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Strengthening the Passivity Default

*Ian Ayres**
*Edward Fox***

In *The Prudence of Passivity*, Bryon Harmon and Laura Fisher (hereafter HF) argue that "passive management become the default approach for the investment of trust funds, to be abandoned only when circumstances specifically dictate the use of active management."[1] In this comment we argue that their thesis could be strengthened (i) by more clearly distinguishing between default law and default investment practices, (ii) by more clearly articulating their favored altering rules.

I. A Clear Legal Default

At times, HF use the term "default" to merely mean "standard" or "normal" as in their claim: "Traditionally, most trustees, like most investors generally, also seemingly view a conventional active management approach as the default approach (or even the exclusive approach) to investing trust funds."[2] But for legal scholars, the more relevant question is whether trust law imposes a default duty on trustees to invest passively. A default legal duty would bind trustees unless the default was displaced – which entails an analysis of trust law's altering rules.[3]

HF at other times seem to be using "default" to mean something close to a default legal duty. For example, when they assert, "[A]s a default approach, passive investing is more likely to meet a trustee's core duties: the duties of loyalty and prudence and their derivative obligations to administer the trust solely in the interests of the beneficiaries and to minimize costs and expenses."[4]

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1 Bryon W. Harmon & Laura A. Fisher, *The Prudence of Passivity: An Argument for Default Passive Management in Trust Investing*, 44 ACTEC L.J. 147 (2019).

2 *Id.* at 150; similarly see *id.* at 148.

3 Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032 (2011).

4 Harmon & Fisher, *supra* note 1, at 150; *see also id.* at 168 ("A default rule in favor of a passive investment approach will increase the likelihood that most trustees will achieve [the] fundamental goals integral to the fulfillment of their duties of loyalty and prudence . . . .").

This lack of clarity is perhaps emblematic of the state of trust law on this question. We have argued elsewhere[5] that the trustee's fiduciary duties should be read together to create a default duty not to invest actively, unless she separately calculates the costs of this strategy in terms of added risk and fees and reasonably concludes that investing actively will produce sufficient excess returns (or "alpha") to justify these additional costs. Our reading of the law accords with the Restatement (Third's) approach, whose official comments state,

> If the extra costs and risks of an [active] investment program are substantial, these added costs and risks must be justified by realistically evaluated return expectations . . . . [The] gains from the course of action . . . [must] reasonably be expected to compensate for its additional costs and risks.[6]

Under this reading of trust law, HF would be reiterating that the Restatement's current legal default is optimal. But as we have pointed out, the Restatement's presumption against active investing has not been adopted by courts in litigation. We found that "no court appears to have quoted or cited this comment since it was published in 1992."[7]

So a first way to improve the passivity default is to have more explicit judicial and statutory recognition that it exists. HF say that "passive investing is more likely to meet a trustee's core duties . . . of loyalty and prudence,"[8] but it would be useful for the law to more clearly recognize that active investing presumptively fails to meet a trustee's duty of prudence. A clear statement of a default duty of passive investing could take a form parallel to the trustee's duty under the UPIA to diversify "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[9]

II. Clearer Altering Rules

The beauty of legal default rules is that they do not restrict freedom of contract. A settlor under a no-active investment default would still be

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[5] Ian Ayres & Edward Fox, *Alpha Duties: The Search for Excess Returns and Appropriate Fiduciary Duties*, 97 Tex. L. Rev. 445, 496 (2019) (This rule would apply if the active investment in question would entail substantial costs in terms of under-diversification, excess fees, and/or sub-optimal exposure to market risk compared to a passive baseline.).

[6] Restatement (Third) of Trusts § 90 cmt. h(2) (Am. Law Inst. 2007). This section was initially published in 1992, before much of the rest of the Third Restatement.

[7] Ayres & Fox, *supra* note 5, at 497.

[8] Harmon & Fisher, *supra* note 1, at 150.

[9] Uniform Prudent Investor Act § 3 (Unif. Law Comm'n 1994); *see also* Restatement (Third) of Trusts § 90(b).

free to contract around the default and direct or authorize a trustee to invest actively.

