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THE PRUDENT PERSON RULE FOR TRUSTEE INVESTMENT AND MODERN PORTFOLIO THEORY

Paul G. Haskell*

The traditional prudent person rule upheld the objectives of the family trust by requiring investment conservatism and diversification. In May 1990, the American Law Institute adopted the Restatement (Third) of Trusts Section 227 which would change the law significantly by its provisions for portfolio theory and flexible risk-return objectives. In this Article Professor Paul Haskell suggests that some of the investment liberalization allowed by the third Restatement is not consistent with the conservative purposes of the family trust.

The prudent person rule for investments by trustees of family trusts has come under attack in recent years as being out of step with contemporary economic learning on investment strategies which would permit greater freedom in the selection of investments by trustees.1 For the most part the courts and the legislatures have not taken into account current economic thinking in this area. There appear to be two explanations for this, in addition to the inertia which inheres in the legal culture. One is that there has not been a compelling reason to modify the law because the past four decades have been a period of economic expansion and rising values. Litigation has been limited, and there has not been much pressure to legislate change, at least until recently. Another reason is that contemporary economic theory dealing with investment is difficult for the lawyer to understand, and when understood is not always convincing.

The thrust of this Article is that the traditional prudent person rule needs some retuning, but that for family trusts2 it remains essentially a sound rule. This conclusion is premised upon the ultra-conservative purposes of the typical family trust, which are to provide a satisfactory income flow, to preserve if possi-

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2. Trusts technically are categorized as private or charitable. Private trusts include pension trusts and other trusts for commercial purposes, as well as those for relatives (or friends). The trust for relatives (or friends) is sometimes referred to as a "personal trust." The phrase "family trust" is used in this Article for the trust for relatives (or friends) because it seems to be more descriptive.
ble the purchasing power of principal, and to minimize loss of value in the event of severe economic decline. If more flexibility is desired in the form of more risk-taking in exchange for the potential of greater gain, or in the form of expansive experimentation pursuant to portfolio theory, the dispositive instrument can provide for it.

Part I of this Article examines the definition and development of the traditional rule and its application by the courts in recent decades. Part II examines in lay terms contemporary portfolio theory. Although pension trusts are not the focus of this Article, Part II also discusses a regulation issued by the Department of Labor under the Employee Retirement Income Security Act (governing private pension trusts), which provides for a qualified use of portfolio theory.3 In May 19904 the American Law Institute adopted provisions changing the sections of the Restatement (Second) of Trusts, which set forth the traditional prudent person rule, to include among other things the principles of modern portfolio theory;5 these changes are discussed in Part II. Part III proposes an adjustment to the traditional rule to bring it up-to-date without compromising the existing ultra conservative investment standards.

I. DEVELOPMENT AND DEFINITION OF THE PRUDENT PERSON RULE

A. History and Status of the Rule

In 1830 the Supreme Judicial Court of Massachusetts in the case of Harvard College v. Amory6 enunciated the prudent man rule for trustee investment as follows:

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a 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.7

At issue in Harvard College was the power of the trustee to invest in the stock of corporations engaged in manufacturing and insurance, which the court upheld. This position contrasted with the early nineteenth century British position which limited trustees to investment in government securities.8 The court's reasoning is captured by the following statements:

It will not do to reject those stocks as unsafe, which are in the management of directors whose well or ill directed measures may involve a total loss. Do what you will, the capital is at hazard. If the

5. RESTATEMENT (THIRD) OF TRUSTS § 227 (Proposed Final Draft 1990) [hereinafter RESTATEMENT (THIRD)].
6. 26 Mass. 454, 9 Pick. 446 (1830).
7. Id. at 469, 9 Pick. at 461.
public funds are resorted to, what becomes of the capital when the credit of the government shall be so much impaired as it was at the close of the last war?

Investments on mortgage of real estate are not always safe. Its value fluctuates more, perhaps, than the capital of insurance stock.

Again, the title to real estate, after the most careful investigation, may be involved, and ultimately fail, and so the capital, which was originally supposed to be as firm as the earth itself, will be dissolved.\(^9\)

In 1869 the New York Court of Appeals in the case of *King v. Talbot* \(^10\) enunciated the standard for trustee investment which was similar in its language to the standard stated in *Harvard College*:

> [T]he just and true rule is, that the trustee is bound to employ such diligence and such prudence in the care and management, as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs.

This necessarily excludes all speculation, all investments for an uncertain and doubtful rise in the market, and, of course, everything that does not take into view the nature and object of the trust, and the consequences of a mistake in the selection of the investment to be made.

It, therefore, does not follow, that, because prudent men may, and often do, conduct their own affairs with the hope of growing rich, and therein take the hazard of adventures which they deem hopeful, trustees may do the same; the preservation of the fund, and the procurement of a just income therefrom, are primary objects of the creation of the trust itself, and are to be primarily regarded.\(^11\)

The New York court concluded, however, that pursuant to these principles, a trustee is permitted to invest only in government obligations and corporate or individual debt secured by a mortgage on real estate. The court reasoned:

> Whenever money is held upon a trust of this description, it is not according to its nature, nor within any just idea of prudence, to place the principal of the fund in a condition, in which it is necessarily exposed to the hazard of loss or gain, according to the success or failure of the enterprise in which it is embarked, and in which, by the very terms of the investment, the principal is not to be returned at all.

> It is not denied, that the employment of the fund, as capital in trade, would be a clear departure from the duty of trustees. If it cannot be so employed under the management of a copartnership, I see no reason for saying that the incorporation of the partners tends, in any degree, to justify it.

> The moment the fund is invested in bank, or insurance, or railroad stock, it has left the control of the trustees; its safety and the hazard, or risk of loss, is no longer dependent upon their skill, care, or discretion, in its custody or management, and the terms of the invest-

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10. 40 N.Y. 76 (1869).
11. Id. at 85-86.
ment do not contemplate that it will ever be returned to the trustees.\textsuperscript{12}

The restrictive New York position soon became dominant among the states. Most states legislated so-called "legal lists," which limited trustee investment to the enumerated categories of debt instruments. By 1900 only a handful of states permitted trustee investment in common stocks, unless, of course, the trust instrument allowed it. This pattern did not change substantially until the 1940s.\textsuperscript{13}

Today only three states have legal lists limited to debt securities,\textsuperscript{14} and two others have legal lists providing for debt securities plus a maximum percentage of common stocks.\textsuperscript{15} The remaining states have the prudent person rule, with most of the statutes providing specifically for investment in common stocks as well as other property.\textsuperscript{16}

Several recent statutes supplement the prudent person principle with language that provides that the trustee's investment decisions are to be judged on the basis of the portfolio as a whole.\textsuperscript{17} This language appears to incorporate modern portfolio theory into the prudent person rule to some degree. The legislation of several states supplements the traditional rule to allow investment in new ventures,\textsuperscript{18} options, and futures,\textsuperscript{19} all of which have been forbidden as spec-

\textsuperscript{12} Id. at 88.

\textsuperscript{13} Shattuck, \textit{The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century}, 12 \textit{Ohio St. L.J.} 491 (1951).

\textsuperscript{14} ALA. CONSt. art. IV, \S 74 (1901, amended 1939); ALA CODE \S 19-3-120-128 (Supp. 1989); KY. REV. STAT. ANN. \S 386.020 (Michie/Bobbs-Merrill Supp. 1988); MD. EST. \& TRUSTS CODE ANN. \S 15-106 (Supp. 1989).

