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INVESTMENT POLICY CHALLENGES TO DIRECTORS OF NON-PROFIT ORGANIZATIONS

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Today I am going to talk about those fiduciaries who are charged with investment responsibility. Of course, there are fiduciaries of many different sorts. One great dividing line might be drawn between those, like the late Robert Moses, who are chiefly engaged in <u>spending</u> other people's money, and those whose trust it is to invest that money and earn a return on it. Moses, the feisty builder of public works in New York City, whose death was recorded this year, was fond of saying:

"Nothing I have ever done has been tinged with legality." Even the boldest of those with duties on the investment side would shy away from any such claim -- even in jest.

Today's fiduciary responsible for the investment of other people's money, whether that money serves a university or college, a foundation, a church or a group of pensioners -- is beset with challenges, most of which are of recent origin. These challenges include (a) the lessons of modern portfolio theory, (b) the new laws applicable to fiduciaries, (c) inflation, and (d) the many new forms and techniques of investment. With these challenges -- which it is my purpose, today, to discuss with you, come opportunties:

1. To shape and interpret the new laws to fit the concepts of modern portfolio theory. For example, to view risk not exclusively as the possibility of loss

of capital, but as a balance between risk and expected return -- an expression of the variability of expected investment returns; and to view the portfolio as the security, whose performance counts in measuring a trustee's duty, rather than each security in the portfolio, viewed separately; and

2. To harness the new forms and techniques of investment to cope with the ravages of persistent inflation.

I want to touch briefly on each of these challenges starting with the lessons of modern portfolio theory.

Modern Portfolio Theory

My purpose here is to mention a few important features of the economics of investing and point out how much at odds they are with the traditional legal theory of prudence. Under modern portfolio theory:

1. The design of the portfolio as a whole is the most important factor -- its performance, and not the performance of individual securities, is what a manager looks at.

2. Risk is not viewed as the possibility of capital loss but an expression of the variability of expected investment returns. Investors are risk adverse. Hence, they pay more for an investment with less variances of possible return around an expected return than for an investment with more variances. Paying more

for an expected return is another way of saying the yield on the investment with less variances is lower than the yield on the investment with more variances. Or, the higher the risk, the higher the expected return.

3. Diversification of portfolio will reduce risk to the extent that securities do not co-vary. Reducing risk through diversification leads to the idea of an index fund. This, of course, is the opposite of "stock picking."

4. Studies show mutual funds do not outperform the indicies against which it is appropriate to compare them. And there are almost no consistently successful mutual funds. Paul Samuelson has observed "there is ample reason for doubting whether even the best of money managers are capable of doing better than the averages on a repeatable sustainable basis."* And there is perhaps even more doubt that fiduciaries (or anyone else) know <u>how</u> to pick the best money managers.

5. Risks of inflation and of illiquidity are important risks to be weighed.

Note how the traditional legal theory of prudence conflicts with these features of modern portfolio theory:

1. Risk is concerned solely with the risk of loss, ignoring risks of inflation and illiquidity.

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* Samuelson, <u>Challenge to Judgment</u>, J. Portfolio Management (Fall 1974).

2. Risk looks at particular securities in isolation rather than at the portfolio as a whole.

3. Risk is viewed in isolation from return.

The New Laws Applicable to Fiduciaries

The Tax Reform Act of 1969 introduced Section 4944 of the Internal Revenue Code, imposing a tax on amounts invested by a private foundation in such a manner as to jeopardize its tax-exempt purposes. This law was essentially aimed at creating an appropriate duty of care for foundation managers in the investment of foundation assets. Through active efforts of the private sector working with Treasury personnel, regulations were developed to implement Section 4944 in ways that might avoid an inflexible interpretation of prudence along traditional lines.

Thus --

1. "Ordinary business care and prudence" was substituted for the traditional "prudent man" language.

2. Expected return -- both of income and appreciation -- could be taken into account.

3. So too could inflation and the need for diversification within the portfolio, including such matters as maturity of issuer, degree of risk and potential for return.

4. No investment or technique would be considered imprudent ("jeopardizing") *per se*.

5. The standard would be applied on an investment by investment basis, but "in each case taking into account the foundation's portfolio as a whole."

6. Delegation to professional managers was consistent with "ordinary business care and prudence," if selection and monitoring met that standard of care.

