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ARTICLES

The Prudence of Passivity: An Argument for Default Passive Management in Trust Investing

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Trustees, like all investors, are exposed to a wide-ranging marketplace of investment vehicles, techniques, strategies, and theories. Trustees have a threshold choice to make with respect to the manner in which trust assets are to be invested. Active management — historically, a conventional approach — aims to "beat the market" and surpass benchmark returns by picking and choosing among individual securities based on the trustee's determination that they are mispriced (i.e., undervalued) and/or by timing transactions based on forecasting. Alternatively, trustees may choose to simply invest in and own entire markets, or asset classes, and accept overall market returns by using low cost asset class index funds. This latter approach is known as passive investing, or indexing.

This article traces both the historical development of financial scholarship regarding investment practices and legal scholarship addressing the evolution of fiduciary duties. It then reviews the modern prudent investing rules governing trust investment and explores several major issues: (1) whether a passive approach is encouraged or even required by law, (2) why so few professional trustees seem to be employing passive investment management and (3) whether recent case law focusing on the costs of investing in the context of ERISA plans is a harbinger of similar arguments in the private trust area.

We conclude with a recommendation that a passive investment strategy become the default standard for corporate and professional trustees under modern iterations of the prudent investor rule.

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The trustee's role in the administration of a trust is comprehensive, involving the custody of assets, making distributions to beneficiaries, preparing periodic accountings and, of course, the investment and monitoring of trust assets. Trustees, like all investors, are exposed to a wide-ranging marketplace of investment vehicles, techniques, strategies, and theories. In investing trust funds, one of the most important decisions a trustee must make is the threshold choice of the manner in which to invest those assets[1] — specifically, whether to pursue a strategy of passive management or active management.[2]

The names of both strategies reveal, at least in a very general way, the tenets underpinning each respective investment management approach. Active investment management, considered the default approach by most conventional investment managers, attempts to exploit real or perceived market inefficiencies in several ways, including security selection (*i.e.*, choosing individual stocks and bonds which the manager believes to be undervalued by the marketplace) and market timing (buying when the manager believes the market will be rising in the future and selling when the manager believes a downturn will likely

1 This assumes, of course, that the applicable trust is not a special purpose trust, created to hold a particular asset such as real estate, a family business or life insurance policy (by way of example).

2 JESSE DUKEMINIER & ROBERT H. SITKOFF, WILLS, TRUSTS, AND ESTATES 624 (Wolters Kluwer Law & Bus., 9th ed. 2013). ("The investment function involves reviewing the trust assets and then implementing an investment program that fits the purpose of the trust and the circumstances of the beneficiaries.").

occur).[3] Passive investment management, in contrast, involves investing in mutual and exchange-traded funds which track and attempt to match major commercial stock exchanges or widely-published indices of publicly traded stocks or bonds.[4] The goal of passive investors is not to try to "beat the market" but rather to efficiently and effectively match the market return of a particular asset class. Passive management is intended to be a long-term strategy designed to take human emotion out of the mix by diversifying investments broadly, allowing the market to operate, and accepting that various asset classes, sectors, markets, and firms will inevitably win, lose, and draw.[5]

When choosing between these two very different investment management styles, most investors consider active management to be the obvious, and sometimes only, way to invest assets, assuming that there are many skillful professionals who can and do "beat the markets."[6] Thus, these investors seem to understand implicitly that their task is to simply identify these money masters.[7] This bias toward active management, of course, is fed and perpetuated by much of the financial management industry and by a willing and complicit media, only too

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[3] *See* John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law: II*, 1977 ABF Res. J. 1, 19-20 (1977) (describing conventional asset management as engaging in stock picking and market timing).

[4] Although, it is important to note that there are mutual fund companies that create their own indices based on various factors or rules, sometimes known as smart-beta funds, or strategic-beta funds. In fact, strictly speaking, such funds are a form of active management, but because they are trying to beat the market without trying to outguess market prices, for purposes of this article they are much more akin to passive funds, and therefore are treated as such herein. Dimensional Funds Advisors is one very prominent example of such a fund company.

[5] Jason Zweig, *The Intelligent Investor: Saving Investors From Themselves*, Wall St. J., June 28, 2013, https://blogs.wsj.com/moneybeat/2013/06/28/the-intelligent-investor-saving-investors-from-themselves/ ("Humans perceive reality in short bursts and streaks, making a long-term perspective almost impossible to sustain — and making most people prone to believing that every blip is the beginning of a durable opportunity.").

[6] *See* William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. Ill. L. Rev. 61, 83 (2010) (contrasting active and passive investment approaches). As of 2014, approximately 80% of portfolio wealth was actively invested. Sam Pittman, *A Model for Building a Lower-Cost Portfolio Using Active, Passive, and Smart Beta Products,* J. Fin. Plan., June 2017, https://www.onefpa.org/journal/Pages/JUN17-A-Model-for-Building-a-Lower-Cost-Portfolio-Using-Active-Passive-and-Smart-Beta-Products.aspx.

[7] Unfortunately, this is not as easy as many investors seem to assume. *See* Jeff Schwartz, *Rethinking 401(k)s*, 49 Harv. J. Legis. 53, 63 (2012) ("Because ordinary investors only have limited tools to aid in fund selection, the choice of a skillful manager is largely guesswork. The reality, therefore, is that investing in an actively-managed fund is essentially a gamble with very poor odds.").

happy to extol the performance of the latest guru.[8] Traditionally, most trustees, like most investors generally, also seemingly view a conventional active management approach as the default approach (or even the exclusive approach) to investing trust funds. In this article, we analyze the wisdom of trustees according active management this default role and conclude that it is, at best, misguided. We suggest, instead, that passive investment management should become the default approach for the investment of trust funds, to be abandoned only when circumstances specifically dictate the use of active management.

The article, which follows, is organized in several parts. First, we provide an overview of the fiduciary duties governing trust administration, focusing on the application of those duties to the investment management of trust funds. Second, we survey the current literature on trust investment law, including a brief exposition of Modern Portfolio Theory. Third, we demonstrate that most active managers fail to deliver sufficient value (in the form of excess return above the indices) and that, as a default approach, passive investing is more likely to meet a trustee's core duties: the duties of loyalty and prudence and their derivative obligations to administer the trust solely in the interests of the beneficiaries and to minimize costs and expenses. Fourth, we explore current trends in fiduciary litigation and suggest that such cases may be a harbinger of the potential consequences of failing to adopt a passive investment strategy without compelling justification. A brief conclusion completes the article.

I. Fiduciary Duties of Loyalty and Prudence in Investing Trust Assets

To frame the analysis, which follows, this Section provides a brief overview of the major fiduciary duties implicated by a trustee's choice of investment strategy. Importantly, although individuals are free to make decisions with regard to how they invest their own funds, a strict standard applies to trustees who are duty-bound to the beneficiaries of the funds they are charged with managing. Because the beneficiaries of modern financial asset management trusts are subject to the peril of mis-

[8] As Steve Forbes, in a moment of candor, once stated: "You make more money selling advice than following it. It's one of the things we count on in the magazine business — along with the short memory of our readers." *See* Larry Swedroe, *You Make More Money Selling Advice Than Following It,* CBS News, May 20, 2010, http://www.cbsnews.com/news/you-make-more-money-selling-advice-than-following-it/. For a critical look at the so-called "expertise" of many investment professionals, see Howard Marks, *The Truth about Investing*, https://www.slideshare.net/MatsLarsson3/2017-0415-hm, slide 4 ("The investment business is full of people who got famous by being right once in a row.").

management or even misappropriation by trustees — corporate, professional or otherwise — trustees are subject to overarching, strict fiduciary duties of loyalty and prudence (or care), and to a host of subsidiary duties, including the duty to invest trust assets prudently.[9] It is therefore axiomatic that, regardless of the jurisdiction, a trustee must be guided by these established common law and statutory fiduciary duties.[10]

Furthermore, a professional or corporate trustee who holds him or herself out as possessing special skills or expertise is subject to an even higher standard.[11]

A. Duty of Loyalty

The most fundamental duty of a trustee is the duty of loyalty and its directive to administer the trust solely in the interests of the beneficiaries of the trust.[12] As stated in Section 802(a) of the Uniform Trust Code, "[a] trustee shall administer the trust solely in the interests of the beneficiaries."[13] The trustee must therefore exclude all self-interest and the interests of third parties. Transactions that could create a conflict between the interests of the trustee and the interests of the beneficiaries are accordingly impermissible acts of self-dealing. The mere appearance of a conflict, such as a trustee's purchase of trust property (for his own account), violates the duty of loyalty, even if the trustee acted in good faith, paid fair market value, and did not profit from the purchase.[14] Indeed, so strict is the rule that, even absent harm, a trustee may not

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9 For a discussion of the history and evolution of the law in this area, see *infra* Section II. *See generally* Robert A. Levy, *The Prudent Investor Rule: Theories and Evidence*, 1 GEO. MASON U. L. REV. 1, 2 (1994); W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 337-38 (1997).

10 The prudent investor rule is codified in the UNIFORM PRUDENT INVESTOR ACT § 1 (UNIF. LAW COMM'N 1994) [hereinafter UPIA], an act adopted in nearly every U.S. jurisdiction. *See Prudent Investor Act*, UNIF. LAW COMM'N, https://my.uniformlaws.org/committees/community-home?CommunityKey=58f87d0a-3617-4635-a2af-9a4d02d119c9 (last visited Mar. 17, 2019).

