

In my practice, I often refer to as the “fiduciary responsibility trinity” (Trinity). The Trinity consists of the *Tibble v. Edison International*¹ (*Tibble I*), *Brotherston v. Putnam Investments*,² (*Brotherston*), and *Hughes/Northwestern*³ decisions.

Tibble recognized the Restatement of Trusts (Restatement) as a legitimate resource in resolving fiduciary issues and ruled that a plan sponsor has an ongoing fiduciary duty to monitor plan investment options for prudence.

Brotherston ruled that comparable index funds can be used for benchmarking purposes, citing Section 100 b(1) of the Restatement.

Hughes/Northwestern ruled that a plan sponsor has a fiduciary duty to ensure that each investment option within a plan is prudent and to remove any that are not.

The question that I am constantly asked by plan sponsors and other investment fiduciaries, as well as attorneys, is “so how do I use all this to evaluate the fiduciary prudence of an investment option?” Since SCOTUS recognized the legitimacy of the common law of trusts in resolving fiduciary questions in its *Tibble* decision⁴, and since the Restatement of Trusts (Restatement) is essentially the codification of the common law of trust, I always suggest consulting the Restatement for guidance.

Three comments within Section 90 of the Restatement, commonly known as the “Prudent Investor Rule,” provide a simple blueprint for selecting prudent investment options for ERISA plans.

- Comment b states that “cost-conscious management is fundamental to prudence in the investment function.”⁵
- Comment f states that “A fiduciary has a duty to select mutual funds that offer the highest return for a given level of cost and risk; or, conversely, funds that offer the lowest level of costs and risk for a given level of return.”⁶
- Comment h(2) essentially says that actively managed mutual funds that are not cost-efficient, that cannot objectively be projected to provide a commensurate return for the additional costs and risks associated with active management, are imprudent.⁷

Taken together, these three comments stress the importance of a properly conducted cost-benefit analysis in selecting prudent investment options. Cost-benefit analysis is routinely used in business to evaluate the viability of projects. Yet, the investment industry typically avoids a cost-benefit analysis, as it knows what the results would show. Academic studies have consistently concluded that actively managed funds are typically cost-inefficient, most even failing to cover their costs:

- 99% of actively managed funds do not beat their index fund alternatives over the long-term net of fees.⁸
- Increasing numbers of clients will realize that in toe-to-toe competition versus near-equal competitors, most active managers will not and cannot recover the costs and fees they charge.⁹

- [T]here is strong evidence that the vast majority of active managers are unable to produce excess returns that cover their costs.¹⁰

It should be noted that when the SEC announced Regulation Best Interest, Chairman Jay Clayton also stressed the importance of cost-efficiency relative to acting in the best interest of customers:

rational investor seeks out investment strategies that are efficient in the sense that they provide the investor with the highest possible expected net benefit, in light of the investor's investment objective that maximizes utility.¹¹

[A]n efficient investment strategy may depend on the investor's utility from consumption, including...(4) the cost to the investor of implementing the strategy.¹²

In 2015, the DOL issued Interpretive Bulletin 15-01 (IB 15-01).¹³ IB 15-01 reinstated earlier language from Interpretive Bulletin 94-1¹⁴, language that supports the previously mentioned Restatement comments and the potential importance of cost-benefit analysis in evaluating the fiduciary prudence of plan investments:

Consistent with fiduciaries' obligations to choose economically superior investments....[Plan fiduciaries should consider factors that potentially influence risk and return. ¹⁵

[B]ecause every investment necessarily causes a plan to forgo other investment opportunities, an investment will not be prudent if it would provide a plan with a lower expected rate of return than available alternative investments with commensurable degrees of risk or is riskier than alternative available investments with commensurate rates of return.¹⁶

The Active Management Value Ratio

As a fiduciary risk management consultant, I created a simple metric, the "Active Management Value Ratio," (AMVR) that allows investors, investment fiduciaries, and attorneys to quickly perform cost-benefit analyses of actively managed investments. My favorite comment about the AMVR has been "it's simply third grade math...but very persuasive third grade math." The attached sample AMVR slide shows how easy the AMVR calculations are using "Humble Arithmetic" – subtraction and division. The actual AMVR formula is the actively managed fund's incremental correlation-adjusted costs divided by the actively managed fund's incremental risk-adjusted returns.

Interpreting the AMVR is equally easy, consisting of answering two questions:

- Did the actively managed fund provide a positive incremental return?
- If so, did the actively managed fund's positive incremental return exceed the fund's incremental costs?

