "...the additional return that we expect a manager can add to a portfolio is small relative to the variation in portfolio returns due to factors which managers cannot anticipate or act upon. Statisticians and engineers say that this problem has a low signal to noise ratio. The signal—whether the manager is skilled—is hard to find because it is lost in noise (variation due to other factors)."

The paradox of the EMH is this: if the market price of securities is close to their fundamental value, there will be no profit opportunities (after trading costs) for well-informed, profit-motivated speculators. But this is the very group of traders that acts when prices drift away from fundamental values. Therefore, in efficient markets, informed traders will not trade; and, therefore, market prices cannot efficiently reflect fundamental value. Not to worry, however. Harris tells us that markets are sufficiently inefficient to assure that they remain relatively efficient: "Prices move away from fundamental values when values change and prices do not change accordingly, or when prices change without a change in values. The former often happens when news arrives. The latter happens when trading by uninformed traders moves prices. Both situations create profit opportunities for informed traders." It is possible to beat the market; however, it is very difficult.

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Selecting Investment Managers

This information is critical for trustees delegating investment management functions. Two observations are germane:

- 1) Despite the verbiage found in a trust company's or money manager's promotional brochure, they cannot successfully pursue a value strategy without a pyramid shaped organization, nor can they pursue a news trader strategy without a relatively flat organization; and
- 2) Many (most?) trust and money management organizations do not fit either approach. They are merely pseudo-informed traders: "Pseudo-informed traders think that they are well informed, but in fact they are not. They lose because they tend to buy when prices are already high and to sell when prices are already low. Pseudo-informed traders are actually uninformed traders."

Liquidity Implications for Speculator Strategies

A successful *Speculator's* continued profitability depends on his ability to predict future prices and to execute trades that have only a small impact on price. But this makes it extremely difficult to be a successful *Speculator* ("beat the market"). For example, executing a trading strategy based on the consensus opinion of financial analysts is probably a losing bet. As Harris explains:

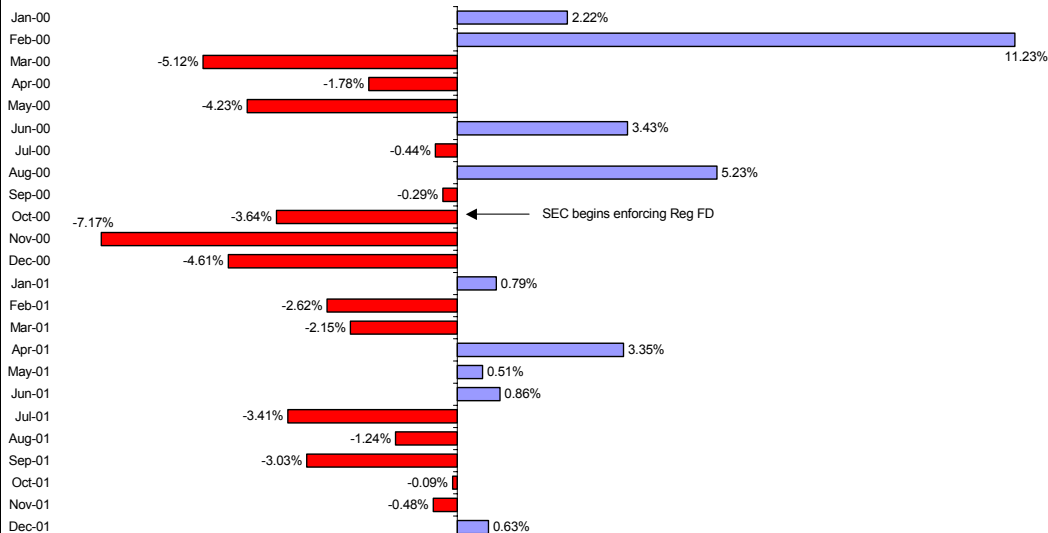
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MONTHLY RETURNS TO ANALYSTS' MOST FAVORED STOCK PORTFOLIOS

The chart below, taken from the article by Barber, B., Lehavy, R., McNichols, M. & Trueman, B., "Reassessing the Returns to Analysts' Stock Recommendations," *Financial Analysts Journal* (March/April, 2003), p. 92, details the market-adjusted returns to portfolios formed on the basis of consensus analyst recommendations (i.e. "buy" or "strong buy") during the period January 2000 through December 2001. A positive number indicates that a capitalization-weighted portfolio of analysts' top picks beat the CRSP capitalization-weighted market index; a negative number indicates that the top picks underperformed the index. On average, the analysts' recommendations underperformed by 50 basis points per month. Recommendations were generated by 226 research/brokerage firms in 2000 and 233 firms in 2001. Trading costs are not calculated; however, previous research by the authors ["Can Investors Profit from the Prophecies?" *Journal of Finance* (April, 2001), p. 553] estimates average round-trip transactions costs at 1.31 percent of share value traded.

