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Date: 2 May 2017

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cc: Karen Green Ross, Chief of Staff, Calif. Controller's Office
Senator Bill Monning, California Senate
Assemblyman Mark Stone, California Assembly
Board of Supervisors, Santa Cruz County
Santa Cruz, Scotts Valley, Capitola, Watsonville City Councils

From: J. Ben Vernazza

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Fourth Update: CalPERS TRUSTEES IN BREACH OF FIDUCIARY DUTIES

Opinion letter from Stewart Frank CPA/PFS AIFA (Accredited Investment Fiduciary Analyst) 248-227-8208 also see www.precisionfiduciary.com/paper

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April 11, 2017

Board of Governance Committee, CalPERS

The California Public Employees' Retirement System's IPS revision of April 2017 omits any mention of how uncompensated risk is to be managed through diversification. Instead, it specifies that investment risk management is to be accomplished through prudent management of market risk factors only.

The Uniform Prudent Investor Act (UPIA) was promulgated by the Uniform Law Commissioners in 1994 and has become the legal standard for fiduciary conduct. The commentary to Section 3 of the UPIA explains the difference between systematic or compensated risk that is non-diversifiable and uncompensated risk that can be diversified away.

> Modern portfolio theory divides risk into the categories of "compensated" and "uncompensated" risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the

investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk—the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks . . . Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk . . .

Thus, uncompensated risk is risk that can be eliminated with diversification and, unlike systematic or compensated risk, investors cannot expect added return for assuming more uncompensated risk. Uncompensated risk comes from the inherent risk of investments with too many holdings that are closely correlated or not prudently uncorrelated.

The *Restatement (Third) of Trusts* was promulgated by the American Law Institute in 1992 and remains the authoritative guidance for applying fiduciary law. Chapter 7, Section 227, addresses the general standard of prudent investment and specifically discusses "risk and the requirement of diversification." Following are three clearly stated pronouncements about what is required of a fiduciary to prudently manage uncompensated risk.

1. The trustee's duties and objectives with respect to [non-diversifiable (compensated)] risk are not as distinct as those with respect to diversifiable [uncompensated] risk. [*Restatement (Third) of Trusts* §227, "Comment on Basic Duties of Prudent Investor," p. 19]
2. [T}he requirement of caution ordinarily imposes a duty to use reasonable care and skill in an effort to minimize or at least reduce diversifiable risks. [T]hese are [uncompensated] risks that can be reduced through proper diversification of a portfolio. [p. 19]
3. Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill. [Id. at 23]

A prudent uncompensated risk management strategy should be employed. One that focuses on complying with uncompensated risk standards and documents procedural prudence by:

1. Developing a prudent diversification strategy for managing uncompensated risk;
2. Incorporating the strategy in the investment policy statement (IPS);
3. Implementing the strategy in managing the portfolio; and
4. Performing periodic monitoring for uncompensated risk and its IPS compliance; it is their duty.

By omitting a plan to manage uncompensated risk, this IPS causes every fiduciary responsible for risk management to be in breach of their fiduciary duties.

Sincerely,

Stewart Frank, CPA/PFS, AIFA ACCREDITED INVESTMENT FIDUCIARY ANALYST