\textsuperscript{15} OHIO REV. CODE ANN. \S 2109.371 (Anderson 1990) (60\% stocks); W. VA. CODE \S 44-6-2 (Supp. 1990) (50\% stocks).

\textsuperscript{16} ALASKA STAT. \S 13.36.075 (1985); ARIZ. REV. STAT. ANN. \S 14-7302 (1975); ARK. STAT. ANN. \S 28-71-105 to -107 (1987 & Supp. 1989); CAL. PROB. CODE \S 16040 (West Supp. 1990); COLO. REV. STAT. \S 15-1-304 (1987); CONN. GEN. STAT. ANN. \S 45-88 (West Supp. 1990); DEL. CODE ANN. tit. 12, \S 3302 (1987); FLA. STAT. ANN. \S 518.11 (West 1988); GA. CODE ANN. \S 53-8-2 (Supp. 1989); HAW. REV. STAT. \S 560:7-302, 406-22 (1985); IDAHO CODE \S 68-502 (1989); ILL. ANN. STAT. ch. 17, para. 1675 (Smith-Hurd Supp. 1990); IND. CODE ANN. \S 30-4-3-3(c) (Burns 1989); IOWA CODE ANN. \S 633.123 (West Supp. 1990); KAN. STAT. ANN. \S 17-5004 (1988); LA. REV. STAT. ANN. \S 9:2127 (West Supp. 1990); ME. REV. STAT. ANN. tit. 18A, \S 7-302 (1981); MICH. COMP. LAWS ANN. \S 700.813 (West 1980); MINN. STAT. ANN. \S 501B.10 (West 1990); MISS. CODE ANN. \S 91-13-3 (1972); MONT. CODE ANN. \S 72-34-114 (1989); NEB. REV. STAT. \S 30-3201 (1989); NEV. REV. STAT. \S 164-050 (1985); N.H. REV. STAT. ANN. \S 564:18 (1974); N.J. STAT. ANN. \S\S 3B:20-1, -13 (West 1983 & Supp. 1990); N.M. STAT. ANN. \S 45-7-302 (1989); N.Y. EST. POWERS \& TRUSTS LAW \S 11-2.2 (McKinney 1967 & Supp. 1990); N.C. GEN. STAT. \S 36A-2 (1984); N.D. CENT. CODE \S 6-05-15 (1987); OKLA. STAT. ANN. tit. 60, \S 161 (West 1971); OR. REV. STAT. \S 128.057 (1989); 20 PA. CONS. STAT. ANN. \S\S 7302, 7310 (Purdon 1975); R.I. GEN. LAWS \S\S 18-4-2, 19-9-12 (1988 & 1989); S.C. CODE ANN. \S 21-11-10 (Law. Co-op. 1976); S.D. CODIFIED LAWS ANN. \S 55-5-1 (1989); TENN. CODE ANN. \S 35-3-117 (Supp. 1989); TEX. PROP. CODE ANN. \S 113:056 (Vernon 1984 & Supp. 1990); UTAH CODE ANN. \S 75-7-402 (Supp. 1990); VA. CODE ANN. \S 26-45.1; WASH. REV. CODE ANN. \S\S 11.100.020, .023 (1987); WYO. STAT. \S 2-3-301 (1980). Massachusetts, Missouri and Vermont have the prudent person rule by judicial decision. Chase v. Pevear, 383 Mass. 350, 362-64, 419 N.E.2d 1358, 1365-67 (1981); Vest v. Bialson, 293 S.W.2d 369, 380 (Mo. 1956); St. Germain v. Tuttle, 114 Vt. 263, 270, 44 A.2d 137, 141-42 (1945). Wisconsin has the prudent person rule but certain categories of trustees cannot invest more than 50\% in common stocks. Wis. STAT. ANN. \S 881.01 (West 1989).

\textsuperscript{17} CAL. PROB. CODE \S 16040(d) (West 1990); DEL. CODE ANN. tit. 12, \S 3302(c) (1974); GA. CODE ANN. \S 33-8-2(c) (Supp. 1989); MINN. STAT. ANN. \S 501B.10 (1990); TENN. CODE ANN. \S 35-3-117(b) (Supp. 1989); WASH. REV. CODE ANN., \S 11.100.020 (1986).

\textsuperscript{18} ARK. STAT. ANN. \S 28-71-107 (1987); MINN. STAT. ANN. \S 501B.10 (1990); WASH. REV. CODE ANN. \S 11.100.023 (1986).

\textsuperscript{19} DEL. CODE ANN. tit. 12, \S 3302(b) (1974).
ulative under the prudent person rule.

The first and second Restatements of the Law of Trusts adopted the prudent man rule. Section 227 of the first Restatement of the Law of Trusts, promulgated in 1935, included the prudent man rule as follows:

In making investments of trust funds the trustee is under a duty to the beneficiary (a) in the absence of provisions in the terms of the trust or of a statute otherwise providing, to make such investments and only such investments as a prudent man would make of his own property having primarily in view the preservation of the estate and the amount and regularity of the income to be derived . . . .

The comments to the first Restatement in 1935 stated that investment in conservative common stock was within the prudent person rule, but recognized that many states by statute restricted trust investments to specified debt securities. The comments to the second Restatement in 1957 noted the trend to the legislative adoption of the prudent person rule. The comments to both Restatements expressly prohibit “speculation,” such as investment in new and untried enterprises, the purchase of securities on margin, the purchase of property for resale, and the employment of trust property in a trade or business.

Both Restatements require that investments be diversified: “Except as otherwise provided by the terms of the trust, the trustee is under a duty to the beneficiary to distribute the risk of loss by a reasonable diversification of investments, unless under the circumstances it is prudent not to do so.”

Comment e of both Restatements provides in part as follows: “Ordinarily the trustee should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or one class of enterprise . . . since the effect is to increase the risk of large losses.”

The comments state that it may be prudent not to diversify if the trust estate is very small or to invest very substantially or wholly in government securities in a time of financial crisis and instability.

The comments also state that diversification is an application of the prudent person standard. The position of the Restatements reflects the holdings of many courts. The courts of New York and Pennsylvania, however, have re-

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20. RESTATEMENT OF TRUSTS § 227 (1935). Restatement (Second) of the Law of Trusts § 227, promulgated in 1957, is identical except for the omission of the word “primarily.”
21. RESTATEMENT OF TRUSTS § 227 comments 1 & n (1935).
23. RESTATEMENT OF TRUSTS § 227 comment f (1935); RESTATEMENT (SECOND) OF TRUSTS § 227 comment f (1959).
24. RESTATEMENT OF TRUSTS § 228 (1935); RESTATEMENT (SECOND) OF TRUSTS § 228 (1959).
25. RESTATEMENT OF TRUSTS § 228 comment e (1935); RESTATEMENT (SECOND) OF TRUSTS § 228 comment e (1959).
26. RESTATEMENT OF TRUSTS § 228 comment e (1935); RESTATEMENT (SECOND) OF TRUSTS § 228 comment e (1959).
27. RESTATEMENT OF TRUSTS § 228 comment e (1935); RESTATEMENT (SECOND) OF TRUSTS § 228 comment e (1959).
28. First Alabama Bank v. Spragins, 515 So. 2d 962, 964 (Ala. 1987); In re Collins, 72 Cal.
versed the emphasis by holding that there is no duty to diversify as such, but that in certain circumstances prudence may require it.  

