Dire Financial Consequence Await Trustees and Fiduciaries Who Fail to Prudently Manage Uncompensated Risk

==============================

This article was condensed from an original article entitled *Uncompensated Risk: The Orphan of Modern Portfolio Theory* that appeared in the June 2017 issue of *The Tax Advisor*, an AICPA Publication. www.precisionfiduciary.com/dire/ .
The entire original article can be viewed at www.precisionfiduciary.com/orphan.

Stewart Frank, CPA/PFS, AIFA &
J. Ben Vernazza, CPA/PFS, TEP emeritus

The Uniform Prudent Investor Act (UPIA) was promulgated by the Uniform Law Commissioners in 1994 and in 1995 was memorialized in California statute as Probate Code §16045 - §16054. The commentary to Section 3 of the UPIA explains the two types of investment risk and how each should be managed.

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

> 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]
>
> (see more details at www.precisionfiduciary.com/restatement/)

Uncompensated risk (UCR) defined: UCR is risk that can be eliminated with diversification and, unlike systematic or compensated risk investors cannot expect added return for assuming more UCR. UCR is removed from a portfolio through the application of prudently exploited diversification.

Diversification's is measured by the size of the gap between the sum of the portfolio's weighted average asset variances and the level of the portfolio's overall variance. A larger gap is the result of having more UCR removed by means of greater diversification.

In 1992 Eugene Fama & David Booth published an article entitled "Diversification Returns and Asset Contributions," 48-3 *Financial Analysts J.* 26 (May-June 1992). <u>In that article they identified and quantified the existence of an additive portfolio return factor attributable to diversification that they named "diversification returns", and approximated its value to be one half of the variance gap.</u>

Uncompensated risk measured: UCR is measured by the degree and number of asymmetrical correlations present in a portfolio (not the overall level of portfolio variance). Fewer degrees and/or fewer numbers of asymmetrical correlations result in portfolios having greater amounts of UCR and reduced amounts of "diversification returns". Thus, if all asset correlations in a portfolio equaled 1.00, then the weighted average asset variance would be the same as the portfolio's variance, indicating that <u>zero</u> UCR was removed from the portfolio and no incremental "diversification return" was obtained.

Uncompensated risk management: Management of UCR is achieved by quantifying existing UCR followed by use of the right combination of non-correlated assets in the portfolio. The authors use a combination of existing and proprietary algorithms to achieve maximum UCR reduction and maximum added diversification return when assisting with the risk management of portfolios that achieve prudent levels of UCR.

Two recent court decisions emphasize the importance of diversification management for trustees and their advisors.

The *Tatum* decision emphasizes the need to show a process as a fiduciary. In a U.S. circuit court opinion in *Tatum v. RJ Reynolds Pension Investment Committee*, No. 13-1360 (4th Cir. 8/4/14) (aka the "good luck case"), the three-judge panel found the defendant breached its fiduciary duty because it failed to practice procedural prudence.

In another major ERISA fiduciary duty case, *Tibble v. Edison International*, 135 S. Ct. 1823 (2015), the Supreme Court ruled 9–0 in favor of 401(k) participants versus Edison International, overturning the Ninth Circuit. The Court held that because there is continuing duty to monitor the investments it means that the "action which constituted a part of the breach or violation" encompassed not just the initial selection of the investments, but the ongoing failure to discharge fiduciary duties with "care, skill, prudence, and diligence" (29 U.S.C. §1104). In other words, the statute of limitation does not start to run until the imprudent actions stop. The takeaway from this case regarding UCR is the necessity for the fiduciary to have a prudent UCR management strategy in place, one that is prudently established and prudently monitored, otherwise the statute of limitation will never start to run.

Dire financial consequences may await unsuspecting fiduciaries and their advisors.

Uniform acts and restatements describing how UCR is to be prudently managed have been in existence for almost 25 years. Yet, most fiduciaries breach this fiduciary duty simply because they ignore or neglect to follow the long-standing, stated, legal requirements for UCR management.

- Most IPSs omit any mention of UCR management, this conspicuous absence attests to the fact that the trustee has committed nonfeasance and establishes that, if brought, a breach of fiduciary duty claim for UCR management breach would easily be classified as prima facie.
- The breach exposes the trustee to large liability claims equal to the amount of forgone "diversification alpha" for all the years UCR management was neglected.
- This failure also highlights potential mal-practice committed by the trustee's advisors, possibly exposing them to large liability claims equal to the amount of forgone "diversification alpha" for all the years UCR management was neglected.
- The amount of forgone "diversification alpha" at the portfolio level is easily obtained by formula and can amount to 1% per annum of a trust's total assets.
- And due to the precedent established by the U.S. Supreme Court in *Tibble vs. Edison International*, statute-of-limitation protection may not be available to trustees who fail to comply with fiduciary standards for UCR management.

Co-authors, Stewart Frank and J. Ben Vernazza are shareholders in Precision Fiduciary Analytics Inc., a fiduciary consulting firm.

About Co-Founder Stewart Frank CPA/PFS AIFA

Mr. Frank is a graduate of the Ross School of Business, University of Michigan and has been a CPA for 55 years. For the past 15 years, he has specialized in the field of Prudent Investor Compliance evaluation. During this time, he provided expert opinions in more than 40 breach of fiduciary duty cases for both plaintiffs and defendants. He is a recognized expert in fiduciary compliance, having recently contributed content for two handbooks on fiduciary best practices, published by fi360. He also served as a Special Consultant on Fiduciary Matters to the Fiduciary Task Force of the American Institute of CPA's (AICPA) Personal Financial Planning Executive Committee during their technical review of the two handbooks.

He is a frequent presenter for the AICPA. Michigan Association of CPAs, and Center For Fiduciary Studies, fi360 at conferences and in webinars on the subject of fiduciary compliance. He co-founded PFA with Mr. Vernazza in 2014.

About Co-Founder J. Ben Vernazza, CPA/PFS, TEP (UK) Emeritus

Mr. Vernazza has been a CPA for 58 years and was an investment adviser for 40 years. He earned both under graduate and graduate degrees from Stanford University. He received the Private Sector Initiative Commendation from President Ronald Reagan in 1984.

In 1998 he founded The Overseas Oversight Group that has oversight responsibilities as protector of overseas trusts and companies, as well as starting three other financial advisory organizations. He sold his investment advisory business in 2012 and co-founded PFA with Mr. Frank in 2014.

He served four-year terms on multiple committees of the AICPA including the Investment Committee for the organization’s pension and health plans that covered the 350,000 members. He is a past chairman of the AICPA special task force on International Tax Reporting Requirements. Prior to these national professional assignments, he participated actively in California CPA Society Committees. Additionally, he served on the asset protection committee of the American Bar Association and as a member of its Probate and Trust Division.