In 1972 the National Conference of Commissioners approved the Uniform Mangement of Institutional Funds Act, now adopted with minor variations in over 25 states. This law applies to fiduciaries managing the endowment funds of universities, hospitals, museums, foundations and other not-for-profit corporations. It establishes a standard of care similar to (and derived from) the standard found in the regulations under Section 4944. It was adopted in some states (*e.g.*, Michigan) only after satisfying the Attorney General and others that the UMIFA standards were simply a modern statement of the prudent man rule.

In 1974, Congress enacted the Employee Retirement Income Security Act, widely known as ERISA. This law contained a federal codification of the prudent man rule for employee benefit plans. Regulations of the Department of Labor, promulgated in June, 1979 (29 CFR 2550.404a-1), gave a modern interpretation to the prudent man rule. The approach taken, in many respects similar to that of the Treasury Department's regulation

under Section 4944, stresses the following elements:

1. The relative riskiness of an investment or investment course of action does not render it either *per se* prudent or *per se* imprudent.

2. The prudence of a particular 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.

3. Prudence will be judged on the particular facts and circumstances of each case.

Before proceding to examine the challenge of inflation, I want to give you a brief update on the celebrated Massachusetts case of *Harvard College v. Amory* -- the case which gave birth to the "prudent man." 1980 marked the 150th birthday of this seminal case, decided by Justice Samuel Putnam of the Supreme Judicial Court of Massachusetts. Let me quickly review the facts.

Amory was trustee of a $50,000 testimentary trust, the settlor's wife was the income beneficiary with Harvard and Massachusetts General Hospital as remaindermen. Amory after 5 years resigned, tendered an accounting and requested an allowance. The trust held bank, insurance and manufacturing stock, yielding 8% but now worth $38,000. The remaindermen charged an abuse of trust -- imprudence -- and asked Amory to restore $12,000.

The will authorized investment in "safe and productive stock . . . according to Amory's best judgment and discretion . . ."

Justice Putnam analyzed the options available to Amory, reasoning that neither real estate mortgages or government securities were necessarily safer than stocks issued by private corporations. "Do what you will," he observed, "the capital is at hazard." Then with extraordinary judicial vision and creativity, Justice Putnam formulated the prudent man rule:

> "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."

With those words, Putnam defined a flexible and ageless standard for fiduciary conduct.

This standard, properly contrued, is limber enough to permit today's fiduciary to meet the challenges posed by modern portfolio theory and inflation. As stated in *Kimball* v. *Whitney*, 233 Mass. 321, 322, 123 N.E. 665, 666 (1919): "It [the prudent man rule] is susceptible of being adapted to whatever conditions may arise in the evolution of society and the progress of civilization." Thus --

- the rule will permit investments off the beaten track.

- the rule is a <u>precept</u> for conduct, not a <u>measure</u> of performance.

- the rule requires no more, but no less, than the good faith exercise of reasonable judgment, in light of available information, with respect to investments.

- we should encourage reliance on it; and resist special legislative or regulatory strictures which have plagued the rule over the years. such efforts have included, for example:

  - efforts to create certainty through lists (legal lists) of what is prudent or imprudent *per se*.

  - efforts to achieve special economic or social objectives by suspending the requirements of prudence with respect to investments in such areas as venture capital.

Signs that the prudent man rule is being construed to meet today's needs abound, and are illustrated by the new laws already described. It is also useful to consider the recent remarks of Dean E. Miller, Deputy Comptroller of the Currency (Remarks before 37th Trust Conference, Florida Bankers Association, September 20, 1979). To cope with inflation, Miller said:

> "the prudent man is going to have to endeavor to carry out his duties to his trust through the investment of its funds in media which offer a higher return, and bear a higher risk. Put another way, it means that he will have to make investments which in another day might be labeled -- yes -- speculative.

> "If I am right, this course of events is not going to make our life easier. When we had the label °speculative° to rely upon, supervision was much less difficult. Now, it may be that nothing is automatically deemed speculative. That is my understanding of the rule of prudence, applicable to all accounts subject to ERISA, and may also be the interpretation made by the courts of the state prudent man rules which apply to all other accounts."

Inflation

This morning Vice President Bush quoted the French poet and critic, Paul Valery, as having said: "The trouble with out times is that the future is not what it used to be." Although he applied it to what he described as the deep pessmism of recent public opinion regarding America°s future in general, I think it°s an apt quotation for investors as well, as they face the phenomenon of embedded inflation at double digit levels.

We are all familar with recent history. Between 1940 and 1979, the purchasing power of the dollar declined by more than 80%. Since World War II, we have had persistent inflation. However, it is important to recall that prior to World War I, periods of deflation were as common as those of inflation. During the long deflationary period from 1867 to 1893 much American corporate and trust law developed. The value of the dollar in purchasing power more than doubled during this period. Gross national product more than tripled.