11 UPIA § 2(f) ("A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.").

12 RESTATEMENT (SECOND) OF TRUSTS § 170(1) (AM. LAW INST. 1959).

13 UNIF. TRUST CODE § 802(a) (UNIF. LAW COMM'N 2000).

14 RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. c. For a criticism of this "no further inquiry" rule, see John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 966-67 (2005) (arguing that self-dealing should be permissible when in the beneficiaries' best interests). For a defense of the traditional rule, and a critique of Professor Langbein's proposal, see Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541, 549 (2005).

reap any personal benefit from a transaction.[15] Justice Cardozo famously, and aptly, explained the duty of loyalty and the strict standard as follows:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[16]

Though some exceptions have been carved out,[17] these exceptions are limited and closely scrutinized.[18] This well-established principle that the trustee should "exclude all selfish interest in [the] administration of the trust, and maintain undivided loyalty to the beneficiaries applies to investments as well as other trust transactions."[19]

B. Duty of Prudence

The duty of prudence is also fundamental to a trustee's duty in managing a trust for the beneficiaries.[20] The trustee is under a duty to the beneficiaries to administer the trust in good faith with reasonable care, skill and caution (i.e., prudence), in accordance with the purposes, terms and other circumstances of the trust.[21] Additionally, "[i]f the trustee possesses, or procured appointment by purporting to possess, special

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15 12 C.F.R. § 9.12(a) (2019). The trustee's good faith and the objective reasonableness of the purchase are "irrelevant" if the transaction involves self-dealing or a conflict of interest. In such a case, the trustee can avoid liability only if the trustee can prove that: "(a) the settlor authorized the particular self-dealing or conflicted action in the trust instrument; (b) the beneficiary consented after full disclosure; or (c) the trustee obtained judicial approval in advance." DUKEMINIER & SITKOFF, *supra* note 2, at 591.

16 Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

17 For instance, some state statutes expressly authorize corporate trustees to invest trust funds in the corporation's or the corporation's affiliate's own funds. *See* DUKEMINIER & SITKOFF, *supra* note 2, at 593.

18 *Id.*

19 AMY MORRIS HESS, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, BOGERT'S TRUSTS AND TRUSTEES § 612 (2018) [hereinafter BOGERT'S].

20 *See* DUKEMINIER & SITKOFF, *supra* note 2, at 602 ("After loyalty, the next great principle of trust fiduciary law is the duty of prudence.").

21 RESTATEMENT (THIRD) OF TRUSTS § 77 (AM. LAW INST. 2007).

facilities or greater skill than that of a person of ordinary prudence, the trustee has a duty to use such facilities or skill."[22] Whether a trustee acts with appropriate prudence is determined based on the trustee's conduct, not the results or performance. Furthermore, under the modern iteration of the rule, the trustee's conduct is evaluated in the context of the circumstances at the time of the conduct and not with the benefit of hindsight.[23]

With respect to investing the trust property, the duty of prudence requires a trustee to thoughtfully invest the trust assets with the care, skill, and caution of a prudent investor with a firm knowledge of current scholarship, as articulated in the Prudent Investor Rule.[24] Even after the trustee has made the initial decision of which fundamental investment strategy to pursue, the duty of prudence charges a trustee with the continuing obligation of monitoring the investments' performance and removing those investments that prove to be imprudent.[25]

Derivative of the trustee's duty of prudence is the duty to avoid incurring unnecessary expenses, broadly defined, when administering a trust. As will be discussed in more detail later in this article, the Restatement (Third) of Trusts devoted considerable attention to this duty, clarifying and emphasizing that "cost-conscious management is fundamental to prudence in the investment function."[26] Professor Halbach, who served as the reporter for the Restatement (Third), stated that trust administration must be cost conscious and take into consideration market efficiencies, investigation expenses, transaction costs, and capital gains taxation when examining management strategies.[27] Halbach further contends that trustees must also consider realistically the prospect and likelihood of such activities generating increased returns to assess whether the activities are consistent with the duty of prudence.[28]

II. Trust Investment Law and Scholarship

To effectively fulfill his or her duty of loyalty and duty of prudence, a trustee must have a thorough understanding of both trust investment

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22 *Id.*

23 Restatement (Third) of Trusts § 77 cmt. a.

24 Restatement (Third) of Trusts § 90 cmt. b.

25 *See* Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828–29 (2015), *aff'd*, 820 F.3d 1041 (9th Cir. 2016), *vacated*, 831 F.3d 1262 (9th Cir. 2016).

26 Restatement (Third) of Trusts § 90 cmt. b. *See also* Restatement (Third) of Trusts, Prudent Investor Rule § 227(c)(3) (Am. Law Inst. 1992) ("[T]he trustee must incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.").

27 Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 77 Iowa L. Rev. 1151, 1174-75 (1992).

28 *See id.* at 1166 (discussing general observations of prudent investment).

law and scholarship's consensus on best current investment theory and practice.[29] Furthermore, trust investment law is intended to evolve in a manner and direction reflective of accepted financial and economic concepts and knowledge.[30] Accordingly, this Section first traces the history of common law and statutory trust investment regulation and standards to understand fully the current state of trust investment law and scholarship. We then review current trust investment law and theory and analyze what it tells a trustee about how to satisfy the duties of loyalty and prudence.

A. The Rise and Fall of the Legal List Approach and the Prudent Man Rule

Historically, two distinct regulatory approaches to trust investing existed in England and the United States. Although the English approach was jettisoned in the United States, it is worth examining as this approach had a significant impact on early American trust investment jurisprudence and regulation.

In 1719, British Parliament explicitly authorized trust investment in South Sea Company equities. When the South Sea Company bubble burst in 1720, share prices declined precipitously and, inevitably, trust beneficiaries bore some of the losses.[31] The English Court of Chancery's response was one of reactive restriction, leading to the development of a limited list of legislatively authorized investments with the aim of providing direct guidance to trustees in the form of presumptively acceptable options.[32] At first, this list included only low volatility, low-yielding government bonds. Eventually, the list was expanded to include safely-secured first mortgages.[33] Over time, some common stocks were also authorized as acceptable investments.[34] This arguably paternalistic approach continued in England in some fashion until 1961, when the statute was amended to allow for up to one-half of a trust fund to be invested in equities more generally.[35]

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29 *See id.* at 1157-58 (discussing how prudent investing depends on modern understandings).

30 In fact, we argue that attention to the significant amount of financial and economic scholarship and understanding that has developed in the past century is essential to complying with a trustee's duty of prudence. *See id.* at 1154 (describing how a trustee's work must be informed by current knowledge and concepts from the investment community).

31 *See* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing,* 81 IOWA L. REV. 641, 643 (1996).

32 *Id.*

33 *Id.* at 644.

34 *Id.* at 645.

35 *Id.* at 643.

In the United States, early development of state law frequently followed the English approach.[36] Some courts attempted to impose definitions of permissible investments; others inquired as to permissibility on a case-by-case basis.[37] The New York case of *King v. Talbot* in 1869 exemplified the legal list approach.[38] The *Talbot* court echoed the English approach and forbade trust investment in corporate securities and limited the list of acceptable investments.[39] As was the case post-South Sea Company collapse, this list of appropriate investments was limited to government bonds and well-secured mortgages.[40] In 1889, the New York state legislature codified the standard, which became known as the "legal list" rule due to its enumeration of permissible investments.[41] Other states also adopted the legal list approach which provided statutorily or judicially authorized trust investments — that is, investments on the list were prudent, *per se*, and those not on the list were seen to be imprudent, *per se*.[42]

Courts in other jurisdictions veered away from the constrictive list approach and instead developed a constellation of prudent investing principles.[43] In 1830, the seminal case of *Harvard College v. Amory*[44] all but eschewed the English practice of authorizing investment in only government-backed securities.[45] This case commenced the trajectory away from the English approach and, for a time at least, provided a more liberal conceptualization of the propriety of certain investments. In its decision, the Supreme Judicial Court of Massachusetts tracked the contemporaneous concept of the "reasonable man" rule developing in tort jurisprudence by endorsing a "prudent man rule" for trust investing.[46] The approach set out by the highest court in Massachusetts was more practical and less constrictive and was generally viewed as a corrective response to an approach which had, in other jurisdictions, be-

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36 *See* Robert J. Aalberts & Percy S. Poon, *The New Prudent Investor Rule and Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 Am. Bus. L.J. 39, 43 (1996) (discussing the development and diversity of states applying either the legal list approach or the *Harvard College* rule).

37 *Id.* at 67.

38 *See* King v. Talbot, 40 N.Y. 76, 78 (1869) (noting that "The investment of such funds by a trustee in canal, bank, insurance, railroad or other stocks of private corporations, is a violation of his duty and the obligation of his trust.").

39 *Id.* at 83-84.

40 Aalberts & Poon, *supra* note 36, at 67.

41 *Id.* at 43 (describing the court of appeals decision).

42 *Id.* at 50 (describing the per se nature of the rule).

43 *See id.* at 43-44 (describing the Headley/Shattuck model statute as a counterforce to the legal list approach).

44 26 Mass. 446 (1830).

45 Aalberts & Poon, *supra* note 36, at 42-43.

46 *See Harvard Coll.*, 26 Mass. at 465 (describing the reasonableness standard).

come rigid and imposing.[47] In *dicta,* the Massachusetts Supreme Judicial Court famously declared that trustees should "observe how men of prudence . . . 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."[48]

During the 1930s and 1940s, various stakeholders (including the American Bankers Association) opposed the vestigial minority of states that still retained the legal list approach and promoted a codification of the *Harvard College* holding known as the Model Prudent Man Investment Statute.[49] The new statute incorporated language from the *Harvard College* decision.[50] By 1950, a version of the Prudent Man Rule was adopted by judicial decision[51] or legislation in the majority of American jurisdictions, usually replacing the more restrictive "legal list" statutes, which, again, categorized investment classes as *per se* proper or improper.[52]

Unfortunately, for trust beneficiaries everywhere, the broad and flexible mandate for trustees originally described in the *Harvard College* decision increasingly was construed in a limiting manner by subsequent cases in other jurisdictions: "As generalizations were articulated and an effort was made to offer guidance to trustees, the prudent man rule tended to lose much of its generality and adaptability. . . . [W]hat was decided in one case as a question of fact tended to be treated as a precedent establishing a rule of law."[53] Similarly, although a formulation of the Prudent Man Rule was also adopted in both the original and second versions of the American Law Institute's Restatement of the Law of

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47 John A. Taylor, *Massachusetts' Influence in Shaping the Prudent Investor Rule for Trusts*, 78 MASS. L. REV. 51-52 (1993).

48 *Harvard Coll.*, 26 Mass. at 461.

49 Aalberts & Poon, *supra* note 36, at 43 n.33. The Model Prudent Man Investment Statute was developed in response to studies revealing that trusts in states like Massachusetts (those adopting the *Harvard College* standard) earned 2% more than jurisdictions utilizing legal lists. *Id.* at 43–44. The model statute was, however, later criticized for ignoring the duty to diversify investments and for failing to provide for the treatment of investment losses. *Id*.

50 *See* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52, 87 (1987) (describing the development of trust law following the depression which included a move toward *Harvard College* language).

