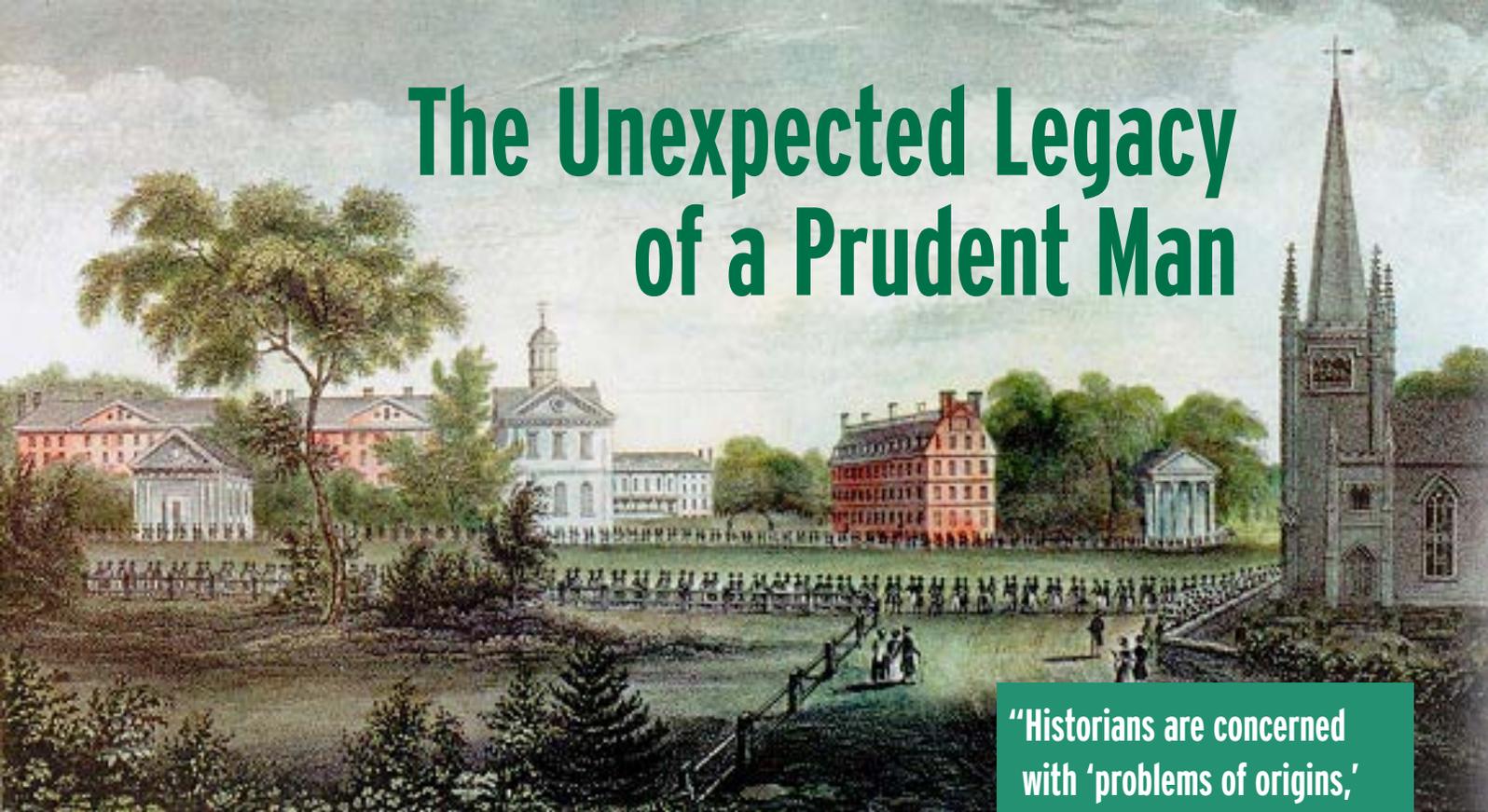


The Unexpected Legacy of a Prudent Man



By Mark Higgins

A POWERFUL INSIGHT THAT EMERGES from the study of financial history is that solutions to past problems often sow the seeds of future ones. But this principle is often hidden by the glacial pace of the transformation process. This is why financial historians often feel like time-lapsed photographers who reveal the motion of financial transformation by separating the snapshots of events with years rather than milliseconds.

