Index Mutual Funds: The Best Investment Strategy for Complying With the California Uniform Prudent Investor Act

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The 1995 enactment of the California version of the Uniform Prudent Investor Act (UPIA) (Prob C §§16002(a), 16003, 16045-16054) has caused estate planning attorneys to give increased attention to the obligations of trustees investing in publicly traded securities. The statute, applicable to investment decisions and actions taken after January 1, 1996, even for preexisting trusts, is based on the Restatement (Third) of Trusts (Prudent Investor Rule) §227 (1992), which provides a valuable guide to practitioners as well as legislative history. This article explores the reasons why the requirements of UPIA, viewed in light of its Restatement antecedents, will generally lead trustees to favor index mutual funds when selecting investments for long-term trusts. For reasons explained below, the case for such investments is sufficiently strong that trustees who instead choose "active" investment strategies may find it difficult to justify their choices.

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The Statute

The cornerstone of UPIA is its prudent investor rule, which states:

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. Prob C §16047(a).

The statute then prescribes more specific duties, including:

- A duty to select risk and return objectives reasonably suited to the particular trust (Prob C § 16047(b)).
- A duty to diversify (Prob C § 16048).
- A duty to evaluate investments in the context of the portfolio as a whole (Prob C §16047(b)).
- A duty to avoid unreasonable or inappropriate costs (Prob C §16050).
- A duty to consider tax consequences (Prob C §16047(c)(3).

Whether a trustee satisfies the requirements of the statute is determined in light of the facts and circum- stances existing when a trustee made his or her investment decisions. Prob C § 16051. These decisions are specifically protected from being judged in hindsight, even if trust investment returns prove to be inferior. ("Inferior" usually means underperforming some market benchmark such as the Standard and Poor's 500 Index (S&P 500).) If a trustee lacks the knowledge or experience to carry out his or her duties, prudent investing may require the trustee to delegate investment decisions to (or at least receive advice from) an investment expert. Prob C § 16052(a); see Introduction to Restatement §227. Assuming delegation is done prudently with respect to costs, the selection of the expert, the terms of the delegation, and periodic review, the trustee will not be liable for the expert's actions. Prob C § 16052(c). See also Prob C §16401.

The Objective of Maximizing Net Total Return

The objective of most individual long-term investors is to achieve maximum "net total return" (the sum of both "income," in the trust accounting sense, and capital appreciation, reduced by commissions, other expenses, and taxes) without exceeding some chosen level of risk. This same objective is appropriate in most trust situations in which (1) the trust will remain in effect for a prolonged period, (2) accomplishment of a major trust purpose will not be prevented by a short-term drop in the market, and (3) the amount distributable to the lead beneficiary is not excessively tied to the amount of "trust income." This will typically be the case when a long-term trust permits the trustee to pay income and principal without distinction to the lead beneficiary, or where the amount payable to the lead beneficiary is described in terms of either an annuity (periodic payments of a stated dollar amount) or a unitrust amount (payout based on the value of the trust estate as redetermined at specified intervals.)

As an aside, readers should note that there tends to be a natural conflict between the desirability of maximizing total investment return and the frequently perceived need to generate traditional dividends and interest, regardless of the adverse effect on capital appreciation, whenever there is need to provide "income" for a traditional "income" beneficiary. In the long run, the resulting negative effect on total return injures not only the remainderman, but the income beneficiary as well. Accordingly, drafters should consider avoiding traditional income interests when they are not needed to qualify for the marital deduction. For further discussion of the problems of "income" trusts and drafting options, see, e.g., Wolf, Defeating the Duty to Disappoint Equally—The Total Return Trust, 32 Real Prop Prob & Trust J 45 (Spring 1997), and Hoisington, Modern Trust Distribution Design and Implementing Investment Strategies, UCLA-CEB Estate Planning Institute (Cal CEB Program Handbook June 1998).