51 *See, e.g.*, U.S. Tr. Co. v. Bohart, 495 A.2d 1034, 1043 (Conn. 1985); Jackson v. Conland, 420 A.2d 898, 900 (Conn. 1979); Hartford Nat'l Bank & Tr. Co. v. The Parish of Trinity Church, 195 A.2d 566, 570 (Conn. 1963).

52 *See* Langbein & Posner, *supra* note 3, at 5 (describing the timing of legal list abandonment).

53 Halbach, *supra* note 27, at 1152 (internal citations omitted).

Trusts,[54] its construction of the standard remained unduly constrained. For instance, Section 227 of the Restatement (Second) of the Law of Trusts stated that "[o]rdinarily it is proper for a trustee to invest in . . . bonds of the United States or of the State or of municipalities, in first mortgages on land, or in corporate bonds."[55] Investing in "speculative" stock and other securities with certain characteristics was still presumptively improper.[56]

Thus, despite its purported generality and increased flexibility, the Prudent Man Rule as it was incorporated into subsequent case law and the Second Restatement was construed in an increasingly narrow manner and remained steadfastly "preoccup[ied] with safety and speculation."[57] Additionally, it was criticized for analyzing each asset in isolation, rather than in the context of the entirety of the portfolio and for its hindsight, retrospective inquiry.[58] Trustees faced liability for a "decline in the value of one stock even if that stock was part of a well-diversified portfolio suited to the purpose of the trust and the risk tolerance of the beneficiaries."[59] Even worse, courts were loath to enforce provisions in trust agreements attempting to opt out of the Prudent Man Rule.[60] In response, trustees understandably became "overly cautious and too conservative in making investments for fear of being surcharged by reason of the rule that the prudence of each investment must be judged separately and apart from other investments of the trust portfolio."[61] When assets were judged individually under the Prudent Man

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54 RESTATEMENT (SECOND) OF TRUSTS § 227 (AM. LAW INST. 1959). Section 227 of the Restatement Second of the Law of Trusts directs trustees to "make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived." This language tracks the *Harvard College* decision in its emphasis on preservation of principal as well as anticipated risk and return. *See* Harvard College v. Amory, 26 Mass. 446, 462 (1830).

55 RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. f.

56 *Id.* (noting that certain classes of equities were still presumptively improper and were analyzed in their own capacity and not in relation to other portfolio holdings).

57 Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Trust Asset Allocation: An Empirical Analysis*, 35 ACTEC J. 314, 318 (2009).

58 *See id.* at 318 ("The old law's preoccupation with safety and speculation invited what psychologists and behavioral economists call hindsight bias in the form of after-the-fact 'searches for evidence that investments were too risky.'").

59 *Id.* (noting how the practice exposed the trustee to liability).

60 *See id.* ("[J]udicial enforcement of language in the trust instrument modifying the prudent man rule, or purporting to release the trustee from the rule altogether, was at best uncertain. Neither a specific empowerment in the trust instrument to make a particular investment nor a broad exculpation clause insulated the trustee from judicial review.").

61 Fred C. Weekley, *Fiduciary Investments and Prudent Investor Act*, NAT'L. ACAD. OF ELDER ATT'YS INST. 17–1, 2003 WL 24002972 (*citing* BOGERT'S, *supra* note 19, at 1).

Rule, "the determination of whether a trust investment was permissible was usually based on some perceived but undefined degree of risk that exceeded the limits of caution."[62] This led, among other things, to a perverse incentive for trustees not to diversify. Indeed, one need only consider the following statement by the Court in *In re Chamberlain's Estate* holding a trustee liable for trust loss to conclude that only the most courageous of trustees would deviate from the list of approved investments:

> It was common knowledge, not only amongst bankers and trust companies, but the general public as well, that the stock market condition at the time of testator's death [in August 1929] was an unhealthy one, that values were very much inflated, and that a crash was almost sure to occur.[63]

B. The Road to Recognition of Modern Portfolio Theory in Trust Investment Law

Over time, the common law Prudent Man Rule — even as it appeared in the Restatement (Second) of Trusts — became unworkable by virtue of the fact that it had been interpreted and applied in a consistently narrowing manner.[64] As its initial adaptability was lost, trustees, like all sophisticated investors, viewed it as largely inadequate and insufficient to deal with changing economic conditions and financial markets, thus creating an opening for new thinking to come along and adapt the old investing by list strategy to an increasingly complicated and volatile world. Trustees needed an approved method to structure investments such that changing circumstances would not destroy investment principal. Unfortunately, widely-accepted investment management practices were prohibited, or at least discouraged, under most interpretations of the Prudent Man Rule.[65]

Economic, investment, and financial scholarship ushered the standard away from the individual security analysis approach and encouraged the adoption of a portfolio-based approach to "free trustees

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62 Halbach, *supra* note 27, at 1152.

63 *In re* Chamberlain's Estate, 156 A. 42, 43 (N.J. Prerog. Ct. 1931).

64 As noted in introductory commentary in the Restatement (Third) of Trusts, "much of the apparent and initially intended generality and adaptability of the prudent-man rule was lost as it was further elaborated in the courts and applied case by case. Decisions dealing with essentially factual issues were accompanied by generalizations . . . . These cases were subsequently treated as precedents establishing general rules . . . . Specific case results and flexible principles often thereby became crystallized into specific subrules prescribing the types and characteristics of permissible investments . . . . " RESTATEMENT (THIRD) OF TRUSTS pt. 6, ch. 17, intro. note (AM. LAW INST. 2007).

65 Stewart E. Sterk, *Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine?*, 95 CORNELL L. REV. 851, 861 (2010).

from the old preoccupation with avoiding speculation."[66] Academics campaigned for the "[differentiation] between market risk, which is inherent to participating in the market, and idiosyncratic risk, which is particular to a given investment."[67] The advent, development, and growth of a new body of investment knowledge, collectively known as Modern Portfolio Theory, demonstrated a clear need for trust investment law to be further refined in accordance with this increasingly well-accepted investing doctrine.

1. *A Brief Primer on Modern Portfolio Theory*

Trust investment law as currently formulated can trace much of its recent development to the work of Nobel recipient Harry Markowitz, who applied the principles of mathematics to stock market analysis and devised what he termed Modern Portfolio Theory ("MPT") in 1952 as part of his doctoral dissertation.[68] MPT sets out how investors can construct portfolios more intelligently by measuring and balancing risk and reward. Generally, Markowitz posited that investors must evaluate portfolio risk as well as return and proposed the notion that diversification of securities promotes investment behavior instead of speculative behavior.[69] Not surprisingly, perhaps, the intricacies of MPT, which continues to evolve, are highly technical so it is fortunate that it is unnecessary to understand them in great detail for purposes of this article.[70] What follows, therefore, is a brief summary of the core tenets of Modern Portfolio Theory[71] with a particular focus on its application to trustee investment law and trustee investment.

a. *Diversification*

Arguably, the most significant principles of Modern Portfolio Theory are the portfolio diversification effect and measurement of risk

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66 Langbein, *supra* note 31, at 650.

67 Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Market Risk: An Empirical Analysis*, 14 J. EMPIRICAL LEGAL STUD. 129, 134 (2017) ("Generally speaking, to obtain a greater expected return, an investor must assume greater market risk. Market risk is thus compensated in that more exposure to market risk yields more expected return. Idiosyncratic risk, the critics argued, is different because it is generally uncompensated. Such risk can be reduced or even eliminated by diversifying. It follows, therefore, that the prudence of a given investment must be considered in light of its contribution to the overall portfolio's expected risk and return."). *See infra* Section II.B.1.b.

68 *See* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

69 *Id.* at 90 (describing diversification).

70 *See* Langbein & Posner, s*upra* note 3, at 32.

71 *See* Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 100 (1990) (explaining Modern Portfolio Theory for laypersons).

through analysis of the portfolio *en masse* instead of analyzing each investment separately without regard to the contextual portfolio.[72] The concept of portfolio diversification, which suggests that investments should be analyzed not in a vacuum but in relation to other investments within the same portfolio, became a significant and central ground for revision of the Prudent Man Rule as set forth in the Restatement (Second) of the Law of Trusts and was most fully realized in the Restatement (Third) of the Law of Trusts.[73]

Risk, Markowitz proposed, depends on correlation of securities within a portfolio.[74] Risk is reduced when investment securities do not have identical return behaviors.[75] Maximum diversification (and therefore maximum idiosyncratic risk reduction) is theoretically achieved when securities are perfectly negatively correlated.[76] Markowitz, *inter alia*, critiqued and discounted the widely influential book *The Theory of Investment Value* by John Burr Williams, who had proposed that investors should focus their efforts on maximizing returns.[77] This latter approach, which dominated fiduciary and non-fiduciary investing for one hundred years, tended to result in highly concentrated portfolios, holding relatively few securities.[78] Markowitz considered that approach to be one-dimensional and risky: by focusing only on maximizing returns, investors ignored the value and stability imparted by circumventing some degree of risk through diversification among securities with negative covariance.[79]

Covariance, most simply, is a measurement of how and to what extent securities move in relation to each other. This is in practice a method of measuring the degree of diversification of a portfolio. Markowitz proposed that the focus on maximizing returns was a foolish investment strategy because it tended to ignore or discount risk analysis. High-return securities are generally high-risk securities and they are often positively correlated, meaning that they track similarly in the mar-

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72 *See* Markowitz, *supra* note 68, at 77.

73 Restatement (Second) of Trusts § 228 cmt. a (Am. Law Inst. 1959). Diversification is a risk management technique that mixes a wide variety of investments and asset classes within a portfolio. The rationale behind this technique contends that a portfolio constructed of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment, or asset class, found within the portfolio. *See Diversification*, Investopedia.com, https://www.investopedia.com/terms/d/diversification.asp (last visited Mar. 17, 2019).

74 *See* Markowitz, *supra* note 68, at 77.

75 *Id.* at 80, 89.

76 *Id.*

77 *Id.* at 77.

78 *Id.* at 89.

