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Prudence, Information, and Trust Investment Law

by John A. Humbach and Stephen P. Dresch

Professors Langbein and Posner recently proposed that fiduciaries be allowed to invest in market funds under a relaxation of the prudent investor standard. But a relaxation of the selectivity requirements may be destructive of capital market efficiency and perhaps of the capital markets themselves.

IN THE MANAGEMENT of assets and portfolios, fiduciaries are required to meet a standard of care known typically as the prudent investor standard. When applying this standard, courts historically have tended to consider each of the fiduciary's investment decisions separately. Losses owing to careless judgments may not be offset by gains from investments more carefully selected. To avoid surcharge, the fiduciary must meet the requisite duty of care with respect to every investment. Meeting this duty involves substantial expense in time and money, and this expense must be deducted from the over-all performance of the portfolio.

In their recent article in this *Journal* (July, page 887), "The Revolution in Trust Investment Law," John H. Langbein and Richard A. Posner, professors of law at the University of Chicago, suggested that the prudent investor standard ought to be changed. Rather than each of a fiduciary's investment decisions being viewed separately, they assert, the fiduciary's exercise of care in certain cases ought to be judged on the basis of his selection of the portfolio as a whole.

The Market Fund Portfolio

The purpose of this revision would be to permit fiduciaries to invest in so-called market fund portfolios. These are highly diversified, broadly based collections of securities purchased rather nonselectively and, once purchased, held more or less indefinitely. The objective of the market fund approach is to create a portfolio that parallels on a miniature scale the diversity and proportionate values of the market as a whole and, accordingly, will perform about as well or as badly as the general market.

In support of their proposed revision, Professors Langbein and Posner argue essentially as follows:

The traditional practice of picking and choosing particular stocks for portfolio inclusion or sale involves

substantial costs, both in gathering information on which to make decisions and in effectuating purchases and sales in conformity with those decisions. These costs are unrewarded since the competition among "prudent" investors, who all must rely on the same general information sources, tends to cancel out any gains that informed judgments could provide. It is apparently the recent experience of mutual funds that none has outperformed the market with a consistency greater than the law of averages would predict. Optimal results in portfolio management are obtainable by simply buying and holding the stocks of every issuer in proportion to the value each issuer's outstanding stocks bears to the aggregate value of all outstanding stocks. Then we can fire all of the securities analysts, save most of the brokerage fees, and still have a portfolio that will perform about as well as any other.

There is, we can see, a certain logic in asserting that fiduciaries should not be required to evaluate and choose individual stocks for their portfolios. If the same results are obtainable at lesser management cost by blind diversification alone, then portfolio managers who are not almost totally passive are simply wasting their principals' money.

Professors Langbein and Posner describe their new standard of prudence as a "revolution in trust investment law." Insofar as they imply that calculated ignorance is really the most prudent approach to investment, their suggestions call for quite a revolution indeed. The question their analysis appears to overlook, however, is whether, more broadly viewed, it would be good public policy to require or even to condone observance by fiduciaries of the ignorance-as-prudence standard. When the over-all effects on capital markets are considered, there is good reason to conclude that the "revolutionary" standard of Professors Langbein and Posner would not be good public policy.

The Functioning of Capital Markets

From a social point of view, perhaps the most important function of competitive capital markets is to allocate capital resources among operating firms in a way that maximizes the productivity of society's aggregate capital assets. In practice this result is achieved by competitive bidding for investment dollars among the various securities issuers who desire to use those dollars for the purchase of "real" capital (machinery, plants, working capital, and the like). In exchange for investment dollars,

these competitive bidders offer participations in streams of future earnings which, it is anticipated, their respective firms can produce. When capital market investors purchase the stocks of firms having the best prospects of highest percentage returns, the result is to allocate monetary capital (and hence "real" capital) to the uses most likely to result in the maximum economic benefit.

Of course, almost all securities trading is in existing shares—the substitution of one investor's dollars for the dollars some other investor already has placed in an outstanding stock issue. Nonetheless, under a free enterprise system of production, the competitive prices developed from this "secondary" trading in common stocks can be seen as essential if "real" capital is to be efficiently allocated to its optimal uses. In any event, the price generating process of active trading is essential to permit investors of monetary capital to distribute their dollars among securities having return, risk, and risk-variance characteristics they desire.

