

THE LAWYER AS TRUSTEE:  
DUTY TO MONITOR AND REVIEW INVESTMENTS

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## PREFACE

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This two-part article addresses the fiduciary duties of lawyers acting as co-trustees. Its focus is the monitoring of investments and investment strategies to determine their ongoing prudence and suitability. The power to delegate investment functions or to direct these functions to a commercial co-trustee may not insulate the attorney from liability resulting from breach of fiduciary duties arising from investment activities. This is particularly the case for chronic investment underperformance. Part One, published in this issue, discusses relevant sections of the Annotated Code as well as recent court decisions. It continues with information concerning the proper (and improper) ways to report return. An accurate presentation of investment return is a critical first step in judging the success or failure of investment activities. Appropriate measures of return should be understood prior to the implementation of the trust portfolio and should be monitored during the trust's planning horizon. Return and risk, as discussed in this article, have little or nothing to do with the task of finding "good" investments. In general, lawyers are not familiar with financial economics nor are they experienced in investment matters. The task of finding "good" investments, therefore, is one that is best left to banks, brokers, or financial advisors. However, the attorney, acting in the capacity of trustee, retains responsibility for setting the terms of any delegation; and, it is critical that effective and easy-to-understand reporting systems be put into place.

The second part of the article, appearing in a forthcoming issue, discusses investment risk and develops a rationale for a portfolio performance reporting system that may be readily understood by trustees irrespective of the depth of their investment expertise. It provides a sample "template" that promotes unbiased performance evaluation. The lawyer/trustee needs to tell the agent responsible for producing investment returns what information is required; and, needs to set a clear and correct format for the presentation of the information. Use of a reporting template that must be completed by the agent responsible for investments is strong evidence that the attorney trustee continues to monitor the performance of the agent according to the terms of the delegation. It places the attorney in the position of "trust protector" and provides clear evidence that the attorney/trustee collects fees for activities that extend beyond mere passive acquiescence to the recommendations of an investment agent interested in commissions or asset management fees.

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PART I

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**MARYLAND ANNOTATED CODE §15-114 & §15-106**

Code §15-114 sets forth guidelines and fiduciary standards for trustees electing “Prudent Investor” status with the Commissioner of Financial Regulation. There is no explicit reference in §15-114 regarding a trustee’s duty with respect to surveillance and monitoring of the trust estate. This stands in marked contrast to the Uniform Prudent Investor Act drafted by the National Conference of Commissioners on Uniform State Laws. Where Annotated Code §15-114(b)(7) states that a fiduciary shall “act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents;” Section 9(a)(3) of the NCCUSL act specifies that the trustee shall exercise reasonable care, skill, and caution in “periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the terms of the delegation.” Presumably, because many lawyers accepting the office of trustee lack the requisite background in financial economics, investment expertise and portfolio management experience, they will take advantage of the new power to delegate investment functions to a qualified agent. Indeed, Restatement 3<sup>rd</sup> §171 suggests that the trustee may have a fiduciary duty to delegate certain duties: “A trustee has a duty personally to perform the responsibilities of trusteeship except as a prudent person might delegate those responsibilities to others.” Despite the fact that the Annotated Code is silent on the obligation for ongoing monitoring of agents, its use of the term “selection and supervision” implies that monitoring of the agent’s performance remains a crucial task for prudent asset management.

Additionally, §15-114(c)(5)(iv) states “in making an investment decision, the fiduciary may consider, without limitation...the role each investment or course of action plays within the investment of the portfolio of fiduciary assets as a whole.” The NCCUSL act §2(c)(4) shifts the verb tense from the subjunctive to the imperative: “among circumstances that a trustee shall consider in investing and managing trust assets are ...the role that each investment or course of action plays within the overall trust portfolio....” The Reporter’s commentary asserts that this provision creates a duty to monitor: “ ‘managing’ embraces monitoring, that is, the trustee’s continuing responsibility for oversight of the suitability of investments already made as well as the trustee’s decisions respecting new investments.”