79 *Id.*

ket.[80] Modern Portfolio Theory champions the proposition that risk and return are inexorably related, and therefore risk is as important a consideration as return and that investors can reduce risk by selecting diverse securities that are not all positively correlated (for the same expected return).[81] Through diversification among a variety of variously correlated securities and asset classes, the exposure to the risk inherent in investing in positively correlated securities (for instance, particular assets or industries) is reduced. Although novel at the time, the concept of diversification as a means of reducing risk of loss is now widely accepted and uncontroversial in both the financial and legal realms.[82] No trustee, of course, would sleep well at night putting all trust assets in one basket. Unfortunately, there is less consensus, however, of what a properly diversified trust portfolio looks like.

b. *Market versus Non-Market Risk*

Through appropriate diversification of equities, Markowitz showed that risks unique to a particular security or industry can be eliminated.[83] Thus, this type of risk is aptly called diversifiable or non-market risk (and sometimes non-systematic or idiosyncratic risk).[84] A simple example of such risk is common stock of a single company. The investor in such a company is implicitly taking the chance that some unexpected event — a missed earnings report, failed product, large legal liability, product defect, *etc.* — will not occur, or if it does, will not materially harm the earnings of the enterprise (and only that enterprise). (Note, though, that a passive approach using an index or similar fund "is not a panacea;" rather, it is "participation in a risky business that eliminates the risk of individual stocks, eliminates the risk of picking managers, eliminates the risk of picking the hot sector of the day, and leaves only the risk [of] the stock market itself."[85]) Modern Portfolio Theory promotes the now well-accepted premise that diversification across and within various asset classes minimizes these risks through dilution and

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80 *Id*. Correlation, as used in the Modern Portfolio Theory context, is a measurement of how often securities move in relation to each other.

81 *Id.*

82 Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine,* 76 COLUM. L. REV. 721, 732 (1976).

83 Markowitz, *supra* note 68, at 89-90 (describing the ability to avoid risks associated with business shocks that would vary in their likelihood across different market sectors).

84 Langbein & Posner, *supra* note 3, at 27 (discussing diversifiable and systemic risks).

85 John Bogle, *The Outsider,* MONEY, May 2017, at 44.

that the investor simply is not paid to take the risk of investing in a particular stock or bond.[86]

However, not all risks can be fully eliminated. Risk inherent to the entire market or asset class is known as market or non-diversifiable risk.[87] Such risks reflect market fluctuations as a whole or of entire market sectors or asset classes and cannot be prevented by diversification of equities or bonds alone.[88] Instead, this risk is best managed through investment in various asset classes and types of securities.[89] This concept of diversification led to the eventual shift away from the constrained conceptualization of the Prudent Man Rule by providing a somewhat mathematical route to reducing non-market, idiosyncratic, diversifiable risk.[90]

c. *Efficient Capital Market Hypothesis*

The Efficient Capital Market Hypothesis ("ECMH"), a corollary of Modern Portfolio Theory, was developed by Eugene Fama at the University of Chicago in the 1960s.[91] This groundbreaking investment theory proposes that a market can be described as efficient when the prices of goods being sold within the market reflect fully all available information about the goods.[92] This theory posits, generally, that major capital markets are efficient; meaning that new information about goods being sold is nearly instantly incorporated and reflected into the price of the goods (or markets).[93] In turn, this concept assumes that assets generally are priced fairly, at least in liquid and well-functioning markets, because

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86 *See* Langbein & Posner, *supra* note 3, at 27 (discussing diversifiable and systemic risks). Although there is no firm consensus on what, exactly, comprises a fully diversified portfolio, some authorities suggest that a portfolio of twenty to thirty U.S. large cap stocks does not satisfy the diversification requirement. *See, e.g.*, Meir Statman, *How Many Stocks Make a Diversified Portfolio?*, 22 J. FIN. & QUANTITATIVE ANALYSIS 353, 353 (1987); Meir Statman, *How Much Diversification is Enough?* (Oct. 2002), https://ssrn.com/abstract=365241.

87 Haskell, *supra* note 71, at 106 (discussing the concept of market risk).

88 *Id.*

89 *Id.*

90 For a good, accessible discussion of non-market and market risk, with examples, *see* Langbein, *supra* note 31, at 647-48; for a more detailed, theoretical and academic discussion, see William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425, 425 (1964) (under a Capital Asset Pricing Model, only systematic (market) risk is compensated).

91 *See generally* Carol R. Goforth, *The Efficient Capital Market Hypothesis – An Inadequate Justification for the Fraud-on-the-Market Presumption*, 27 WAKE FOREST L. REV. 895, 896 n.7 (1992) (discussing Fama's early work on the subject).

92 JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 38 (2d ed. 1998). *See also* Haskell, *supra* note 71, at 103 (discussing the definition of efficient markets and the concept of efficient pricing).

93 MACEY, *supra* note 92*,* at 38.

the price accurately reflects all available information and that, in the case of capital markets, stock prices accurately reflect the intrinsic value of the underlying entity at any given point in time.[94]

Over time, the ECMH has been subdivided into a gradient of subsidiary theories accounting for the relative strength or weakness of the hypothesis: (1) weak form efficiency, (2) semi-strong form efficiency, and (3) strong form efficiency.[95] In weak form, the ECMH presumes that a stock's price is largely independent of past price performance and that historic progression or fluctuation in that price is incorporated and reflected into the stock's current price. Information inherent in the history of a stock's pricing is assumed to be reflected in the current price under this form of the ECMH.[96] Therefore, (even) the weak form of ECMH naturally leads to the conclusion that investor analysis of a stock's historical prices does not reliably enhance that investor's ability to select underpriced stocks and, thereby, exploit future gains in value (nor is there any benefit whatsoever to the school of active management known as technical analysis).

The semi-strong form of ECMH builds on the concepts espoused by the weak form of ECMH. It posits that current stock prices also fully reflect *all public knowledge*. Therefore, acquisition of additional public knowledge about the stock is, again, not a means of gaining an advantage when attempting to discern undervalued stocks.[97]

Lastly, the strong form of the ECMH goes even further and assumes that *public as well as private information* is collectively fully reflected in a stock's price.[98] If the strong form of the ECMH were entirely correct and accurate all of the time, it would follow that no investor could ever outperform the market[99] by finding mispricings of securities, at least in a reliably consistent way, because the market would

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[94] Note that the "hypothesis is often misrepresented as a statement that financial markets forecast the future perfectly." Eugene Fama, who developed the hypothesis as a PhD student at the University of Chicago, stated in describing ECMH "in an efficient market, prices incorporate all available information. Put simply, the market knows more than any individual." DIMENSIONAL FUND ADVISORS, 35 QUOTATIONS ON A BETTER WAY TO INVEST 8 (2016).

[95] *See* Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work,* 25 J. FIN. 383, 413-16 (1970) (discussing results of testing various efficiency-strength hypotheses).

[96] *See* MACEY, *supra* note 92, at 39.

[97] *See* Fama *supra* note 95, at 414 (discussing the semi-strong form's information assumptions).

[98] *See id.* (discussing the strong form's assumptions and how they are unlikely to hold in the real world).

[99] In sum, ECMH in any of its forms effectively pokes holes in historically popular active investment strategies which necessarily rely to some degree on inefficiencies.

incorporate and reflect all available knowledge.[100] In short, a strong form efficient market would be impossible to outsmart. For most trustees, determining whether markets are efficient, and to what extent, is academic. What is relevant is to meaningfully understand the historical data on investment returns. Thus, paraphrasing Eugene Fama we posit: Trustees need not be convinced that markets are efficient, but they certainly should invest as though they are.

Evidence supporting the ECMH is empirical in nature and is maintained by the Center for Research in Security Prices at the University of Chicago, which has maintained historical information regarding share prices including those listed on the New York Stock Exchange since 1926.[101] Significant data supports the weak and semi-strong versions of the ECMH,[102] and the ECMH's principles figured heavily in the development of the Modern Prudent Investor Rule.[103] Although this concept is the subject of much dispute, for purposes of this article, we assume that capital markets are at least somewhat efficient.[104] The salient point should be accordingly obvious: In no version of the ECMH is it productive and beneficial to speculate in individual stocks and bonds, i.e. investing using an active strategy.

2. *Incorporation of Modern Portfolio Theory into the Modern Prudent Investor Rule*

In the latter half of the 20th century, as the scholarship and research on the tenets of Modern Portfolio Theory grew and became widely accepted, a push was made to revise and update trust investment law to "reflect and accommodate current knowledge and concepts in the financial communities."[105] The incorporation of the teachings of Modern Portfolio Theory was effected in 1992 when the American Law Institute undertook the "Prudent Investor Project" to overhaul the Restatement (Second) of Trusts, to review the tenets of Modern Portfo-

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[100] MACEY, *supra* note 92, at 39.

[101] *Id.* at 38.

[102] *Id.*; *See also* Fama, *supra* note 95, at 414-16 (discussing the conclusions of empirical work on ECMH).

[103] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. h(1) (AM. LAW INST. 2007).

[104] Halbach noted that acceptance of markets as wholly efficient would necessarily lead to the use of passive investment strategies: "[c]urrent assessments of the degree of market efficiency support the adoption of various forms of passive strategies by prudent investors, including the widespread reliance on index funds. Assessments also tend to discourage incurring heavy investigative and transaction costs, including taxation of gains, in pursuit of strategies designed to beat the market through 'timing' or 'stock picking' in major central markets." Halbach, *supra* note 27, at 1162.

[105] *Id.*

lio Theory, to reflect the criticisms of the former rule, and to modernize trust investment law.

The first publication of the Restatement (Third) of Trusts, known as the Prudent Investor Rule, incorporated the principles espoused by Modern Portfolio Theory and significantly altered the provisions concerning trust investment standards in accordance with contemporary financial and economic scholarship. The Prudent Investor Rule is comprised of three Restatement sections — Sections 227, 228, and 229 — and significant associated commentary and explanation. The text of the Prudent Investor Rule is "dominated by the language of Modern Portfolio Theory and the Efficient Market Hypothesis."[106] Indeed, the Restatement (Third) of Trusts and its internal commentary consistently identify Modern Portfolio Theory as its investment lodestar.[107]

Specifically, the intrinsically connected MPT concepts of diversification and equity covariance permeate the text of the Restatement (Third) of Trusts.[108] The Introduction to the Prudent Investor Rule instructs trustees and courts that "sound diversification is fundamental to risk management and is therefore ordinarily required of trustees."[109] Further, Section 227 requires a trustee to

> invest and manage the funds of the trust *as a prudent investor would* . . . . [T]his standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments *not in isolation but in the context of the trust portfolio* and as a part of an overall investment strategy, which should *incorporate risk and return objectives* reasonably suited to the trust . . . . [T]he trustee has a *duty to diversify the investments of the trust* unless, under the circumstances, it is prudent not to do so.[110]

In essence, the Prudent Investor Rule instructs the fiduciary to use prudence; that is, "not to avoid risk altogether but rather to evaluate the purpose and circumstances of the trust, to choose a commensurate level of overall market risk and expected return, and to avoid wasteful idiosyncratic risk."[111]

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106 Jeff Troutner, *A Contrast in Integrity: From Oakland to Geneva*, ASSET CLASS (Equius Partners), Mar. 2010, at 3.