If Market Fund Portfolios Were to Predominate

The capital market's price generating process cannot work efficiently—and it cannot allocate capital to its most productive uses—unless investors in the capital market pick and choose intelligently among competing investment opportunities. If investors blindly purchase and retain some of every stock offered, the result will be a nonoptimal and "irrational" allocation of both investment dollars and "real" capital assets. Promising and nonpromising uses of capital alike would share arbitrarily in the limited supply of capital. The prices of all stocks, moreover, would be frozen (irrespective of changing returns, risks, etc.) at the relative levels reached once the last investors discovered the logic of totally passive market fund investment.

Professors Langbein and Posner admit that the capital market would cease to be efficient if all investors adopted the passive "buy-the-market-and-hold" strategy. In fact, it would almost cease to be at all. For the most part, the only remaining types of transactions would be those involved in the purchases of wholly new issues and those required in order to place net increments or to recover net decrements in the aggregate of investment dollars.

Professors Langbein and Posner suggest that trading also would be necessary "when substantial changes in the market price of a security require its inclusion or exclusion from the portfolio in order to maintain the portfolio's fidelity to the market as a whole." This is, however, erroneous. If the market price of a security changed, thus altering the relationship between its value in aggregate and the aggregate value of all securities in the relevant market, the price change itself would simultaneously effectuate a corresponding alteration within a market fund portfolio. Unless resort be had to a picking and choosing strategy—for example, selecting securities for inclusion or exclusion in the relevant market—there would be no justification for altering holdings in response to changes in market price.

In connection with increments-decrements transactions, there also might be a certain amount of reshuffling activity as market fund investors changed in size relative to each other and as new investors entered or old ones left the "industry." However, there would be no logical place for the active public trading markets that now exist for common stocks, and one would expect those markets to be quickly replaced by a decentralized "market" dominated by privately negotiated transfers. The question may be asked: Who would be available to negotiate competently these private transfers once all of the analysts had been dispensed with? This problem, however, is only an offshoot of the primary paradox posed by the Langbein-Posner proposal.

Professors Langbein and Posner deny that the capital market would freeze in this Vonnegutesque fashion as the application of their strategy crystallized into reality. They point out that there still would be "many other investors" who would be willing to continue incurring information and transactions costs and using their hard-bought information to bid up undervalued stocks and bid down overvalued ones. We are told that "enormous gains" would be available to these inveterate traders, and we assume, although are not told, that enormous losses also would be available. In any event, however, the activities of these traders supposedly would mean that stock prices would continue to be established in competitive trading and that the market would remain efficient as an allocator of capital. The passive market fund investors could enjoy a free ride on the information and transactions expenditures others would incur in order to keep the relative pricing of securities economically rational.

The Free Ride for Market Fund Investors

From a policy viewpoint, three observations may be made concerning this free ride.

First, if those who are involuntarily piggybacked happen not to be representative in their attitudes toward the factors influencing stock prices—for examples, risk and return, risk-adversity, economic conditions affecting the issuer, and the like—then the relative prices developed in trades among them will not be representative either. By "representative" prices, we mean the prices that would be established if all investors were active in the pricing process, not just a self-selected few.

There is no reason to believe that the insistent traders or the prices they establish would be representative. In the first place, once the Langbein-Posner insights become generally known, the traders would have to be persons willing to ignore the obvious advantage to the individual of applying the passive, market fund strategy. The remaining traders probably would be (if rational) at least more risk seeking than the norm, and the price patterns they generate would reflect this. Worse yet, if the thesis is correct about the self-cancelling effects of competitive trading, those traders may have to be practically risk oblivious, not unlike horse bettors who know

that the odds are always substantially against them but hope to beat the odds nonetheless. To the extent that capital allocations were heavily influenced by these persons' decisions, aggregate rates of return and production would decline; that is, stocks having a sufficiently high risk variance would be able to command new capital from these investors even though offering a relatively lower expected return. As a result, the rate of return to the aggregate of capital would decline; that is, production would decline.

Second, even if those who were piggybacked did constitute an attitudinal cross-section of all investors, almost by definition they would not be representative in terms of resources available for gathering information. This is because the market fund strategy can be used only by investors or investor pools having large amounts of capital. The investors who will withdraw from the price generating process will be precisely those who are likely to be best informed and whose information is likely, by the magnitude of their trades, to have the maximum impact on prices. Much of the rationalizing effect on prices would certainly be lost if, as Professors Langbein and Posner appear to suggest, fiduciary investors were legally required to apply the market fund strategy to portfolio management. But even if the market fund strategy were not a legal requirement for fiduciaries, condoning the use of the strategy will cost the market and society its best endowed and probably best informed participants in the capital allocation process. Capital markets would continue to reach equilibria as the perceived expectations of the traders changed. However, the equilibria reached, and the capital allocations based on them, would be distorted to the extent that the curtailment of information inputs distorts the over-all "market judgment" concerning the relative values of stocks.

