

Inside the UPIA

Using ETFs to practice fiduciary investing

In today's investment environment we hear more and more about the importance of fiduciary responsibility, but the concept is often ambiguous and open to interpretation. Which laws govern fiduciary responsibility? What do they entail? To whom do the laws apply? Over a decade since its passage, we turn to a law called the Uniform Prudent Investor Act for answers.

What is UPIA?

The Uniform Prudent Investor Act (UPIA) was developed in 1994 and since has been passed as law with various modifications in nearly all states. The Act provides guidance to investment managers regarding legal standards for managing an investment portfolio.

What does UPIA say and why?

UPIA essentially translates Modern Portfolio Theory (MPT) into law.¹ Developed in 1952 by Harry Markowitz, MPT demonstrates that portfolio diversification can reduce overall investment risk. Markowitz determined that individual security risk involves two components: systematic risk (e.g., recessions and wars); and specific risk (which is particular to individual securities and can potentially be diversified away). According to MPT, the risk of each individual security contributes little to portfolio risk. Instead, the difference—or covariance—between individual securities' risk levels determines overall portfolio risk.

With MPT as its foundation, UPIA fundamentally changed trust investment law and mandated that fiduciaries focus on the portfolio as a whole, rather than focus on individual securities. Specifically, the Act says:

- ▶ Overall investment strategy must be based on suitable risk and reward objectives;
- ▶ Fiduciaries have a duty to diversify across asset classes after considering the purpose of a trust;

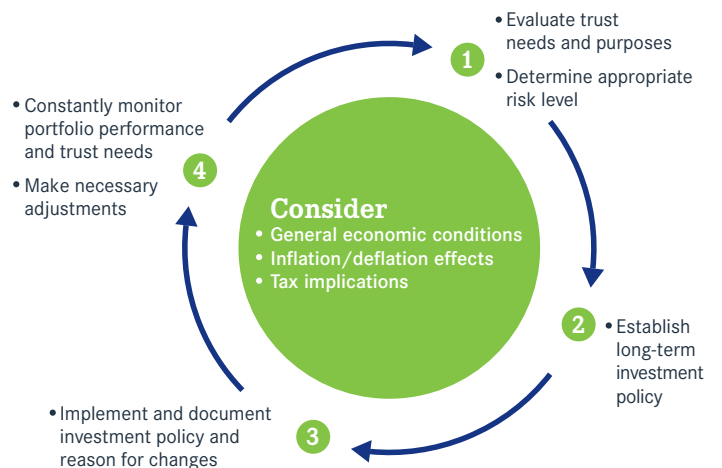
- ▶ Standard of prudence applies to a trust's overall investment policy plan, versus individual investments;
- ▶ No specific investments are inherently prudent/imprudent or mandatory; and
- ▶ Delegation of investment management and other functions are permitted.

Who does UPIA apply to?

Any financial professional who manages investments for:

- ▶ Private trusts;
- ▶ Foundation/endowment funds that are trust charter (versus corporate charter); and
- ▶ Retail clients (when acting as a fiduciary).

Figure 1: Investment process implications



1. Source: Restatement of Trusts 3d: Prudent Investor Rule, Uniform Prudent Investor Act.

Why is UPIA still relevant today?

UPIA mandates a rigorous investment process such as the one described in Figure 1. By granting broad investment powers to trustees, UPIA also imposes significant duties upon them. If these duties are inadequately performed, a trustee can be held liable regardless of positive or negative returns.

Even in non-trust settings, UPIA is widely considered a barometer of good investment practice.

“ETFs are dream vehicles for fiduciary investors... advantages of ETFs include their pricing transparency, their tax efficiency, their greater variety, and the economies of scale that can inhere in their greater size.”

– John Langbein
Sterling Professor of Law
at Yale University and
Principal Architect of the UPIA

How did UPIA change previous law?

UPIA traces its history back to an earlier doctrine known as the Prudent Man Rule, which was established in 1830 by a Massachusetts Court decision (*Harvard College v. Amory*). UPIA differs from the previous law in four major ways:

- ▶ A trust account’s entire investment portfolio is considered when determining the prudence of an individual investment.
- ▶ Diversification is explicitly required as a duty for prudent fiduciary investing.
- ▶ No category or type of investment is inherently imprudent.
- ▶ A fiduciary is permitted to delegate investment management and other functions to third parties.

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How has UPIA impacted the investment landscape and the financial profession?

By eliminating categorical exclusions against certain investments and by emphasizing diversification, UPIA has set four major trends in motion:

- ▶ Increased international investing;
- ▶ Greater use of equities;
- ▶ Widespread use of pooled investment vehicles (which facilitate diversification by virtue of their structure); and
- ▶ Heightened cost sensitivity.

How can ETFs play a role in a UPIA-governed portfolio?

Due to their inherent transparency, modularity and diversification characteristics, iShares ETFs can be an ideal complement to fiduciary investing. John Langbein, Sterling Professor of Law at Yale University and principal architect of the UPIA said it best:

“ETFs are dream vehicles for fiduciary investors. Particular funds tend to be extraordinarily well diversified within the particular asset class each represents. Moreover, the range of ETF asset classes facilitates that dimension of diversification as well. The large variety of ETFs allows the trustee or other investor to tailor asset allocation to the needs of each account with exceptional precision.

Other advantages of ETFs include their pricing transparency, their tax efficiency, their greater variety, and the economies of scale that can inhere in their greater size. Moreover, the expense ratios of ETFs tend to be low. That’s a fairly impressive set of achievements for fiduciary investors.”

Mr. Langbein was compensated for his time in the writing of the original interview from which his statements are excerpted in this material. This is not meant to be investment advice. The information provided here may not be representative of the experiences of other individuals and does not guarantee future performance.

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