107 Edward A. Moses, J. Clay Singleton & Stewart A. Marshall III, *Modern Portfolio Theory and the Prudent Investor Act*, 30 ACTEC J. 166, 167 (2004).

108 *Id.*

109 RESTATEMENT (THIRD) OF TRUSTS pt. 6, ch. 17, intro. note (AM. LAW INST. 2007).

110 *Id.* § 90 (Prudent Investor Rule) (emphasis added) (Note that § 227 was originally published in the 1992 Prudent Investor Rule, but is now out of print in that form.). For more on the duty to diversify, see generally Jeffrey A. Cooper, *Speak Clearly and Listen Well: Negating the Duty to Diversify Trust Investments*, 33 OHIO N.U. L. REV. 903, 906-10 (2007) (discussing the duty).

111 Schanzenbach & Sitkoff, *supra* note 67, at 135.

At once, the Prudent Investor Rule incorporates the teachings of Modern Portfolio Theory and corollary theories,[112] while also ensuring that further evolution of the standards will follow the industry's best practices.[113] The language of the Rule creates a standard meant to track much of the investment industry by requiring management in comportment with the actions of prudent investors.[114] Professor Halbach explained this change by noting that it restored the flexibility of the standard and was meant to "adapt over time to changes in the operation of financial markets, in the investment products available, and in the practices of many fund managers, as well as in the theories and knowledge underlying those practices."[115] Indeed, Professor Halbach noted that the Prudent Investor Project was in fact undertaken

> with a *clear recognition that trust investment law should reflect and accommodate current knowledge and concepts in the financial community* . . . [A]n important objective in drafting the prudent investor rule was to preserve the flexibility necessary for the incorporation of future learning and developments.[116]

Spurred by the economic and financial scholarship and the publication of the Prudent Investor Rule in 1992, the National Conference of Commissioners on Uniform State Laws developed the 1994 Uniform Prudent Investor Act ("UPIA"). The UPIA provided a model codifica-

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112 "The Prudent Investor Rule . . . gives . . . fiduciaries both the authority and the requirement to consult the well-established principles, strategies, and tools of Modern Portfolio Theory . . . . [T]he Rule is based upon . . . MPT. . . . [T]he associated commentary and the Restatement identify MPT as the source of investment guidance for fiduciaries." Moses et al., *supra* note 107, at 167 (emphasis omitted).

113 *See* Larry E. Swedroe, What Wall Street Doesn't Want You to Know: How You Can Build Real Wealth Investing in Index Funds 80 (2001) ("By rewriting the Prudent Investor Rule, the ALI recognized both the significance and efficacy of MPT. It also recognized the poor and inconsistent results delivered by active managers.").

114 This alteration was a significant move away from the language of the Restatement (Second) of Trusts which incorporated the Prudent Man Rule as espoused by *Harvard v. Amory*. Specifically, the standard was altered to move away from directing trustees to make investments "as a prudent man would make of his own property" and instead aspires to reflect the management a "prudent investor" would undertake. The alteration revises the standard to reflect industry practices; as such, it was intended to be a flexible and evolving standard. As noted by the Reporter, Edward Halbach, "[i]f one is responsible for managing trust funds, one should be acquainted . . . with modern investment principles and concepts . . . . [F]iduciary investment calls for application of some reasonable understanding of investment principles . . . . [A] trustee's work should reflect what has been learned from the last half century of important research into matters that range from financial markets to modern investment products." Edward C. Halbach, Jr., *Redefining the "Prudent Investor Rule" for Trustees*; 129 Tr. & Est., Dec. 1990, at 14.

115 *Id.*

116 Halbach, *supra* note 27, at 1154 (emphasis added).

tion of the tenets of Modern Portfolio Theory, as adopted by the revisions to the Restatement in the Prudent Investor Rule.[117] The UPIA and its commentary overtly reflect the influence and intentional incorporation of Modern Portfolio Theory into uniform legal standards,[118] and the Modern Prudent Investor Rule, enacted in nearly every state over the last 30 years,

> is the centerpiece of trust investment law. Repudiating the prior law's emphasis on [mindlessly] avoiding [all] risk, the Prudent Investor Rule, as incorporated in the Uniform Prudent Investor Act, reorients trust investment towards risk management in accordance with Modern Portfolio Theory. The Rule directs a trustee to implement an overall investment strategy having risk and return objectives reasonably suited to the trust.[119]

III. The Case for Passive Management

In this section, we set forth our view that passive investment management is the obvious, most appropriate default approach to fiduciary investing for corporate and professional trustees in most circumstances. We consider both active and passive management within the previously discussed framework of a trustee's fiduciary duties and the evolution of the Modern Prudent Investor Rule, as well as the law's express adoption of MPT, and conclude that the passive approach to trust investment typically will better fulfill the trustee's mandate to implement an overall investment strategy having risk and return objectives reasonably suited to the trust.[120] Indeed, we conclude modern portfolio scholarship and academic and financial data, together with the modernization of the Prudent Investor Rule, weigh so heavily in favor of passive over active investment strategies that trustees should default to a passive invest-

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117 Moses et al., *supra* note 107, at 166-67.

118 Although it seems to the authors that "incorporating modern portfolio theory into the law of trust investment should provoke little controversy," at least anecdotally it does not appear that many corporate and professional trustees are applying the tenets of MPT in practice. Schanzenbach & Sitkoff, *supra* note 67, at 130. The only empirical evidence we have to date is that corporate trustees have increased the allocation of the average trust portfolio to equities. *See id.* at 129-30.

119 *Id.* at 129.

120 In the case of an existing trust portfolio already actively invested, the trustee must consider the cost of recognizing large capital gains and make a determination that the benefits of passive management going forward will outweigh the costs of paying the "voluntary" capital gains tax. This necessarily assumes that the diversification requirement has been met or has been waived. *See* Langbein, *supra* note 31, at 665 ("[T]here will remain cases in which the tax cost of diversifying a low-basis asset may outweigh the gain.").

ment approach for most trust investing. A default rule in favor of a passive investment approach will increase the likelihood that most trustees will achieve these fundamental goals integral to the fulfillment of their duties of loyalty and prudence: enhancing the likelihood of achieving a satisfactory, risk-adjusted return, minimizing the fees and costs of achieving that return, while holding a broadly diversified portfolio.

A. Likelihood of Underperformance of Active Management

As previously noted, although the duty of prudence does not scrutinize a trustee's performance or results, the expected risk adjusted return for the investment approach selected by the trustee is relevant in determining whether the trustee's conduct complied with this duty.[121] A trustee might be justified in pursuing active management strategies if the investment returns were reasonably expected to outperform the appropriate index benchmark.[122] The challenge for the trustee who plans to pursue an active management investment strategy to add value by beating the indices, however, is that the evidence militating against such an approach is overwhelming. Indeed, a veritable mountain of robust data shows that actively managed funds have tended to underperform index funds (or, said another way, that properly diversified index funds have noticeably outperformed actively managed funds).[123]

The record shows conclusively that across all company sizes, geographic regions, sectors and investment styles, indices are very difficult to beat.[124] Indeed, only a lucky relative few manage to beat the indices, and it is difficult, if not impossible, to forecast those that will do so during any given period. Data aggregated, compiled and analyzed by the Center for Research in Security Prices (CRSP) at the University of Chicago, Standard & Poor Dow Jones Indices (SPIVA) and Morningstar all show that "[o]ver both short and longer time horizons the deck is stacked against investors seeking outperforming equity and fixed income funds" not only in U.S. markets, but in capital markets throughout the world.[125] Indeed, across all funds for the fifteen year period though

121 RESTATEMENT (THIRD) OF TRUSTS § 77 (AM. LAW INST. 2007).

122 There may also be other reasons for favoring an active approach, such as if active management provided a diversification benefit not otherwise available with a passive approach.

123 Burton G. Malkiel, *You're Paying Too Much for Investment Help*, WALL ST. J., May 28, 2013, https://www.wsj.com/articles/SB100014241278873234753045785029735215 26236.

124 *Id.*

125 DIMENSIONAL FUND ADVISORS LP, MUTUAL FUND LANDSCAPE (Jul. 27, 2017), https://cdn2.hubspot.net/hubfs/4236008/Mutual_Fund_Landscape_US.pdf.

2016, only 17% of equity funds and 18% of bond funds survived and outperformed their benchmarks.[126]

Furthermore, while a common misconception exists that there are dark corners of the markets that are under-analyzed and somehow less efficient than larger capitalization markets and therefore ripe for exploitation by active investors, the data shows otherwise. According to the S&P Dow Jones Indices SPIVA Scorecard through June 30, 2017, fewer than 8% of small and mid-cap professional mutual fund managers who invest using an active approach outperformed their benchmarks. The performance of active managers in the international emerging markets asset class is better over the same five-year period (24.69% beating), but over the same ten and fifteen-year periods the results are similar with fewer than 5% outperforming over fifteen years.[127]

Of course, many investors, including and perhaps especially, professional and corporate trustees, believe that they can identify those relative few active managers who do outperform and so, seemingly rationally, they invest with recent winners. Unfortunately, chasing last year's winners appears only to ensure disappointment. In fact, the likelihood that a top quartile fund manager at the end of a five-year period will be a top quartile manager at the end of the subsequent five-year period is a dismal 20%.[128]

An understanding of Modern Portfolio Theory (as well as the body of extensive and robust data detailed above) exposes the fallacy underlying active management's claim to be able to beat the market by exploiting real or perceived market inefficiencies and market timing.[129] Even supposing most major markets only meet the weak version of the ECMH, discussed above, it is understandably difficult for even the large number of hard working, highly-educated, experienced and motivated (due to pecuniary incentives) investment managers to consistently beat market returns.

