Damage Analyses in Claims regarding an Investment Management Trustee Breach of Fiduciary Duty

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The management of trust assets is often handled by a third-party trust fiduciary ("trustee"). Trustees have an obligation to manage trust assets with the intent of providing the best risk-adjusted outcome possible for trust beneficiaries based on the stated investment goals in the trust documents. In some situations, trustees can be accused of breaching their fiduciary duty to trust beneficiaries while managing the trust assets. Two types of claims typically made by dissatisfied trust beneficiaries are that (1) the trustee made overly aggressive investment decisions or (2) the trustee made overly conservative investment decisions. One part of either proving or disproving such trustee breach of fiduciary duty allegations while managing trust assets is the measurement of the damages (if any) that resulted from the claimed wrongful actions of the trustee. This discussion focuses on (1) investment management trustee fiduciary duties and (2) damage measurement methods that analysts may apply to conclude whether or not potential damages were incurred due to the alleged breach of fiduciary duty.

Introduction

This discussion addresses investment management decisions made by trustees who hold a fiduciary responsibility to trust beneficiaries. That is, this discussion considers a trustee (whether a corporate trustee or an individual trustee) that makes investment management decisions on behalf of a trust.

Although not all trustees are directed by the trust agreement to be an investment manager trustee (as such rights may be delegated to the donor, beneficiary, or an independent third party), most allegations of mismanagement of trust assets are claimed against an individual or corporate trustee that has the fiduciary duty to manage the investments (or assets) of the trust.

This discussion summarizes the role of the investment management trustee, the fiduciary duties held by the investment management trustee, the typically asserted claims against investment management trustees, and the damages measurement analyses applied to determine whether or not potential damages were incurred due to alleged breaches of fiduciary duty.

Fiduciaries and Fiduciary Duty

A fiduciary relationship is one in which one party (or entity) holds a legal and/or ethical relationship of trust with another party (or group). Trust fiduciaries fall into this category when managing assets and investments held in trust. Trustees generally have power over the assets of the trust.

The trustee is under a legal obligation to:

- put the trust beneficiary's interest first,
- avoid potential conflicts of interest, and
- not personally profit without both the beneficiary's knowledge and consent.

Fiduciary duty is the standard to which a fiduciary is held when managing the assets of a beneficiary. The Legal Information Institute at Cornell Law School sets forth the following definitions:

> A fiduciary duty is the highest standard of care. The party who has a fiduciary duty is called the fiduciary, and the person to whom they owe the duty, is typically referred to as the principal or the beneficiary. If a fiduciary breaches their fiduciary duties, they would need to account for any and all ill-gotten profit. The beneficiaries who are owed the fiduciary duty are then entitled to damages, even if they suffered no harm.[1]

> The trustee is the party who holds legal title to the trust property. The trustee may also be the trust beneficiary, but he may not be the sole beneficiary because then there would be no separation between legal and equitable ownership, which is required for a valid trust. A trustee is a requirement of an express trust along with trust property, trust intent, and definite beneficiaries.[2]

The role of a trustee is to serve as a fiduciary of the trust assets, but the role can also include administrative duties. The risk of the trustee not satisfying its fiduciary duty to the beneficiaries is lower with respect to the trustee's administrative duties and greater with respect to the trustee's power to make investments of trust assets.

The roles and duties of the trustee may include (but are not limited to) the following:

1. Review and understand the trust document
2. Administer the trust according to the trust terms
3. Prepare records, forms, statements, and tax returns
4. Communicate with beneficiaries
5. Distribute trust assets, if and when applicable
6. Invest and manage trust assets

The following sections discuss the procedures involved in managing trust assets and breach of fiduciary duty claims that may arise.

Trust Investment Objectives and Policies

One important procedure in the process of administering a trust or acting as a trust fiduciary is the creation of an investment policy statement ("IPS"). An IPS is a legal document required when implementing an investment strategy on behalf of a trust. An IPS may act as a blueprint for investment strategy and a score card for measuring investment performance.

There are usually specific questions that may be identified within an IPS that can guide trustees when they make investment decisions for trusts. These questions may include the following:

- What assets does the trust currently hold?
- What percentage of the trust assets may be invested in any current period?
- How long will these assets be invested?
- What are the expectations for investment returns (net of inflation) each year for these trust assets?
- How much of a loss can be recognized over a short, medium, and long-term period?
- What (if any) is the target asset allocation of the trust assets, and what (if any) is the risk tolerance of the trust beneficiary?
- What (if any) is the trust assets' ability to be diversified?
- What are the benchmarks or performance indicators used to measure trust investment performance?