The "Active Investing" Strategy for Maximizing Total Return

Many investors who try to maximize return (whether acting on their own or in a fiduciary capacity for others) try to "beat the market." This process, known as "active investing," involves stock picking and market timing. The goal of "stock picking" is to identify and profit from mismatches between the current prices of stocks and what are thought to be their "true" underlying values. (As used herein, the term "stock picking" includes picking mutual funds as well as individual stocks and bonds.) The goal of "market timing" is to shift money in and out of different investments in order to profit from short-term cyclical events in financial markets.

The "Indexing Investing" Strategy for Maximizing Total Return

Unfortunately, as will be explained later in detail, the odds of beating the market over the long run are not very good. The mere attempt to actively manage a portfolio typically has a variety of negative side-effects, including increased management fees, increased costs related to the increased number of stock purchases and sales, and increased or accelerated capital gain tax recognition resulting from the increased sales. Thus, it is not surprising that, on a risk-adjusted basis, a majority of all actively managed mutual funds underperform the S&P 500 in any given year.

In sharp contrast to investment strategies designed to beat the market, indexing investment strategy provides for investing in mutual funds that emulate the market as a whole by acquiring and holding all (or a representative sample) of the investments represented in a selected index.

For example, the goal of the Vanguard S&P 500 index fund is to provide the investment performance of the stocks in the S&P 500 index by holding them in the same proportionate amounts as they are represented in the index. The popularity of this investment approach is reflected by the fact that this fund is now the second largest mutual fund in America and is closing fast on the leader, Fidelity Magellan. The advantages of a fund such as the Vanguard S&P 500 index fund include sharply lower management fees and the lower costs and taxes that result from fewer purchases and sales of stock.

Not surprisingly, a Reporter's General Note to the Restatement might be read as inviting trustees *to start from the presumption that index mutual funds are the best way to invest and manage trust assets*. (This suggestion assumes that the trust's assets have no "special relationship or special value" to the trust or any of its beneficiaries. See Prob C §16047(c)(8). Such "special" situations most commonly involve a trust of which a principal asset is a family-owned business.) The Note observes: "The greater the trustee's departure from one of the valid passive [e.g., indexing] strategies, the greater is likely to be the burden of justification [for choosing an active investment strategy] and also of continuous monitoring." General Note on Restatement §227, Comments e-h. More emphatically, Merton H. Miller, a co-recipient of the 1990 Nobel Memorial Prize in Economic Science, has observed: "[A]ny pension fund manager who doesn't have the vast majority—and I mean 70 percent or 80 percent of his or her portfolio— in [indexed] investments is guilty of malfeasance, non-feasance or some other kind of bad feasance!" See Tanous, Investment Gurus (1997). Even that paragon of stock picking, Peter Lynch, former manager of Fidelity Magellan, has noted that most investors would "be better off in an index mutual fund." See also Bogle, Bogle on Mutual Funds (1994) and Slater, John Bogle and the Vanguard Experiment (1997).

This is not to suggest that either UPIA or the Restatement precludes active management strategies. On the contrary, active strategies are expressly permitted (Restatement §227, Comment f; Prob C § 16047(e), and the Reporter notes that "[a]lthough commentary in the prudent investor rule understandably tends to emphasize relatively passive investment" such as index funds, "efforts were also made throughout to avoid suggesting that active management strategies are impermissible." Nevertheless, a Comment to the Restatement explicitly warns trustees about the dangers of venturing into the stock picking and market timing of active investing (Restatement §227, Comment h):

> Active strategies. . . entail investigation and analysis expenses and tend to increase general transaction costs, including capital gains taxation. Additional risks also may result from the difficult judgments that may be involved and from the possible acceptance of a relatively high degree of [uncompensated] risk. These considerations are relevant to the trustee initially in deciding whether, to what extent, and in what manner to undertake an active investment strategy and then later in the process of implementing any such decisions.

The Prudent Investment Process

To understand why UPIA should frequently cause a trustee to select index funds as the principal trust investments, it is helpful to further review the requirements of the statute, beginning with a requirement for evaluating trust objectives and responding with investment choices that are appropriate for accomplishing the objectives of the particular trust, taking into account relevant circumstances. Prob C §§16047, 16049. The circumstances may include general economic conditions, the potential effects of inflation or deflation, tax problems, distribution requirements, and other assets of beneficiaries.