But default rules necessarily have associated altering rules – the legal rules establishing the necessary and sufficient conditions for displacing or altering a legal default.[10] We believe HF would do well to more explicitly consider these altering rules. The Restatement comment quoted above already hints at a set of altering rules when it says "these added costs and risks must be justified by realistically evaluated return expectations."[11] This suggests that a trustee must undertake a cost-benefit analysis before displacing the passivity default and investing actively.[12] In addition, the trustee's existing duty to keep adequate records would also include contemporaneously recording the reasoning and calculations underlying this cost-benefit analysis.[13]

The problem with the Restatement approach is that it doesn't clarify how much expected alpha is necessary to justify the extra fees and necessary diversification losses of active investment.[14] We have attempted to quantitatively estimate the size of the expected alphas required to offset these costs. We find that an average investor would need to expect to beat the market each year by 6-15% to entirely forego the benefits of diversification and invest solely in a single stock.[15] In addition, we find that during times of crisis, trustees need higher expected

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[10] Ayres, *supra* note 3, at 2033.

[11] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. h(2).

[12] One small quibble that we have with HF's analysis of this section is their claim: "Logically, therefore, the costs associated with active management are not justified unless they realistically can be expected to produce returns in excess of their necessarily higher fees or provide a diversification benefit not otherwise available." Harmon & Fisher, *supra* note 1, at 173 (citation omitted). The authors' suggestion that active management can "provide a diversification benefit not otherwise available" misunderstands both the Restatement and modern portfolio theory. Active investment necessarily sacrifices diversification, because the process of selecting a subset of investments that one believes will beat the market entails exposing the portfolio to some idiosyncratic risk. *See* Ayres & Fox, *supra* note 5, at 449, 463-64 ("Actively managed funds . . . require some diversification sacrifices because the fund managers must pick a limited number of firms that they believe will outperform the market."). The Restatement approach implicitly reflects this by requiring trustees to justify taking on both the "extra costs and risk" of active investment. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. h(2).

[13] As discussed in Ayres & Fox, *supra* note 5, at 499, many professional fiduciaries already have investment protocols that require this kind of alpha justification for underdiversified portfolios with single holdings making up more than 10 or 20% of the trust's assets.

[14] *See id.* at 497. We observed there that perhaps the failure of courts to cite the Restatement "is not surprising: before our work [in *Alpha Duties*] there have been few attempts to systematically estimate the size of offsetting alphas, and these figures are needed to make the calculations that the Restatement seems to call for." *Id.*

[15] *Id.* at 449.

alpha in order to justify the reduced diversification of active investment, with alphas rising to 9-18% per year.[16] The increased costs of active investment during times of market upheaval make it especially important that the reasonableness of active investment, as with other aspects of the duty to invest prudently, be evaluated "at regular intervals to ensure that they are [still] appropriate."[17] Likewise, high fees charged by active managers must be offset by alphas equal to the excess of those fees above those charged by passive funds.[18]

Any analysis of investing in actively managed mutual funds should include a consideration of the extent to which the funds are pursuing "closet index" strategies. Martijn Cremers and Antti Petajisto estimate that a substantial number of funds claiming to be actively managed persistently achieve returns that correlate strongly with passively managed funds.[19] Their "active share" measure provides an estimate of what portion of a fund's portfolio is really actively managed from an economic perspective and this measure is freely available for thousands of mutual funds.[20] Understanding the active share proportion is essential to assessing whether the fund fees are "alpha justified," because a fund that is charging a 1% annual fee, but only actively invests 50% of its portfolio is in effect charging close to a 2% annual fee on the actively managed proportion of its portfolio.[21] Cremers and Petajisto find that "funds with the lowest Active Share have poor benchmark-adjusted returns and alphas before expenses (between 0.11% and -0.63%) and do even worse after expenses, underperforming by -1.42% to -1.83% per year."[22]

The altering rules discussed above would be sufficient to stamp out imprudent active investment of trust assets in an ideal world. Trustees

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16 *Id.*

17 *Compare* Harmon & Fisher, *supra* note 1, *with* Tibble v. Edison Int'l, 843 F.3d 1187, 1197 (9th Cir. 2016) (en banc) (citations omitted) (quoting Amy M. Hess, George G. Bogert & George T. Bogert, The Law of Trusts and Trustees § 684, at 147–48 (3d ed. 2009)) (internal quotation marks omitted).

