PLAN INVESTMENTS

Illuminating the "Broad Range" Requirement of ERISA Section 404(c) with the Language of Modern Portfolio Theory Found in the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule)

This column helps illuminate the "broad range" requirement of ERISA Section 404(c) with the language of modern portfolio theory and other notions of financial economics that is found in the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule)

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ERISA charges the investment fiduciaries of a qualified retirement plan such as a 401(k) plan with the duty to, in effect, provide plan participants with a menu of healthy foods (*i.e.*, a prudent variety of diversified investment options). Many fiduciaries are surprised to learn that they also have the responsibility to make sure that participants eat their food (*i.e.*, make prudent asset allocation decisions for their plan accounts). If plan participants fail to eat their food (*i.e.*, they make imprudent asset allocation decisions) or they eat the wrong food and get sick (*i.e.*, they invest in investment options provided imprudently by fiduciaries), investment fiduciaries may incur liability.

ERISA Section 404(c)

One way for investment fiduciaries to avoid liability for the risk that plan participants may not eat their food or that they will eat the wrong food and get sick is to obtain the limited protection of ERISA Section 404(c). In order to obtain such protection, a 401(k) plan must be participant-directed. A plan is considered participant-directed only when plan participants can "exercise control" over the investments in their accounts. Participants are considered to exercise control only when they have the opportunity to choose from a broad range of investment alternatives.

The Preamble to the final 404(c) regulations ("Preamble") issued in 1992 explains that this broad range requirement is met if "participants . . . are afforded a reasonable opportunity to materially affect the potential risk and return on amounts in their accounts; choose from at least three diversified investment categories; and diversify investments so as to minimize the risk of large losses. . . . [T]he three categories of investments in the aggregate enable the participant, by choosing among them, to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant . . . . [E]ach of the investment categories, when combined with investments in either of the other categories, must tend to minimize the risk of a participant's portfolio at any given level of expected return."

Modern Portfolio Theory

Because the language in the Preamble is somewhat opaque, it is doubtful that one in a thousand investment fiduciaries of 401(k) plans has taken the time

to read it, much less understood its real meaning and importance. Where did this language come from and what does it mean?

The language in the Preamble is the language of modern portfolio theory. This theory, which is a body of academic and empirical work that describes the behavior of financial markets, originated in the mind of a 23-year-old graduate student one day in 1950 as he was reading a book in the library at the University of Chicago. The student, Harry Markowitz, demonstrated mathematically that day why *investors must consciously think about risk as well as return*. This simple yet fundamental idea, one of the most crucial investment insights of the 20th century, later earned Markowitz a Nobel Prize in economic sciences and designation as the father of modern portfolio theory.

Modern Portfolio Theory and the Uniform Prudent Investor Act

Modern portfolio theory and other notions of financial economics provided the impetus for the reformation of trust investment law in the 1990s. The vanguard of these reforms was the Restatement 3rd of Trusts (prudent investor rule) ("Restatement") promulgated in 1992. The Uniform Prudent Investor Act ("Act"), promulgated in 1994 and now law in 42 states and the District of Columbia (plus the US Virgin Islands), draws upon and codifies the principles of investment prudence laid down by the Restatement. The prefatory note to the Act states, in part: "[The Act] undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as 'modern portfolio theory.'"

Modern Portfolio Theory and ERISA

ERISA, long before promulgation of the Restatement or the Act, was actually first to apply key tenets of modern portfolio theory to the management of assets by investment fiduciaries. "[I]n Labor Reg. § 2550.404a-1 (42 FR 54122, 1977), the DOL determined that ERISA redefined the investment duties of fiduciaries to require [them]Éto act as a prudent investment manager under the modern portfolio theory." [*See* "Legal Memorandums for Prudent Investment Practices," written by Fred Reish and Bruce Ashton for the Foundation for Fiduciary Studies.] "[B]oth the DOL and the courts have found that ERISA's investment provisions are based on . . . modern portfolio theory." [*See* "A Prudent Process for Selecting 401(k) Investment Options (Part I)" by Fred Reish, July 2003.]