An IPS may be helpful in outlining the specific objectives of the trust assets. The trustee(s) and trust beneficiaries may want to create specific target objectives for the investment period. These objectives may relate to the following:

1. Maximizing financial returns
2. Minimizing financial losses
3. Achieving steady long-term growth
4. Providing for liquidity
5. Other desired outcomes (such as following an environmental, social, and governance strategy)

When creating the IPS, the objectives may be made with constraints in mind, such as a large holding in a family-owned public or private company. In some situations, while diversification may be the most appropriate strategy, the trustee may be barred from reducing certain core holdings.

Depending on the goals and objectives of the investment of trust assets, the trustees and beneficiaries, may need to establish:

1. the desired financial goals,
2. the duration of the investment(s), and
3. the acceptable cost of investing trust assets.

Investment Philosophy

A trustee may also require an IPS to include the overall investment philosophy of the trust to determine the proper investment strategy. Some issues to consider when determining the investment philosophy outlined in an IPS may include the following:

- Overall investment objective
- Risk tolerance and risk management
- Traditional versus nontraditional investments
- Asset allocation strategy
- Frequency of trading activity
- Limitations on investment costs
- Tax management strategies
- Provide for sufficient liquidity for required distributions, if any, and lifestyle spending

These issues may help a trustee to select an investment strategy that best addresses the desired investment outcomes of trust assets. The individual trust should not necessarily be considered as a stand-alone trust, but be taken in the context of the beneficiaries' portfolio as a whole.

Challenges may arise when beneficiaries have different total portfolios or different risk tolerances. A qualified investment adviser may assist the trustee with solving these issues.

Investor Risk Tolerance

When administering a trust or acting as a fiduciary over trust assets, it is often required to properly understand the risk tolerance of the beneficiaries whose assets are being managed.

If the trustee of the trust assets does not properly assess the level of risk that investors (i.e., the trust beneficiaries) are willing to accept, issues may arise due to the disconnect of investment expectations and actual investment outcomes.

Assessing the risk tolerance of the beneficiaries includes discussing the risks and returns of holding a concentrated or undiversified portfolio if that is the desire of the beneficiaries.

Investor risk tolerance can be thought of as the level of uncertainty that a particular investor (or group of investors) is willing to accept. In general, the higher level of uncertainty (or risk) that an investment has associated with it, the higher level of return will be required. When a trustee is administering a trust, the trustee must determine what level of uncertainty (or risk) that the investors are willing to accept.

According to the U.S. Securities and Exchange Commission:

> In general, an aggressive investor is one with high risk tolerance and is willing to risk losing money in order to potentially achieve better results and higher returns for their investment. In contrast, a conservative investor is one with low risk tolerance who may likely favor investments that protect their original investment (or grow it slowly).[3]

Determining the risk tolerance of an investor(s) is often a function of the following:

1. Investment time horizon
2. Desired return on invested assets
3. Future earning capacity (or alternate sources of income)
4. Presence of other assets (such as a home, pension, or inheritance)

A trustee should consider all of these factors as they relate to the trust beneficiaries whose assets are being managed.

Investor Goals and Objectives

The complement to risk tolerance is expected or required return. A trustee should understand the specific objectives of the beneficiaries whom they represent with regards to the trust assets being invested and what level of return is necessary to achieve those goals. For instance, if trust assets are sufficiently large to fund ongoing living expenses and distributions, and the goal is to maintain a standard of living, a relatively low risk, low return strategy may be appropriate.

Alternatively, the beneficiaries may express an interest in capital appreciation, in which case, a higher risk, higher return strategy may be appropriate.

However, if spending is outpacing the growth in assets, the trustee should communicate with the beneficiaries regarding how much additional return is required to maintain or increase the value of trust assets and what additional risk is required or what reductions in spending will be necessary to achieve the beneficiaries returns given a certain level of risk.

In the context of asset management for the beneficiaries of a trust, the trustee's goals and objectives may fall into one of three categories:

1. Income generation
2. Growth and income
3. Asset growth

In addition to income and growth objectives, risk tolerance and risk management are important considerations.

Exhibit 1 presents a summary of potential investors' objectives and risk tolerance.

Investment Performance Benchmarking and Measurement

When managing trust assets, a trustee may continually monitor and measure the performance of the trust's investments to ensure that the desired goals and objectives are being met.