The evolution of the Prudent Investor Rule fits neatly in this framework. This article reveals how the rule evolved over nearly 200 years to intermittently solve and cause problems. The history begins in the 1820s with the establishment of the Prudent Man Rule. It then recounts its slow evolution over the next 160 years, culminating in its conversion into the Prudent Investor Rule at the end of the 20th century. The narrative then returns to the present and explains how trustees now use the Prudent Investor Rule to rationalize progressively higher levels of portfolio diversification, despite

Illustration of Harvard University with an alumni procession, dated 1830s. This was the same decade that *Harvard College v. Amory* reached the Supreme Court of the State of Massachusetts.

mounting evidence that such efforts are more likely to increase fees, impair performance and distract trustees from more important financial tasks. In 2024, it once again appears that the current interpretation of the Prudent Investor Rule has outlived its utility, making it necessary for another revision.

Origin of the Prudent Investor Rule

On October 23, 1823, a wealthy merchant named John McLean passed away in Boston, Massachusetts. In his will, he bequeathed \$50,000 to two sets of beneficiaries using a structure commonly referred to as a remainder trust. The first beneficiary was his wife, Ann McLean, who was entitled to the income produced by the trust for the remainder of her life. A second set (Harvard College and Massachusetts General Hospital) was entitled to receive what remained after Ann McLean's death. The will listed Jonathan and Francis Amory as the executors, and it provided them with a flexible set of investment guidelines.

The problem with McLean's trust was that the trustees representing Ann McLean and the remaindermen held different beliefs regarding the flexibility of the investment guidelines. The disagreement surfaced when the trustees offered to

"Historians are concerned with 'problems of origins,' but they must remember that all origins are also conclusions of previous periods."

— Robert Sobel, author of *The Great Bull Market: Wall Street in the 1920s*

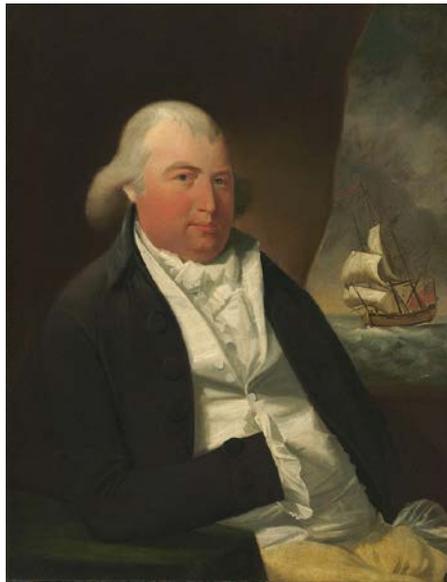
turn over the trust assets to the remaindermen in exchange for a guaranteed annual payment of 6% per year for the remainder of Ann McLean's life. The trustees based this requirement on the expected return of securities in which much of the estate was already invested. These included two manufacturing company stocks, an insurance company stock and a bank stock. The manufacturing company stock was most concerning to the remaindermen, as they believed it was too risky and, thus, inconsistent with John McLean's instructions.

On February 9, 1824, the trustees sought approval of their estate plan by presenting the portfolio to the Supreme Court of Probate in the State of Massachusetts. The remaindermen voiced no formal objection in court, even though they had expressed disapproval on several occasions during the preceding year. The court approved the plan, and it seemed that the case would quickly disappear in the annals of history.

Over the next several years, however, Ann McLean received an income yield that far exceeded 6%, and the remainderman witnessed a sharp decline in the market value of the portfolio. In October 1828, the disagreement re-entered the courts when Francis Amory (the only surviving trustee) sought to tender his resignation from the trust and presented the account to the probate court for approval. The remaindermen demanded that Amory settle the account by paying the difference between the current and original market value of the insurance and manufacturing stocks, which they argued did not meet the investment guidelines. After several years, the case of *Harvard College v. Amory* reached the Supreme Court of the State of Massachusetts. Justice Samuel Putnam decided the case in favor of Amory and delivered the court's final opinion. It included two sentences (below), which became known as 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.”

Justice Putnam's ruling established an important legal precedent which was subsequently used to judge the prudence of trustees' decisions based on the soundness of the decision-making process, rather than discrete outcomes. This was a critical distinction, as it recognized the inherent uncertainty of investing. But the rule did not give trustees carte blanche on their decisions. On one hand, the ruling provided fair protection for trustees who cannot possibly predict investment outcomes with precision. On the other hand, it forced trustees to establish and prove adherence to a sound investment process.