The American Law Institute’s objective in adopting (at their 1990 annual meeting) and promulgating the Restatement of trust law was to encourage the courts to adopt a modern portfolio theory standard in judging the conduct of trustees as well as to encourage trustees to consciously develop appropriate risk management strategies and to monitor the portfolios to assure that they remain appropriate in light of the purposes, terms, distribution requirements, and other circumstances of the trust. A recent case defining a standard of care, skill and caution with respect to the fiduciary’s duty to monitor investments is the 1995 Janes case (Estate of Janes, 630 N.Y.S. 2d 472 (Sur. Ct. 1995) *aff’d* 681 N.E.2d 332 (N.Y. 1997). Ironically, this case concerned a twenty-year history of a commercial fiduciary’s trust administration that predated New York’s adoption of the Uniform Prudent Investor Act. Nevertheless, the court found that monitoring and review of the portfolio to assure its continuing suitability is a critical fiduciary duty. Following a precipitous decline in the value of a portfolio highly concentrated in a single blue-chip stock, plaintiff brought a fiduciary surcharge action. The defense case rested, in part, on the fact that the bank trust department monitored the investment and conducted periodic reviews of the portfolio. The Surrogate Court, finding for the plaintiff, stated “to assert that mere review, analysis, and

monitoring satisfies the standard of due care by a prudent person where action and activity are indicated, tests the Court's sense of reason and logic....” The court's decision implies not only that fiduciaries have a duty of surveillance and monitoring, but also that investment performance must be evaluated and, if necessary, the trustee must implement a prudent course of action for portfolio change. Simply put, the court upheld a standard that might best be termed “active monitoring.”

The extent to which Maryland courts will follow the lead of the New York judiciary is, of course, uncertain. Annotated Code §15-114(c) enumerates statutory standards for judging a fiduciary's investment decisions. With respect to inception assets existing at the time the fiduciary appointment was accepted, the fiduciary must use “the exercise of good faith and reasonable prudence.” With respect to other investment decisions, the fiduciary “may exercise reasonable business judgment....” The reasonableness of the decision making process is to be judged not by the future outcome but “under the facts and circumstances prevailing at the time of the decision or action.” Thus, the Annotated Code does not set an inflexible or uniform standard for prudent asset management. By charging the fiduciary to “invest and manage fiduciary assets as a prudent investor would,” the requisite standards of care, skill and caution would seem to be those that comply with the generally accepted statistical and quantitative evaluation processes that form the underpinning of Modern Portfolio Theory. However, terminology such as “good faith,” “reasonable prudence” and “reasonable business judgment,” suggests that the legislature was not seeking to promote a strict-constructionist interpretation of the Uniform Prudent Investor Act.

Annotated Code §15-114 applies to trust companies, investment advisors controlled by trust companies and persons electing to make a “Prudent Investor” election with the Commissioner of Financial Regulation. Lawyers acting in the capacity of trustee who do not make this election are restricted to the “Lawful investments” list of §15-106. Although this code section defines lawful investments primarily as government-guaranteed fixed income investments or mutual funds investing in such government obligations, subsection g is a triple-negative phrase stating, “this section shall not be construed to make unlawful any investment not listed in this section.” If a lawyer is co-trustee with a corporate fiduciary (a bank, a trust company, or “any other corporate entity that is authorized to act as a fiduciary under the laws of this State”) the corporate fiduciary has express permission to invest in certain mutual funds and investment trusts. It is doubtful that §15-106 is a safe harbor even with respect to government debt obligations. Subsection e (Liability for lack of reasonable care) states, “this section shall not be construed as relieving any person from any duty of exercising reasonable care in selecting investments.” It is likely that reasonable care also extends to investment retention as well as selection and that it would be difficult, for example, to defend a decision to invest in and retain an all US T-Bill portfolio for a generation skipping trust with no income distribution requirements. Although, in many respects, §15-106 appears to relax the duty to monitor, it may, in fact, augment the importance of continued surveillance and monitoring in order to mitigate the likelihood of unsatisfactory future performance.