Diversification avoids the risk of large loss that follows from the concentration of investments that are affected by the same economic factor or factors. If investments are spread among a number of different industries and categories of securities, which tend to be affected differently by various economic factors, some of the investments may fall and some may rise, and the portfolio is safer, i.e., less volatile, as a result. Diversification, the purpose of which was perceived in a rough way by the common law, has been reduced to a mathematical principle in modern portfolio theory, as discussed in Part II below.

In May 1990 the American Law Institute radically changed the prudent person rule of section 227 to include the principles of portfolio theory, among other things. The new provisions are also set forth and discussed in Part II.

B. Functional Analysis of the Prudent Person Rule

The prudent person rule is something of a misnomer. Prudent investors frequently invest a small portion of their capital speculatively. This is forbidden under the prudent person rule. Comment e of section 227 of the second Restatement succinctly explains why:

In making investments, however, a loss is always possible, since in any investment there is always some risk. The question of the amount of risk, however, is a question of degree. No man of intelligence would make a disposition of property where in view of the price the risk of loss is out of proportion to the opportunity for gain. Where, however, the risk is not out of proportion, a man of intelligence may make a disposition which is speculative in character with a view to increasing his property instead of merely preserving it. Such a disposition is not a proper trust investment, because it is not a disposition which makes the preservation of the fund a primary consideration.

The trustee may lend money to the government or to established corporate borrowers, or to reliable noncorporate borrowers with adequate security. The trustee may invest in equity securities of corporations having a history of positive performance, with the objective of sharing in the earnings and growth of the enterprise. Such investments are to be diversified to minimize the risk of sub-


30. See supra text accompanying notes 73-83.

31. Restatement (Third), supra note 5.

32. Restatement (Second) of Trusts § 227 (1959).

33. 3A. Scott, supra note 8, §§ 227.6 at 443-44, 227.8 at 450.

34. Id. § 227.11, at 472.
stantial loss. Investment in new enterprises is forbidden.35 Buying on margin,36 buying options and futures,37 and buying for the purpose of short-term resale38 are viewed as forms of gambling which use the channels of capital exchange as the medium, and therefore are forbidden.

The standard of prudence is applied to each investment in isolation. Each investment is either in compliance or it is not, without regard to its relationship to other investments in the portfolio. The trustee is liable for loss in value of any improper investment, without regard to the performance of any other investment, proper or improper, or to the performance of the portfolio as a whole.39 The trustee whose investment strategy is generally successful is liable for the decline in dollar value of the individual investment that is not in compliance with the standard of prudence.

The prudent person rule has as its objective the production of income and preservation of principal. The risk to principal has been perceived as the financial decline of corporate enterprise. The danger to the preservation of principal arising from monetary inflation has not been a major consideration in the law. There is no authority that the trustee has a duty to invest to protect principal from erosion by inflation.40 It has been recognized that inflationary concerns are a proper consideration in investment judgments, but that is different from imposing a duty to invest in a manner that protects against inflation. Undoubtedly the practice of trustees to invest a substantial portion of the portfolio in common stocks is motivated by considerations of inflation as well as growth.41

40. Restatement (Third), supra note 5, comment e, provides that there is a fiduciary duty to invest with a view to the protection of the purchasing power of the trust assets.
In times of hyperinflation, however, stocks are not likely to fare well because of the economic uncertainty and instability caused by it.\textsuperscript{42}

The interest paid on debt securities reflects the anticipated course of inflation. Interest of nine percent may be considered six percent projected inflation and three percent real return.\textsuperscript{43} In times of hyperinflation debt securities may be a better form of inflation protection than common stocks.\textsuperscript{44} The problem for the trustee, however, is that the entire income is payable to the income beneficiary and is immediately subject to income taxation.

The prudent person rule is wholly inconsistent with contemporary economic learning on portfolio management. Under the prudent person rule, any speculative investment is a breach of trust. Under portfolio theory (discussed in Part II) risk is not a matter of the volatility of the individual investment, but is a matter of the risk content of the portfolio viewed in its entirety. Under portfolio theory a volatile investment which contributes to the diversification of the portfolio may not increase total portfolio risk.\textsuperscript{45} The prudent person rule, in contrast, requires diversification, but only among unspeculative investments because none other is permitted.

Contemporary economic thinking also embraces a passive strategy of broad investment in the market such as investment in the Standard and Poor’s 500 stocks, without adjustment for stocks whose recent performance has not been favorable.\textsuperscript{46} This strategy (discussed in Part II) assumes the efficiency of the pricing of market components and the consequent unlikelihood of doing better than the market by attempting to identify underpriced stocks by means of costly research. Such broad investment in the market, of course, provides great diversification. There is substantial empirical support for the proposition that one cannot do better than the market as a whole over the long term by selecting stocks.\textsuperscript{47} This passive investment strategy would not be permitted under the prudent person rule because it does not take into account the speculative or otherwise unsatisfactory nature of individual investments.

C. How Some Courts Recently Have Applied the Prudent Person Rule

Although in recent years there has been little litigation of significance dealing with the prudent person rule, there have been differences in the manner of application of the rule in several instances. First Alabama Bank of Montgomery v. Martin\textsuperscript{48} represents the traditional method of application. This was a class action by the beneficiaries of 1,250 individual trusts against the bank as trustee

\textsuperscript{43} See, e.g., id. at 314. Since the debt is paid at maturity in a fixed dollar amount, the lowered purchasing power is taken into account in the fixing of the interest rate.
\textsuperscript{44} Id. at 94.
\textsuperscript{45} See infra text accompanying notes 64-77.
\textsuperscript{46} See infra text accompanying notes 78-81.
\textsuperscript{47} Elton & Gruber, Lessons of Modern Portfolio Theory 170, 180, appearing as Appendix A in B. Longstreth, supra note 1; B. Malkiel, supra note 42, at 180; Langbein & Posner, Market Funds and Trust Investment Law, 1976 Am. B. Found. Ras. J. 1, 16.
\textsuperscript{48} 425 So. 2d 415 (Ala.), cert. denied, 461 U.S. 938 (1983).
of two common trust funds, one a bond fund and the other an equity fund, for a declaration that certain investments were imprudent and to require the restoration to the common trust funds of the losses sustained.

The investments in issue in the bond fund were debentures of six real estate investment trusts that had been established shortly before their purchase and were highly leveraged. The trial court found the purchase of these investments imprudent. The trial court also found the purchase of the common stock of seventeen "growth" corporations to be imprudent. The Alabama Supreme Court affirmed the judgment.

The challenged debentures paid a high rate of interest in exchange for the inordinate risk involved. This risk-taking clearly violated the prudent person rule. The testimony of the experts for the parties concerning the appropriateness of the stock purchases was, of course, conflicting, but the witnesses agreed that the corporations were "growth" companies that were not well-known and whose stocks were selling at low price-earnings ratios. The bank's investment purpose with respect to these stocks was to protect against inflation. The court reiterated the traditional rule and emphasized the primary duty to preserve the principal of the trust estate. The court concluded that the stock investments were speculative because they were made for the purpose of capital appreciation and resale rather than for long-term investment.

The bank had promulgated certain standards of quality for the purchase of stocks as trustee, not all of which had been followed in these instances. The court did not use this internal inconsistency as the basis for its conclusion, but used the traditional criterion of prudence as its rationale.

*Chase v. Pevear* reflects a somewhat more liberal application of the prudent person rule. Beneficiaries of a testamentary trust objected to the accounts of the trustee for the period from 1968 through 1974, challenging, among other things, seven investments: Convertible debentures of Continental Mortgage Investors, Evans Products, and W.T. Grant; and common stock of MGIC Investment Corporation, U.S. Industries, Meredith Corporation, and Penn Central. Continental was a real estate investment trust; Evans and U.S. Industries had recently become "conglomerates"; MGIC was a mortgage insurer; Meredith was a publishing company; W.T. Grant was a retailer; and Penn Central was in real estate and railroads.