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126 *Id.*

127 Aye M. Soe & Ryan Porier, *SPIVA U.S. Scorecard*, S&P Dow Jones Indices 1 (2017), https://us.spindices.com/documents/spiva/spiva-us-year-end-2017.pdf.

128 Aye M. Soe & Ryan Porier, *Does Past Performance Matter? The Persistence Scorecard,* S&P Dow Jones Indices 7 (2018), https://us.spindices.com/DOCUMENTS/SPIVA/PERSISTENCE-SCORECARD-DECEMBER-2017.PDF. Additionally, if the investor believes he or she can rely on Morningstar, they appear to be sadly mistaken. Following a recent in-depth review, The Wall Street Journal concluded that Morningstar quality ratings have little to no predictive value with regard to future performance. *See* Kirsten Grind et al., *The Morningstar Mirage*, Wall St. J., Oct. 25, 2017, https://www.wsj.com/articles/the-morningstar-mirage-1508946687.

129 *See* Restatement (Third) of Trusts § 90 (Am. Law Inst. 2007) ("What has come to be called 'modern portfolio theory' offers an instructive conceptual framework for understanding and attempting to cope with nonmarket risk.").

As noted by Professor Halbach, with regard to major markets, significant evidence exists to illustrate that beating the market through stock picking is unpredictable and inconsistent.[130] Rather, the data shows that

> the application of expertise, research and diligence in efforts to "beat the market" in these publicly traded securities ordinarily promises little or no payoff. . . . Empirical research supporting the theory of efficient markets reveals that in such markets, skilled professionals have rarely been able, with any regularity, to identify underpriced securities or to succeed at market "timing."[131]

The pursuit of strategies such as stock picking and market timing may require a degree of acceptance of risk that could otherwise be diversified away by utilizing a passive investment strategy.[132] As noted by Halbach, "[t]hese efforts involve searching out advantageous segments of a market or seeking to discover individual bargains within highly efficient markets, as well as in those markets that are less efficient . . . . Vigorous management activities that enhance an investment program present practical concerns that a cautious investor should not disregard."[133]

B. Minimizing Investment Management Fees and Costs

Passive management is also superior to active management in a second metric essential to trustees: the avoiding of unnecessary expenses.[134] The Restatement, its commentary, and the UPIA all direct that trustees are duty-bound to minimize costs and expenses. Passive investment strategies typically are far less expensive than their active counterparts[135] and thus are the best means for trustees to meet this cost-minimization mandate.

In most circumstances, trust investments should reflect the lowest possible costs and risks for a particular expected return, and the direct

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130 Halbach, *supra* note 114, at 14, 18 (discussing the difficulty of beating the market).

131 Halbach, *supra* note 27, at 1161.

132 *See id.* (noting that the Restatement specifically incorporates the norm of diversification as a means to reducing market risk; "In the absence of contrary statute or trust provision, the requirement of caution ordinarily imposes a duty to use reasonable care and skill in an effort to minimize or at least reduce diversifiable risks. Often called nonmarket risk, or somewhat less precisely 'specific' or 'unique' risk, these are risks that can be reduced through proper diversification of a portfolio.").

133 Halbach, *supra* note 27, at 1165.

134 In fact, it is necessarily the case that performance and fees are inexorably related.

135 *See* DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 226 (2005).

and indirect transaction costs can be reduced through investment in index funds or other passive mutual funds that track broad equity and bond markets.[136] The passive approach is lower in commission loads, annual operating expenses, trading costs and income taxes, simply because the passive approach is indeed passive — that is, it is essentially hands-off investment management. Fees are lower because there is infrequent portfolio change, and trading and other frictional costs are also much lower due to the simple fact that passive investing engages in far fewer trades over the life of the fund, instead relying on conservative adjustments in accordance with Modern Portfolio Theory.[137] And, perhaps most importantly, no "star" money managers need to be paid outsized salaries, thus yielding further cost savings accruing to investors who utilize passive investments.

The Prudent Investor Rule sets forth a reference to investment management costs which did not appear in prior Restatements. It states that trustees must "incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship."[138] The duty to be conscious of costs is not necessarily a new feature or directive but rather an elucidation derived more generally from basic principles of prudence and loyalty.[139] The requirement was also intended to reflect the importance of market efficiency concepts and differences in the degrees of efficiency and inefficiency in various markets.[140] The reference to costs in the Rule is therefore tied directly to Modern Portfolio Theory and the surrounding normative assumptions made by the Third Restatement: that efficient markets minimize the need to incur costs associated with active management.[141]

Similarly, the UPIA adopted the duty to avoid incurring unnecessary expenses, noting that "in investing and managing trust assets, 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 trus-

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136 *See* Aalberts & Poon, *supra* note 36, at 65.

137 *See* Laura Saunders, *How Passive Funds Trim Your Tax Bill*, WALL ST. J., Oct. 21, 2016, http://www.wsj.com/articles/how-passive-funds-trim-your-tax-bill-1476968401; *see also* Anne Tergesen & Jason Zweig, *The Dying Business of Picking Stocks*, WALL ST. J., Oct. 17, 2016, http://www.wsj.com/articles/the-dying-business-of-picking-stocks-1476714749.

138 RESTATEMENT (THIRD) OF TRUSTS, PRUDENT INVESTOR RULE § 227 (AM. LAW INST. 1992).

139 *Id.* at cmt. a (describing the scope of the rule).

140 RESTATEMENT (THIRD) OF TRUSTS pt. 6, ch. 17, topic 3 intro. note (AM. LAW INST. 2007).

141 *See id.* (discussing how modern investment strategies require attention to administrative costs).

tee."[142] Commentary to Section 7 of the UPIA notes that to waste a beneficiary's money is imprudent and that trustees are obligated to minimize costs when investing and managing trust assets,[143] suggesting that the UPIA accords with the view that modern prudent investing is generally skeptical of high-cost strategies.[144]

In fact, the introductory commentary to the Restatement (Third) seems to suggest this very point, noting that "active management strategies involve investigation expenses and other transaction costs . . . that must be considered, *realistically*, in relation to the likelihood of increased return from such strategies."[145] In keeping with the general aim of providing flexibility and loosening trustee restrictions, this commentary does not necessarily foreclose the use of active management strategies; however, incorporation of Modern Portfolio Theory into the Restatement precepts solemnly dictates a realistic examination of fees associated with active management strategies. Use of such strategies must arguably be justified by an economic rationale reasonably related to the worthiness of such an undertaking. As stated in the Restatement (Third) of Trusts,

> Active strategies involve searching for underpriced securities, assuming that these securities may be mispriced. These strategies generally incur higher transaction costs from security analyses and buying and selling of securities. Also, these approaches are riskier . . . because of the uncertainty inherent in judging the mispricing of securities. The Restatement . . . does not preclude trustees from active strategies as long as the trustee can select securities that are expected to contribute to the trust portfolio's overall diversification and return objectives. Of course, the additional costs and risks . . . *must be justified by an economic rationale at the time, not after the investment decision was made and by a higher than expected return from the strategies.*[146]

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142 *See* UPIA § 7 ("A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.").

143 *Id.* § 7 cmt.

144 *See generally* W. SCOTT SIMON, THE PRUDENT INVESTOR ACT: A GUIDE TO UNDERSTANDING (2002).

145 RESTATEMENT (THIRD) OF TRUSTS pt. 6, ch. 17, topic 3 intro. note (AM. LAW INST. 2007) (emphasis added) (discussing how modern investment strategies require attention to administrative costs); *See also* Troutner, *supra* note 106, at 1, 3.

146 Aalberts & Poon, *supra* note 36, at 70 (emphasis added) (citing RESTATEMENT (THIRD) OF TRUSTS § 227).

Such an interpretation of the affirmative duty to minimize costs and expenses may, in itself, necessarily limit the use of active management strategies to the small number of cases where such criteria may be met.

Along with increased risk, additional active management pitfalls include the cost of continuous monitoring, heightened investigation, judgments, and analysis, leading to higher commissions and transaction costs and, with more frequent realization events associated with buying and selling securities, more taxes.[147] Logically, therefore, the costs associated with active management are not justified[148] unless they realistically can be expected to produce returns in excess of their necessarily higher fees or provide a diversification benefit not otherwise available. However, as noted previously, historical data indicates that the results of active management do not generally justify its use, as both academic and financial industry scholarship illustrate that higher expenses (as the proxy for a conventional active management approach) are not correlated with superior returns.[149]

In fact, a fund's expense ratio is the most consistent indicator of its returns.[150] Incredibly, on average, strategies with higher fees "perform worse than less expensive funds even on a pre-fee basis."[151] The data generally indicates that the actively managed dollar tends to underperform the passively managed dollar.[152] Indeed, fiduciaries are "confronted with potent evidence that the application of expertise, investigation, and diligence in efforts to 'beat the market' ordinarily promises little or no payoff, or even a negative payoff after taking account of research and transaction costs."[153] In short, active management

147 *See generally* SIMON, *supra* note 144.

148 *See* RESTATEMENT (THIRD) OF TRUSTS pt. 6, ch. 17, topic 3 intro. note; *see also* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. h (explaining how any choice to engage in active management must be justified by a cost benefit analysis that incorporates risks and the entire portfolio).

149 *See* Tergesen & Zweig, *supra* note 137 ("Over the decade ended June 30, between 71% and 93% of active U.S. stock mutual funds, depending on the type, have either closed or underperformed the index funds they are trying to beat.").

150 *See* Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1993 (2010) (referencing Vanguard-Founder John Bogle's comments on academic and industry consensus).

151 *See generally* Javier Gil-Bazo & Pablo Ruiz-Verdu, *When Cheaper is Better: Fee Determination in the Market for Equity Mutual Funds*, 67 ECON. BEHAV. & ORG. 871 (2008).

152 *See* William F. Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J. 7, 8 (1991) ("Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs.").

