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# TRUSTEE INVESTMENT POWERS: IMPRUDENT APPLICATION OF THE PRUDENT MAN RULE

## I. Introduction<sup>1</sup>

The importance of the modern private trust is beyond dispute. The value of assets held in simple trusts alone amounts to many billions of dollars. Charitable, pension, and profit sharing trusts account for many billions more.<sup>2</sup> The decisions made by trustees holding these funds in trust portfolios are naturally subject to legal constraints. This note will evaluate one constraint, the prudent man rule, in light of modern capital market theory.

First, the current interpretation of the prudent man rule will be analyzed. Second, utilizing modern capital market theory, it will be shown that the investment field has changed so rapidly that it has left its legal restraints behind. Presently, the prudent man rule actually prevents the trustee from acting prudently in many circumstances. Finally, solutions will be proposed to remedy the gap between the present scope of administrative powers and the requirements of the investor under present economic conditions. Given the magnitude of trust investments, this analysis is of direct concern to both economists and lawmakers.

## II. The Prudent Man Rule: Prevailing Wisdom

### A. *Rationale Behind the Rule*

The law of trusts seeks to provide legal guidelines to govern trust policy, particularly when the settlor has not done so himself.<sup>3</sup> When a trust instrument does not define the trustee's investment powers, the law provides definitions by supplying guidelines which create a standard against which the trustee's performance will be measured. By applying certain guidelines in every instrument where the settlor is silent,<sup>4</sup> transaction costs<sup>5</sup> are reduced. One such guideline is the prudent man rule.<sup>6</sup>

### B. *The Development of the Rule*

The prudent man rule originated, practically speaking, in the 1830 case of

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1 This note is limited to the analysis of the prudent man rule of trustee investment powers with regard to investments in organized securities markets.

2 See generally J. COHEN & E. ZINBARG, *INVESTMENT ANALYSIS & PORTFOLIO MANAGEMENT* 662-731 (1970), P. HARBRECHT, *PENSION FUNDS AND ECONOMIC POWER* (1959).

3 Friedman, *The Dynastic Trust*, 73 *YALE L.J.* 547, 551 (1964) [hereinafter cited as Friedman].

4 R. POSNER, *ECONOMIC ANALYSIS OF LAW* at 195 (1973) [hereinafter cited as POSNER].

5 Transaction costs are costs involved in effectuating any transfer of rights or duties among parties. The price system does not operate without costs, e.g., brokerage costs. See Coase, *The Problem of Social Costs*, 3 *J. LAW & ECON.* 1, 15 (1960).

6 The alternative, the legal list approach, confines permissible trust investments to those listed either by the legislature or courts. This approach is no longer followed by the majority and will not be dealt with in this note. For the development of the legal list approach and its subsequent demise see Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 *OHIO ST. L.J.* 491 (1951).

*Harvard College v. Amory.*<sup>7</sup> The remaindermen of a trust brought suit alleging impermissible investment of the corpus in corporate stock which had declined in value. Upholding the investment, Justice Putnam stated:

All that can be required of a trustee, is that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.<sup>8</sup>

The rule thus imposes three duties on the trustee. First, he must exercise care in the selection of investments. Second, he must exercise skill in making the selection. Finally, he must exercise the caution that a reasonable trustee would exercise.<sup>9</sup>

When announced in 1830, this standard was in sharp contrast to the then prevailing English emphasis on conservation of principle.<sup>10</sup> Before the *Harvard College* rule was glossed by subsequent decisions, it provided for great flexibility in the administration of trusts.<sup>11</sup> Rather than drawing rigid distinctions between categories of "proper" and "improper" investments as was done later,<sup>12</sup> the trustee was given wide latitude to exercise his judgment when making investment decisions.

Before long the prudent man rule was burdened with detailed restrictions. Some courts, holding that a particular investment was improper, did so as a matter of law.<sup>13</sup> Other courts concluded that a particular investment decision was improper in a particular time and place and created rules which they regarded as universal in their application.<sup>14</sup> As the common law verified, two different approaches developed: a legal list rule and a modified prudent man rule.