The Massachusetts Supreme Court held that the purchases of all these securities were within the prudent person rule. The beneficiaries challenged several of the investments on the grounds that real estate investment trusts, convertible debentures, new conglomerates, and real estate were by their nature imprudent investments. The court held that these investments were consistent with the prudent person rule.

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51. Real estate investment trusts, convertible debentures, and conglomerates are described in B. Malkiel, supra note 42, at 303-04 n.*, 61, 58-65.
ture speculative. The court responded that real estate investment trusts were accepted in the investment community as evidenced by the fact that they were held by many institutional investors including common trust funds. In addition, Continental was the nation's largest and strongest real estate investment trust. Convertible debentures also were held by many common trust funds. Evans and U.S. Industries, although recent entries into the world of conglomerates, were held by many institutional investors, including common trust funds. Penn Central's real estate holdings did not make its stock imprudent, and its stock also was held by many institutional investors including common trust funds.

There has been a tendency under the prudent person rule to classify certain types of investments as imprudent per se, such as new enterprises or new types of investments whose characteristics have not met the test of time. The Massachusetts court expressly took the position that such labelling is unsound. Real estate investment trusts, conglomerates, convertible debentures, and real estate are not necessarily speculative; it is a question of the nature of the specific investment. The court emphasized that the sophisticated investment community had accepted such investments as suitable.

The court's reliance on the conduct of the investment community seems questionable. Some institutional investors take risks which family trustees are not permitted to take. Some common trust funds are aimed at capital appreciation in accordance with the liberal investment powers of the contributing trusts. That other persons are doing it does not make a particular investment strategy proper under the prudent person rule. The court would seem to allow the trust companies to set the standard of prudence measured by their own common conduct.

Stark v. United States Trust Company of New York represents a novel approach to the assessment of the prudence of trustee investment. The standard adopted is the procedural care taken by the trustee in the process of investment selection rather than the substantive merit of the selection itself. The federal district court purported to apply New York law.

This was an action by beneficiaries of four inter vivos trusts created in 1965 by one settlor, to recover for losses incurred as a result of imprudent management attributable to the retention of shares of the common stock of Clorox, Evans Products, and Coleco Industries. The trusts held 4,000 shares of Clorox transferred by the settlor; some of it was sold in 1973, 1974 and 1976, and 1,320 shares remained in the trusts at the time of trial. The stock peaked at 51 dollars per share in January 1973, declined to 5 in late 1974, and at the time of trial was at 13. The trusts held 8,000 shares of Evans Products transferred by the settlor; the shares were sold in January 1975. The stock was priced as high as 23 1/2 dollars per share in February 1972, and was sold at 3. The trusts purchased 8,844 shares of Coleco, at the settlor's urging; none of it had been sold at the time of trial. In February 1972 it was priced at 57 7/8 dollars per share, and at the end of 1976 it traded at 5 1/4. The court described the investments as

52. RESTATEMENT (THIRD), supra note 5, comment k.
"young companies embarked on programs of diversification and acquisition.” These were several of the aggressive “conglomerates” of the 1960s and 1970s.

The court described in detail the manner in which the defendant bank managed investments. An investment policy committee evaluated the market environment and made general recommendations on portfolio strategy. There was a stock selection committee which made suggestions on specific stocks to portfolio managers with respect to purchase, sale or retention. Each trust was managed by a portfolio manager who made the investment decisions. All of the above were assisted by a research department which issued reports on industries and companies. The court concluded that the bank’s management of investments generally, and of these specific stocks in particular, was conducted carefully and prudently. The decline in the investments in issue took place during a period of market decline, although the decline in these investments greatly exceeded the decline in the market. Emphasizing that there is no magic percentage of decline which mandates sale, the court granted judgment for the defendant bank.

The trust instrument provided that the bank was not to be held liable for retention of any assets transferred by the settlor to the trust, as were the Clorox and Evans stock. The court noted that such language did not exculpate the trustee for reckless or intentional misconduct. The court stated that the bank had acted prudently and that its decision was not based on the exculpatory language.

Stark is unusual in its exclusive reliance upon the procedural aspects of the management of the investments as the basis for satisfying the prudent person standard. Unquestionably the bank was attentive to its responsibility to keep abreast of the developments in the market and in these stocks. There is, however, no discussion of whether it is proper to invest in what the court describes as “young” companies engaged in programs of “diversification and acquisition.” These are usually high-risk enterprises. The issue of whether such level of risk is appropriate for a trustee is not discussed in the opinion. It seems clear that a trustee can conduct its investment strategy carefully while employing the wrong substantive criteria.54

In the case of In Re Newhoff55 the intermediate appellate court of New York took the position that procedural prudence is not sufficient. The beneficiaries of several trusts created by the will of a decedent filed objections to the accounts of the trustees who had invested more than one-half of the assets of each trust in the shares of four real estate investment trusts, all of which placed their funds in site development and construction loans. The court emphasized the high-risk nature of real estate investment trusts engaged in this form of lending and concluded that the four investments were not within the prudent person rule. The court cited First Alabama Bank v. Martin56 as a case in which invest-

54. The same view was adopted by the New York Surrogate’s Court in In re Morgan Guaranty Trust Co. of N.Y., 89 Misc. 2d 1088, 396 N.Y.S.2d 781 (N.Y. Sur. Ct. 1977), in which summary judgment was granted for the bank fiduciary based on its careful and thorough procedures in its selection of investments without any reference to the merits of the investments.
ments of this nature were held to be imprudent, and distinguished *Chase v. Pevear* in which the real estate investment trust in question was one of the nation's strongest whose shares were widely held by institutional investors.

The trustees argued that they obtained information from various sources concerning the investments before making the purchases. The court responded that such investigation is only one aspect of the prudent person rule; the trustees must then proceed to exercise the requisite skill in making the investment. The court stated that the trustees had as their goal the maximizing of income without sufficient regard for the magnitude of the risk.

The prominent case of *In Re Bank of New York* reiterates the traditional position that under the prudent person rule each investment must be justified independently, but there is language in the opinion which, wittingly or unwittingly, leaves the door open for the application of modern portfolio theory.

The bank as trustee of one of its common trust funds brought a proceeding for the judicial settlement of its accounts for a four year period. The guardian ad litem for the principal interests objected to four investments. The surrogate's court granted the trustee's motion for summary judgment as to the stock of Harcourt, Brace and World, Inc., and Mercantile Stores, and denied it as to Boeing and Parke, Davis. The appellate division modified by granting the trustee's motion with respect to Boeing and Parke, Davis. The court of appeals affirmed the determination of the appellate division.

The court stated that each investment is to be judged independently, and the fact that the portfolio as a whole has increased in value is irrelevant. The court, however, elaborated as follows:

The record of any individual investment is not to be viewed exclusively, of course, as though it were in its own water-tight compartment, since to some extent individual investment decisions may properly be affected by considerations of the performance of the fund as an entity, as in the instance, for example, of individual security decisions based in part on considerations of diversification of the fund or of capital transactions to achieve sound tax planning for the fund as a whole. The focus of the inquiry, however, is nonetheless on the individual security as such and factors relating to the entire portfolio are to be weighed only along with others in reviewing the prudence of the particular investment decisions.

