

**A Prudent Expert Standard of Care:
What Now?**

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Observation #1

**"We can't solve our problems by using
the same thought process we used in
creating them."**

- Albert Einstein

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Observation #2

**"What The Human Being Is Best At Doing
Is Interpreting All New Information So
That Their Prior Conclusions Remain
Intact."**

- Warren Buffett

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An Examination of “Prudent Expertise”

1. What is implied by these observations?
2. A new look at the foundation for these observations.
3. How do these apply to the “fiduciary” space?
4. Prudent Expertise is _____.
5. What obstacles can we expect to encounter in addressing the problem?
6. What now?

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Einstein’s Statement

Notice that Responsibility is Embedded:

- It recognizes that “WE” are at cause in the matter.
- It does not assign judgment or blame.
- It creates the distinction that using a particular thought process gave birth to the problem.
- It implies that a thought process, as a subject matter, is distinct from who we are as individuals?
- It contains the seeds of the solution to any quandary.

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Buffett’s Statement

Notice What Is Implied About Learning:

- Justification is what we do BEST.
- It is neither an incidental or contrived element of our behavior. So to speak, it comes naturally.
- The lack of data is not a gating factor.
- The urge to want to be “right” serves as a kind of fuel that sustains the perception that indeed we already are “right”.
- Most arguments are conducted as emotional tautologies. They are not designed to persuade but to confirm.

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Moment for Pause

- When was the last time you changed your mind with regards to any significant issue?
- When was the last time you told the person you were arguing with that you saw their point of view and would spend some time digesting it?

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Moment for Pause

The similarities to behavioral finance are stunning.

- We are overly optimistic about our abilities.
- We are anchored in our most recent experience.
- When we make a mistake, we become, cognitively speaking, reluctant (fearful) in exercising the judgment necessary to make the next decision.

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The Neurobiology of Information Processing

- Our experience is THE “framework” of our reality.
- Behavioral science tells us that we have biases in how we interpret our experience.
- Some biases are biological. Most are developmental and occur at an early age. We have forgotten their source.
- Based on prior experience, we process information in the same way every time that same experience or a closely related experience occurs.

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The Neurobiology of Information Processing

- It is highly unusual for a re-examination of the same information by the same individual(s) to result in a different conclusion.
- A group of like-minded people cannot solve the problems that make them a group of like-minded people.
- This is why bankers struggle to “solve” the banking crisis.
- Mechanistically speaking, this is the same as Post Traumatic Stress Disorder. Repetitive related stimuli invoke a similar (neurobiological) response as was generated the last time the stimuli was received.

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The Neurobiology of Information Processing

Query:

- Given that we AREN'T our thought process, rather, we HAVE a thought process; and
- Given that we tend to reinforce our biases in how we interpret new information,
- What happens when we allow for new input that alters the existing information processing mechanism? (example: EMDR Therapy)

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Applicability to the Fiduciary Space

- What is Prudence, an Expert, a Standard of Care?
- Who says?

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Applicability to the Fiduciary Space

From the CFA Institute (via Investopedia): **Fiduciaries Must Follow the Prudent Expert Rule. They must:**

- "Act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."
- Under the prudent expert rule, the fiduciary must be as prudent as the average expert, not the average person.

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Prudence: is it...

1. exemplified by a quality of cautiousness demonstrated by one's gathering of information, analysis of that information and subsequent actions?
2. exemplified by a rigorous consideration of all the relevant factors one would expect a person, with no conflicting economic interests, to examine in their process of their decision making when that person is educated in the subject matter and has a minimum of 15 years of relevant professional experience in those same matters?
3. exemplified by a rigorous written assessment of all risks short of acts of God, which can be reasonably anticipated that could result in non-attainment of the goal?
4. what the average, reasonably intelligent, reasonably experienced person would do in a given set of circumstances?

Let's take a closer look at all 4 examples.

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Prudence: Is It Exemplified By A Quality Of Cautiousness Demonstrated By One's Information Gathering and Actions?

Q: In recognizing we were in an easy money and real estate bubble that would not last – what did you do for your clients?