The Link Between the Uniform Prudent Investor Act and ERISA

ERISA, as federal law, preempts all state laws "insofar as they may now or hereafter relate to any employee benefit plan." [ERISA § 514(a)] The standards of the Act nonetheless apply to the conduct of investment fiduciaries responsible for qualified retirement plans (even though the standards apply primarily to the investment conduct of trustees of private family trusts). The Prefatory Note to the Act states, in part: "the prudent investor rule [of the Act] also bears on . . . pension trusts [governed by ERISA] . . . [ERISA] . . . absorbs trust-investment law [developed by the states] through the prudence standard of ERISA Section 404(a)(1)(B)." The legislative history of ERISA makes clear that the law governing qualified retirement plans is tied closely to trust investment law. [*See* the Preamble to ERISA Reg. § 2550.404a-1 and the accompanying discussion.]

Because ERISA is derived from the common law of trusts, the Restatement restates the common law of trusts, and the Act is a codification of the Restatement, it is not difficult to see that the standards of the Act have a direct bearing on the conduct of investment fiduciaries of qualified retirement plans such as 401(k) plans. John Langbein, the reporter for the Uniform Prudent Investor Act and Chancellor Kent Professor of Law and Legal History at Yale University Law School, observes: "ERISA has always been interpreted with a strong eye on the common law, and it is therefore quite clear that the Uniform Prudent Investor Act will powerfully affect the federal courts in their interpretation of ERISA." [*See* "The Uniform Prudent Investor Act and the Future of Trust Investing" by John H. Langbein, *Iowa Law Review* 81 (1996): 641-669.]

Given the link between ERISA and the Uniform Prudent Investor Act as well as the Restatement from which the Act is derived, it might be useful to turn to the Act and the Restatement for help in beginning to introduce investment fiduciaries to the meaning and importance of the "broad range" requirement found in the Preamble (issued in final form the same year the Restatement was promulgated) to the final 404(c) regulations. This general information may help such

fiduciaries start to think about providing menus of 401(k) investment options that are more in line with the kind envisioned by the Preamble.

A Fiduciary's Central Consideration: Determine the Tradeoff Between Risk and Return

The first bit of information that investment fiduciaries may find helpful concerns the notion of *risk and return*. The Preamble states, in part: "a reasonable opportunity to materially affect the potential *risk and return* on amounts in their accounts . . . achieve a portfolio with aggregate *risk and return* characteristicsÉminimize the *risk* of a participant's portfolio at any given level of expected *return*." ERISA regulations [ERISA Reg. § 2550.404a-1] interpret the "prudence" rule of ERISA Section 404(a)(1)(B) as it applies to the investment duties of fiduciaries of employee benefit plans. These regulations note that some of the facts and circumstances to look to in making that interpretation "[include] giving appropriate consideration to the role that the investment or investment course of action plays (in terms of such factors as . . . *risk/return* characteristics)." In accord is ERISA Interpretive Bulletin 94-1 which states, in part: "any models or materials presented to participants or beneficiaries will be consistent with widely accepted principles of modern portfolio theory, recognizing the relationship between *risk and return*."

This language of modern portfolio theory found in the Preamble and any number of regulatory interpretations of ERISA is reflected in Section 2(b) of the Act which reads, in part: "A trustee's investment and management decisions respecting individual assets must be evaluated . . . as a part of an overall investment strategy having *risk and return* objectives reasonably suited to the trust." The great importance that the notion of risk and return has to prudent fiduciary investing is clearly evident in the prefatory note to the Act: the "central consideration" of a fiduciary when investing and managing assets is to determine the tradeoff between risk and return, Dr. Markowitz's crucial insight that day in 1950.

The goal is to find a tradeoff that will achieve the highest return for a given level of risk or the lowest risk for a given level of return for a portfolio. Investment fiduciaries of 401(k) plans therefore have the duty to provide a prudent menu of investment options that will allow plan participants to determine an optimal tradeoff between risk and return so that they can build prudent portfolios. Plan fiduciaries that fail to follow such requirements and simply add or delete investment options willy-nilly based on, for example, pressure from plan participants to invest in the latest investment fads may be risking liability.