Section 15-106 reflects, to a great extent, a general principle of Scott's Law of Trusts (Restatement 2<sup>nd</sup>) which holds that the trustee cannot delegate the task of generating investment returns. Under this standard, it is natural for the trustee to seek a measure of protection by inserting exculpatory provisions into the trust instrument. Under, §15-114, which encourages delegation of the task of generating investment returns, it is probable that broad-scope exculpation language will be a less effective strategy for mitigating liability—especially in light of the statute's directive to supervise the performance of agents. As the

Reporter's commentary to Restatement 3<sup>rd</sup> suggests, it may be difficult to draft provisions that excuse trustees from performing fundamental duties that are inherent in the office: "The trustee's duties apply not only in making investments but also in monitoring and reviewing investments, which is to be done in a manner that is reasonable and appropriate to the particular investments, courses of action, and strategies involved."

#### WHAT'S THE RATE OF RETURN?

There are several components to an effective surveillance and monitoring program. The challenge to the attorney / trustee is to implement an academically sound and legally defensible program in a cost-effective and administratively practical manner. Generally, under modern standards of prudent asset management, the trustee will, at a minimum, want to have a quantitative measure of the portfolio's expected return and expected risk. If a trustee cannot articulate the risk/return tradeoff it is difficult to see how he or she can demonstrate the prudence of ongoing asset management decisions. If a trustee (or investment advisor!) has neither a clear idea of the portfolio's return nor its level of risk over applicable periods (i.e. last year, since inception, etc.), this omission may trigger future liability for breach of trust. Attorneys, however, practice law and, for the most part, cannot represent their clients' interests either cost-effectively or coherently if they must negotiate the intellectual maze that underlies investment performance evaluation. Therefore one remedy is to direct the investment agent (or commercial co-trustee) to report information in a format that provides clarity with respect to investment performance. We present some useful guidelines and provide some brief, non-technical insights into why a monitoring and surveillance program is critically important. In the majority of cases, the attorney / trustee will not want to be burdened with the tasks required to implement a rational system of performance reporting and evaluation; but, if investment agents are given well-designed guidelines, the attorney / trustee should only have to bear the responsibility for a brief periodic review to determine what, if any, actions need to be taken with respect to the portfolio.

The first step is to determine the portfolio's rate of return over relevant periods (quarter, year, since inception, etc.). For the sake of simplicity, discussion is limited to portfolios consisting entirely of publicly traded assets with easily determined valuations. Although many trust companies, brokerage houses, private money managers, financial planners, etc., provide detailed transaction ledgers as well as useful position summary statements, investment return calculations are sometimes missing. Furthermore, when returns are reported, they may not be comparable to the returns that the trustee sees in, for example, the mutual fund section of the newspaper. Thus, the trustee may not realize that certain return comparisons are "apples and oranges." In extreme cases, the attorney / trustee may unknowingly reach patently incorrect conclusions regarding the performance of the trust portfolio. A trustee, for example, maintains that a portfolio achieved a 20% yearly return over the previous two years. Further investigation reveals that the portfolio was up by approximately 80% in year one and down approximately 40% in year two. Averaging the rate of return difference (+40%) over the two-year period equals a +20% performance. Assuming no cash flows, however, the correct (continuously compounded) rate of return over the two years is 3.85%—a small return for an investment that evidences great risk.

Generally, returns are calculated under two measures: time weighted return (TWR) and dollar weighted return (DWR). The following example clarifies the difference between the two measures. Suppose a portfolio earns 10% in year one and 30% in year two. If \$1 is invested, the account balance at the end of year one is \$1.10. At the end of year two, it is

\$1.43. DWR answers the question “what interest rate compounds \$1.00 to \$1.43 over two years?” In this example, the answer is 19.58%. The DWR measure is helpful because it measures the rate at which wealth is growing.