According to *Performance Measurement: The What, Why, and How of the Investment Management Process*, investment performance measurement is a four-step process that entails the following:[4]

- Benchmarking
- Calculating the portfolio's excess return
- Performance attribution analysis
- Risk analysis

Benchmarking

The performance measurement process requires that the trustee selects an appropriate benchmark to assess the performance of trust assets. Ideally, that benchmark will be:

1. investable,

Exhibit 1
Investor Risk Tolerance and Investment Objectives

Objective	Risk Tolerance	Low	Moderate	High
	Income	Conservative income investors favor low risk strategies at the expense of returns. Low duration bond funds, short-term Treasury bonds, or short-term high-quality corporate debt will typically be a significant portion of the portfolio. Dividend paying equities may be included as well, but equities will comprise a small portion of the portfolio.	Moderate income investors favor a balanced portfolio while still focusing on current income. A combination of equities and fixed income are typically used in the account. High-quality fixed income will still be sought; the duration of the bond portfolio may increase to achieve higher returns. Additionally, equities may comprise a portion of the portfolio.	Aggressive income investors favor maximizing current returns while accepting high risk. These investors may use more aggressive strategies that may offer higher potential returns. Preferred equities, high dividend paying equities, corporate debt, high-yield debt, and derivative strategies may all be considered as possible investments.
	Growth & Income	Growth and income investors with low risk tolerance seek current income balanced somewhat with capital appreciation. They are willing to accept lower potential returns in exchange for a lower risk investment. Fixed income will be a significant portion of the portfolio, but an allocation to dividend-paying equities will be expected.	Investors seeking some current income and long-term growth may increase their returns (and risk) by incorporating a larger portion of dividend-paying and non-dividend-paying equities and reducing exposure to fixed income. Risk of losing principal increases, but so, too, does the expected return.	Investors with a high risk tolerance seeking both growth and current income may invest in a combination of fixed income, equities, and derivatives. Fixed income may be a relatively small portion of the high risk portfolio. A long-term time horizon is necessary to allow more aggressive strategies with the opportunity to earn higher potential returns.
	Growth	Conservative growth investors seek to maximize capital appreciation while focusing on low risk strategies. Investors in this category are willing to accept lower potential returns in exchange for lower risk. The time horizon is often intermediate. Equities of large capitalization companies in developed markets will typically be a significant portion of the account, and some fixed income will be considered.	Investors seeking capital appreciation with moderate risk may focus on large capitalization equities in developed countries and may also consider smaller capitalization equities or equities from emerging markets.	Investors with a high risk tolerance seeking growth typically have a long-term time horizon, allowing the investor to pursue higher risk with more aggressive strategies that may offer higher potential returns over time. Equities may be as much as 100 percent of the account and may have increased allocations to small capitalization equities from both developed and emerging markets. Depending on the size of the investment assets, alternative investments (such as private equity) and hedge funds may be appropriate.

2. accessible,
3. independent, and
4. relevant.

As a standard, benchmarks can be based on market indexes (e.g., Standard & Poor's 500, Wilshire 5000), peer groups (a portfolio that contains the same or similar type of assets in the trust), or based on specific targeted returns (e.g., the risk-free rate, inflation plus funding requirements).

Calculating the Excess Return

The excess return on an investment or pool of investments and its benchmark's return can be calculated arithmetically or geometrically, as presented in Figure 1.[5]

Arithmetic excess return is generally more common due to the fact that it (1) is easier to understand and (2) provides large and absolute values in rising markets. However, geometric return may be more appropriate when measuring excess returns over multiple periods, in different currencies, or when comparing returns.

Alternatively, when the initial value of the portfolio assets differs from the initial value of the assets of the benchmark, excess returns can be simply calculated as the difference of returns of the portfolio and the benchmark. This calculation is presented in Figure 2.

Performance Attribution Analysis

According to *Performance Measurement: The What, Why, and How of the Investment Management Process*, performance attribution quantifies:

> [t]he relationship between a portfolio's excess returns and the active decisions of the portfolio manager. In other words, it relates the excess returns of the portfolio (both positive and negative) to the active investment decisions of its manager (or trustee). It provides feedback to portfolio managers, senior management, and external consultants on why the portfolio either outperformed or underperformed its benchmark.