The Duty To Select Risk and Return Objectives Reasonably Suited to the Trust

Under Prob C § 16047(b),

> [a] trustee's investment and management decisions respecting individual assets and courses of action must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

The Restatement recognizes that all investments involve risk in some form. Even short-term Treasury securities are subject to risk in that their purchasing power may be eroded by inflation. Other risks include the risk of loss of principal or expected income and a variety of risks that essentially boil down to a lack of certainty that an expected value can be readily accessed at a specific time because of such things as price volatility. For the most part, markets reward investors for taking higher risks. This is simply the inevitable result of the fact that the typical investor confronted with a choice of two investments will not choose the one presenting higher risks unless there is a probability of higher returns.

To choose a suitable risk-and-reward investment objective, a trustee must first identify the trust's objectives. What does the settlor want it to accomplish for what beneficiaries over what period of time? A trustee must then target a level of risk and rate of return for the portfolio that will allow the trust to meet these objectives. Generally, the analysis of risk should include an assessment of the pernicious effect that inflation will have on the future purchasing power of a trust's assets. See Prob C §16047(c)(2).

A trustee should also determine the type and amount of risks that each of the trust's beneficiaries can tolerate. This assessment is based on the following factors, among others (Prob C §16047(c)):

- age;
- current health;
- life expectancy;
- genetic profile;
- particular needs for liquidity, regularity of income, and appreciation of capital;
- financial condition;
- tax status;
- level of financial responsibility; and
- level and nature of other resources.

Obviously, the risks that may be appropriate to prevent erosion of purchasing power for a long-term trust benefiting persons with other assets will likely be totally inappropriate to a trust designed to meet short-term needs of an elderly person whose needs for cash may be immediate and, in case of a health care problem, difficult to predict.

Once the potential demands on the trust are understood, the trustee can begin to make preliminary decisions regarding the classes of assets (e.g., cash equivalents, bonds, equity securities) that are appropriate for the trust. As discussed below, an advisor can help with this process by using the extensive historical risk and return data that are available for most asset classes.

The Duty To Diversify

Next, the trustee must take into account the fact that the trustee ordinarily has the duty to diversify the investments of a trust "unless, under the circumstances, it is prudent not to do so." Prob C § 16048. This duty is based on the notion that failure to diversify exposes a portfolio to a risk that is not "compensated." The market usually rewards the investor who invests in equities rather than Treasury bills, but it usually does not reward the investor who chooses to put all of his or her eggs in one basket by purchasing only the shares of a particular company.

Situations in which it may be prudent not to diversify are largely limited to those in which the trust was created in whole or in part for the very purpose of holding a particular asset (e.g., shares of a closely held corporation or a life insurance policy) and temporary situations in which, relative to the expected benefits, conversion of investments would be especially costly (e.g., substantial gains would be recognized a short period before the death of the settlor of a revocable trust).

With respect to the duty of diversification, the benefits of mutual fund investing are obvious.

The Duty To Evaluate the Portfolio as a Whole

Under UPIA, a trustee's prudence is based on an evaluation of the portfolio as a whole. Prob C § 16047(b). Thus, individual investments or classes of investments may have risk and return attributes that are higher or lower than the target for the entire portfolio. For purposes of making such evaluations and corresponding decisions, index funds can be easier to work with than actively managed funds, because there is typically greater certainty about the general nature and aggregate risk level of the assets in an index fund.

The Duty To Be Cost-Conscious

Next, a trustee has the duty to incur only appropriate and reasonable costs. Prob C § 16050. Control of costs is one of two areas in the investment decision-making process—the other is control of taxes—where a trustee can most influence a trust portfolio's performance.

There are three principal reasons why index funds are far more cost-efficient than active funds. First, annual operating expenses are minimized because computers take the place of the highly paid stock pickers and market timers employed by active funds.