Consider, however, the investor who puts an additional \$1.00 into the portfolio at the beginning of year two. The new contribution brings the account balance to \$2.10. During year two, the portfolio earns 30% and the ending balance is \$2.73. The portfolio’s DWR is 22.63%. Two investors who hold the same investment during the same time period achieve different returns! The difference is solely the result of cash flow activity. DWR is not a stable measure on which to judge investment results because it is sensitive to all interim contributions or withdrawals from the portfolio. In the example, the investor over weights dollars during periods of high return and under weights dollars during periods of low return. DWR is not an accurate performance measure of the portfolio’s underlying investments. DWR should not be used to measure investment performance for any portfolio with cash flow activity.

Time Weighted Return (TWR) unitizes the portfolio and accounts for cash flows by buying or selling an appropriate number of units each time a cash flow occurs. Thus, TWR calculates return per unit. It measures the investment unit’s rate of return performance not the rate of change in investor wealth. TWR is not sensitive to cash flows and is, therefore, the proper measure for determining investment return. Mutual fund returns in the newspapers, for example, are generally reported as Time Weighted Returns. Both return measures provide useful insights; and, the attorney / trustee should request that the investment agent report both numbers over all relevant planning periods. The trustee can determine how wealth is changing over time by reference to DWR; and can judge the value of the investment advice by reference to TWR. The distinction between DWR and TWR reporting is so crucial that the Association for Investment Management and Research (AIMR) suggests that performance presentations that lack TWR reporting may subject their membership to charges of malpractice.

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## PART II

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### WHAT'S THE RISK?

The black letter language of Restatement 3<sup>rd</sup>'s §227 (General Standard of Prudent Investment) instructs trustees to develop “an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.” It is not entirely obvious, however, why risk matters. The Wall Street aphorism: “no one ever spent a risk-adjusted dollar,” implies that a money manager’s focus should be on return rather than risk. Trustees however, are seldom charged with the task of maximizing return; rather, they are charged with maximizing the probability of a successful financial outcome “in light of the purposes, terms, distribution requirements, and other circumstances of the trust.” But the mathematics of prudent investing suggests that these two objectives are incompatible. Maximizing the chance of achieving maximum return is, in economic terms, a “maximize the maximum” or Max/Max strategy.

The opposite of a Max/Max strategy is a “minimize the minimum” or, Min/Min strategy. This is a strategy designed to maximize safety. We may view the ‘safety maximization function’ as the inverse of the ‘return maximization function.’ Following such a strategy, however, entails a significant opportunity cost. For example, the worst that could happen to an automobile driver is a fatal accident. An effective strategy for minimizing the minimum is never to drive a car. The opportunity cost is that the driver remains homebound—a price that most people would deem to be too high. It is easy to see the mistake of the Min/Min strategy. However, the mistake of the Max/Max strategy may be just as onerous. The true (high leverage) Max/Max strategy is a bankruptcy strategy given a sufficiently long planning horizon. Intelligent investment planning requires quantification of both risk and reward so that investors can make a good decision regarding the portfolio best suited to their economic needs and risk tolerance. Lacking explicit risk/reward guidelines, there can be no objective, independent standard against which the success or failure of trust administration can be measured.

One reason why risk matters is that losses hurt a portfolio more than equivalent percentage gains help. If a dollar loses 20%, the remaining \$0.80 must earn 25% in the next period in order to break even. A loss of 50% requires a 100% return to break even; and a loss of 90% requires a 1000% return to break even. The greater the magnitude of loss, the more difficult it is for the portfolio to recover. In mathematical terms, variance penalizes the wealth accumulation function. This phenomenon is known as “variance drain.” Variance is a statistical measure of the dispersion of actual returns over time from the average of the returns. The following example demonstrates the importance of knowing the variance statistic (or, the standard deviation statistic which is the square root of variance). Assume that both manager A and manager B produce a yearly return of 16%. Does a trustee care which one he engages to manage trust assets? Assume that each manager invests equal amounts in ten stocks with the following results:

Stocks	Manager A	Manager B
1	-2%	+16%
2	+2%	-3%
3	-1%	+22%
4	-9%	+17%
5	-2%	+15%
6	+108%	+29%

Manager A's track record reveals no ability to pick winning stocks. In fact, a single lucky bet is the source of the portfolio's returns. The variance statistic confirms this intuition. Manager A's variance is 18 times higher than that of Manager B. Given the variance of returns, it is difficult for Manager A to claim that he is skilled rather than lucky. Variance is commonly captured by the standard deviation statistic (the square root of variance), which measures the dispersion of returns. Dispersion is a good proxy for risk; and, the higher the dispersion, the more uncertainty regarding the likelihood of a successful outcome.