The above language lends itself to the following form of analysis: An investment is a high-risk stock when viewed in isolation. However, its inclusion in the portfolio theoretically does not increase total portfolio risk because the events that affect this stock negatively affect another stock in the portfolio positively. Indeed, because of the reciprocal relationship, the investment theoretically may decrease total portfolio risk. It may follow that this stock is a prudent investment in the circumstances. It is not suggested that this is what the court

59. Id. at 517, 323 N.E.2d at 703, 364 N.Y.S.2d at 168.
actually had in mind, but its language may be used to support this conclusion, which would be in line with contemporary portfolio theory (discussed in Part II).

Two recent cases on diversification illustrate the contrasting positions on this issue. *Baker Boyer National Bank v. Garver*\(^6\) represents the prevailing position requiring diversification unless special circumstances excuse it. The trustee bank had invested almost all the assets in tax-exempt bonds. Beneficiaries objected to the trustee's account on the ground, among others, that such investments were a violation of the duty to diversify. The trial court held the bank liable for failure to diversify and determined damages on the basis of the loss in value of the portion of the tax-exempt bonds that was excessive, namely forty percent. The appellate court modified this judgment by determining damages on the basis of the gain that would have been obtained had the excessive portion been invested in common stocks. In this instance this measure had the effect of increasing damages.

In *Estate of Knipp*,\(^6\) testamentary trust beneficiaries brought an action to surcharge the bank executor, who was also the trustee, for failure to diversify estate assets. The estate included 4,314 shares of Sears Roebuck common stock owned by the decedent at death. The Sears Roebuck stock constituted seventy-one percent of the assets of the estate, and ninety-seven percent of the value of all the stocks in the estate. Four hundred shares of Sears Roebuck were sold during the first year to cover costs of administration, and the rest was retained. The stock declined steadily during administration. The will authorized, but did not direct, the executor and trustee to retain this asset. The trial court denied the claim for surcharge, and the supreme court affirmed.

The court stated that the authorization to retain did not excuse the executor from acting prudently with respect to the stock. The court held that Sears Roebuck was worthy of investment by a fiduciary, and that there was no duty to diversify, reasoning as follows:

> Although many financial authorities advocate diversity of investment as a desirable course for trust management, a judicial decision declaring non-diversification to be presumptively imprudent would arbitrarily foreclose executors and trustees from opportunities to retain beneficial holdings. The preferable approach, therefore, is to determine on a case by case basis. . . . Here we cannot say that the record does not adequately support the determination of the court below that retention of the Sears stock, without diversification, was not imprudent.\(^6\)

The position that diversification is not an independent duty is radically inconsistent with contemporary economic theory.

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60. 43 Wash. App. 673, 719 P.2d 583 (1986).
62. *Id.* at 514, 414 A.2d at 1009.
II. MODERN PORTFOLIO THEORY

A. An Outline by a Layperson for Laypersons

Contemporary economic thinking on the subject of investments differs greatly from the prudent person rule. The prudent person rule requires that every investment be "safe," i.e., not "speculative." Contemporary economic thinking is concerned with the relationship of the individual investment to the entire investment portfolio. If contemporary economic theory were adopted as the legal standard of prudence, the trustee would be in breach only if the portfolio viewed in its entirety contained risk that was imprudent under the circumstances.63

All investments have an expected return which varies positively with risk.64 Return means total return, income and principal. The baseline return is short-term U.S. government debt, which is viewed as riskless and provides the lowest return. Expected returns on other investments are greater in accordance with the degree of risk. Risk is the recognized possibility of performance below the expected return; the greater the potential negative departure from expected return, the greater the risk.65 The greater the risk, the greater the expected return must be in order to justify or compensate for the risk.66

The discussion that follows is concerned with publicly traded common stocks, although the same rules with appropriate adjustments are considered to be applicable to the entire range of investments. There are two types of risk for

63. B. LONGSTRETH, supra note 1, at 111; Gordon, supra note 1 at 93; Langbein & Posner, Market Funds and Trust Investment Law, 1976 AM. B. FOUND. RES. J. 1, 27; RESTATEMENT (THIRD), supra note 5, introduction at 5, comment e at 23.
64. Langbein & Posner, supra note 63, at 7, describes expected return:
The expected return of a security ... is constructed simply by multiplying every possible return by its probability of being the actual return, and then adding up the results of the multiplication. To illustrate, assume that there is a 50 percent probability that a particular stock, the price of which today is $10, will be worth $12 one year from now, a 40 percent probability that it will be worth $15, and a 10 percent probability that it will be worth nothing. Consequently, there is a 50 percent probability of a $2 return, a 40 percent probability of a $5 return, and a 10 percent probability of a $10 return, so the expected return is $2 (.5 x $2 + .4 x $5 - .1 x $10).

To simplify the analysis, it is assumed that no dividends are paid during the course of the year. See J. LORIE, P. DODD AND M. KIMPTON, THE STOCK MARKET: THEORIES AND EVIDENCE, 110-12 (2d ed. 1985) [hereinafter LORIE].
65. Economic theorists define risk as the probable variability or dispersion of future returns, including those above as well as those below the expected return. The layman, of course, does not consider the pleasant surprise as a form of risk. See B. MALKIEL, supra note 42, at 216-19 (discussing this semantic question).

It follows that there should also be a systematic difference between the expected returns of common stocks that differ in their riskiness. Suppose the expected per-share returns of two stocks (A and B) are the same, $2; but for A the expected return is a combination of a 50 percent probability of no return and a 50 percent probability of a $4 return, while for B the expected return is a combination of a 50 percent probability of a $6 return and a 50 percent probability of a $10 return ... the difference in risk should make ... investors prefer A at the same price, and therefore ... B's price will be bid down below A's.
investments. One form of risk is that which affects the entire range of securities, such as general economic conditions. This is referred to as "systematic" or "market" risk. Almost all stocks are affected by this risk in the same way, albeit in different degrees. As the market as a whole rises, each stock tends to rise, some in the same degree, some more, some less; and as the market as a whole declines, each stock tends to decline, some in the same degree, some more, some less. Almost all stocks "covary positively" with respect to systematic risk.

The other form of risk is that which peculiarly affects a particular investment or industry, as climate affects an agriculturally related investment, as Japanese imports affect the American auto companies, and as the federal budget affects the aerospace industry. This risk is referred to as "specific," "unsystematic" or "residual" risk. A risk that affects one stock negatively may affect another stock positively, in which case the stocks are said to "covary negatively" with respect to that risk; if they are affected in the same way by the same risk, they "covary positively" with respect to that risk.

A fundamental principle of contemporary economic thinking is that the marketplace compensates the buyer for systematic risk but does not compensate the buyer for specific risk. Systematic risk is unavoidable; almost all stocks covary positively, albeit in different degrees, in relation to that risk. Expected return is the riskless rate (short-term U.S. government debt) plus a rate determined in accordance with the degree of systematic risk.

The marketplace does not compensate the buyer for specific (unsystematic) risk. This is because the investor can balance the specific risk to one stock with the purchase of another stock that is affected positively by the same factor which adversely affects the first stock. In other words, through diversification specific risk can be virtually eliminated. If the investor can avoid the effect of specific risk, there is no reason for the marketplace to compensate him for the risk. The expected return of a stock need not be adjusted upward (i.e., the price of the stock lowered) to reflect specific risk. The expected return is responsive therefore only to systematic risk, which is unavoidable.

