Time to Rethink Prudent Investor Laws?

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Stewart E. Sterk, *Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine?*, **95 Cornell L. Rev.** (forthcoming 2010), *available at* SSRN.

With the stock market of recent years dashing so many hopes and dreams, investors are all asking the same questions: How could we have let this happen? How can we be sure it won't happen again? Included among those asking these questions are the beneficiaries of countless trusts who have witnessed significant declines in the value of their trust portfolios. In his article "Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine?," Professor Stewart E. Sterk joins this search for answers, ultimately concluding that modern prudent investor laws fail to adequately protect trust beneficiaries in troubled economic times.

Professor Sterk's article consists of three major Parts. In Part I, Professor Sterk lays the historical framework for his analysis by summarizing the evolution of laws governing trust investment management. In particular, he explores how two widely-accepted economic theories regarding the behavior of financial markets, modern portfolio theory ("MPT") and the efficient capital market hypothesis ("ECMH"), came to influence trust investment law. Sterk chronicles how both the Restatement (Third) of Trusts and the Uniform Prudent Investor Act wholeheartedly embraced MPT and ECMH in a quest to encourage the investment of trust funds in the manner these theories suggested would maximize the economic interests of trust beneficairies.

Unfortunately, argues Professor Sterk, the economic history of the past decade revealed that modern investment law placed too much faith in MPT and ECHM. As the stock market endured a boom and bust cycle over the past ten years, most equity investors endured a gut-wrenching emotional roller-coaster but generated no net investment returns. Modern trust investment laws exposed trust beneficiaries to this same tragic scenario, leaving many longing for the "good old days" of boring, stable, safe trust investments.

In Part II of his article, Professor Sterk explores the shortcomings of modern portfolio theory as the basis for trust investment law and questions several of the core principles of MPT and ECMH. In particular, Sterk questions the widely-accepted notion that since risk-averse investors will demand a higher return from risky investments, invisible market forces ensure that riskier investments (e.g., common stocks) will provide superior returns to less risky investments (e.g., bonds). Sterk suggests that modern investors may be far less risk-averse than the ECHM presumes, and thus far more likely to overvalue investments in common stocks–a phenomenon compounded by investors misperceiving the true risks inherent in such investments. Sterk also contends that investor behavior may be less rational than MPT envisions, offering the 'dot.com bubble' of the late 1990s as a case in point.

In Part III, Professor Sterk considers the trust investment law implications of the past decade of experience. In particular, Sterk concerns himself here with the agency costs which result from modern trust law misaligning beneficiaries' economic interests with those of trustees. The crux of this perceived agency cost problem lies in the way trustees market their own services. Drawing in part on the work of Melanie Leslie and Rob Sitkoff, Sterk suggests that market forces and the battle for trust business drove trust companies and other professional fiduciaries to focus more on generating higher investment

returns (which they hoped to "advertise" as a means of gaining additional market share) and worry less about the risks taken to secure those returns. Professional trust companies thus sought out riskier investments as a means to generate additional business, yet trust beneficiaries bore the true financial risk of these decisions. Rather than lead to the optimal investment of trust funds, prudent investor laws misaligned the interests of professional trustees and the beneficiaries they were supposed to be serving.

Professor Sterk's article leads us in one of two possible directions. If, as he suggests, the fundamentals of investment management have truly changed such that riskier investments no longer compensate investors with higher returns, we might need a new regime that more effectively aligns the interests of trustees and beneficiaries and encourages more appropriate risk-taking by fiduciaries. Sterk sketches out what such a regime might look like, suggesting that prudent investor laws should offer trustees more precise investment guidelines–including "safe harbors" from liability designed to channel trustees towards more appropriate asset allocations for trust portfolios. Alternatively, however, the market may simply be doing what markets have always done–cycling, correcting, and recentering to a new baseline from which it will soon move forward. If the latter is true, then Professor Sterk's proposal might lead us to do the very thing he now suggests prudent investor laws may have done–create a new investment regime which would have worked brilliantly in the previous market cycle but which is ill-suited to the current one.

Professor Sterk seemingly concedes this final point. By his own admission, he offers his article not as a complete solution but merely as a means to begin a dialogue about the investment experience of the last decade and its implications for laws governing the investment of trust funds. This is a crucial dialogue and Professor Sterk has made an extremely valuable opening comment. There is much more to be said, and written, on this topic, and many, including myself, ultimately might disagree with some of Professor Sterk's viewpoints. That doesn't make Professor Sterk's article less valuable. Indeed, to the contrary, the more fervent the dissent and discussion which ensues, the more we will have to thank Professor Sterk for focusing scholarly attention on a crucial emerging issue in the field of trust investment law.

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