The Primacy of the Portfolio

Another bit of information that investment fiduciaries may find helpful concerns the *primacy of the portfolio*. The Preamble states, in part: "achieve a *portfolio* with aggregate risk and return characteristics . . . each of the investment categories, when combined with investments in either of the other categories, must tend to minimize the risk of a participant's *portfolio* at any given level of expected return." This language of modern portfolio theory found in the Preamble is reflected in Section 2(b) of the Act, which states, in part: "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust *portfolio as a whole*."

A basic tenet of modern portfolio theory is the primacy of the portfolio, not just its individual parts. (Without belaboring the obvious, Dr. Markowitz is the father of modern *portfolio* theory, not modern *investment* theory.) This tenet as well as the language of modern portfolio theory found in the Preamble and the Act instructs investment fiduciaries of 401(k) plans to avoid thinking in terms of "bits and pieces" so that they do not provide discrete, stand-alone investment options with risk and return characteristics that have no relation to each other within the context of a portfolio. Plan fiduciaries that violate this requirement by adopting a non-portfolio mindset may be risking liability.

Horizontal and Vertical Diversification of Portfolio Risk

Another bit of information that investment fiduciaries may find helpful concerns *diversification of portfolio risk*. The "diversification" rule of ERISA Section 404(a)(1)(C) states, in part: "[Investment fiduciaries must] . . . diversify . . . 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." "ERISA's investment diversification rules are based in part on a concept known as modern portfolio theory. In ERISA, this is known as the 'broad range' requirement." [*See* "Modern Portfolio Theory and Selection of Asset Classes" by Fred Reish, August 2004, available at *http://www.essentialsny.com/assets/archives*.] In accord is Section 3 of the Act, which states: "A

trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." Commentary to the Restatement adds that broad diversification of portfolio risk is usually preferred. [*See* Section 227 of the Restatement, Comment f, page 25.]

Although little known or not well understood, broad diversification occurs at two different levels: diversification *across all* the asset classes in a portfolio (which can be termed "horizontal" diversification) and diversification *within each* such asset class of the portfolio (which can be termed "vertical" diversification). [*See* Section 227 of the Restatement, Comment f, page 25; see also the Preamble, "What 404(c) Can and Can't Do for You," presented by Bruce Ashton at the First Mercantile Trust Company 2005 Consultant Seminar, April 22, 2005, and "Meeting Your Fiduciary Responsibilities," a Department of Labor publication.]

Horizontal diversification reduces the *variance risk* (a Markowitzean notion) of a portfolio, whereas vertical diversification reduces the *uncompensated risk* (this notion was introduced by William Sharpe, another Nobel Laureate in economic sciences) of an asset class (or a mutual fund). The overall objective of this two-level approach to diversification is to minimize the risk of a plan participant's portfolio which, after all, is the fundamental, underlying objective of modern portfolio theory. Minimizing risk is, counterintuitively, also a more dependable way to increase return than attempting to be a successful stock picker or market timer. That interesting notion, as well as a number of others touched on here, will be discussed in a future column.

A Building Block Approach to Achieving Broadly Diversified Portfolios

Investment fiduciaries of 401(k) plans are required to provide plan participants with a prudent menu of diversified investment options. The process of selecting investment options from this menu can be likened to "fitting together" a set of building blocks optimally in order to form a broadly diversified portfolio. The "tightest" and "strongest" fit is achieved when each building block is broadly diversified internally and has "low covariance" or even "negative covariance" (yet more Markowitzean notions) to each of the other building blocks within the portfolio. Each plan participant should be given the opportunity to assemble a portfolio comprised of asset class building blocks with aggregate risk and return characteristics uniquely appropriate to the participant. This building block approach to forming portfolios is in accord with modern portfolio theory and with the standards of prudent investing applicable to investment fiduciaries responsible for 401(k) plans. The approach is also the best way to help plan participants eat the right kind of food and avoid getting sick. ■