The development of the modified prudent man rule over the last century<sup>15</sup> resulted in a distinction between speculative securities,<sup>16</sup> which were not proper investments for a trustee, and investment securities<sup>17</sup> in which investment was

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

8 *Id.* at 461. See also *In Re Cook's Trust Estate*, 20 Del. Ch. 123, 125, 171 A. 730 (1934); *Marshall v. Frazier*, 159 Ore. 491, 80 P.2d 42 (1938); RESTATEMENT (SECOND) OF TRUSTS § 227 (1959).

9 *Campbell v. Albers*, 313 Ill. App. 152, 39 N.E.2d 672 (1942); *In Re Walsh's Estate*, 171 Misc. 231, 12 N.Y.S. 2d 298 (1939); 90 C.J.S. Trusts § 247 (1965); G. BOGERT, TRUSTS AND TRUSTEES, (2d ed. 1960) Chapter 26.

10 3 A. SCOTT, TRUSTS § 227 (3d ed. 1967) [hereinafter cited as SCOTT].

11 "It is susceptible of being adapted to whatever conditions may arise in the evolution of society and the progress of civilization." *Kimball v. Whitney*, 233 Mass. 321, 331, 123 N.E. 665, 666 (1919).

12 "Do what you will; the capital is at hazard." *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 at 460.

13 SCOTT, note 10 *supra*, § 227.

14 *Id.*

15 See Shattuck, *The Massachusetts Prudent Man in Trust Investments*, 25 B.U.L. REV. 307, 319-47 (1945); Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L.J. 491, 491-96 (1951).

16 Speculative securities carry a high risk of capital loss and are purchased primarily for short-term profit.

17 Investment securities carry a low risk of capital loss and are purchased primarily for short-term profit.

proper. *Kimball v. Reding*<sup>18</sup> is an early case making this distinction. The New Hampshire court held that an investment in shares of stock in a contemplated railroad was speculative and improper unless authorized by the terms of the trust. In adapting this rule against speculative investments, the New Hampshire court narrowed the standard of prudence set forth in *Harvard College* and trustee investment powers suffered a corresponding diminution.

Many states followed the lead of *Kimball v. Reding*, holding that certain types of investments are proper and others are "forbidden fruit." Among the "forbidden fruit" were included: securities in new and untried enterprises,<sup>19</sup> shares in a speculative corporation,<sup>20</sup> bonds selling at a large discount due to uncertainty of payment at maturity,<sup>21</sup> and the purchase of securities on margin or the "selling short" of a security.<sup>22</sup> A trustee had not performed his duty merely by avoiding "forbidden fruit"; he was also required to use care, skill, and caution in selecting any particular investment.<sup>23</sup>

Prior to making even a permissible investment, it is the duty of the trustee to use reasonable care in determining the safety of the investment and the probable income it will yield.<sup>24</sup> This typically involves securing information from sources on which prudent men in the community rely.<sup>25</sup> Having made the investigation, the trustee is under a duty to exercise a reasonable degree of skill in selecting an investment.<sup>26</sup> In reaching this decision, the trustee must act with caution not only of a prudent man, but of a prudent man whose primary concern is the preservation of the funds invested and the income to be derived from the investment.<sup>27</sup>

Thus the modified prudent man rule imposes two restrictions on the trustee.<sup>28</sup> First, the investment must be of a type which trustees can properly make. In many states this requirement has crystallized into holdings that certain types of investments are proper and others improper. Second, if it is an investment of that type, the particular investment must be proper. The investment is proper if at the time it was made the trustee exercised care, skill, and caution in the selection of that investment.

Because of the detailed restrictions inherent in the modified prudent man

18 31 N.H. 352, 64 Am. Dec. 333 (1885).

19 See, e.g., *In Re Dickinson*, 152 Mass. 184, 25 N.E. 99 (1890) (stock in a new railroad company); *In Re McDowell*, 102 Misc. 275, 169 N.Y.S. 853 (1918), (bonds of companies engaged in new ventures).

20 See, e.g., *In Re Cady's Estate*, 211 App. Div. 373, 207 N.Y.S. 385 (1925) (oil stocks); *St. Germaines v. Tuttle*, 114 Vt. 263, 44 A.2d 137 (1945) (shares of a corporation heavily indebted, which had not declared a dividend in two years and whose business was declining).