A: Nothing. I was uncomfortable in second guessing the math of MPT. If its good enough for Morningstar (Ibbotson) it's good enough for me. If they weren't changing their methods for portfolio management, I wasn't going to change mine.

B: I threw out efficient frontier planning using historical asset allocation correlations after the tech bubble in 2000. I just didn't believe it was prudent to assume that the numbers from the bubble period should count. I wanted to be more conservative than that.

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Prudence: Is It Exemplified By A Quality Of Cautiousness Demonstrated By One's Actions?

C: It was clear this downturn would be more like the early 1970's than the early 1990's. So, I discounted all prior planning and communicated with clients. I then raised cash in all client accounts and made other changes based on individual liquidity goals.

D: I advised my DC clients of my concern but I couldn't do anything dramatic. After all, I don't manage the investment allocation for ee's in their 401(k) accounts. The best I could do was urge ee's to be cautious and stay diversified.

E: I put my concerns about the bubble into writing and informed every client I thought it prudent that they examine their risk tolerance – yet again and get back to me if they thought that they needed to make changes to their portfolio.

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Prudence: Is It Exemplified By A Rigorous Consideration Of All The Relevant Factors One Would Expect A Person To Examine In Their Process Of Decision Making When That Person Is Educated In The Subject Matter And Has Many Years of Relevant Professional Experience In Those Same Matters?

Q:In recognizing we were in an easy money and real estate bubble that would not last – what did you do for your clients?

A: Recognizing that in the real world investment risk isn't represented by a bell curve – I threw out MPT and studied long-tailed risk. However, I made no changes in client accounts. I felt like any decision was nothing more than an educated (sort of) guess.

B: Recognizing that the financial sector of the S&P had the greatest direct risk to the real estate market. I eliminated all indexed positions and established short positions in the relevant ETFs for all client accounts.

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Prudence: Is It Exemplified By A Rigorous Consideration Of All The Relevant Factors One Would Expect A Person To Examine In Their Process Of Decision Making When That Person Is Educated In The Subject Matter And Has Many Years of Relevant Professional Experience In Those Same Matters?

C: Recognizing that a falling dollar might cause a commodities bubble, I went long oil and the Canadian dollar in all client accounts. I also added an allocation to the best long/short managers I could find.

D: I verified the liquidity needs of all clients. We decided to ride out the storm unless they had needs within the coming 5 years. We said we would do all we can to take advantage of low equity prices during the downturn.

E: We got on the phone and talked to every client about the bubble. I urged them to call me if they got scared or if they decided to be more cautious in

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Prudence: Is It A Consideration Of All Risks Which Can Be Reasonably Anticipated That Could Result In Non-attainment Of The Goal?

Q:In recognizing we were in an easy money and real estate bubble that would not last – what did you do for your clients?

A: I don't believe in market timing so I assessed the range of projections as to how bad this would get and decided to target the middle of the range for planning purposes. I made only a few adjustments in clients accounts.

B: I eliminated all indexed positions and focused on increasing allocations to value managers. I thought that would reduce portfolio volatility. We also eliminated any funds that had even neutral weighting to financials or real estate.

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Prudence: Is It A Consideration Of All Risks Which Can Be Reasonably Anticipated That Could Result In Non-attainment Of The Goal?

C: I checked the liquidity needs of all clients and communicated with every single client. We threw out all prior planning and went to no less than 50% cash in the summer of 2008.

D: I informed every client that while I could be wrong I thought it prudent to express my concerns about the bubble in writing. I urged them to consider being more cautious in their allocations and call me so we could discuss it.

E: When Cramer said get out of the market on the Today show, I got scared and went to cash in many client accounts. We knew then that this was going to get bad. We increased allocations to gold for most clients.

F: I told all clients to buy gold, gave them all clients

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Prudence: Is It What The Average Knowledgeable Person Would Do In A Given Set Of Circumstances?

Q:In recognizing we were in an easy money and real estate bubble (2006) that would not last, what did you do for your clients?