Second, transaction costs are minimized because an index fund manager trades stocks only when they are bought for, or sold from, a fund to match the changes that are made in its underlying index. (Index funds also trade when their investors invest and reinvest in fund shares and, more rarely, cash out of them. Low-turnover index funds incur transaction costs that are only one-twentieth those of the average active fund.) Usually, fund transaction costs are significantly higher in active funds because their managers are involved in stock picking and market timing attempts to beat the market. These attempts, whether successful or not, always incur costs.

Third, commission loads are practically nonexistent because, unlike active funds, index funds are sold directly to the public rather than through stockbrokers and other commissioned salespeople. (Caution: A few large stock brokerage firms now feature index funds, but they are either sold as "loss leaders" or sold through high-cost "wrap accounts.")

Assuming reasonable care has been taken to select an index fund with appropriately low management fees and no "loads," the cost advantages of index funds constantly work for those who invest in them, just as the disadvantages of high cost active funds are always working against their investors. Further, these cost advantages are neither dependent on the fleeting nature of investment skill (or luck) nor sensitive to a particular time period.

The Duty To Consider Tax Consequences

A trustee has the duty to consider the expected tax consequences of his or her investment decisions. Prob C §16047(c)(3). It is well settled (although not widely appreciated) that taxes can be devastating to investment performance. Because index fund managers do not attempt to beat the market, they are generally able to retain assets longer, thereby deferring capital gain recognition. In contrast, active fund managers typically generate substantial capital gain taxes as a result of their stock picking and market timing efforts to beat the market. To some extent the problem is aggravated by the fact that standard mutual fund performance data do not reflect the effect of the manager's transactions on the investors' taxes, thus reducing the manager's incentive to minimize transactions. It should be noted, however, that some actively managed funds now claim to be tax-sensitive and attempt to recognize losses that will offset recognized gains in a given year to the extent this is feasible. Presumably, the utility of this strategy will often be limited in long bull market situations, due to a shortage of available losses.

Evaluating the Prudence of Active Fund Investing

As noted earlier, commentary to the Restatement explicitly warns trustees about the high costs of stock picking and market timing. Yet, because they are unfamiliar with the new UPIA requirements, many trustees continue to pursue investment strategies using high-cost active mutual funds or management. How does a trustee determine whether a particular actively managed portfolio is permissible under UPIA? A Comment to the Restatement provides the answer: "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." Restatement §227, Comment h.

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Thus, a trustee must conduct a two-pronged inquiry: (1) Are the extra costs and risks of the active strategy "substantial" and, if so, (2) are they "justified by realistically evaluated return expectations?"

A trustee can begin to answer the first question by comparing active funds to index funds in the areas of commission loads, annual expenses, and transaction costs. About 50 to 60 percent of active funds bear commission loads, while only a few index funds carry them. (Trustees are advised never to invest in an index fund carrying a load, however low.) The annual expenses of the average active fund are approaching 1.6 percent, while those of most index funds are under .5 percent, and this gap is widening. (Speech of John C. Bogle, Sr., Chairman of The Vanguard Group of Investment Companies, Los Angeles Times Investment Strategies Conference, Los Angeles, February 7, 1998, citing Lipper Analytical Services data.) The annual transaction costs of the average active fund (a product of "portfolio turnover" that is generated by efforts to beat the market) are about 1 percent, while those of index funds range from 50 to 95 percent less. (Even ostensibly small differences in expenses and costs can greatly affect the lifestyle of a trust beneficiary. A $1 million trust yielding 5.2 percent generates a monthly income of $4333. This drops to $3333 if just 1.2 percentage points of the yield are eaten up by expenses and costs. In addition, an index fund that tracks the S&P 500 or the Wilshire 5000 index is about 25 percent less risky (less volatile) than the average active stock fund. (According to John C. Bogle, citing Morningstar data.) It is clear that, in general, the extra costs and risks of active funds are substantial in comparison to index funds.

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Are Track Records Sufficient Justification?