21 *In Re Kohns' Estate*, 158 Misc. 853, 286 N.Y.S. 930 (1936).

22 See, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bacoek*, 247 F. Supp. 373 (S.D. Tex. 1965).

23 *Campbell v. Albers*, 313 Ill. App. 152, 39 N.E.2d 672 (1942); *Delafield v. Barret*, 270 N.Y. 43, 200 N.E. 67 (1936). See also, RESTATEMENT (SECOND) OF TRUSTS § 227, comment (m) for a listing of factors which a trustee should consider when choosing among authorized investments.

24 SCOTT, note 10 *supra*, § 227.1, RESTATEMENT (SECOND) OF TRUSTS § 227, comment (b). See also *Tuttle v. Gilmore*, 36 N.J. Eq. 617 (1883).

25 RESTATEMENT (SECOND) OF TRUSTS § 227 comment (b).

26 SCOTT, note 10 *supra*, § 227.2; RESTATEMENT (SECOND) OF TRUSTS § 227, comment (c).

27 RESTATEMENT (SECOND) OF TRUSTS § 227, comment (e). See also *In Re Ebert*, 136 N.J. Eq. 123, 40 A.2d 805 (1945).

28 See SCOTT, note 10 *supra*, § 227.

rule, much of the flexibility of the *Harvard College* approach has been lost. This loss of flexibility has handicapped trustees who must make effective investment decisions under current economic conditions. This is a major cause of the current dissatisfaction with the modified prudent man rule.

### C. *Dissatisfaction With the Rule*

Behavior which is legally "prudent" is not necessarily in conformity with the contemporary economic definition of prudence.<sup>29</sup> Recognizing this inconsistency between legal and economic standards, one commentator has concluded that:

From one side of his mouth the chancellor admonishes the trustee to manage the property as a prudent man would manage his own; from the other side he warns him and all who deal with him that the law in its wisdom will not permit prudent management according to twentieth century standards.<sup>30</sup>

In order to fully understand the effect of the reduction in flexibility imposed upon trustees by the modified prudent man rule which bans investments in speculative securities, it is necessary to recognize that the purposes underlying trust formation may differ. Differences in purpose necessarily place upon the trustee different demands.

Private express trusts may be divided into two general types according to their underlying purposes.<sup>31</sup> The first, caretaker trusts,<sup>32</sup> are usually short-term and designed to protect the interests of particular beneficiaries. The demands of a caretaker trust are flexibility in its beneficial provisions in order to serve the needs of the beneficiaries and elaborate safeguards on investment discretion in order to preserve the safety of the principal and carry out the trust purposes. Possible gains from a bold investment policy are not worth the risk that the beneficiary's inheritance be dissipated.<sup>33</sup>

The second, dynastic trusts, are usually long-term and established to perpetuate the estate.<sup>34</sup> The overriding need of a dynastic trust is administrative flexibility. Rigid rules of investment policy would cripple the trust, for, in order to survive under changing investment market conditions, it must be able to shift the investments as the economy changes over the years.<sup>35</sup>

By failing to come to grips with the dynastic trust as a distinct trust type, American jurisprudence has discriminated against the dynastic trust. Applying rules more appropriate for the regulation of caretaker trusts, the law fails to provide the flexibility required by dynastic trusts. The reason for this bias against dynastic trusts is largely historical. The modified prudent man restriction on powers of trust administrators was developed during a period when the com-

<sup>29</sup> See text accompanying notes 40-81 *infra*.

<sup>30</sup> Fratcher, *Trustees' Powers Legislation*, 37 N.Y.U.L. REV. 627, 658-59 (1962).

<sup>31</sup> Friedman, note 3 *supra*, at 547.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 551.

<sup>34</sup> *Id.* at 547-549. Pension funds and university endowment funds are common examples of dynastic trusts.