If an investor purchases only one stock, she has an expected return that is equal to the riskless rate of return plus the rate of return attributable to the systematic risk of that stock, but the stock also bears its specific risk for which

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67. R. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 111, 125 (2d ed. 1983); B. Malkiel, supra note 42, at 229.
69. R. BREALEY, supra note 67, at 117, 125; B. Malkiel, supra note 42, at 230.
71. R. BREALEY, supra note 67, at 160, 165; B. Malkiel, supra note 42, at 232.
72. J. Cox, FINANCIAL INFORMATION, ACCOUNTING, AND THE LAW: CASES AND MATERIALS 172 (1980); Elton & Gruber, supra note 47, at 170; Modigliani & Pogue, supra note 66, at 70.
73. R. BREALEY, supra note 67, at 165; B. Malkiel, supra note 42, at 234.
74. Lorie, supra note 64, at 84-85, 136-38; Elton & Gruber, supra note 47, at 171; Gordon & Kornhauser, supra note 66, at 778; Langbein & Posner, supra note 63, at 9.
she receives no compensating return. The investor has an expected return which inadequately compensates for the total risk.

An investor holding a substantial portfolio which contains stocks which covary negatively with respect to specific risks has an expected return which adequately reflects the systematic risks of each, and the specific risks of each have substantially cancelled out. The larger the portfolio, the closer the specific risk factor of the portfolio can approach zero. The experts tell us that specific risk can be reduced to a low level with as few as twenty stocks appropriately chosen.

The measurement of systematic risk has been closely quantified. The stock market as a whole is deemed to have a so-called "beta" of 1. All stocks are given a systematic risk figure relating to that standard. A stock with a beta of 1 rises and falls to the same degree on average as the market as a whole. A stock with a beta of 1.5 rises and falls fifty percent more than the market as a whole; a stock with a beta of 2 rises and falls twice as much as the market as a whole; a stock with a beta of .5 rises and falls fifty percent less than the market as a whole, and so on.

Contemporary economic theory supports the position that the investor should maintain a broad portfolio in order to reduce specific risk to a low level. An effective method would be to invest in a so-called "index" or "market" fund which holds the Standard and Poor's 500 stocks, or even broader group of stocks, which substantially replicates the entire market. This investment strategy reduces specific risk to insignificance, and provides a systematic risk of beta 1. If a lower beta is desired, this broad market investment can be mixed with short-term U.S. government securities or other safe short-term debt securities. The riskless investment has the effect of lowering the volatility of the portfolio as a whole. If a higher beta is desired (greater risk in exchange for greater expected return), this can be done by buying more shares of the market fund with borrowed money.

The investor, of course, can establish a portfolio with a beta higher than the market simply by selecting stocks with an average beta greater than the market,

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75. Restatement (Third), supra note 5, at 91.
77. J. Cox, supra note 72, at 173; E. Fama, Foundations of Finance 253 (1976); Pozen, supra note 70, at 923.
78. R. Brealey, supra note 67, at 126; B. Malkiel, supra note 42, at 229.
79. J. Cox, supra note 72, at 174; Elton & Gruber, supra note 47, at 170; Langbein & Posner, supra note 63, at 10.
80. B. Malkiel, supra note 42, at 235; Restatement (Third), supra note 5, comment h.
81. Elton & Gruber, supra note 47, at 172; Langbein & Posner, supra note 63, at 12. Increasing beta by purchasing stocks with borrowed money works as follows: Assume the risk-free rate of return is 10%, and the stock market rate of return (beta 1) is 15%. The portfolio having a value of 100 is invested in the market, returning 15%. The trustee borrows 50 at 11%, and invests it in the market. The net return on the borrowed money is 4%, or 2 on the borrowed 50. This provides a return of 17 on the portfolio of 100. Obviously if the market declines, the loss in this circumstance would be correspondingly more severe. For further treatment of portfolio theory, see E. Elton & M. Gruber, Modern Portfolio Theory and Investment Analysis (2d ed. 1984); A. Rudd and H. Clasing, Modern Portfolio Theory: The Principles of Investment Management (1982); J. Weston & E. Brigham, Managerial Finance 456-69 (7th ed. 1981).
or he can establish a portfolio with a beta lower than the market by selecting stocks with an average beta lower than the market. This type of portfolio, however, compromises the diversification that obtains with the market fund.

It is apparent that contemporary economic thinking allows for the inclusion of stocks of a speculative nature in a portfolio that is conservatively invested. The speculative stock by definition has high specific risk, and is likely to have high systematic risk as well. It is part of a broad portfolio, however, which cancels the specific risk by diversification and which has a stock beta of 1. The portfolio also has, let us assume, short-term U.S. government securities which reduce the portfolio below the level of beta 1. The speculative stock would be a breach of trust under the prudent person rule.

Most economic theorists conclude that the pricing of publicly traded stocks is reasonably efficient, i.e., the price of a stock at any time reflects most, if not all, of the information concerning that stock.\(^{82}\) If this is accepted, then there is no point in trying to do better than the market as a whole by selecting stocks that are underpriced because there are none, and the cost of research that goes into the selection process is a waste of money. The only way to increase return is to increase risk. There is substantial empirical support for the proposition that institutional investors who are selective with respect to publicly traded stocks do not do any better than the market as a whole over the long term.\(^{83}\)

If the pricing is reasonably efficient, then a passive strategy of investing broadly in the market without selecting in or out is a prudent and conservative investment policy.\(^{84}\) This strategy could be implemented by means of a bank common trust fund or by means of investment in a so-called "market" or "index" investment fund. This form of investment by a trustee would be questionable today because the fund would include "speculative" stocks which are unsuitable for trustee investment. The trust instrument, of course, could authorize such an investment strategy.

A cautionary note is warranted at this point. The "laws" of economics are different from the laws of nature, such as gravity, for example. What happened yesterday in nature is an excellent predictor of what will happen tomorrow. The same assurance does not exist with respect to past economic experience. Contemporary portfolio theory is all a reflection of the immediate past, and it is uncertain that the future will be consistent with the immediate past. Certainly to the extent that some of the theory appears counterintuitive, skepticism is justified. Concepts such as expected return, specific risk, negative covariance, and beta level are educated guesses based upon what has gone before and what is now known. The economic tomorrow may vary from conclusions based on such information. Indeed there are studies that indicate that beta as a measure of risk

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82. LORIE, supra note 64, at 55-77; RESTATEMENT (THIRD), supra note 5, at 88-90.


84. RESTATEMENT (THIRD), supra note 5, at 88-90.
has a degree of unreliability, and that specific risk may play a role in the pricing of the individual security.85

B. Portfolio Theory for Regulated Pension Trusts

This Article is concerned with the family trust. Contemporary portfolio theory has made no inroads there except in several states which have enacted legislation which may allow for the inclusion of portfolio theory within the prudent person standard.86 There has been, however, a qualified inclusion of portfolio theory in the management of pension trusts subject to the Employee Retirement Income Security Act of 1974.87

The Act provides that the fiduciary shall discharge his duties with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; [and] by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so . . . .88

This differs from the statement of the traditional prudent person rule inasmuch as it makes no reference to the importance of safety in investment. The Act prohibits trust provisions which would modify the statutory standard or exculpate the fiduciary.89

In 1979 the Department of Labor issued a regulation which opened the door to the application of portfolio theory by pension fiduciaries. It reads in part as follows:

(b) Investment Duties. (1) With regard to an investment or investment course of action taken by a fiduciary . . . the requirements of . . . the Act . . . are satisfied if the fiduciary: (i) Has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in . . . [the] investment portfolio . . . and (ii) Has acted accordingly.