18 While HF are correct that a trustee has a duty to minimize fees, we think it makes more sense to consider the prudence of active management after considering all the costs of such a strategy together including excess fees, under-diversification, and potentially taking on the wrong amount of market risk.

19 K.J. Martijn Cremers & Antti Petajisto, *How Active is Your Fund Manager? A New Measure that Predicts Performance*, 22 Rev. Fin. Stud. 3329 (2009).

20 ActiveShare, https://activeshare.info/ (last visited May 31, 2019).

21 For example, the authors estimate that the fee on the active portion of the Fidelity Advisor Dividend Growth Fund is 1.67% even though its expense ratio is just 1%, because it is estimated to actively invest just 60% of its portfolio. *Fidelity Advisor Series I: Fidelity Advisor Dividend Growth Fund*, ActiveShare, https://activeshare.info/fund/fidelity-advisor-series-i-fidelity-advisor-dividend-growth-fund (last visited May 31, 2019).

22 Cremers & Petajisto, *supra* note 19, at 3329. *See also* Sam Mamudi, *What Are You Paying For?*, Wall St. J., Dec. 8, 2009, https://www.wsj.com/articles/SB10001424052748704402404574529550789419572.

would only invest actively if the excess returns outweigh the costs of using such a strategy. In fact, there are a variety of reasons why we might expect this perfect deterrence to go awry. For example, settlors and trustees may lack sufficient knowledge about the costs and benefits of active investment to make fully informed choices. Moreover, the difficulty of evaluating such decisions ex post may provide cover for uninformed or even conflicted decisions by the trustee to invest actively. As a result, courts or legislators may wish to add procedural requirements to the altering rules to make them more effective.

Courts might establish a "cautionary" altering rule, mandating that to be effective, a trust instrument opting out of the default duty to invest passively must indicate that the settlor has been apprised of and understands the alpha tradeoff relevant to active investment and possibly the initial estimates of expected costs (fees and diversification losses) and benefits (expected alpha) of active investment. At a minimum, the trustee could disclose the expected alpha required to offset fees and diversification losses during crisis and non-crisis periods.[23]

Trust law might go further and require settlors to pass a sophistication test before authorizing trustees to eschew passive investing. We suggested a similar prerequisite concerning non-diversified ERISA investments:

> This testing requirement is an example of an altering rule that "reduces the likelihood of error by requiring individuals to demonstrate actual knowledge of the issues related to opt out before they can deviate from the status quo."[24] Train and test altering has been deployed in other high-stakes settings (such as student loans and human-subjects approval) and has been recommended for testing securities sophistication.[25]

Settlors who demonstrate by passing the test that they are aware of the kinds of tradeoffs entailed by active investing would be free to have their trustees seek alpha in ways that exposed the trust beneficiaries to some mixture of diversification, exposure, or excess-fee losses. But this procedural altering rule pre-requisite would beneficially impede many settlors from ill-advisedly agreeing to active trust investment.[26]

In addition to testing for settlor sophistication, it might be worthwhile to only allow active investing by trustees who are able to pass a

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[23] *See* Ayres & Fox, *supra* note 5, at 494.

[24] Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans*, 124 YALE L.J. 1476, 1525 (2015).

[25] Ayres & Fox, *supra* note 5, at 513-14 (some citations omitted).

[26] The possibility of a sophistication test is also explored by Ayres and Curtis in *Beyond Diversification*, *supra* note 24, at 1525, albeit without testing participants' knowledge of alpha tradeoffs.

test concerning alpha tradeoffs.[27] Just as there are licensing tests for both broker–dealers and investment advisers, we might require trustees who invest actively to demonstrate some enhanced financial acumen. FINRA currently requires both broker–dealers and investment advisers to pass exams that include sections covering the suitability requirement, which is akin to the duty of prudent investment.[28] But the questions on these exams fail to test applicants on whether failures to diversify or take appropriate levels of risk or to minimize investment fees can be justified by expectations of excess returns. Trust testing could assure that trustees have both a theoretical and empirical understanding about the central tradeoffs entailed in active management. For example, they should not only know theoretically that some alpha is required before sacrificing the benefits of diversification (and that it tends to increase during crisis periods), but they should also know empirically what order of magnitude this alpha must be for beneficiaries of different levels of risk aversion. They should be tested on what alpha is required before taking on too much or too little market risk. And, most simply, they should know that any superficially excessive fees on an actively managed mutual fund must be justified by even higher alpha expectations.