<sup>35</sup> *Id.* at 551.

mon trust type involved was the caretaker trust. The need for flexible investment powers was thus minimal.<sup>36</sup> As dynastic trusts have grown in importance, the law has attempted to apply to both long and short trusts rules more appropriate for regulation of short-term trusts.<sup>37</sup>

If regulations are to permit the flexibility necessary for the effective administration of dynastic trusts, there must be a return to the flexible prudent man rule as it was initially stated in *Harvard College*. This revival of the rule as originally stated would provide the flexibility needed for the application of the appropriate rules for dynastic trusts as outlined by modern capital market theory. Such a revision<sup>38</sup> of the prudent man rule would result in the coincidence of legal and economic definitions of prudence and would provide trustees with more realistic and specific guidelines.

### III. Economic Approach to Investment Choice: Theory and Application<sup>39</sup>

Modern capital market theory seeks to determine the prices of securities under conditions of uncertainty in a market which is in equilibrium.<sup>40</sup> It is in reality a combination of separate theories concerning risk, investor reaction to risk, and the efficiency of securities markets. The following discussion will establish the analytical underpinnings of modern capital market theory, derive implications as to investor behavior, and evaluate its application to the prudent man rule of trust law.

#### A. Modern Capital Market Theory

Inherent in the concept of investor prudence is the element of risk. The prudent man rule is essentially a legal standard regulating the maximum level of acceptable risk appropriate for a given trust investment; however, it is based upon an incomplete concept of risk, the risk of capital loss. This concept of risk assumes that trust beneficiaries are concerned exclusively with capital losses, rather than with all possible future values of their investments. As such, this approach ignores the probabilities associated with these other possible values. Economic risk is concerned not only with the risk of capital loss but also with all possible future deviations from that which was expected. This uncertain measure of risk<sup>41</sup> is in marked contrast to the legal approach which concentrates exclusively

36 See Fratcher, *Trustees' Powers Legislation*, 37 N.Y.U.L. Rev. 627 (1962).

37 The same rules could hardly apply to both dynastic and caretaker trusts, since they differ in function and legal needs. See Friedman at 550-51.

38 Undoubtedly revision is needed. In recent years there has been a more scientific study of investments, yet the results of this study are not reflected in the cases. See Scott, note 10 *supra*, § 227 and text accompanying notes 40-78 *infra*.

39 Given the long-term nature of a dynastic trust it is particularly well suited to modern capital market theory. Therefore, the application of modern capital market theory for purposes of this note will be limited to dynastic trusts.

40 Equilibrium is a state of rest, *i.e.*, the attainment of a position from which there is neither incentive nor opportunity to move. The equilibrium price is one from which there is no tendency to move, so long as the underlying supply and demand conditions do not alter. See also R. LEFTWICH, *THE PRICE SYSTEM AND RESOURCE ALLOCATION* 358 (1970); G. STIGLER, *THE THEORY OF PRICE* 93 (3d ed. 1972).

41 The statistical measure of uncertainty risk, standard deviation, measures the width of the random variables' probability distribution. For the purpose of simplicity this note will

on capital loss. The narrow legal concept of risk is but a subcategory of the more general concept of uncertainty risk. Because of this, exclusive concentration on capital loss can lead to imprudent investment decisions since it is possible that one portfolio may exhibit greater economic risk than another, even though that portfolio has a lower probability of capital loss.<sup>42</sup> By not limiting its inquiry to capital loss, the economic concept of risk incorporates more available investment information and, therefore, provides a more complete measure of risk. The economic concept of risk is thus a more appropriate index of risk because it considers every possible future deviation.<sup>43</sup>

In addition to being a more appropriate index of risk, the economic concept of risk emphasizes the relationship between the risk of an individual security and the risk of a portfolio.<sup>44</sup> This is a significant contribution since the risk of a portfolio is not the simple arithmetic mean of the average risk of the individual securities but rather the covariance<sup>45</sup> among the individual securities within the portfolio. In fact, with a large, well-diversified portfolio, the effect of the independent risk of a security upon the portfolio is likely to be quite small, almost trivial, relative to the effect of the security's covariance with the portfolio.<sup>46</sup> It is therefore possible to reduce the risk of the portfolio as a whole by the addition of a speculative security.<sup>47</sup>

Thus, the owner of a diversified portfolio is shielded against factors operating to depress the securities of a particular firm or market because such factors usually tend to improve the earnings of some other firm or market.<sup>48</sup> An index of risk which measures a security's risk without consideration of the effect of that security upon a portfolio is incomplete and meaningless<sup>49</sup> because the effect of a single security's independent risk upon a portfolio is minute. Therefore, the true economic measure of a security's risk is its contribution to portfolio risk.