If the answer to either question is "no," then the actively managed fund is neither cost-efficient nor prudent under the Restatement's guidelines.

The AMVR is based on the research findings and concepts of investment icons Nobel laureate Dr. William F. Sharpe, Charles D. Ellis, and Burton L. Malkiel:

The best way to measure a manager's performance is to compare his or her return with that of a comparable passive alternative.¹⁷– Dr. William F. Sharpe

So, the incremental fees for an actively managed mutual fund relative to its incremental returns should always be compared to the fees for a comparable index fund relative to its returns. When you do this, you'll quickly see that the incremental fees for active management are really, really high – on average, over 100% of incremental returns.¹⁸– Charles D. Ellis

Past performance is not helpful in predicting future returns. The two variables that do the best job in predicting future performance [of mutual funds] are expense ratios and turnover. ¹⁹- Burton G. Malkiel

Selecting prudent investments is just that simple. Cost-benefit analysis is consistent with applicable legal standards. Using an objective analysis metric, can an investment be projected to provide a commensurate return to an investor for the additional costs and risks associated with the investment in question?

“Black Box” Target Date Funds and Qualified Designated Investment Alternatives (QDIAs)

Studies have consistently suggested that the majority of the public is financially illiterate when it comes to personal finances and investing. Target Date Funds (TDFs) were designed to simplify the investment process for investors, including plan participants, by creating professionally designed asset allocation plans designed to prudently reduce investment risk as an investor got older, while still providing a prudent return in anticipation of retirement.

Nice in theory, but actual results are still questionable given the disparity in risk among TDFs once the TDF owner reaches their “target” retirement date. In many cases, the asset allocation errors have been attributed the use of “black box” portfolio optimizers/asset allocation computer applications, many of which utilize Markowitz's “Mean Variance Optimization” (MVO) theory. The issues involved with the use of MVO by such “black box” computer applications are well-known and were summed up perfectly by Michaud:

Although Markowitz efficiency is a convenient and useful theoretical framework for defining portfolio optimality, in practice it is an error-prone procedure that often results in “error-maximized” and “investment irrelevant” portfolios.²⁰

In practice, the most important limitations of MV optimization are instability and ambiguity. Small changes in input assumptions often imply large changes in the optimized portfolio....²¹

In other words, molehills of erroneous assumptions result in mountains of erroneous projections out. Plan participants deserve better and ERISA demands better.

Notes

1. Tibble v. Edison International, Inc., 135 S. Ct. 1823, 1828 (2015) (Tibble).
2. Brotherston v. Putnam Investments, 907 F.3d 17 (1st Cir. 2018).
3. Hughes v. Northwestern University, 595 U.S. ____ (2022).
4. Tibble
5. Restatement (Third) of Trusts, Section 90, cmt. b. American Law Institute, All rights reserved.
6. Restatement (Third) of Trusts, Section 90, cmt. f. American Law Institute, All rights reserved.
7. Restatement (Third) of Trusts, Section 90, cmt. h(2). American Law Institute, All rights reserved.
8. Laurent Barras, Olivier Scaillet and Russ Wermers, *False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas*, 65 J. FINANCE 179, 181 (2010).
9. Charles D. Ellis, *The Death of Active Investing*, Financial Times, January 20, 2017, available online at <https://www.ft.com/content/6b2d5490-d9bb-11e6-944b-eb37a6aa8e>;
10. Philip Meyer-Braun, *Mutual Fund Performance Through a Five-Factor Lens*, Dimensional Fund Advisors, L.P., August 2016.
11. SEC Release 34-86031, "Regulation Best Interest: The Broker-Dealer Standard of Conduct (Reg BI), 279.
12. Reg BI, 279.
13. DOL Interpretative Bulletin 15-01, 29 CFR.2015-01.
14. DOL Interpretative Bulletin 94-01, 29 CFR.1994-015.
15. DOL Interpretative Bulletin 15-01, 29 CFR.2015-01.
16. DOL Interpretative Bulletin 15-01, 29 CFR.2015-01.
17. William F. Sharpe, "The Arithmetic of Active Investing," available online at <https://web.stanford.edu/~wfs Sharpe/art/active/active.htm>.
16. Charles D. Ellis, "Letter to the Grandkids: 12 Essential Investing Guidelines," <https://www.forbes.com/sites/investor/2014/03/13/letter-to-the-grandkids-12-essential-investing-guidelines/#cd420613736c>
17. Burton G. Malkiel, *A Random Walk Down Wall Street*, 11th Ed., (W.W. Norton & Co., 2016), 460.
18. Michaud at XIV
19. Michaud, 2.