153 *See* LARRY SWEDROE ET AL., ACTIVE VERSUS PASSIVE MANAGEMENT (2010).

rarely adds cognizable value, but instead often does not surpass market benchmarks, especially when fees are taken into consideration.[154]

C. The Endurance of Active Management

Given its dismal track record, why does active management remain the predominant investment strategy for investors, including professional and corporate trustees? There are, of course, many reasons. Active management is conventional and historical and, as such, many beneficiaries are comfortable with trusts owning the familiar names of storied American companies. Moreover, many bank and trust company portfolio managers, trained in the art of "stock picking," may take it on faith that they can beat the markets. As one brave and self-aware (active) manager has noted that "perhaps in a triumph of hope over experience, we continue to believe active managers can add value."[155]

But there may be another, more problematic, factor at work as well. As author Upton Sinclair aptly stated in an unrelated context, "it is often difficult to get a man to understand something when his salary depends upon him not understanding it."[156] Wall Street and the financial press have created and perpetuated a robust business for investment managers who market their achievements despite the fact that, with regard to active management strategies, past successes are in no way indicative of a reliable trend, and most of them, most of the time, underperform the indices. As John Maynard Keynes once astutely remarked, "The prime directive is first and last to keep your job. . . . People [tend] to tailor their views to the necessity of staying employed."[157] In any event, facts are, indeed, stubborn things and the simple fact remains that the vast majority of active investment managers fail to beat their benchmark indices over meaningful time periods.[158] Some corpo-

154 *See* Gil-Bazo & Ruiz-Verdu, *supra* note 151, at 883 ("The empirical evidence implies that superior management is not priced through higher expense ratios. On the contrary, it appears that the effects of expenses on after-expense performance (even after controlling for funds' observable characteristics) is more than one-to-one, which would imply that low-quality funds charge higher fees. Price and quality thus seem to be inversely related in the market for actively managed funds.").

155 *See* LARRY SWEDROE, THE SUCCESSFUL INVESTOR TODAY: 14 SIMPLE TRUTHS YOU MUST KNOW WHEN YOU INVEST 20 (2003) (quoting Galbraith's letter to investors).

156 UPTON SINCLAIR, I, CANDIDATE FOR GOVERNOR: AND HOW I GOT LICKED 109 (1935).

157 James Grant, *The Apostasy of Jeremy Grantham*, 35 GRANT'S INT. RATE OBSERVER, June 16, 2017, at 4.

158 *See* Chris Newlands & Madison Marriage, *99% of Actively Managed US Equity Funds Underperform*, FIN. TIMES, Oct. 23, 2016, https://www.ft.com/content/e139d940-977d-11e6-a1dc-bdf38d484582 ("99 per cent of actively managed US equity funds sold in Europe have failed to beat the S&P 500 over the past 10 years, while only two in every 100 global equity funds have outperformed the S& P Global 1200 since 2006."); Tergesen

rate and professional trustees, who know or should know the data that shows this to be the case, thus may continue to implement active management strategies simply for their own business reasons, perhaps to meet the needs of their sales and marketing departments, rather than to pursue the needs of trust beneficiaries. Such self-interested reasons for continued pursuit of active management are obviously problematic. The fiduciary duty of loyalty, of course, requires sole devotion to the interests of the beneficiaries and not the interests of the fiduciary. Yet, many corporate and other professional trustees continue to compete for business by either marketing their historical investment track records, even though it is now widely known and understood that past investment successes (such as they may be) are in no way indicative of future successful returns, or, at least implicitly, by promising future higher returns.[159] In fact, the rates of such active management successes, again such as they are, appear to occur with essentially the same frequency as simple chance.[160]

Compounding the problem is the fact that active management is often more costly and more complicated than passive investment ap-

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& Zweig, *supra* note 137 ("Stock pickers, archetypes of 20th century Wall Street, are being pushed to the margins. . . . Over the three years ended August 31, 2016, investors added nearly $1.3 trillion to passive mutual funds and their brethren — passive exchange-traded funds — while draining more than a quarter trillion from active funds."). Even Warren Buffett, in his 2014 Shareholder Letter, stated that he had advised the trustees of a trust he is creating for his wife after his death to invest the assets in a low cost S&P 500 index fund, with 10 percent in short-term government bonds. Lauren Young, *Will Warren Buffett's Investment Advice Work for You?,* REUTERS, Mar. 3, 2014, http://www.reuters.com/article/us-buffett-letter-advice-idUSBREA221YY20140303. In case the reader believes that this is all a recent phenomenon, consider an article in the Wall Street Journal by Jason Zweig, who reported "that in 1975 [Charles Ellis] predicted that institutional investors will, over the long term, underperform the market. With so many smart people competing so intensely to outperform, bargains would disappear almost instantly. Instead of trying to win by beating the market . . . investors should seek to avoid losing — by buying an index fund." Jason Zweig, *A Long Time Coming: 40 Years of Forecasting the Decline of the Stock-Picker,* WALL ST. J., Aug. 22, 2014, https://blogs.wsj.com/totalreturn/2014/08/22/a-long-time-coming-40-years-of-forecasting-the-decline-of-the-stock-picker/. Additionally, the revered Charles Ellis is quoted as saying "Active fund management is outmoded, and a lot of stock pickers are going to have to find something else to do for a living. . . . The debate about whether you should hire an 'active' fund manager who tries to beat the market by buying the best stocks and avoiding the worst — or a 'passive' index fund that simply matches the market by holding all stocks — is over." Jason Zweig, *The Decline and Fall of Fund Managers,* WALL ST. J., Aug. 22, 2014, https://blogs.wsj.com/moneybeat/2014/08/22/the-decline-and-fall-of-fund-managers/.

159 Stewart E. Sterk, *Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine?*, 95 CORNELL L. REV. 851, 881-82 (2010).

160 *See id.* at 882 n.161 (describing how a strong investment track record is indistinguishable from random chance over the time scales investors often use to evaluate asset managers).

proaches. As discussed above, trustees may and do charge more in fees for actively managing trust assets due to the heightened attention, analysis, and attempts to predict real or, more likely, perceived market inefficiencies. Active managers also may feel the need to appear to "do lots of stuff"[161] to justify the heightened fees associated with this type of management. The result is increased fees and transaction costs, which further erode performance.

In sum, the default approach of many corporate trustees—active management—may be ill advised. Considering the general efficiency of the markets in question, the riskiness and unreliability of returns of actively managed funds, and the consensus and data illustrating that passively managed funds outperform actively managed funds when fees are considered, the question must be asked whether those trustees who blindly pursue active management styles are truly fulfilling their duty of loyalty. Making such risky and costly investments may not serve the interests of beneficiaries but, instead, simply attempt to justify higher fees for the trustee and allow the trustee to continue to market and sell investment performance that most often fails to materialize to benefit trust beneficiaries.

Accordingly, we pose the following questions: If an active management approach is frequently not in the best interest of the beneficiaries, in whose interest is it pursued? Does active management promote some degree of self-dealing when it is not the result of sound logic and justification? At the very least, the failure to recognize and incorporate recent scholarship and data regarding the unreliability and unpredictability of active management strategies, especially when compared with the lower-cost passive approach, may well implicate the duty of loyalty.

Perhaps the solution is to rethink the default approach. Perhaps passive investment management should become the presumptively reasonable default for the investment of trust funds. Professional trustees who continue to pursue active strategies should be required to detail specific reasons why such strategies are appropriate and justified, calculated to meet the needs of a specific trust rather than the trustee's own business considerations.

IV. Divining the Future of Trust Investment Standards: Current Trends in Litigation

As discussed in this Section, recent trends in fiduciary litigation reinforce our view that trustees generally will be better served pursuing a

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161 W. Scott Simon, The Prudent Investor Act: A Guide to Understanding 106 (2002).

passive investment approach. Indeed, there has been an "explosion"[162] in class action lawsuits[163] concerning the propriety of certain methods of investment management that has targeted trustees of large corporate defined-contribution plans (401(k)s), alleging breach of fiduciary duty with regard to investment strategies and plan fees.[164] A growing number of class-action suits brought by participant/employees in tax-qualified retirement plans have levied charges that institutions with fiduciary duties to participants, similar to those of trustees, in qualified plans have breached those same duties through imprudent plan offerings (namely, high fee mutual funds) and associated high expenses.[165] These recent cases suggest growing support for low-cost, passive investing of fiduciary funds and may reveal changing norms in the law of fiduciary investing.

Though these suits have been brought under the Employee Retirement Income Security Act (ERISA), the principles at issue are equally applicable to the law of trust investment more generally. In fact, in 2015 the U.S. Supreme Court stated that "[i]n determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts."[166] The language of the fiduciary standards under ERISA closely mirrors the standards set forth in the Restatement (Third) of Trusts.[167] Specifically, a fiduciary under ERISA must

> discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries . . . for the exclusive purpose of providing benefits to participants and their beneficiaries, . . . defraying reasonable expenses of administering the plan . . . with the care, skill, prudence, and diligence under the

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162 Gillian Tett, *Lawyers Shake Up a Sleepy Pension World*, FIN. TIMES, Nov. 24, 2016, https://www.ft.com/content/05c10350-b22d-11e6-a37c-f4a01f1b0fa1.

163 A recent review of U.S. court documents by the Financial Times uncovered payments to plan participants from 19 large companies totaling nearly $400 million in settlement of cases involving "increased scrutiny on the hidden fees and conflicts of interests built in to the 401(k) plans." Beagan Wilcox Volz & Emily Laermer, *Retirement Plan Abuse Claims Cost US Companies $400m*, FIN. TIMES, May 21, 2017, https://www.ft.com/content/52df1834-3ca2-11e7-821a-6027b8a20f23; *see also* Petition for Writ of Certiorari, Putnam Invs., LLC v. Brotherston, 907 F.3d 17 (Jan. 11, 2019) (No. 18-926) at 14.

164 *See* Greg Iacurci, *Neuberger Berman Sued for Excessive 401(k) Fees,* PENSIONS & INV., Aug. 4. 2016, http://www.pionline.com/article/20160804/ONLINE/160809930/neuberger-berman-sued-for-excessive-401k-fees?newsletter=daily&issue=20160804 (discussing how high fees and poor success can constitute a fiduciary breach).

165 *See id.* (describing a series of similar lawsuits targeting at least four other institutions).

166 Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828 (2015).

167 *See* Schanzenbach & Sitkoff, *supra* note 67, at 129-30 (describing the relationship between trust investment law and ERISA from the perspective of federal courts).