A quantitative measure of risk is crucial for prudent asset management. Investing funds based solely on speculative opinion is highly problematic. The variance statistic brings out the informational content of track record in a clear and useful form. Not only does it address the skill-versus-luck question; but, more importantly, it demonstrates likely future risk and return tradeoffs that confront the trustee. Risk matters; and, in capital markets, returns in excess of risk free securities cannot be achieved without taking risk. Thus, the second cornerstone of an effective monitoring system is the requirement that the agent responsible for generation of investment returns also reports the standard deviation of the returns (i.e. risk) over applicable planning periods.

#### **HORSE RACE OR PERFORMANCE BENCHMARK**

According to conventional wisdom it is easy to identify superior investment performance: simply line up money managers and let them run for a reasonable period of time—i.e. three or five years. The one that produces the greatest return is, by definition, the best manager. Undoubtedly, this “horse race” model is intuitively appealing, easy to monitor and administratively easy to implement.

Should investment performance be evaluated in a peer group context (i.e. a horse race) or should performance be compared to a pre-specified and appropriate benchmark? The answer to this question has profound implications. The peer group metric suggests that the trustee will seek hot-hand managers; the benchmark evaluation metric suggests that there is a predetermined yardstick by which to measure performance. Under the benchmark metric, the performance evaluation question reduces itself to whether the manager added or subtracted value relative to the benchmark. Under the horse-race metric, the performance evaluation question reduces itself to whether the manager produced better than average returns.

In an actual horse race, laying a bet might warrant examining the weather and track conditions under which the horse competed in past races; the horse's running times; the horse's jockey; the horse's trainer and training regimen, and so forth. This research is, of course, comparable to much investment research that explores past track records in order to forecast future outcomes. One problem is that, in the investment race, there is no racing commission that tests for steroids; and, a horse running on steroids might be only a race away from total collapse. Investment managers do not reveal portfolio strategies, investment valuation models, trading tactics, etc. This is proprietary information—the investor does not see how the game is played, he only sees the race results. But are the results a product of skill or luck? In the short term, a run of luck may produce a very attractive investment management record. Over a longer term, the top performing managers will likely be the ones that took the most risk. Seeking managers with top performance rankings is equivalent to selecting for portfolio strategies that carry significant risk—i.e. a probability of future underperformance. This is why the great majority of independent,

academic studies of the money management industry fail to find performance persistence even among the group of top-quartile managers.

The alternative to the horse race or peer group performance evaluation metric is a benchmark performance metric. A valid benchmark is:

- Unambiguous and Investable: the composition of the benchmark must be verifiable and; the benchmark should be available to investors as an alternative to hiring the manager;
- Measurable: benchmark returns are readily available;
- Appropriate: the benchmark matches the investment universe of the manager;
- Defined: the comparative benchmark must be specified in advance.

Once the benchmark is defined, investment returns are compared in order to determine whether the investor is adequately compensated for portfolio risk. Underperformance of a benchmark at a low level of risk is no more a sign of poor investment skill than out performance of the benchmark at a high level of risk is a sign of superior skill. The returns of the agent (or co-trustee) delegated to produce investment results can easily be levered up or down to match the risk level of the designated benchmark. The trustee simply has to look at the risk-adjusted return of the agent in order to determine whether the investment strategies add or subtract value relative to a passive low cost investment alternative.