Bonds offered a good return for income beneficiaries <u>and</u> a marked increase in the value of the principal. Thus, many reasonably prudent fiduciaries would prefer a bond to a riskier investment -- like a share of stock.

The period from 1926 to 1976, however, witnessed a different trend, as shown by a look at total annual returns of different types of investment products. With inflation averaging 2.3% per annum over the 50-year period, here are the results.

Investment	Nominal Return	Real Return
Common Stock	9.2%	6.9%
Long Term Corp. Bonds	4.1%	1.8%
Long Term Gov. Bonds	3.4%	1.1%
Treasury Bonds	2.4%	-0.1%

Looked at differently, $1 million invested in 1926 in one of the four categories, with all yields reinvested, in 1976 was worth, in real dollars:

Common Stock	$24,170,000
Long Term Corp. Bonds	2,200,000
Long Term Gov. Bonds	1,561,000
Treasury Bills	980,000

This experience led to a new view of common stock, as uncritical as the earlier view of bonds. Stocks were seen as the best hedge against inflation. And yet, look at the total annual returns over the 1968 to 1977 period, in real dollars:

Common Stock	-2.6%
Long Term Corp. Bonds	-0.1%
Long Term Gov. Bonds	-0.8%
Treasury Bills	-0.4%

The fundamental inflation rate in the United States is now reckoned at 6 1/2% or more. At 7%, it takes only 10 years to cut the value of an endowment in half. Of course, in fact, double-digit inflation has been the rule in the recent past.

Inflation has fostered intense efforts by fiduciaries and money managers to find new investments and to try new investment techniques, in order to stay ahead of inflation. With inflation at, say, 10%, and a need to use, say, 6% of endowment for operating costs, a foundation, university or hospital must earn a <u>16%</u> total return. This challenge has led to a growing array of different investments and investment techniques, many of which challenge the traditional notions of prudence.

<u>The New Forms and Techniques of Investment</u>

As mentioned earlier, index funds may be -- and are thought by some among the "Chicago School of Economics" to be -- the most prudent way to invest in common stocks. Important to this argument is the notion that <u>the market</u> prices stocks accurately, based on knowledge widely in circulation. Skill, industry and foresight in analysis of that knowledge yield little or no marginal utility over mindlessly tracking the index.

Whether one believes this theory or not, one should be able to accept the idea that skill, industry and fore-

sight are increasingly rewarded as the investment market selected becomes increasingly imperfect. It is this idea which explains the efforts of fiduciaries to exploit the more arcane avenues of investment activity. And so we find a dazzling variety of investment products being used or considered for use by fiduciaries today.

-- Real Estate Equities
-- Venture Capital
-- Securities Lending
-- Index Funds
-- Foreign Investments
-- Risk Arbitrage
-- Options
-- Commodities Futures
-- Futures on Financial Instruments
-- Options on Futures on Financial Instruments

I have a few concluding observations to share with you.

With UMIFA on the books in so many states, it seems wise to avoid super-imposing another standard on top of that one. At least for investment activity, any Model Act should incorporate the solidly developed modern principles embedded in UMIFA.

Regardless of which law one is considering -- UMIFA, ERISA, Section 4944 of the IRC or the more venerable versions of the prudent man rule, several things can probably be noted about the fiduciary's duty of care:

1. Safety in numbers. Recognition of a form of investment or investment technique by the investment management community as a valid means of accomplishing

an investment purpose provides protection. Conversely, the less well-tested a method, the greater the burden to show a solid basis for action.

2. No per se categories. Investments and investment techniques are unlikely to be held speculative per se (exposing the trustee to surcharge) or of investment grade per se (satisfying the duty of care).

3. The process is the key. The issue is becoming less what did you invest in, and more why did you invest in it.

4. Documentation. Given a sufficient record of care, no investment or investment technique should render the fiduciary liable.*

5. Standard of management. Given the ability to track the standard indicies, at low management cost and transactional expense, a fiduciary seeking better returns than the indicies may now have the burden of proof to show why his particular approach is likely enough to outperform the indicies to justify the added risk and cost.

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* Support for this proposition is found in Stark v. United States Trust Co., 445 F. Supp. 670 (S.D.N.Y. 1978) and In re Morgan Guaranty Trust Company, 89 Misc. 2d 1088, 396 N.Y.S. 2d 781 (Surr. Ct., N.Y. Co., 1978).

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