Portrait of John McLean, the wealthy merchant whose last will and testament led to disagreements resulting in the Prudent Man Rule.

Contraction and Expansion of Trustee Flexibility

After the ruling by Justice Putnam, interpretations of the Prudent Man Rule slowly evolved as new precedents were established by case law. Throughout the remainder of the 1800s, precedents tended to restrict the types of investments in which trustees felt comfortable investing. For example, the 1869 case of *Matter of King v. Talbot* tilted trustees more toward the “safety of capital,” thus encouraging greater investment in government bonds and mortgages rather than common stocks.

As case law continued to accumulate in the early 1900s, the American Law Institute set out to create a consolidated reference of key legal principles. This culminated in the publication of the American Law Institute's *Restatements of Law* in 1935. Among the first volumes was the first *Restatement of Law Trusts*, and the Prudent Man Rule served as an important guiding principle.

Soon after the United States exited the Depression and World War II, trustees pressured the American Law Institute to revise the *Restatement of Law Trusts*. At issue, once again, was the need for greater investment flexibility. Ironically, the problem was that “legal lists” that trustees used to determine allowable investments had limited their exposure to common stocks. While stocks had plummeted during the Great Depression, they had recovered

over time. Non-government bonds also experienced massive losses during the Depression, but many never recovered. This strengthened trustees' interest in common stock investments.

The second *Restatement of Law Trusts* (commonly referred to as *Restatement of Law Trusts 2d*) was published in 1957 to address this problem. The first notable change was the creation of broader, approved “investment categories,” as well as the use of more ambiguous language on what constituted prudent investment decisions. Contrary to expectations, however, the revision continued to discourage risk taking. One problem was that by defining prudence in accordance with standard practices at the time, few trustees were willing to invest in non-conventional securities as markets evolved. A second problem was that the guidance on prohibited investments proved more restrictive than intended. Problematic language included restrictions on “speculative stock” and “buying discounted bonds.” As a result of these issues, throughout the mid-1900s, most trustees continued investing primarily in low-risk government bonds and high quality, dividend paying stocks. In 1974, their conservatism intensified even further after the passage of the Employee Retirement and Income Security Act (ERISA).

An Unanticipated Impact of ERISA

President Gerald Ford signed ERISA into law on September 2, 1974. The primary objective was to strengthen protections for employees covered by private pension plans. However, as is often the case with new regulations, ERISA produced several unexpected side effects. The impact on the nascent venture capital (VC) industry was especially troubling. Incorporation of the Prudent Man Rule into ERISA required trustees to discharge their duties “by diversifying the investments of the plan so as to minimize the risk of large losses.” Many trustees interpreted this language as an implicit ban on VC investments, which routinely invested in multiple companies that were likely to produce large losses.

ERISA plan trustees responded by limiting exposure to VC investments, as well as traditional investment fund managers that ventured far beyond high-quality stocks and bonds. Non-ERISA plans, such as public pensions, foundations and endowments, adopted similar practices out of an

The Overlooked Obligation to Evaluate Return on Investment Fees

“A trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee... Wasting beneficiaries’ money is imprudent.”

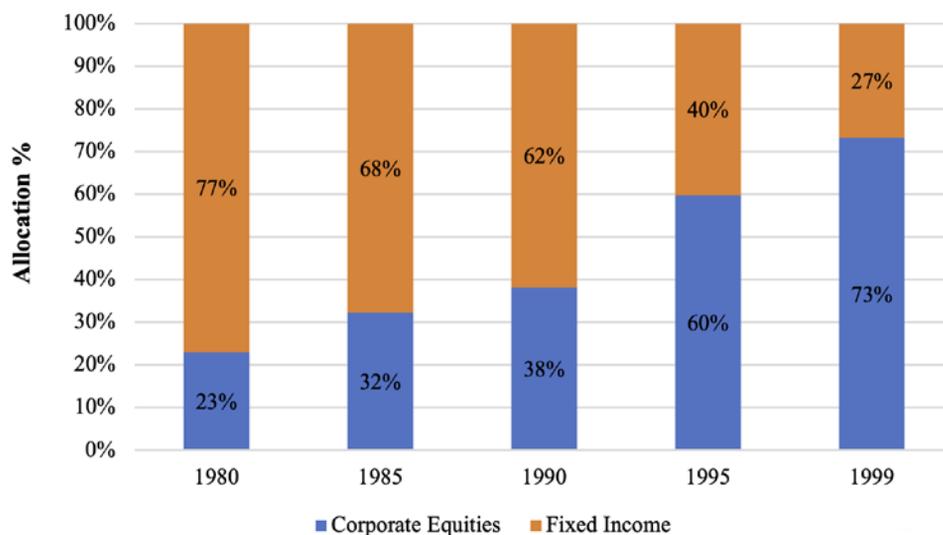
Uniform Prudent Investor Act (UPIA)