Opting to use the horse race metric, however, forever condemns the evaluation process to an “apples and oranges” comparison. A closer examination of the characteristics of a valid benchmark suggests that the horse race metric fails most standards. The median manager’s portfolio is ambiguous; it cannot be pre-specified (indeed, you don’t know who the median manager will be until after the end of the period); and, the probability of the median manager’s portfolio aligning with the trust’s portfolio is extremely remote. The horse race metric tells the trustee who, in the long run, took the most risk; not who is the best manager.

It is reasonable for the attorney / trustee to require the investment agent to report accurately calculated return statistics, variance (or standard deviation) statistics and to provide a side-by-side comparison of results with a pre-specified benchmark. If a vendor of investment products or services cannot (or will not) provide basic information in a format that the trustee can use for performance evaluation, then the trustee is well advised to reexamine the prudence of continuing to delegate investment responsibilities to the agent.

#### **A SAMPLE REPORT TO THE ATTORNEY / TRUSTEE**

The following is a sample report that investment service providers can prepare for the trustee. The sample assumes a portfolio with a fixed asset allocation (i.e. no market timing activities). The asset management strategies of trusts differ markedly and the actual monitoring information may be very different depending on the degree of active vs. passive investment management, the degree of tactical vs. strategic asset allocation, and so forth. The point is that the attorney / trustee should expect to receive the information necessary to make preliminary evaluations of performance at no cost from commission-based advisors or as part of the priced service package of fee-based investment advisors. We illustrate a simple five asset class portfolio where the actual investments may be individual stocks and bonds, mutual funds, unit trusts, or other investment vehicles. We also assume that the trustee elects to invest in actively managed funds under the expectation that the investment

agents will be able to outperform comparable indices. Passively managed investments represent a reasonable and low cost alternative asset management strategy but they require different reporting formats. The following table presents the benchmark portfolio:

<b>Asset Class</b>	<b>Asset Allocation %</b>	<b>Proxy Index</b>
US Large Co. Stocks	25	S&P 500 Index
US Small Co. Stocks	15	Russell 2000 Index
Foreign Large Co. Stocks	15	MSCI EAFE Index
Foreign Small Co. Stocks	5	DFA Small Cap Foreign Index
US Bonds	40	Lehman US Corp/Gov't Index

As time unfolds, the trustee should maintain an unambiguous record of how well or poorly the investment agent performs relative to a pre-specified and unambiguous benchmark. That is to say, the attorney / trustee sets investment policy and implements a mechanism to supervise the agent within the guidelines of the policy. If, for example, the trustee determines that it is prudent to expose 15% of the trust portfolio to the risks and rewards of large company foreign stocks, careful and critical inquiry should be made if the agent deviates substantially from this target. In dynamic portfolios, the 15% target acts as the “normal” proxy and the broker or manager’s skill is evaluated by means of an attribution analysis [not shown] that compares the value added/subtracted from the proxy index because of stock selection and market timing (i.e. overweighting or underweighting the index weights from period to period). Setting up an appropriate monitoring and reporting template allows the trustee to consider a comprehensive set of information both cross-sectionally (relative performance within a period) and serially (relative performance across multiple time periods).

A cross sectional reporting template for above portfolio conveys the following sample returns:

<b>Actual Investment</b>	<b>Actual Time-Weighted Return</b>	<b>Benchmark Index</b>	<b>Index Return</b>	<b>Value Added/Subtracted</b>
US Large Stocks	8%	S&P 500 Index	12%	-4%
US Small Stocks	5%	Russell 2000 Index	7%	-2%
Int'l Large. Stocks	-2%	MSCI EAFE Index	-6%	+4%
Int'l Small. Stocks	4%	DFA Small Co. Foreign Index	3%	+1%
US Bonds	7%	Lehman US Corp/Gov't Index	8%	-1%
Return of the Actual Portfolio for the Period: 5.45%				
Return of the Benchmark Portfolio for the Period: 6.50%				
Annual Risk Free Rate (30 Day US T-Bills): 6%				