(2) For purposes of paragraph (b)(1) of this section, "appropriate consideration" shall include, but is not necessarily limited to, (i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain . . . associated with the investment or investment course of action, and . . . (ii)(A) The composition

85. B. Malkiel, supra note 42, at 242-48, 259.
86. See supra note 17.
88. Id. § 1104(a)(1)(B)-(C).
89. Id. §§ 1104(a)(1)(D), 1110(a).
of the portfolio with regard to diversification.\textsuperscript{90}

The lengthy preamble to the regulation states that the legislative history of the Act indicates that the common law of trusts need not be followed mechanically. It reads in part as follows:

The Department is of the opinion that (1) generally, the relative riskiness of a specific investment or investment course of action does not render such investment or investment course of action either \textit{per se} prudent or \textit{per se} imprudent, and (2) the prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the overall plan portfolio. Thus, although securities issued by a small or new company may be a riskier investment than securities issued by a "blue chip" company, the investment in the former company may be entirely proper under the Act's "prudence" rule.\textsuperscript{91}

The significance of this language seems to be diluted, however, by later language in the preamble:

The regulation, however, is not intended to suggest either that any relevant or material attributes of a contemplated investment may properly be ignored or disregarded, or that a particular plan investment should be deemed to be prudent solely by reason of the propriety of the aggregate risk/return characteristics of the plan's portfolio. Rather it is the Department's view that an investment reasonably designed — as a part of the portfolio — to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk. The Department also believes that appropriate consideration of an investment to further the purposes of the plan must include consideration of the characteristics of the investment itself. Accordingly, . . . "appropriate consideration" shall include a determination by the fiduciary that the particular investment or investment course of action is reasonably designed . . . to further the purposes of the plan, taking into account the risk of loss and the opportunity for gain . . . associated with the investment or investment course of action.\textsuperscript{92}

The regulation and the preamble seem to be saying that portfolio theory is acceptable, but the fiduciary still must pay attention to the individual investment in a way that is left unclear. It may be that an investment that carries risk greater than that permitted at common law is alright, but not too much greater.

The preamble also provides that a passive investment strategy of an investment in "index" funds, or the like, is acceptable provided that there is a process for filtering out specific companies which are in financial difficulty.\textsuperscript{93}

\begin{itemize}
\item \textsuperscript{90} 29 C.F.R. § 2550.404a-1(b) (1989).
\item \textsuperscript{91} 44 Fed. Reg. 37,222 (June 26, 1979).
\item \textsuperscript{92} Id. at 37,224.
\item \textsuperscript{93} Id.
\end{itemize}
The preamble states that comments to the regulation as proposed included a request that the regulation state whether or not investments such as small or recently formed companies, precious metals, and objects of art were permissible. The Department responded that the statutory rule does not necessarily limit the fiduciary to those investments permitted at common law, but that it would not be advisable to establish a "legal list."94

There has been no reported litigation clarifying the status of portfolio theory as it applies to the pension fiduciary. There is dictum in one case, however, that supports the use of portfolio theory in assessing the performance of the pension trustee:

When investment advisors make decisions, they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of risk and return for the investor. The risk of a given investment is neutralized somewhat when the investment is combined with others in a diversified portfolio. The risk inherent in the entire portfolio is less than that of certain assets within that portfolio. Ideally, after diversification only market risk remains. Likewise, the return from a portfolio over time should be more stable than that of isolated investments within that portfolio.95

C. Restatement (Third) of Trusts Section 227

Restatement (Third) of Trusts section 227, adopted by the American Law Institute in May 1990, provides as follows:

§ 227. General Standard of Prudent Investment

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:

(1) conform to fundamental fiduciary duties of loyalty (§ 170) and impartiality (§ 183);

(2) act with prudence in deciding whether and how to delegate authority to others (§ 171); and

(3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§ 188).

94. Id. at 37,224, 37,225.
(d) The trustee's duties under this Section are subject to the rule of § 228, dealing primarily with contrary investment provisions of a trust or statute.96

The introduction, comments and reporter's notes to the section refer to the standard it establishes as the "prudent investor rule." The prudent investor rule radically changes the traditional prudent person rule in several respects.

The section explicitly states that the prudence of an investment is not to be judged in isolation but rather on the basis of its relationship to the portfolio as a whole. An investment which has high specific risk and is "speculative" under the prudent person standard may be permissible under the prudent investor standard if it contributes to diversification of the portfolio and the consequent reduction of total portfolio risk.97

The traditional prudent person rule requires a conservative, low-risk investment policy, unless the terms of the trust broaden the trustee's investment powers. Although it is not made explicit in the text of the new section 227, it is clear from the comments to it that the prudent investor standard permits the trustee to adopt an investment strategy that contains more risk than is allowed by the prudent person standard without express authorization in the trust investment, if the objectives, liquidity requirements and risk tolerance of the trust make such a strategy reasonable.98 Indeed, high-risk investment in relatively inefficient markets such as real estate and new ventures may also be appropriate without express authorization.99 There is a recognition, however, that something akin to a presumption of conservatism in investment policy exists even under the prudent investor standard.100 In sum, the standard of risk and return is a matter of discretionary judgment for the trustee.

Adequate diversification to minimize specific, uncompensated risk is stated to be fundamental under the prudent investor standard, although departure from it may be permissible in special circumstances.101 The level of suitable risk, therefore, is generally a function of systematic risk. It seems, however, that the principles relating to specific and systematic risk may have limited applicability to investments in relatively inefficient markets.

It should be emphasized that the adoption of portfolio theory is a separate matter from the adoption of a flexible approach to risk-return objectives for trustees. That is to say, the Restatement could have adopted portfolio theory without granting the trustee authority to invest at relatively high levels of risk.

At the same time that Restatement (Third) of Trusts section 227 was adopted, other provisions were adopted including a new section 228 which requires that the trustee conform to the terms of the trust instrument and of

96. RESTATEMENT (THIRD), supra note 5.
97. Id., comment f.
98. Id., comments e, f, h, 1.
99. Id., comments e, o, p.
100. See id., comment e & reporter's note, comment e.
101. Id., comments f, g, & reporter's notes, comments e, f, g, h.
course any statute which are not consistent with the prudent investor rule.102

Restatement (Third) of Trusts section 171 also was adopted, which has the
effect of permitting the trustee to delegate the decision-making with respect to
individual investments,103 although the trustee must personally be involved in
the formulation of the investment strategy and personally must monitor the
agent's performance.104 The delegation of investment decisions is not permitted
under existing law unless authorized by the trust instrument or statute.105

III. A PROPOSAL FOR MODEST CHANGE IN THE PRUDENT PERSON RULE

The traditional prudent person rule assesses the risk of each investment in
isolation. Modern portfolio theory assesses risk in terms of the interrelationships among the investments comprising the portfolio. A portfolio may contain
a number of investments which are highly volatile and therefore imprudent under the traditional rule. The portfolio may be so diversified, however, that a
volatile investment is balanced by one or more investments which are positively affected by factors which negatively affect the first investment. The cause of risk
for the first investment is neutralized by the negative covariance of the other
investment or investments. As a consequence, under portfolio theory the well-diversified portfolio may have a low level of risk despite the presence of individually volatile components.

The risk, or volatility, referred to above is specific, i.e., risk peculiar to the individual investment. Systematic, or market, risk is not affected by diversification and is unavoidable. Almost all stocks are affected by general economic conditions in the same way, albeit in different degrees.106 A well-diversified portfolio which contains negligible specific risk because of diversification may have a high systematic risk because many of the stocks have high betas, i.e., high systematic volatility.

