

Prudent Management of Investment Risk

A Summary of Legal Requirements from: *Restatement (Third) Trusts Full Text & Updates 1992-2018**

Modern Portfolio Theory and *Restatement (Third) Trusts (Prudent Investor Rule)* identify two types of equity risk that fiduciaries must manage. Each type of risk embodies different exposures to risk requiring different approaches to their management.

1. Compensated Risk, aka non-diversifiable risk** and
2. Uncompensated Risk, aka diversifiable risk. ***

Compensated Risk is unavoidable; its impact is economy-wide affecting all participants within a given market and cannot be changed with diversification (the reason it is also known as non-diversifiable risk). It is considered the price one must pay to participate in the equity markets. This type of risk is compensated through market pricing so that the expected return from a portfolio is directly affected by the level of these risks that cannot be diversified away. Management of compensated risk consists of determining the appropriate degree of risk to take in a portfolio (through asset allocation) in pursuit of a pre-determined level of expected return.

Uncompensated Risk, unlike compensated risk, is risk that can be avoided with diversification and changes to its level within a portfolio do not materially alter the original portfolio's expected returns. This type of risk is idiosyncratic to the number, degree, and weighting, of a portfolio's constituent holdings and the symmetry of their individual correlations to one another.

Because prudent diversification not only moderates risk that is inherent to investing but also reduces risks that are not justified by some prospect of gain, allowing (even by default) uncompensated risk to reside, unmanaged in a portfolio is a breach of the fiduciary duties of care, skill, and caution. See *Restatement decree* below:

"Failure to diversify on a prudent and 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."
[*Restatement (Third) of Trusts* §227, "Comment on Basic Duties of Prudent Investor," p. 23]

The ultimate goal of diversification is to achieve a portfolio that has only the rewarded or "compensated" element of risk. Management of uncompensated risk is achieved by adding the right balance of diversification to a portfolio's asset allocation.

Management of uncompensated risk is achieved through prudent diversification, defined as the right number, degree, and weighting, of asymmetrically correlated portfolio constituents (not the overall level of portfolio variance), added to a portfolio's asset allocation.

* "This work provides a contemporary treatment of trust law, offering authoritative guidance to legislators, judges, trustees and those who counsel beneficiaries or endeavor to draft instruments that accurately reflect the lawful intentions of donors."

www.precisionfiduciary.com/restatement/

For a good example of how the US Supreme Court relies on the *Restatement (Third) Trusts* for contemporary guidance, see *Tibble v. Edison International*, 135 S. Ct. 1823 (2015), and (*Tibble, slip op. at 5*)

**A majority of advisers, trustees, fiduciaries, etc. do compensated-risk asset allocation, (e.g. Mean-Variance) believing it is also a diversification tool, but not realizing that in most cases their allocation has created uncompensated risk (UCR); sometimes made worse by constraints. The statement in their brochures and advertising is "our portfolios are diversified, you're OK", yet they show no proof they measured or prudently reduced UCR. Realistically, "UN-MEASURED is UN-MANAGED" (by Peter Drucker) and a significant amount of money is left on the table, not to mention a breach.

*** Uncompensated Risk removal occurs after generating a compensated risk asset allocation. Diversification Alpha Optimization techniques are overlaid without materially disturbing the original allocation. UCR risk assets are not adding any additional returns and they can be replaced with uncorrelated assets that have a higher Sharpe Ratio effectively raising the original non-diversified allocation's Sharpe Ratio.
See <https://Portfolio-Diversification-Institute.com/glossary/>

For more information contact:

J. Ben Vernazza CPA/PFS TEP emeritus - beny@CPA.com - 831-688-6000

Stewart Frank CPA/PFS AIFA sfrank@precisionfiduciary.com 248-227-8208

<https://precisionfiduciary.com/services/> https: <https://Portfolio-Diversification-Institute.com/member-benefits/>