Modern capital market theory also recognizes that investment decisionmaking under uncertainty is two-dimensional. The two relevant dimensions are the expected return and the degree of risk.<sup>50</sup> Every investor faces a trade-off: he will incur greater amounts of risk only if compensated by increased returns. The in-

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assume a normal distribution. This assumption does not detract from the analysis which can be generalized to nonnormal symmetric stable distributions. See Fama, *Portfolio Analysis in a Stable Pareto Market*, 11 *MANAGEMENT SCIENCE* 404-419 (1965).

The use of the term *risk* for the remainder of this note will be restricted to its economic connotation, unless otherwise specified.

42 Note, *The Regulation of Risky Assets*, 83 *HAR. L. REV.* 603, 619 (1970).

43 *Id.*

44 *Id.*

45 Covariance is the degree to which two variables move together.

46 For a demonstration of this fact see E. FAMA & M. MILLER, *THE THEORY OF FINANCE* 253-55 (1972).

47 H. MARKOWITZ, *PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENT* 112-115 (1959).

48 POSNER at 192. Approximately ninety percent of the independent risk in a portfolio can be eliminated through diversification by the inclusion of only ten randomly selected stocks. Therefore, investors can easily obtain a combination of assets that will approximate the market. See Evans and Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 *JOURNAL OF FINANCE* 761 (1968).

49 See E. FAMA & M. MILLER, note 46 *supra* at 291.

50 See, M. HAMILTON & J. LORIE, *STOCK MARKET: THEORY AND EVIDENCE X-3* (Oct. 1972) (unpublished manuscript, University of Chicago Graduate School of Business) [hereinafter cited as LORIE].

vestor does not choose between risk minimization and return maximization but rather seeks the maximization of return for a given degree of risk.<sup>51</sup>

In equilibrium, the price of any security will be a function of two components.<sup>52</sup> The first is a risk-free rate of return.<sup>53</sup> The second is a risk premium which compensates the investor for incurring the risk associated with the return. Investors, of course, are compensated only for a particular kind of risk—market risk.<sup>54</sup> Independent risk<sup>55</sup> can be eliminated through diversification.<sup>56</sup> Since investors do not have to bear independent risk, they are not compensated for it. Thus, an investor who wishes to increase his expected return must do so by increasing his exposure to market risk and not to independent risk.<sup>57</sup>

Then, too, capital assets are priced in an efficient market.<sup>58</sup> The prices of securities in an efficient market fully reflect available information and adjust quickly and in an unbiased manner to new information.<sup>59</sup> “The implication is not that every stock is correctly valued at every moment in time but that the cost of finding out whether or not it is correctly valued will usually exceed the profits to be made from knowing its true value.”<sup>60</sup> The analysis of past price changes and public information provides no help in achieving increased returns in an efficient market. Investors can increase their expected return only through risk manipulation and not by attempting to presage general market movements.<sup>61</sup>

The concepts of modern capital market theory, uncertainty as a measure of risk, risk-return relations, and the efficiency of capital markets will now be used to derive a modern standard of prudence.

51 *Id.*

52 See Linter, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 *REVIEW OF ECON. & STAT.* 13 (1965); Linter, *Security Prices, Risk, and Maximal Gains from Diversification*, 20 *JOURNAL OF FINANCE* 587 (1965); Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 *JOURNAL OF FINANCE* 425 (1964). For a clarification of the Sharpe-Linter models see Fama, *Risk, Return, and Equilibrium: Some Clarifying Comments*, 23 *JOURNAL OF FINANCE* 29 (1968).

53 The return on short-term federal government securities is a good example of a security with a risk from rate of return.

54 Market risk is that portion of a security's risk which is related to the risk of all other securities in the capital market. See F. Black, *Capital Market Theory: An Introduction*, 4 (Feb. 1972) (University of Chicago Graduate School of Business, Wkg. Paper Ser. No. 24B).