Further, the following list presents three types of performance attribution:

- Returns-based attribution, which uses factor analysis
- Holdings-based attribution, which is calculated periodically and uses holdings data
- Transactions-based attribution, which is calculated from holdings and transactions data

Performance attribution analysis is an important component of managing invested assets as the analysis can help determine whether investment performance is due to the asset manager or the investment adviser.

Risk Analysis

According to *Performance Measurement: The What, Why, and How of the Investment Management Process*, basic risk measures can be divided into the following categories:

- Absolute risk measures, such as standard deviation
- Relative risk measures, such as tracking error
- Regression, which measures the alpha, beta, and standard error of the portfolio's return

When evaluating the investment performance of trust assets, a trustee may wish to consider all of the preceding items in order to ensure that they adequately adhere to the fiduciary duty entitled to trust beneficiaries.

Figure 1
Arithmetic Excess Return versus Geometric Excess Return

$$\text{Arithmetic Excess Return} = \frac{\text{End Portfolio Value - End Benchmark Value}}{\text{Initial Portfolio Value}} \times 100 \text{ Percent}$$

$$\text{Geometric Excess Return} = \frac{\text{End Portfolio Value - End Benchmark Value}}{\text{Initial Benchmark Value}} \times 100 \text{ Percent}$$

Figure 2
Excess Return Calculation

$$\text{Excess Return} = \frac{\text{End Portfolio Value - Initial Portfolio Value}}{\text{Initial Portfolio Value}} - \frac{\text{End Benchmark Value - Initial Benchmark Value}}{\text{Initial Benchmark Value}}$$

Damages Analyses Related to Allegations of Investment Management Trustee Breach of Fiduciary Duties

A damages measurement analysis is informed by a number of legal standards that should be met to support the damages claim. Legal standards are usually addressed in a later stage of the lawsuit.[6] However, if the facts and circumstances of the lawsuit do not satisfy these legal standards, while the lawsuit may be valid in terms of the defendant's performance of a wrongful act, the plaintiff may not be eligible to receive any pecuniary relief.

Prior to filing the judicial action, the plaintiff's counsel will evaluate the lawsuit based on the merits of addressing these legal standards.

Assuming the legal standards are met, to quantify a breach of fiduciary duty damages measurement for the trier of fact, an analyst can apply generally accepted damages methods.

Allegation of Investment Trustee Breach of Fiduciary Duties

Allegations of a breach of fiduciary duty occur from time to time. These allegations are typically due to an actual or realized loss of investment principal and are typically coupled with other allegations of malfeasance.

Remedies sought by the plaintiff/claimant in litigation vary depending on the severity of the alleged breach of fiduciary duty. In instances where a suit is brought alleging mismanagement of assets due to a lack of diversification or selecting investments inappropriate for the trust, damages are typically limited to the recovery of principal lost due to the trustee's actions.

However, in instances where allegations are brought due to fraud, conflict of interest, self-dealing or other misconduct, damages may not be limited only to the recovery of principal.

The following sections discuss four generally accepted damages methods that analysts may consider when measuring damages related to allegations of investment trustee breach of fiduciary duty with regard to investments.

Damages Measurement Approaches and Methods

In the case of allegations against investment management trustees for either overly aggressive or overly conservative investment strategy, the measurement of damages may be measured by applying one of the following:

1. Ex-ante damages measurement methods
2. Ex-post damages measurement methods

In an ex-ante damages measurement, lost profits are discounted at a risk-adjusted rate from the terminal date to the date of the alleged wrongful acts. The analyst may then add interest damages from the date of the alleged wrongful acts to the date of the trial based on the prejudgment interest rate.

Ex-ante damages measurements typically consider only information that was known or knowable as of the date of the alleged breach of fiduciary duty.

In an ex-post damages measurement, the analyst discounts future lost profits (from the current date to the terminal date) back to the current date based on a risk-adjusted rate. For historical lost profits, the analyst does not apply a discount rate, but instead totals the undiscounted lost profits from the date of breach through the current date.

Ex-post damages measurements rely on all information available as of the date of trial.

If the damages award is taxable to the plaintiff, it may be appropriate to recommend to the court that the total damages award include both the after-tax damages measurement and the income tax expense related to the damages measurement.

There are several generally accepted methods to measure damages in a trustee breach of fiduciary tort claim. While these measurement methods are often applied to quantify lost profits economic damages for business operations, they can also be tailored to effectively analyze and quantify investment management damages as a result of a trustee breach of fiduciary duty.