The advocates of portfolio theory maintain that it should be within the prudent person rule to have a well-diversified portfolio which (a) contains individual stocks having high specific risk and (b) has moderate systematic risk. A diversified portfolio, which (a) contains individual stocks having high specific risk and (b) has high systematic risk, may not be within the prudent person rule even under portfolio theory.107

The critics of the traditional prudent person rule emphasize that investments which are speculative and therefore forbidden under that rule may not, in certain circumstances, increase total portfolio risk and, indeed, may decrease it, and therefore should not be illegal. This makes a good deal of sense as applied to a portfolio of hundreds of stocks such as the Standard and Poor's 500 stocks

102. Restatement (Third) § 228.
103. Id. § 171.
104. Id., comment h.
106. B. Malkiel, supra note 42, at 229; Restatement (Third), supra note 5, reporter's notes, general note on comments e through h.
107. See Restatement (Third), supra note 5, comment e.
or some other comparable portfolio. A family trust could not hold such a port-
folio directly, but it could invest in this manner by purchasing shares of a mutual
fund or bank common trust fund which holds such a portfolio. Such a stock
portfolio combined with a substantial portion of short-term government securi-
ties or other short-term debt of high quality constitutes a conservative and pru-
dent investment strategy. It is sensible to adopt a passive stock investment
strategy of this kind, rather than to attempt to do better than the market by
selection. Current law may make such an investment strategy impermissible
because some of the stocks in the fund in isolation would be imprudent. It
should be made clear, by judicial decision or legislation, that such an investment
strategy is prudent.

The experts tell us that the specific risk of a portfolio can be reduced to a
low level by a strategy of selective diversification among as few as twenty
stocks. It may be possible to establish that twenty specified stocks, if acquired
five years ago, would have demonstrated stability similar to that of the fund
which replicates the market, but that does not establish that those same twenty
stocks will demonstrate the same stability for the next five years. The critics of
the traditional prudent person rule would allow the family trust to invest in
stocks of high specific risk in a diversified portfolio of a relatively small number
of stocks.

It is inadvisable to allow trustees of family trusts to invest in volatile stocks
in a small portfolio. The history of performance notwithstanding, the selection
of stocks for future negative covariance is problematic. Doing this with stocks
with a history of low volatility is what is required under the traditional prudent
person rule. Doing this with stocks of high volatility involves risk to the trust
estate that is inconsistent with the ultra-conservative purposes of the family
trust. Maintenance of the real value of the portfolio and minimization of loss in
the event of severe economic decline are the objectives of the family trust.
Trustees should not be allowed to play fast and loose with high-risk stocks in
portfolios of limited components. In seeking diversification other than in a very
broad manner which replicates the market generally, the trustee should be lim-
ited to investments, whether stocks or other forms, that appear to have low
volatility.

In the past the trust was usually employed to protect financially the benefi-
ciaries or to assure that the benefit of wealth would inure to successive genera-
tions or individuals, or for both purposes. In recent decades the trust has often
been used primarily for the purpose of minimizing estate taxes, although
even in this circumstance there may be a protective purpose as well. In the
situation where tax considerations are foremost, a more aggressive investment
policy than that dictated by the traditional prudent person rule may be appropri-

108. See id., reporter's notes, general note on comments e through h.
110. The Restatement (Third) states that broad diversification is to be preferred, but that diversi-
fication with a limited number of stocks is permissible. RESTATEMENT (THIRD), supra note 5, com-
ment g & reporter's notes, general notes on comments e through h.
111. See id., reporter's notes, comment e.
ate; such a policy can be and sometimes is provided for in the trust instrument. Because the settlor can free the trustee from the constraints of the prudent person rule, there is no compelling reason for substantial modification of the rule. The proposed modification to allow for a passive strategy of investing in a market fund does not increase risk; indeed, it probably is safer than the selective diversification of low-risk stocks. In addition it is likely to produce a greater return than the selection of stocks. A case could be made that diversification by investing in a market fund should be required under the prudent person rule, but that departure is not proposed. The evidence of the pricing efficiency of the stock market is not conclusive; room should be left for selection among stocks of low volatility. If the settlor wants the trustee to be free to select stocks of high volatility, he can authorize it and also include a broad exculpatory clause which is valid short of recklessness.

The preceding discussion has focused on publicly traded securities in which the markets are reasonably efficient. There is the further question of whether the family trustee should be permitted to make investments in relatively inefficient markets such as real estate and new ventures. By definition these forms of investment have higher than average risk and also pose problems of selective diversification. It seems that such forms of investment should require authorization in the trust instrument.

At the present time the economic landscape is a mine field. There are large perennial federal budget deficits and an enormous federal debt. There are large perennial trade deficits. There is a huge and growing foreign investment in our federal debt and in our economy. Our major banks have huge loans of questionable value to third world countries. Some of our major industries have great difficulty competing with foreign products. The economic impact of the European Community remains to be seen. Elementary and secondary education in this country is a disaster area. Many of our older cities have rotting infrastructures (bridges, sewer lines, water mains, gas lines). The social pathology of our urban centers worsens. Unless the business cycle is obsolete, a recession is long overdue. When this nation decides to face up to the reality of its situation, it will be enormously expensive, with uncertain consequences. I would suggest that anyone who is daring with another's money in these circumstances is not acting responsibly.

The prudent investor rule defined in the Restatement (Third) of Trusts section 227 allows for higher risk-return objectives than are permitted under the traditional prudent person rule, without authorization by the trust instrument.

112. B. Malkiel, supra note 42, at 360.
113. Id. at 188-203; RESTATEMENT (THIRD), supra note 5, reporter's notes, general notes on comments e through h.
115. B. Longstreth, supra note 1, at 121-33 (suggesting such aggressive investment practices). They are also recognized as permissible in appropriate circumstances by the Restatement (Third). RESTATEMENT (THIRD), supra note 5, comment h.
Indeed, it would allow aggressive investment strategies such as new ventures without authorization by the trust instrument. Such practices, of course, would be permissible only if they were considered suitable and reasonable given the circumstances of the trust. It is suggested that such fiduciary practices are peculiarly inappropriate in the present economic climate. It is also my position that such practices should always require authorization in the trust instrument. It is my view that the Restatement makes a profound contribution by its introduction of portfolio theory to fiduciary law. The Restatement's break with tradition on the matter of risk-return objectives for fiduciaries is, in my view, not well-founded, at least as applied to the family trust.

CONCLUSION

The prudent person rule may make it illegal for a trustee to invest in a market fund because some of the components may be speculative. This is unsound and should be changed. Investing in this manner provides as much diversification as can be practically obtained. It carries low risk, particularly when combined with short-term debt securities of good quality. It is unlikely that the trustee is able to outperform such a portfolio by investing on a selective basis at the same level of risk. The objectives of the typical family trust are to provide a reasonable income, preserve the purchasing power of capital, and protect against severe economic decline, all of which are served by such an investment strategy.

The trustee of the family trust should not be permitted to use portfolio theory to justify selective diversification involving volatile stocks or other investments in a portfolio of limited components. The offsetting of the volatility of one investment against the volatility of another is problematic in normal economic circumstances; in abnormal economic circumstances it would seem to be dangerous. Such a practice probably would have as its objective portfolio performance which exceeds that of the market generally, with the concomitant risk, and should be permitted only if the settlor authorizes it.

The post-World War II period has been one of economic growth and rising values. Certain economic and social developments, however, make it uncertain that the future will be as productive for investments as the past. This is not the time for substantial innovation in the management of the property of others who are dependent upon such property for their needs.