The *Restatement of Law Trusts (3d)* incorporated what was known as the Uniform Prudent Investor Act (UPIA). In 1994, the National Conference of Commissioners on Uniform State Laws approved the UPIA and recommended its enactment in all states. As of December 31, 2023, nearly all 50 states have codified the UPIA into law.

Most trustees appreciate the diversification principles required under the UPIA, but few appreciate the obligation to manage costs. Yet this responsibility is clearly articulated in Section 7 of the UPIA. The quote above provides the specific language. As trustees continued to add investments that increased asset management fees and corresponding costs of portfolio oversight over the last 30 years, few asked themselves the critical question of whether the incremental benefits exceeded the incremental costs. With each passing year, therefore, the costs of diversification began to increasingly outweigh the benefits.

abundance of caution. For the remainder of the 1970s, VC firms were unable to raise sufficient capital from institutional plans, which caused pain for the nascent technology industry. Desperate to reestablish relationships with institutional plan trustees, the National Venture Capital Association lobbied the Department of Labor (DoL) to permit a more lenient interpretation of the Prudent Man Rule.

FIGURE 1: Asset Allocation of Private and Public Pension Funds (1980–1999)



Source: *Statistical Abstract of the United States: 2000*, U.S. Census Bureau, 530.

In June 1979, the DoL issued new guidance to allow for a more flexible interpretation of the Prudent Man Rule. On June 21, 1979, Ian Lanoff, the administrator of pension and welfare programs stated, “Although securities issued by a small or new company may be a riskier investment than securities of a blue chip company, such an investment may be entirely proper under ERISA’s prudence rule.” The DoL’s shift on the issue of prudence restored VC funding. In addition, trustees had the flexibility they needed to allocate more heavily to common stocks. This contributed to a multi-decade shift of institutional investment plans toward publicly traded equities. In 1980, equity allocations constituted 23% of pension plan allocations. By 1999, equity allocations constituted 73% of their portfolios (See Figure 1).

Modern Portfolio Theory and the *Restatement of Law Trusts 3D* (1992)

In 1990, Harry Markowitz was one of three co-recipients of the Nobel Prize in Economic Sciences. The award recognized the impact of a paper he had written nearly four decades earlier. Published in March 1952, Markowitz’s article, entitled “Portfolio Selection,” provided a mathematical construct that reframed the discipline of portfolio management. Mathematical models based on MPT enabled investors to visualize the return and risk attributes of a portfolio by inputting estimates of

the expected return, volatility and correlations of various asset classes in the portfolio. By measuring return and risk at the portfolio level, the risk of any single investment became less impactful. This gave trustees greater leeway to invest in riskier assets, provided that total portfolio risk was tolerable.

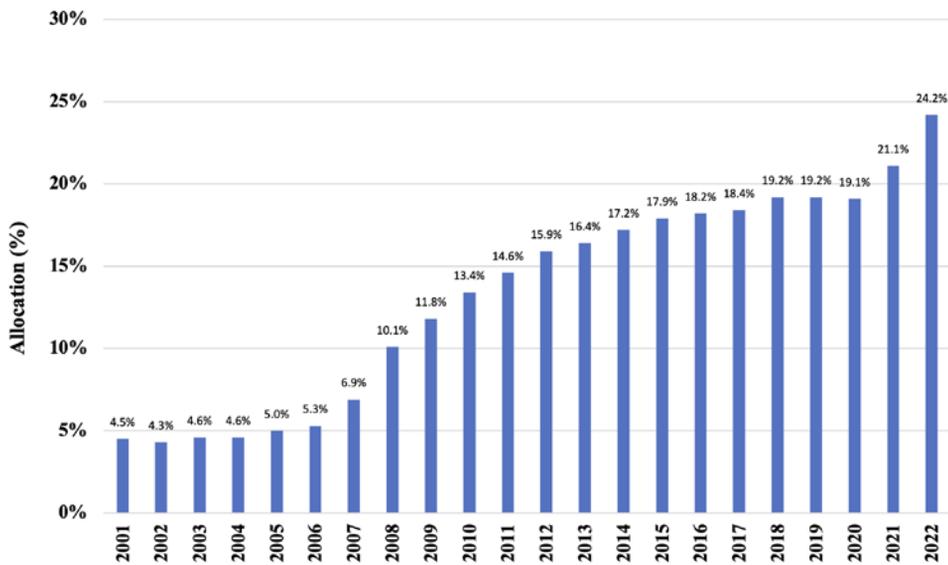
MPT also provided the American Law Institute with a powerful tool to provide trustees with the flexibility that they long desired. In 1992, they published a third revision of the *Restatement of Law of Trusts*. By embracing MPT and refocusing prudence on the “totality” of portfolio risk, trustees finally felt empowered to venture beyond the most conservative stocks and bonds. The restatement also instructed trustees to create a diversified portfolio unless specifically instructed otherwise. Finally, the restatement modernized the language of the Prudent Man Rule by renaming it the Prudent Investor Rule.