Even if an active investment strategy is determined to have high costs, the second prong of the inquiry still permits a trustee to pursue it if the higher costs can be justified by "realistically evaluated return expectations." Although some trustees go through elaborate analyses of expected rates of return, they nearly always end up basing their decisions on the proposed investment strategy's performance, or track record, over the past three to five years. This technique, called "track record investing," looks to the past to evaluate expectations about the future and involves consulting a rating service such as Morningstar and selecting five-star mutual funds based on the belief that their outstanding historical performances will continue. According to General Note on Restatement §227, Comments e-h, however, "evidence shows that there is little correlation between fund managers' earlier successes and their ability to produce above-market returns in subsequent periods." Indeed, it is well documented and known among active money managers that no reputable study has shown that past superior investment performance is a reliable way to predict future long-term superior performance. Nevertheless, in actual practice, managers attempt to refute this fact by employing track record investing. Michael Stolper, the publisher of an investment newsletter, sums up how active money managers view track record investing: "We know that the past is meaningless, but it is all we have." The Wall Street Journal (Apr. 5, 1995). If this is "all we have," it would appear that track records are dubious justification for active management investing.

Is Manager Selection Sufficient Justification?

Another technique trustees commonly use to help them in the second prong of the inquiry involves attempts to identify specific money managers who are exceptionally skillful. These attempts often entail rating active mutual fund managers according to their (1) performance relative to assumed risk, (2) performance among peers, and/or (3) consistency of performance in both rising and falling markets. See Trone, Albright & Madden, Procedural Prudence (1991). Yet, in each of these instances, the word "performance" is just another way of saying "track record." Since it is generally agreed that track record investing is meaningless, it is illogical to think that skillful managers can be identified based on such performance ratings. Despite this, there is a cottage industry of well-paid investment management consultants that tells its clients just the opposite.

There are other problems in attempting to identify skillful money managers. One is that "markets make managers," so even an unskillful manager can turn in an outstanding performance (even for a substantial period of time) if the market has favored his or her investment style. Another problem is that a manager must have established a track record of at least 15 years, and sometimes as much as 80 years (depending on the extent to which the manager outperformed the market), before it is possible to determine whether the performance is attributable to skill or just luck. Finally, even when a track record is long and a manager is determined to be truly skillful, there is no guarantee that he or she will outperform the market over any future period of time. Based on attempts (often themselves costly) to identify skill, then, a prudent trustee cannot realistically evaluate whether a given active investment strategy can be expected to earn greater investment returns.

Understanding Why Costs and Taxes Are More Important Than Stock Picking

All Financial Markets are Zero-Sum Games

It is important that trustees thoroughly understand why index funds are the best way to invest and manage trust assets under UPIA. Fundamentally, the case for index funds is a mathematical one. Simply put, due to the high costs and taxes that characterize actively managed mutual funds (and other forms of active money management), the chances of beating a given financial market are very slim over the long run, and most active investors (whether professional or amateur) will underperform it—likely substantially. Active money managers who disagree with this mathematically certain result by condemning indexing as the acceptance of "mediocrity" demonstrate their misunderstanding of the fundamental nature of financial markets.

Such assertions by proponents of active management ultimately count for little in the face of unchanging, yet surprisingly simple, laws of arithmetic. These laws, which present an overpowering case why investors should invest in index funds, hold true for yesterday, today, and tomorrow for all financial markets the world over, whether efficient or inefficient. (The belief, endlessly repeated by the media, that there are "greater opportunities" to beat the market by picking "inefficiently" priced stocks such as small stocks and foreign stocks is therefore false.) The following explains the relentless logic that underlies these little understood laws that govern all financial markets.

Every financial market in the world (whether the U.S. stock market or the Brazilian bond market) is a zero-sum game— a game where some win and some lose relative to a market's return. (This means that the investor on one side of a market trade will always outperform the market return relative to that trade and the investor on the other side will underperform it, even though both investors can make money on the trade in an up market.) The players who participate in a given financial market consist of four groups of investors: (1) indexers who earn the market return, (2) active investors who earn the market return, (3) active investors who underperform the market return, and (4) active investors who outperform it.