A: When things started going south in 2007 I saw that the Bernanke and Paulsen weren't too concerned. I figured they ought to know so I played the downturn by dollar cost averaging all the way down. It was painful but we did get in some good buys.

B: I read everything I could get my hands on. I talked with other advisors. Some talked about the buying opportunity that was coming from buying at the bottom. That resonated and so we let cash build in all accounts.

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Prudence: Is It What The Average Experienced Professional Would Do In A Given Set Of Circumstances?

C: I am sick and tired Chicken Little types. I don't pay attention to doomsayers. I stuck with diversified portfolios and will continue to do so. This too shall pass. We came out of the depression and we'll come out of this. We just need to give it time.

D: I know that the average person isn't concerned when they should be and is overly concerned when it is too late. Early on I tried to talk clients into being more conservative but only a few listened. I gave them a clear opportunity to change their course of action. Some took it. Some didn't. What else could I do?

E: I followed the surveys in the industry rags and thought that the fear of a collapse seemed over blown. We are supposed to be long-term investors. Like Warren Buffett, I still believe this is the best, most productive country on the face of the Earth.

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Why Was Every Course Of Action Prudent?

Prudence:

- > During 2008 was it prudent to _____.
- > What is the purpose of the ambiguity?
- > Is that the endpoint of this fiduciary exercise?
- > Is that what we meant to create?
- > Is there really no tangible measurement for prudence?
- > Why are we paid?
- > Why do our client's think we are paid.
- > Can we get better at this?

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The Other Half of the Standard

Expertise:

- > How much is related to education?
- > How much is related to experience?
- > Can you measure it?
- > With regards to expertise, what *really* matters?
- > Were the people running banks, risk mgt departments, Boards of Directors, the Fed, the Treasury all experts?
- > Maybe there is something about expertise we ought to examine more closely.

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Why Do We Call Something So Ambiguous – a “Standard”.

Standard of Care:

- How is it that being a fiduciary implies a standard of care that is so malleable as to be amorphous?
- How authentic can a standard be if the defining elements of the standard aren't standardized?
- Why have WE settled for this?
- Did investment fiduciaries define this?
- If not, who did? When? Why?

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Challenges to Enhancing A Prudent Expert Standard of Care

- Biases have a neurobiological foundation derived from how information has been processed in the past.
- Biases in our individual and collective thought processes are embedded into our existing economic framework.
- One consequence is that individually and collectively we have learned not to trust our intuition.
- At the same time, fear is not an effective framework for prudent decision making.

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Challenges to Enhancing A Prudent Expert Standard of Care

- Lawyers have PhD's in the art of language.
- Their art form is linear. Our art form (that of investment fiduciaries) is not.
- Integrity (the resonance of thought, language and action) is non-linear.
- What are the implications of this distinction?

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**Challenges to Enhancing
A Prudent Expert Standard of Care**

- In some measure we may simply be too self oriented to expand our capacity to be of service, especially in times where fear pervades much of our thinking.
- We may be unreceptive to the examination, adoption or endorsement of any changes that lead to reduced revenue.
- We may be concerned about what will others think of us.
- Transforming a static thought process into a dynamic one isn't easy. This will take a concerted and durable effort.

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A Few Worthy Questions

- Why is it a Prudent Expert standard rather than an un-conflicted Prudent Expert standard?
- Is a culture focused on what you get conducive to the construction of and respect for a standard of care grounded in what you give?
- Do Guilds of old give us a basis for doing things differently?
- We are Guardians of the freedom envisioned by the Founders. We hold title to this on behalf of our children. If we give up on this now, what is the legacy we will have created?

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Final Offering

These are the times in which A genius would wish to live.

It is not in the still calm of life, or the repose of a pacific station, that great characters are formed.

The habits of a vigorous mind are formed in contending with difficulties.

Great necessities call out great virtues.

When a mind is raised and animated by scenes that engage the heart, then those qualities which would otherwise lay dormant, wake into life and form the character of the hero and the statesman.

- Abigail Adams,
Wife of John Adams, and
Mother of John Quincy Adams

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