55 Independent risk is the risk that a security will decline in price independently of whether the market as a whole is rising or falling. See Black *id.*

56 See LORIE, note 50 *supra*, XI at 10, 11; W. SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* 77-103 (1970); E. FAMA AND M. MILLER, *THE THEORY OF FINANCE* 253-255 (1972).

57 This is accomplished through leverage, use of debt, and not by concentration in riskier securities. See G. Bigger, *Risk-Adjusted Portfolio Performance: Its Investment Implications* 32 (1971) (Smith Barney & Co.: Research Development).

58 The term commonly used to describe this situation is that security prices follow a random walk i.e., the successive price changes are statistically independent. For the evidence on this fact see Fama, *The Behavior of Stock Prices*, 38 *JOURNAL OF BUSINESS* 34 (1965); Granger & Morgenstern, *Spectral Analysis of New York Stock Market Prices*, 16 *KYKLOS* 1-27 (1963); c.f. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 35 *JOURNAL OF FINANCE* 383 (1970).

59 The implication is not that every stock is correctly valued at every moment in time, but that the cost of finding out whether or not it is correctly valued and the costs of effectuating the transition will usually exceed the profits to be made from knowing its true value. See Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, *id.*

60 POSNER, note 4 *supra*, at 193.

61 Costs of search and underdiversification entailed by attempts to “beat” the market will generally exceed the returns of such activity. See Black, *Implications of the Random Walk Hypothesis for Portfolio Analysis*, *FINANCIAL ANALYST JOURNAL* 1 (Mar.-Apr. 1970).



### B. Prudence Under Modern Capital Market Theory

In an efficient market, the expected return on a portfolio will depend more on the amount of risk incurred than on any secret knowledge or the special abilities of the portfolio manager.<sup>62</sup> Therefore, in an efficient market an investor should follow a passive portfolio strategy.<sup>63</sup> The specific requirements of such a strategy are high diversification, low turnover, risk control, minimization of management fees, and minimization of taxes.

High diversification is a practical necessity given the fact that investors are not compensated for bearing independent risk and the only manner in which independent risk can be eliminated is through diversification. In an efficient market, attempts to anticipate market movements will be counterproductive since they will generate needless brokerage expenses and management fees as well as an unstable risk level. As such, a passive portfolio strategy will eschew such actions. Finally, the investor with a passive portfolio strategy must also consider whether any gains or losses should be realized for tax purposes and whether any realized gain can receive capital gains treatment.<sup>64</sup>

Modern capital market theory not only suggests this type of passive investment strategy but also provides the necessary tool for formulating and evaluating a particular investor's conduct within it. Precise mathematical specifications replace vague standards like "prudence" or "reasonableness."<sup>65</sup> The availability of such tools makes investment decisions more precise and rational. This analytical framework provides the necessary background for a comparison of modern capital market theory and the prudent man rule.

### C. Modern Capital Market Theory and the Prudent Man Rule

The current law of trustee investment powers suffers from the vagueness of its governing standards. Prudence, according to the Uniform Probate Code, requires that a trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another.<sup>66</sup> Thus, the prudent man rule has no fixed meaning.

The erroneous legal approach to risk and the failure of the law to differentiate between types of trusts has resulted in the misapplication of the prudent

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62 See R. BREALEY, SECURITY PRICES IN A COMPETITIVE MARKET 211 (1971). See also, Ambachtsheer, *Portfolio Theory and the Security Analyst*, FINANCIAL ANALYST JOURNAL 53 (Nov.-Dec. 1972).

63 A passive portfolio strategy implies that an investor should follow a buy-and-hold strategy, keeping turnover low, and not act on information on specific stocks. This is in contrast to an active portfolio strategy in which the investor concentrates his holdings in stocks he believes will perform well, and exchanges one stock for another whenever he gets new information. See F. Black, *Capital Market Theory: An Introduction*, note 54 *supra* at 3.

64 See LORIE, note 50 *supra*, at XIV-15. A logical consequence is the necessity for utilizing tax loss sales.

65 The mathematical specifications are the correlation and the beta coefficients. The prescription of a beta, measure of market sensitivity, would control the relative risks of the portfolio and serves as a measure of the trustees' effectiveness to control risk. The prescription of a correlation coefficient, the degree to which two variables move together, measures the diversification of the portfolio relative to a comprehensive market index. See LORIE, note 50 *supra*, at XV-6 and glossary.