In effect, the losing active investors who underperform a financial market are "sacrificial lambs" for the winning active investors who outperform it. For example, suppose that there are only four investors in a particular financial market: three active investors and one indexer. Further suppose that the market return was 30 percent last year and that only one of the active investors outperformed this return—by 20 percentage points—thus earning a return of 50 percent. As sure as the sun rises in the morning, the other two active investors must have collectively underperformed the market return by 20 percentage points. Naturally, the indexer earned the market return of 30 percent. An indexer is never a sacrificial lamb who loses to winning active investors. It is important to understand that these returns are before costs and taxes. Once these two critical factors are taken into account, the one winning active investor actually earned less than 50 percent and the two losing active investors lost more than 20 percent.

This dictates three outcomes: First, indexed money will always outperform half of all active money invested in a financial market, before costs and taxes. For example, an indexer invested in Vanguard's Total Stock Market index fund (tracking the Wilshire 5000) will always outperform, on a gross basis, 50 percent of active money invested in all U.S. stocks. (This does not necessarily mean that an indexer will outperform 50 percent of all active mutual funds in all market scenarios. Most active funds hold cash, so in the event of a steep but short market downturn, the cash will "cushion" some of the shock and thus briefly mitigate some of the cost disadvantages of active funds. In this kind of limited situation, an indexer will thus outperform less than 50 percent of all active mutual funds. Reciprocally, cash becomes a drag on fund performance in a rising market.) Second, after costs and taxes, indexed money will always outperform more than 50 percent of active money. Third, the percentage of active money that will be outperformed by index investments increases with time as the net performances of most (even superior) active mutual funds regress to less than the market average due to the erosion of good performances by bad performances, high costs and taxes, and the negative compounding they generate. In this respect, it is important to understand that money used to pay for loads, costs, and expenses is "lost money" because it is no longer available to be compounded into future wealth. If, for example, an investor pays a 5 percent load, the value of the fund will always be reduced by 5 percent, and the value of that lost 5 percent increases over time as the value of the investment grows. This is why indexers who earn "only" the average market return are above average investors over the long run in comparison to most active investors.

The Apparent Impossibility of Consistently Beating the Market Average by Enough To Cover Costs and Taxes

A wide variety of studies examining mutual fund performance and the recommendations of such sources as stock advice newsletters have long demonstrated that neither fund managers nor other supposed experts are able to beat the market consistently, particularly not by an amount sufficient to compensate for the increased costs and taxes of active investing. (See, e.g., the landmark study, Jensen, The Performance of Mutual Funds in the Period 1945-1964, 23 J Finance 389 (1968). This conclusion has subsequently been confirmed in over 200 studies. See also, e.g., Graham & Harvey, Market Timing Ability and Volatility Implied in Investment Newsletters Allocation Recommendations, National Bureau of Economic Research Working Paper No. 4890 (Oct. 1994).) Malkiel, A Random Walk Down Wall Street: Including a Life-Cycle Guide to Personal Investing (6th ed 1996).

One explanation of this phenomenon, known as the efficient market hypothesis (first set forth in Fama, The Behavior of Stock Market Prices, 37 J Business 34 (1965)), posits that, at any given time, securities are fairly priced based on the information available and the inferences about the future that can be drawn from that information. New information will result in price changes, but in the absence of illegal insider trading there is no systematic way to obtain and act on new information more quickly than the rest of the market. Such a theory leaves open the possibility of discovering small investments that for some reason are not efficiently priced, but, given the size and sophistication of the investment community, these opportunities will not involve publicly traded securities. Despite debates about the validity of the hypothesis as the proper explanation, the conclusion remains well proven that one cannot reasonably expect to beat the market over time when saddled with the costs and taxes associated with active investing.