Among the most significant impacts of the Prudent Investor Rule was that it gave trustees license to invest in a wide variety of new asset classes and sub-asset classes. This was critical to the rise of alternative asset classes in institutional portfolios.

The Rise of Alternative Investments and Corresponding Plan Costs

In 2000, David Swensen, CIO of the Yale Investments Office, published his best-selling book, *Pioneering Portfolio*

FIGURE 2: Public Pension Fund Allocation to Alternative Asset Classes (2001–2022)



Source: *Public Pension Plans Data*. Accessed June 28, 2023. <https://publicplansdata.org/public-plans-database/>

Note: Alternative assets include assets categorized as private equity, hedge funds, miscellaneous alternatives, commodities, and other. Although percentages varied, roughly 80–85% of alternatives allocations consisted of private equity and hedge funds in any given year.

Management. The book explained the strategy that he employed to produce exceptional returns for the Yale University Endowment. Soon after its publication, institutional investors rushed to reengineer the “Yale Model,” but nearly all of them copied Yale’s strategy only at a superficial level, mistakenly concluding that the mere addition of alternative asset classes—such as venture capital, buyout funds and hedge funds—was all that was required. Few appreciated that the key to Yale’s success was a culture of excellence that was hardwired into the mind of every investment professional, trustee and asset manager who touched the portfolio. The Yale Model depended on the presence of a carefully crafted investment ecosystem that few institutions could hope to replicate. Nevertheless, soon after the publication of *Pioneering Portfolio Management*, trustees began chasing Yale’s returns by investing heavily in alternative asset classes. Figure 2 shows the total allocation of public pension plans to alternative asset classes from 2001 to 2022.

Several decades have now passed since institutional investment plans began their steady migration toward alternative asset classes, and there is now a reasonably robust data set to evaluate whether the

strategy has paid off. The results are not encouraging. In fact, in a recent study by Richard Ennis, one of the original founders of the institutional investment consulting profession, the use of alternative investments in a large sample of public pension plans resulted, on average, in a negative alpha of approximately 1.2% per year.

A New Mandate for the Prudent Investor

The current interpretation of the Prudent Investor Rule appears to have outlived its utility once again. Adding alternative asset classes and using active managers in traditional asset classes is invariably accompanied by significant asset management fees, consulting fees, staff salaries, custodial fees and the hidden, but substantial, cost of neglecting other important financial priorities. Trustees often pursue diversification with little regard for the associated costs—and even less regard for their fiduciary obligation to ensure that the fees they pay on behalf of their beneficiaries are well spent.

The Prudent Investor Rule has now completed yet another long-wave transformation from solution to problem. Many, if not most, trustees place too much value on incremental increases in diversification

and fail to properly consider the offsetting costs and probability of success. This behavior persists because trustees are surrounded by people who believe that their business models, careers and even their sense of self-worth depend on maintaining the status quo. The greatest irony is that all stakeholders can resurrect their value propositions by acknowledging the limits of their capabilities and discovering new value propositions to replace those that ceased adding value long ago. Perhaps the American Law Institute can serve as a catalyst of reform by issuing a fourth *Restatement of Law Trusts* and place greater emphasis on the obligation of trustees to properly consider plan fees before writing larger and larger checks using other people’s money. 💰

Mark Higgins, CFA, CFP® is a financial historian, experienced institutional investment advisor and frequent contributor to Financial History magazine. His book, Investing in US Financial History, recounts the full financial history of the United States from 1790 to 2023. The book will be published in February 2024 by Greenleaf Book Group.

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