In October 2000, the SEC began enforcement of Regulation FD requiring companies to make simultaneous disclosures of any material, non-public information to both analysts and to the general public. Prior to this, companies could selectively disclose information to analysts prior to making it public. This gave analysts and their clients an opportunity to trade on such information.

Value Added by Following Analyst Recommendations



As early as 1936, Professor Albert Cowles concluded that anyone possessing true market timing ability would never want to disclose this fact simply because, keeping their own counsel, they would soon amass fabulous wealth. Once the system was disclosed, however, profits would be trampled as other investors rushed to implement it.

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Prior to 1998, the market delighted investors with a spectacular run that Alan Greenspan characterized as irrational exuberance. Huge profits had been made and were now slipping away.

Since profitability of informed trading depends on liquidity ["liquidity" is the total cost of trading including commissions, bid/ask spreads, timing and liquidity probing costs, and market impact costs], the most profitable informed traders are often those who want to trade when no other informed traders want to trade. Such traders do not have to compete with other traders to complete their trades. Liquidity therefore is relatively cheap for them.

Competition for Trading Opportunities

But here is where it may get dicey for trustees: "Informed traders who want to trade when no other informed traders want to trade either have unique insights that other traders do not have, or they have estimated values incorrectly." This observation highlights the fact that trustees face operational issues that are similar to the risk/reward tradeoffs discussed in a various commentaries on the legal and academic side of prudence. Trustees seeking beat-the-market money management operating on high cost trading platforms must have a reasonable expectation that the commercial fiduciary will be a successful *Speculator*. But successful *Speculators* are mavericks:

"...traders who estimate values from the same information, using the same methods, tend to estimate the same values. Their estimates are highly correlated. They must compete with each other to profit from their insights....The most profitable traders have very accurate estimates of value that are uncorrelated with the value estimates made by other traders.

Many trust companies offering money management services, however, go to great lengths to convince clients that they do not engage in maverick trading. The image projected to clients is one of a "safe," "solid," "straight down the middle" money management firm. Indeed, bank and trust company investment committees frequently check their buy and sell recommendations against the consensus picks of financial analysts to double-check that they are buying good stocks for their clients' portfolios. But these firms may be merely pseudo-informed traders; and, in Harris' opinion: "If you cannot predict whether you will trade profitably, you should not speculate."

Statistical Approach to Manager Selection

How then does the fiduciary, choosing not to pursue a passive investment strategy that characterizes the *Investor* approach to wealth management, make a prudent delegation decision? Harris devotes a lengthy chapter to a discussion of statistical methods of performance

evaluation [readers may be interested to learn that Warren Buffet passes the statistical tests; and, in Harris' words, "probably is a skilled manager" rather than a lucky monkey]. Harris reminds us that although most active managers seem like winners, the sample that we see is highly biased because all of the losers have long since disappeared.

Although statistical approaches to performance evaluation yield great insight into the likelihood that past performance is the result of skill rather than of luck, Harris comments that: "Past performance simply does not predict future returns with enough confidence to be of much use for most applications." Therefore, Harris turns to game theory in search of an economic approach to performance evaluation with greater predictive value: "In the long run, players win games when they have a comparative advantage over their opponents. Players have a comparative advantage when they have greater skills or greater resources than their opponents." It is worth reviewing the concept of 'comparative advantage' because, in Harris' judgment, it is the most important indicator of a superior money manager.

