

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.2

A risk level has been identified.

ERISA Requirements

Historically, fiduciaries were governed by the common law of trusts, which required that the riskiness of each investment in a portfolio be measured in isolation. [*Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d, 313, 23 E.B.C. 1001 (5th Cir.), cert. denied, 528 U.S. 967 (1999); see also *Chase v. Pevear*, 383 Mass. 350, 419, N.E. 2d 1358, 1366 (1981)] But in DOL Reg. §2550.404a-1, the DOL determined that ERISA redefined the investment duties of fiduciaries to require that:

... the fiduciary shall be required to act as a prudent investment manager under the modern portfolio theory [Laborers, 173 F. 3d, at 317]

Specifically, the fiduciary's investment duties under ERISA §404(a)(1)(B) are satisfied if the fiduciary:

Has given appropriate consideration to those facts and circumstances that ... the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties.... [29 C.F.R. §2550.404a-1(b)(1)(A)(i)]

The DOL explained its regulations that:

"appropriate consideration" shall include, but is not necessarily limited to:

*(A) determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio ... to further the purposes of the plan, **taking into consideration the risk of loss and the opportunity for gain (or other return)** associated with the investment or the investment course of action, and*

(B) consideration of the following factors as they relate to such portion of the portfolio:

(i) the composition of the portfolio with regard to diversification;

(ii) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(iii) the projected return of the portfolio relative to the funding objectives of the plan. [Emphasis added] [29 C.F.R. §2550.404a-1(b)(2)]

Practice SA – 2.2 (continued)

The focus of the regulations is on structuring a portfolio that takes into account the relationship between risk and return, and on properly balancing that relationship in light of the objectives of the trust. That process requires that the levels of risk and reward must be identified and compared.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA set forth the standards a trustee must use in deciding on the trust's portfolio strategy, and risk and return objectives. They require that the trustee employ modern investment practices.

*A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy **having risk and return objectives reasonably suited to the trust.** [Emphasis added] [UPIA §2(b). See also, UPMIFA §3(e)(2)]*

According to the Comments section, UPIA §2(b) describes the main theme of modern investment practice, *i.e.*, sensitivity to the risk/return curve.

Returns correlate strongly with risk, but tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries. [UPIA §2, Comments]

The Comments to UPIA §2 also state that:

[a]n investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets....

Subsection 2(c) of the UPIA describes some of the factors the trustee should consider in investing and managing trust assets. According to the Comments to §2, these factors

... commonly bear on risk/return preferences in fiduciary investing. [UPIA §2, Comments]

The factors include:

- (1) General economic conditions;*
- (2) The possible effect of inflation or deflation;*
- (3) The expected tax consequences of investment decisions or strategies;*
- (4) The role that each investment or course of action plays within the overall trust portfolio ...;*
- (5) The expected total return from income and the appreciation of capital;*

Practice SA – 2.2 (continued)

(6) Other resources of the beneficiaries; and

(7) The needs for liquidity, regularity of income, and preservation or appreciation of capital.... [UPIA §2(c)(1-7)]

As a result, the trustee needs to determine the trust's purpose and objectives, and then develop an investment strategy to achieve the needed returns at an appropriate level of risk.

MPERS Requirements

Section 8 of MPERS describes the trustee's duties in investing and managing assets of a retirement system. MPERS §8 includes the requirement that the trustee, who has investment and management authority, identify investment objectives and risk levels:

*A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and **acceptable levels of risk** for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance. [Emphasis added] [MPERS §8(b)]*

In the Comments to §8, the commentators discuss different types of investment risks and offer insight into the considerations the trustee should use in evaluating those risks. Risk is divided into the categories of "compensated" and "uncompensated" risk, with "compensated" risk having a higher expected rate of return in order to induce investors to bear the greater risk associated with the particular investment. Risk can be reduced by configuring the portfolio to include investments in a variety of industries and categories so that the risk in a diversified portfolio will be less than the average risk of the separate holdings. [MPERS §8, Comments]

Under MPERS, then, trustees are required to identify and evaluate the different risk levels of each investment in the portfolio to create an overall investment strategy for the plan.