> circumstances then prevailing that a prudent man . . . would use.[168]

Tibble v. Edison International may prove to be a seminal case in this regard, at least with respect to the Restatement Third's direction to minimize investment costs. In *Tibble*, the participants of an ERISA defined-contribution (401(k)) plan alleged, among other things, that the trustees of the plan breached their fiduciary duties by failing to offer lower expense share classes of several mutual funds offered by the 401(k) plan.[169] The U.S. Supreme Court, adopting and applying trust common law, held that the trustees had a continuing duty to monitor the plan investments and remanded the case to the Ninth Circuit to determine whether, based on this duty, the plan trustees should have offered lower-cost institutional class funds in lieu of the more expensive retail class funds.[170] Importantly, in reaching its conclusion, and, in addition to citing to common trust law, the Court cited the Uniform Prudent Investor Act.[171] On further remand from the Ninth Circuit, the District Court (C.D. California) quoted from the Third Restatement in reviewing the duty of prudence, stating that "cost-conscious management is fundamental to prudence in the investment function, and should be applied not only in making investments but also in monitoring and renewing investments."[172] Ultimately, the District Court held that the employer violated its duty of prudence in failing to offer the lower cost institutional shares.

Post-*Tibble*, the recent *Bell v. Anthem*[173] litigation is illustrative of the growing scrutiny of the costs of investment options for and management of defined-contribution plans. In *Bell*, a class of plan participants alleged that the plan's sponsor included excessively high-priced investment options (including actively managed funds) within the plan's investment menu, noting that academic and financial literature demonstrate that high expenses are not correlated with superior investment management and returns.[174] The case, at its core, draws upon many correlative facets of Modern Portfolio Theory in alleging a breach of fiduciary duty. For instance, in the Complaint, the plaintiffs argue that "[t]he empirical evidence implies that superior management is not

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168 29 U.S.C. § 1104(a).

169 *Tibble*, 135 S. Ct. at 1824-25.

170 *Id.*

171 *Id.* at 1828.

172 Tibble v. Edison Int'l, No. 07-5359, 2017 WL 3523737, at *10 (C.D. Cal. Aug. 16, 2017) (quoting Tibble v. Edison Int'l, 843 F.3d 1187, 1198 (9th Cir. 2016) (internal citations omitted)).

173 Complaint at 1, Bell v. Anthem, No. 1:15-cv-2062 (S.D. Ind. Dec. 29, 2015).

174 *Id.* at 11.

priced through higher expense ratios. . . . Price and quality thus seem to be inversely related in the market for actively managed funds."[175] The Complaint further argues that, even when a manager is able to beat the market, the "outperformance is nearly always dwarfed by . . . expenses," and, of course, proper calculation of actively managed funds reveals that these funds underperform passively managed funds consistently, especially in light of costs.[176] In support of these claims, the Complaint recites a bevy of financial and economic research highlighting the long-term costs of actively managed investment options.[177]

Tellingly, the *Bell* Complaint proffers what is an increasingly common refrain: "investment costs are of paramount importance to prudent investment selection, and a prudent investor will not select higher-cost actively managed funds without a documented process to realistically conclude that the fund is likely to be that extremely rare exception, if one even exists, that will outperform its benchmark index over time, net of investment expenses."[178] In short, the plaintiffs allege that the plan's use of actively managed investment options violates the strict fiduciary standards of loyalty and prudence mandated by ERISA concepts, which, essentially, mirror those of the law of trusts.[179]

Finally, in 2018, the First Circuit advanced the arguments in *Tibble* and *Anthem* a major step further in *Brotherston v. Putnam Investments, LLC*[180] by, in essence, holding that a passive investment strategy is a safe harbor or, "fail-safe option" for ERISA fiduciaries.[181] In *Putnam*, the plaintiff employees sued Putnam Investments, a Boston-based active mutual fund manager. Though the plaintiff's primary claim concerned Putnam Investment's alleged breach of its fiduciary duty of prudence by offering only actively managed Putnam funds (presumably with accompanying higher fees) to plan participants, of critical importance is the First Circuit's analysis of the appropriate measure of damages if Putnam did in fact breach its fiduciary duty to the plan participants. Citing Restatement (Third) of Trusts, Section 100, the Court stated that the loss to plan participants in the event of breach is equal to "the amount required to restore the values of the trust estate and trust distributions to what they would have been if the portion of the trust affected by the breach

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175 *See id.* (citing Gil-Bazo & Ruiz-Verdu, *supra* note 151).
176 *Id.* at 12-13 (citations omitted).
177 *See, e.g.*, *id.* at 11-13.
178 *Id.* at 13.
179 As of February 2019, it seems that the parties in *Bell* had reached a settlement, subject to Court approval. *See* COURT LISTENER, https://www.courtlistener.com/docket/4266890/bell-vpension-committee-of-ath-holding-company-llc/?page=2 (last visited Mar. 25, 2019).
180 Brotherston v. Putnam Invs., LLC, 907 F.3d 17 (1st Cir. 2018).
181 *Id.* at 32.

had been properly administered."[182] In turn, the Court adopted the Restatement's view that "suitable index mutual funds or market indexes (with such adjustments as may be appropriate)"[183] are an appropriate comparator of a properly administered portfolio.[184] Thus, the Court effectively concluded that a passive investment strategy is a per se properly administered, prudently invested portfolio. The U.S. Supreme Court may have the opportunity in the near future to weigh in on the active versus passive question, as the defendants in *Putnam* have petitioned for a writ of certiorari from the decision of the First Circuit.[185]

These cases may serve as a prescient warning for trustees of private trusts indicating that now generally accepted academic and financial knowledge exposes the pitfalls of active management and dictates that the fiduciary must provide affirmative reasons for the use of such an investment strategy. A similar trend seems to be developing in the investment of retirement funds in 403(b) plans.[186] It may be only a matter of time before a parallel line of fiduciary litigation aimed at trustees of private trusts emerges imposing a heavy burden on trustees to justify the costs of active management.

V. Conclusion

A trustee's duties of prudence and loyalty require a trustee to fully diversify trust assets, avoid conflicts of interest, and minimize fees and costs — thereby best promoting and protecting the interests of the beneficiaries. However, the available data suggests that the current default

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182 *Id.* (quoting Restatement (Third) of Trusts § 100 (Am. Law Inst. 2007) (emphasis added)).

183 *Id.* at 32 (quoting Restatement (Third) of Trusts § 100).

184 *Id.* at 31 (quoting Restatement (Third) of Trusts § 100 cmt. b(1)).

185 *See* Petition for Writ of Certiorari, Putnam Invs., LLC v. Brotherston, 907 F.3d 17 (Jan. 11, 2019) (No. 18-926).

186 *See* Darla Mercado, *College Retirement Plans Face a New Wave of Lawsuits*, CNBC, Aug. 15, 2016, http://www.cnbc.com/2016/08/15/college-retirement-plans-face-a-new-wave-of-lawsuits.html. When asked about the similarities between the string of 401(k) plan fiduciary breach suits and the 403(b) plan suits, attorney Jerry Schlichter (the attorney for the plaintiff-participants) noted that the suits are "similar in that the fiduciary duty is the same, the duty to make sure fees are reasonable and investments are prudent. And there are similarities in some of the allegations — excessive record-keeping fees, . . . excessive investment management fees [and] . . . imprudent investments with a historical track record of poor performance." Greg Iacurci, *Attorney Jerry Schlichter Opens Up About 403(b), 401(k) Suits*, Inv. News, Aug. 18, 2016, www.investmentnews.com/article/20160818/FREE/160819927/attorney-jerry-schlichter-opens-up-about-403-b-401-k-suits. This litigation further highlights that, despite the recent realignment of retirement investments from the defined-benefit plan model to the defined-contribution model, plan sponsors and, in turn, investment managers remain bound by fiduciary duties despite the shifting of many of the investment decisions to plan participants.

approach to the investment management of trust funds — the active management approach by which a portfolio manager seeks to "beat the market" through security selection and market timing generally — has only a remote chance of achieving an excess return in efficient financial markets.

In contrast, effective diversification, superior investment performance and reduced fees can generally be achieved through investing in passively-managed index funds that track the overall markets.[187] Put bluntly, the passive approach touted by many in the academic literature typically proves superior to the active approach systematically employed by many professional trustees.[188]

We contend that most of those managers, and the beneficiaries they seek to serve, thus would do better if trustees altered their approach to trust investing and increasingly relied on passive investment management rather than active management. Indeed, the academic theory and historical data arguing in favor of such a shift toward passive management is so compelling that passive management arguably should become the default means of investing trust funds. Professional trustees who seek to deviate from this course by pursuing active management styles for all or part of a portfolio should be required to justify that decision with respect to both the prudent investor laws and fiduciary duties by articulating specific reasons why they expect active management will

187 The authors do not dispute that some active managers can and will outperform passive investment benchmarks over meaningful periods of time. However, doing so with any consistency is uncommon and such managers are very difficult to identify in advance (and, if discovered, are hard to access for all but the largest trusts). Given that such managerial success is the exception rather than the rule, it does not support the widespread, default use of active investment management.

188 Given the complexity of the considerations involved and the established heightened standard of care applicable to professional trustees, we direct our proposal to corporate and professional trustees, rather than individual lay trustees. As Professor Halbach has observed, since "there is a great variation . . . in the experience and qualifications of trustees and in the reasons for their selection," only corporate and professional trustees should be held to the standard of knowing and understanding the tenets of Modern Portfolio Theory and the data clearly showing the superiority of passive investing. Halbach, *supra* note 27, at 1158 ("It follows from the requirement of care as well as from sound policy that, if the trustee possesses a degree of skill greater than that of an individual of ordinary intelligence, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill. It also states that if a corporate or professional fiduciary 'procured appointment as trustee by expressly or impliedly representing' that it possesses greater than ordinary skill or if the trustee 'has or represents that it has special facilities for investment management, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill or of those special facilities.'").

better meet the needs of trust beneficiaries[189] and further the fiduciary duties of loyalty and prudence.[190]

[189] Three obvious ways in which this burden could, conceivably, be met are outperformance, diversification, and tax efficiency. There may be others.

[190] In addition to better meeting the needs of trust beneficiaries, we contend that passive investing may be preferable for trustees as well. All other things being equal, the trustee who invests passively will not have to concern itself with chasing performance, predicting the future and explaining to disappointed settlors and beneficiaries the inevitable underperformance compared to the appropriate benchmark(s). It is simply a better investing experience for both the beneficiary and trustee. For an excellent explication of the idea that trustees and investment managers generally would be better served by avoiding the focus on "performance investing" (herein active management), see Charles Ellis, *The Rise and Fall of Performance Investing*, 70 FIN. ANALYSTS J. 4 (2014).