Comparative vs. Absolute Advantage

Most people confuse 'comparative advantage' with 'absolute advantage.' The source of the confusion may well lie in evolutionary biology. A competitor "...has an absolute advantage when he or she can do something well." Harris uses the analogy of the athlete capable of running the marathon in a time of 2 hours and 20 minutes. This is very fast and will be good enough to win most races held each year. This runner has an absolute advantage. However, as Harris points out, "You do not win such races by running extremely fast. You win them by running faster than every other runner." In the 2000 Olympics, a time of 2:20 would have put the athlete in 36th place: "To win a game, you must not just play it well. You must play it better than your opponents."

Thus, absolute advantage is a skill that enables the player to perform better than most individuals. A skilled money manager can manage better than most individuals. However, in the security markets, the skilled money manager competes primarily with other informed *Speculators*, and not with the average person. Therefore, hiring a skilled money manager is not sufficient to have a reasonable expectation of future success—successful *Speculators* must have both an absolute advantage over the average opponent and a comparative advantage over other skilled traders:

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Managers who are not constantly thinking about their comparative advantages cannot know when they should trade. I would be very reluctant to invest with managers who confuse absolute advantage with comparative advantage.

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is published by:

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The most important comparative advantage that a manager or trader should have is a thorough appreciation of the need to have a comparative advantage. Traders who do not understand why comparative advantage is important will not consider whether they have a comparative advantage before they trade. If they do not consider this question, they can have no reason to expect that they will trade profitably.

Without clear identification of a comparative advantage, a manager will be merely a pseudo-informed trader:

Traders who appreciate the importance of comparative advantage consider both why their trading strategy should work, and why they expect other traders will lose to them. Since trading is a zero-sum game, the two issues are inseparable. Most traders, however, focus only on why they think they will profit and not also on why they think other traders will lose to them. Traders who understand both sides of their trades will undoubtedly be more successful than those who consider only the logic of their side.... To win a zero-sum game, you must not just be good, you must be better.

Harris does not discuss consequential issues, like how skilled managers' increasing compensation demands of may decrease their future returns so that they approximate market averages. He does allude, however, to several important issues that successful traders must face. Harris observes that the more successful an informed speculator becomes, the more reluctant other market participants will be to trade with them, the greater the bid/ask spreads he or she must face from dealers, and the more difficult it will become to reasonably control costs. Harris is emphatic that comparative advantage must be identified. His admonitions are of great importance to fiduciaries:

...the most important indicator of a skilled manager is whether the manager clearly understands that success comes from having a comparative advantage. Managers who are not constantly thinking about their comparative advantages cannot know when they should trade. I would be very reluctant to invest with managers who confuse absolute advantage with comparative advantage. Successful managers should be able to clearly articulate the comparative advantages that they believe will allow them to profit in the zero-sum game.

WHAT'S NEW AT
SCHULTZ COLLINS
LAWSON CHAMBERS?

Patrick Collins has accepted a position as adjunct professor at the University of San Francisco for their new Masters of Science in Financial Analysis program.

This fall, Mr. Collins will teach the "Asset Management" course for the Certified Employee Benefit Specialist program offered through San Francisco State University.

On August 7th, Mr. Collins testified before the Illinois Senate Finance Committee on SB 77—a bill providing trustees flexibility with respect their characterization of trust receipts as either income or principal.

Mr. Collins' forthcoming publications include "Tax Motivated Life Insurance: An Exciting and Helpful Tool" in ACTEC Journal, "Diversification: Recent Legal and Academic Perspectives" in California Trusts and Estates Quarterly, and "The Lawyer as Trustee: Duty With Respect to Inception Assets" (co-authored with Mark Griffin, Esq.) in the Maryland Bar Journal.

Currently, Mr. Collins acts as a consultant on several cases litigating ERISA Retirement Trust (working jointly with Jon Chambers), Estate Trust, and Charitable Trust fiduciary breach allegations.

Jon Chambers has begun his tenure as President of the San Francisco Chapter of the Western Pension and Benefits Conference (WP&BC).

On October 14th, Mr. Chambers will present to Pensions & Investments' Defined Contribution/401(k) West Coast Conference in San Francisco. His topic is Plan Governance: A Blueprint for Fiduciaries.

Mr. Chambers authored a Benefits Newsbreak article for the WP&BC discussing a recent Department of Labor Advisory Opinion on 12b-1 Fees Received by Directed Trustees.

Mr. Chambers was interviewed for an article in the September 2003 issue of Global Finance magazine. The topic was Selecting a 401(k) Plan Provider: Navigating the Maze.