A similar reporting template for the portfolio conveys the following annual risk measures based on the standard deviation of monthly returns:

Actual Investment	Actual Investment risk	Benchmark Index	Proxy Index risk
US Large. Stocks	13%	S&P 500 Index	15%
US Small. Stocks	23%	Russell 2000 Index	26%
Int'l Large Co. Stocks	18%	MSCI EAFE Index	19%
Int'l Small Co. Stocks	26%	DFA Small Cap Foreign Index	28%
US Bonds	12%	Lehman US Corp/Gov't Index	11%
Risk (Standard Deviation) of the Actual Portfolio: 16.3%			
Risk (Standard Deviation) of the Benchmark Portfolio: 17.4%			

Finally, a risk-adjusted performance evaluation template conveys the following information:

Actual Investment	Reward to Risk Ratio*	Benchmark Index	Reward to Risk Ratio	Difference
US Large Stocks	.154	S&P 500 Index	.40	-0.246
US Small. Stocks	-.043	Russell 2000 Index	.038	-0.081
Int'l Large Stocks	-.444	MSCI EAFE Index	-.631	+0.187
Int'l Small. Stocks	-.076	DFA Small Cap Foreign Index	-.107	+0.031
US Bonds	.083	Lehman US Corp/Gov't Index	.181	-0.098
Actual Portfolio Reward to Risk Ratio: -.0337				
Benchmark Portfolio Reward to Risk Ratio: .0287				
Risk-Adjusted Return Shortfall: 4 basis points per year.				
* Reward to Risk Ratio = (Actual Return – Risk Free Return) ÷ Standard Deviation				

Based on the above data the trustee can readily determine if the investment agent is performing satisfactorily and can identify areas for critical inquiry. Specifically:

- 1) The fact that the actual portfolio has a slightly negative reward to risk ratio while the benchmark portfolio has a slightly positive ratio suggests that the investment program is not adequately compensating the trust for its risk exposure;
- 2) The portfolio added risk-adjusted value in two categories and subtracted value in three. The largest negative difference in ratio values occurs in the US large company stock asset class, which was the top earner in the actual portfolio. The largest positive difference in ratio values occurs in the foreign large company stock asset class, which was the poorest earner in the actual portfolio. This suggests that critical inquiries regarding investment strategies would most profitably be directed towards the apparent “winner” rather than the apparent “loser”—a counterintuitive finding.

Should the agent responsible for generating investment returns be fired for underperformance? Based on only one year’s results, it is not possible to make such a

determination. More to the point, however, is the fact that the actual portfolio's return (5.45%) was achieved at a lower level of risk (16.3%). We know that the benchmark portfolio earned 6.50% at a risk level of 17.4%. One critical question is: given the benchmark's performance, how much should the actual portfolio have earned at a 16.3% risk level. The answer to this question provides a true "apples to apples" comparison. A standard statistical adjustment [known as the M<sup>2</sup> statistic] calibrates return to risk. It indicates that the annual return shortfall of the actual portfolio amounts to merely 4 basis points on an adjusted basis.

The more salient issue is whether the investment positions deviate so far from the pre-designated proxy benchmarks that they will result in systematic future underperformance. But this is just another way to highlight the importance of written investment policy for prudent management of trust assets. The primary focus of the Court of Appeals in the Janes case was on the failure of the fiduciary to develop, implement and monitor an investment plan. Absent such a plan, mere reviews of investment performance were not evidence of procedural prudence. Without policy, the rationale for action may be unclear, and may rely on the random variable of forecasted investment returns. Investments cease to be evaluated in the portfolio context and the trusteeship becomes more an exercise in "treasure hunting" and stock forecasting than coherent asset management. Demanding, for example, that a broker use only five-star mutual funds (last year's horse-race winners) is a good example of how not to design a balanced, prudent and diversified portfolio.

A credible monitoring and surveillance program is easy to establish and simple to maintain. The ability to generate accurate calculations should be within the skill set of most investment agents; and a sound program evidences use of care skill and caution in the administration of the trust estate.