How Important Is Informed Trading?

The third observation, which arises from the second, is that Professors Langbein and Posner are erroneous in assuming that if some investors are willing to make a market, then active and informed trading by others is "unnecessary and unprofitable."

Active selection, rejection, and rearrangement of portfolios—that is, active, informed trading—is constantly required of all investors if the market's equilibria and capital allocations are to be based on the maximum possible input of information and attitudes. Suggesting that the market can get by on less information is rather like suggesting that it is unnecessary to vote. It is true that the advantages secured through information and transactions costs are generally cancelled out by similar advantages others have secured to themselves. But all this says is that, once the market closely approaches an equilibrium position, information from which that equilibrium position can be inferred and on which it is based is useless. No surprises there. The important thing, from a policy viewpoint, is to be sure that the patterns of prices existing at equilibrium are the

best possible market estimates of the "right" prices for purposes of optimal capital allocation.

To get the best possible market estimates, the input of the greatest possible number of informed individual estimates is required. As these individual estimates are "voted in" by bids and offers, many (most?) will be cancelled out by others. At equilibrium, all will be cancelled out. But if there are abstainers, unless their selection as such is statistically random, the pattern of prices at equilibrium will be nonrepresentative. If the abstainers are those likely to be best informed, moreover, the equilibrium price pattern will probably be less maximizing than if there were no abstentions. This is because, presumably, the better the over-all knowledge of traders, the more efficient will be the market. Thus, in order to allocate capital as efficiently as possible, informed trading by all investors, particularly well-endowed ones (such as, typically, fiduciaries) is necessary.

The Social Cost of Abstaining Investors

Finally, there is the question whether active, informed trading by a portfolio manager is unprofitable. In answering this question, it must be asked: Unprofitable compared with what? If Professors Langbein and Posner mean that active, informed trading is unprofitable compared with free loading, they are undoubtedly correct. On the other hand, if they mean that it is socially unprofitable to have every investor engage in largely duplicative and self-cancelling securities analysis and portfolio rearrangement, the correctness of the assertion is more problematical.

On a cost-benefit basis, the cost of absentions by investors is the lost production that results from a greater or lesser misallocation of capital resources. The benefits



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of abstention are, of course, the savings in information and transactions expenditures. Whether the costs of abstentions outweigh the benefits, or vice versa, is a matter for the perspicacious. We, at least, are not able to discern whether having abstainers in the market process is profitable or unprofitable. We would note, however, that better information should allocate capital more beneficially than worse information and that the sources of information we should least like to excuse are those who can most accurately and efficiently (cost per dollar of investment) serve as such.

Implications for Policy Concerning Market Funds

What conclusions can be drawn from the foregoing? First, it is submitted that a market-fund investment strategy, although perhaps individually advantageous, is socially disadvantageous and that it would be bad policy to condone, much less require, that strategy. Given the financial analyses referred to and developed by Professors Langbein and Posner, and which in the main we do not dispute, this would appear to mean that in practice no investment portfolio could be expected consistently to exceed or even to match the performance of broadly based common stock indices. That the indices' performance cannot be consistently exceeded appears simply

to be a fact of life, inherent in the nature of capital markets. That the performance cannot even be equalled would merely be the result of a policy decision—that information and transaction costs must be borne and free loading must be disallowed. But it appears to be an appropriate policy decision nonetheless.

There is no reason in principle why certain portfolios should be entitled to perform as well as an imaginary, frictionless-world portfolio, such as the Standard and Poor's 500. Transactions costs and information costs are a part of doing business. On the other hand, by attempting to save the costs of informed investment decisions, portfolios managers in effect would be trying to evade their fair share contribution to the costs of effectuating rational allocations of capital. Just because this particular social function—capital allocation—happens in the free enterprise system to be decentralized (unlike, say, national defense), it does not follow that attempted evasions of one's aliquot support for this function are any less to be condemned.

Only by requiring portfolio managers to use due care in selecting each issue for purchase and sale can the capital allocation process itself be said to be operated with due care. Revolutions that corrode the efficiency of free enterprise ought to be eschewed. ▲