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The Misleading Media

Of course, the "investment information system" (comprised of the media, mutual fund families, stock-brokerage firms, mutual fund ratings guides such as Morningstar, investment advisory services such as Value Line, and others) fuels the belief that investors can beat the market, because it derives vast sums of money by doing so. Indeed, anecdotal evidence about how A, B, or C beat the market over some past time period abounds in the media. On closer examination, though, it is often found that these stories spotlight short-term winners who are never heard from again. Even when long-term winners are profiled, they often turn into losers once taxes and commission loads (neither of which are reflected in performance data) are taken into account.

Even the fact that there are long-term after-tax and after-load winners is largely irrelevant to active investors because the past superiority of these winners has no bearing on whether they will be superior in the future and because they cannot be identified in advance anyway. If there are enough players in the game, it is statistically certain that there will be winners over any given period, just as there are winners of the California lottery, but it doesn't follow that the success will be repeated in the future.

Despite this, the hope of finding the next hot stock tip, identifying the next winning mutual fund, or crowning the next guru saturates the investment world that investors live in and from which they get their information about investing. Yet, such hopes are not what prudence is about. When all is said and done, the high costs and taxes typical of most active funds affect investment performance so heavily that, over the long run, they usually overwhelm whatever real investment skills even "superstar" mutual fund managers may possess. The fact that it is possible to count on one hand the number of mutual fund managers who have beaten the market with skill on a net long-term basis during the last 40 years confirms this. And even this fails to address the problem of how to find these wonders before they become famous.

Using a Financial Advisor

The premise that trust assets should ordinarily be invested in index funds does not mean that trust investment programs will not benefit from the assistance of a financial advisor.

The most valuable (although little appreciated) way that a financial advisor can assist a trustee is to bring discipline to the investment process—plain, old-fashioned investment counseling that relies on a "steady hand at the tiller"—especially during the euphoria of up markets and the despair of down markets. Even many sophisticated trustees who believe they can prudently invest and manage trust assets on their own can find it beneficial to have the assistance of a qualified advisor. Studies consistently show that investors who have such advisors do better than those who do not. See, e.g., 1993 Quantitative Analysis of Investor Behavior, DALBAR Financial Services, Inc. (Jan. 1995).

The initial task of a financial advisor retained by a trustee is to formulate a prudent investment strategy for a trust to ensure that its targeted return and level of risk are reasonably consistent with its objectives and risk tolerance. Part of this involves a decision-making process known as "asset allocation," in which an advisor determines how a portfolio should be "split" into stock and/or bond "asset classes" and/or cash. (An "asset class" is made up of investments with common characteristics, such as the large company "blue chip" stocks represented in the S&P 500 index.) A famous study (the conclusions of which are widely accepted by investment experts) found that asset allocation, not stock picking and market timing, is the overwhelmingly most important determinant of variance in investment returns. See Brinson, Hood & Beebower, Determinants of Portfolio Performance, 42 Financial Analysts

J 39 (July/Aug. 1986).

It should be noted that index fund investing facilitates accurate asset allocation, because any given index fund remains constantly invested solely in all (or a representative sample) of the particular class of assets indexed by that particular fund. Active funds usually reflect different allocations among asset classes at different times. Such “asset class drift” makes it difficult to use active funds to realize a specific investment strategy.

Once the advisor and trustee have agreed on an appropriate asset allocation for the portfolio, the advisor must propose a specific plan for establishing the chosen allocation with the right kinds of index funds. The advisor should also periodically remind the trustee about the possible need to rebalance a portfolio that has incurred changes in asset allocation as a result of varying investment performance within asset classes. Decisions of this type require considerable attention to transaction costs and taxes.

An important aspect of the financial advisor’s task is to suggest ways to increase the diversification of the portfolio and thereby reduce its risk. An advisor who uses index funds to design a well-diversified portfolio can reduce risk in two ways. The first way is at the individual fund level. Because an index fund holds all (or a representative sample) of the investments that comprise a discrete asset class, it maximally reduces risk within that asset class. In contrast, most active funds are poor risk reducers in this way because they really do not stay invested in one asset class. The second way to reduce risk is at the portfolio level. A financial advisor can ensure maximum diversification among all of a portfolio’s asset classes by including index funds that suitably offset each other’s performance under different market conditions.