66 UNIFORM PROBATE CODE § 7-302.

man rule. The worst effect of this approach is the judicial concern with the narrow concept of individual security rather than with portfolio risk: "However well the portfolio performs, the trustee may be held accountable for the poor showing of one of his investments in the portfolio if he failed to verify the soundness of the investment before making it."<sup>67</sup> This narrow focus fosters several undesirable consequences.

First, trustees are under a duty to investigate the prospects of individual securities,<sup>68</sup> even though in an efficient market the costs of search will generally exceed the expected benefits. In addition, the trustee is obligated to review continuously the trust portfolio and dispose of investments originally proper which have subsequently become improper.<sup>69</sup> The trustee is thus under a duty of active portfolio management despite the fact that actively managed portfolios rarely outperform comparable passive portfolios.<sup>70</sup> The result is increased management and transactions costs without any corresponding increase in benefits.

Second, and perhaps most serious, the investment-by-investment application of the prudent man rule induces the trustee to hold underdiversified portfolios.<sup>71</sup> The requirement that a trustee investigate and monitor each security he holds will limit the number of securities which will be held. A trustee, being limited in investigative and monitoring capabilities by time and expense, will hold fewer types of securities as the burden for justifying each security is increased. The diseconomies of underdiversification are compounded because of the prohibitions against purchasing speculative securities.<sup>72</sup> The trustee is precluded from considering a number of securities which, although risky from an independent standpoint, may actually lower the risk of the portfolio if included therein.<sup>73</sup> The result of this underdiversification is the exposure of the trust to large amounts of uncompensated independent risk.

Third, the present legal approach concentrates exclusively upon only one aspect of a security, its independent risk, and fails to recognize the existence of the risk/return trade-off.<sup>74</sup> Rather than viewing the decision as one of minimizing risk, one should assess the maximum degree of risk that can be tolerated and

67 POSNER, note 4 *supra*, at 196. See also SCOTT, note 10 *supra*, § 227.1.

68 See, e.g., *In Re Harmon's Estate*, 60 Cal. App. 154, 212 Pac. 399 (1923) (loan on mortgage without investigating the nature of land); *In Re Cook's Estate*, 20 Del. Ch. 123, 171 A. 730 (1934) (purchase on recommendation of broker without independent investigation); *Tuttle v. Gilmore*, 36 N.J. Eq. 617 (1883) (no investigation of real estate).

69 See SCOTT, note 10 *supra*, § 231. See also *State Street Trust Co. v. Walker*, 259 Mass. 578, 157 N.E. 334 (1927) (mortgage on depreciating property).

70 As to evidence regarding the inability of active portfolio management to outperform passive portfolios see M. JENSEN, *STUDIES IN THE THEORY OF CAPITAL MARKETS* (1972). The problem is that one is rarely able to gain enough from active portfolio management to consistently offset his transaction costs.

71 The analysis of mutual fund performance suggests that active portfolio management will not result in superior results over a comparable portfolio. By analogy one would expect the same fact to hold true for trustees. See Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 *JOURNAL OF FINANCE* 389 (1968); Sharpe, *Mutual Fund Performance*, 39 *JOURNAL OF BUSINESS* 119 (1966).

72 POSNER, note 4 *supra*, at 196.

73 See text accompanying notes 3-38 *supra*.

74 See text accompanying notes 39-78 *supra*.

select a portfolio that fits this description.<sup>75</sup> By so doing, the investor's return would be maximized consistent with his preference for risk.<sup>76</sup>

Furthermore, the present legal emphasis upon individual assets leads to undesirable tax consequences since the taking of capital losses for tax purposes is discouraged. One court has stated ". . . losses in one investment of trust funds cannot be set off against other investments of the trust and each investment must stand or fall by itself."<sup>77</sup> A truly prudent investor would plan to use every legal means necessary to avoid taxes.<sup>78</sup> Yet the law, developed in a century when such tax problems did not exist, inhibits the trustee from acting prudently as to taxes.

The prudent man rule, because of its evolution, is outdated and inadequate. The present interpretation is based upon incomplete and erroneous suppositions, resulting in the rule actually preventing the trustee from acting prudently. The law must focus on a more rational concept of administrative powers if this problem is to be solved.