Last, the altering rules should be sensitive to conflicts of interest. HF argue conflicts of interest are a main reason why active management persist in trusts.[29] Their concern about conflicts makes sense in general. Conflicts of interest seem to drive many of the worst decisions to invest actively. For example, brokers often recommend retail investors choose actively managed mutual funds which underperform but pay the brokers high commissions.[30] This costs retail investors billions of dollars a year.[31]

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[27] Ayres & Fox, *supra* note 5, at 510 make an analogous proposal regarding enhanced testing of brokers-dealers and investment advisers.

[28] *See id.* Before recommending transactions involving stocks, bonds, and a variety of other securities, broker–dealers must, inter alia, pass a 6-hour Series 7 exam. *Series 7: General Securities Representative Exam*, Fin. Indus. Regulatory Auth., http://www.finra.org/industry/series7 (last visited May 31, 2019). Conversely, investment adviser representatives must pass a 3-hour Series 65 exam. *Series 65: Uniform Investment Adviser Law Exam*, Fin. Indus. Regulatory Auth., http://www.finra.org/industry/series65 (last visited May 31, 2019). See Michael Kitces, *Are the Licensing and Other Requirements to Become a Financial Advisor Too Easy?*, Kitces (Aug. 24, 2015), https://www.kitces.com/blog/are-the-licensing-and-other-requirements-to-become-a-financial-advisor-too-easy/ for the License Requirements.

[29] Harmon & Fisher, *supra* note 1, at 173-76.

[30] *See* Ayres & Fox, *supra* note 5, at 452, 503.

[31] The Council of Economic Advisers concluded that brokers' conflicted promotion of actively managed funds cost retirement savers alone $17 billion per year. *See* Council of Econ. Advisers, The Effects of Conflicted Investment Advice on Retirement Savings 10–11, 13 tbl.4 (2015), https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf. Indeed, there is evidence that broker-sold mutual

Trustees, in contrast with brokers, are subject to a strict duty of loyalty. In addition, many trustees are compensated on a fixed percentage of the trust assets, which will usually align the trustee's incentives with beneficiaries in terms of not paying excess fees to outside managers. HF argue nevertheless that corporate and professional trustees may still be incentivized to manage actively to benefit "their sales and marketing departments."[32] To the extent that these arrangements do not violate the duty of loyalty, the test for determining whether the passivity default has been reasonably displaced should factor in this conflict. For example a trustee who—after analyzing the costs and benefits—chooses to invest with an actively managed mutual fund run by the trustee's subsidiary would be scrutinized more carefully than if the trustee chose another actively managed fund with similar fees and risks but from which the trustee could not in any way benefit.

III. Conclusion

HF have a worthy target. There is undoubtedly excessive active investing of trust assets. Enlightened strengthening of a passive investing default together with well-designed altering rules can preserve contractual freedom while channeling assets toward lower fees and better diversified investments.

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funds account for the bulk of the under-performance of actively managed mutual funds. *See* Diane Del Guercio & Jonathan Reuter, *Mutual Fund Performance and the Incentive to Generate Alpha*, 69 J. Fin. 1673 (2014) (finding broker-sold funds substantially underperform but that actively managed funds sold directly to investors do not under perform passive indices).

[32] It would be useful for HF to be a bit more specific about the types of compensation arrangements which they believe are most problematic. They seem to be referring to trustees' ability in most states to invest trust assets in mutual funds operated by the trustee or an affiliate or to take reasonable management fees directly from the trust corpus. Harmon & Fisher, *supra* note 1, at 152 n.17. *Cf.* Jesse Dukeminier & Robert H. Sitkoff, Wills, Trusts, and Estates 593 (Wolters Kluwer Law & Bus., 9th ed. 2013).