#### IV. Proposed Remedies

The problem of modernizing trustee investment powers should be approached in two stages. The first stage concerns the short-term resolution of the problem through the drafting of appropriate trust provisions which mitigate the limitations that are imposed by trust law in the absence of such language. The second stage concerns the long-term resolution of the problem through statutory reform.

Trustee investment powers can be enlarged by the terms of the trust; however, the extent of the enlargement is a question of interpretation which the courts are likely to interpret rather strictly.<sup>79</sup> Trust provisions authorizing a trustee to make investments "in his discretion" do not extend the trustee's powers beyond those of a prudent man.<sup>80</sup> Courts do not favor attempts to release the trustee from the general obligation of prudence by means of trust provisions granting unlimited discretionary investment powers. What is needed, therefore, is a trust clause which does not remove the obligation of prudence entirely, but rather defines the standard of prudence to be used in a manner that can be objectively applied and evaluated.

Such a clause would give the trustee full investment powers by delineating under the definition of "prudence" desired portfolio management goals: high diversification, low turnover, risk control, and the minimization of taxes and management fees. The clause would also allow the trustee to defend any investment by demonstrating its favorable effect on the portfolio. The clause would thus incorporate the basic principles of modern capital market theory by redefining prudence, but it would not do away with the general obligation of prudence.

<sup>75</sup> R. BREALY, *SECURITY PRICES IN A COMPETITIVE MARKET* 211 (1971).

<sup>76</sup> This is due to the fact that risk and return are, on the average, positively related.

<sup>77</sup> *McKechnie v. City of Springfield*, 311 Mass. 406, 414, 41 N.E.2d 557, 561 (1942); see also *Creed v. McAleer*, 275 Mass. 353, 175 N.E. 761 (1931).

<sup>78</sup> Buek, "Qualified" Trustee Performance, 99 *TRUSTS AND ESTATES* 194 (1960).

<sup>79</sup> See SCOTT, note 10 *supra*, § 227.14.

<sup>80</sup> *In Re Davis*, 183 Mass. 499, 67 N.E. 604 (1903) (broad discretion did not relieve the trustee from the requirement of the general rule regarding prudence).

The second stage of this proposed solution would dispose of the problem through statutory reform. A statute building upon the Uniform Trustees Powers Act could be used to remedy the current problem of outmoded trustee investment powers. This statute would have three major sections. First, it would define risk in terms of uncertainty rather than simply as risk of loss. The standards for holding an investment undesirable would consequently change from risk of loss to deviation from rational expectations. Second, the statute would specify precise standards of prudence corresponding to the basic principles of modern capital theory. Third, such a statute would shift the law's emphasis away from the risk of individual securities to the risk of entire portfolios. This would be accomplished by allowing the investor to defend any investment by showing that it affected the portfolio favorably.<sup>81</sup> Such a statute, by incorporating the basic principles of modern capital market theory, would conform trustee investment powers to twentieth-century economic reality.

### V. Conclusion

The economic impact of private trusts is significant and necessitates substantial revision of the prudent man rule. The trustee of today no longer acts as caretaker passing blackacre from generation to generation. Instead, he usually holds a dynastic trust portfolio consisting of various types of securities. He, therefore, needs much broader and more flexible investment powers than his historical counterpart. Failure to recognize the distinction between dynastic and caretaker trusts has inhibited the development of trustee investment powers to the prejudice of the dynastic trust.

The solution to this problem is not the abolition of the prudent man rule but rather the redefinition of prudence to conform to modern capital market theory. The basic concepts of modern capital market theory, the uncertainty measure of risk, the risk-return relation, and the efficiency of capital markets, imply specific standards of prudence. These standards of prudence, high diversity, low turnover, minimization of taxes and management fees, and risk control, would be implemented in a two-step process. To resolve the problem over the short term, trust clauses should be drafted which implement modern capital market theory by defining prudence in terms of that theory. The problem cannot be fully solved, however, until the goals of modern capital market theory become those of our state legislators.

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81 Note, *The Regulation of Risky Investments*, 83 HAR. L. REV. 603, 625 (1970).