Lost Profits Damages

One damages measurement method is the lost profits method. The lost profits method quantifies the additional profits (above actual profits) that the plaintiff would have achieved but for the wrongful act of the defendant.[7]

Sales Projection Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the projection method is described as follows:

> The sales projection method utilizes company-specific forecasts for certain items, preferably by using forecasts that the company has prepared in the ordinary course of business or for some other purpose other than the litigation. Some business are more sophisticated than others, and their projections (formatted like a typical income or operating statement) may specify revenues by product lines, detailed expenses, income taxes, and miscellaneous income/expenses.[8]

Many courts have concluded that the projection method for calculating damages is reliable. However, as presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*:

> [T]he challenge for the financial expert remains not to make the appropriate estimates and analyses and then relate them to the performance that the specific event impacted so the conclusions are reliable.[9]

Before-and-After Method

In the before-and-after method, analysts may compare:

1. income from the time period in which profitability was affected by the alleged damaging acts (the "damage period") to
2. results attained prior to or after the damage period (the "comparison period").

If performed correctly, this measurement method allows the analyst to identify lost profits resulting from the alleged breach of fiduciary duty.

In order to apply this measurement method, the analyst should identify and quantify the effects of all other factors that may affect profitability in either the damage period or the comparison period.

For example, if the analyst measures damages for a trust by comparing returns from the 2009 to 2010 damage period with income from the 2005 to 2008 comparison period, the analyst should also consider the impact of the decline in returns during the damage period.

The reliability of the before-and-after method may be reduced to the extent that adjustments have to be made for the results of additional external factors.

Another potential limitation of the before-and-after method may be the availability of data. The before-and-after method requires operating data for the analyst to identify meaningful returns from the damage period and the comparison period.

These data may not always be available due to factors such as a limited investment history, challenges identifying or clarifying a distinct damage period, and other factors.

"But-For" Portfolio Analysis

A "but-for" investment portfolio is a technical term. A "but-for" investment portfolio is a tool that may be applied to measure certain types of damages in certain types of disputes.

A "but-for" investment portfolio is a hypothetical alternative investment portfolio that is modeled and then compared to an actual investment portfolio.

The analyst may construct the "but-for" investment portfolio to estimate the value of the investment portfolio "but for," say, an alleged trustee breach of fiduciary duty.

Damages may be measured by subtracting:

1. the ending value of the actual trust investment portfolio (i.e., the actual portfolio that suffered from the alleged breach of fiduciary duty) from
2. the ending value of the "but-for" trust investment portfolio.

Of course, such a measure of damages only considers one investment metric: return.

So, the "but-for" portfolio analysis only measures incremental return (the "but-for" portfolio compared to the actual portfolio). A complete measure of damages also has to measure the other investment metric: risk. Therefore, the "but-for" portfolio damages analysis is not complete unless it measures both of the following:

1. Incremental return
2. Incremental risk

Two methods incorporating the "but-for" portfolio analysis are the following:

1. The yardstick method
2. The market model method

Yardstick Method

In the yardstick method, the analyst compares the performance of the subject trust assets to benchmark data from the same time period. As previously discussed, the benchmark data may be the investment performance of market indexes, investment peer groups, or targeted returns that were unaffected by the alleged wrongful acts.

In order to correctly apply this method, the analyst should select benchmark data that are

sufficiently similar to the subject portfolio of assets. The credibility of results from the yardstick method may be reduced to the extent that benchmark data are dissimilar to the subject portfolio of assets.

The analyst may consider qualitative and quantitative similarities between the subject portfolio of assets and the benchmark data. Regression analysis is a useful tool to analyze quantitative similarities. For example, an analyst could perform a regression analysis to compare the subject portfolio of assets returns to peer group returns over a certain number of years.

The analyst should also consider any other changes in the subject portfolio of assets that may have affected the performance of the subject portfolio of assets relative to the benchmark data over the period reviewed (e.g., changes in asset management, changes in trust asset composition).

Market Model Method

As presented in the *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the market model method is described as follows:

> The fourth methodology for determining lost profits, the market model, is not used as often as the first three models already discussed. According to this methodology, the expert considers the plaintiff's market share prior to the defendant's alleged act to determine lost revenue/sales. For example, in a market in which the plaintiff and defendant are sole competitors, the plaintiff needs only to show "evidence defining the market, demonstrating what share of the market would have been but for the defendant's breach, and establishing the profit he would have earned on the increased sales."[10]

While this measurement method is sometimes applied in patent infringement matters, it may be applied in other damages scenarios resulting from allegations of overly conservative or overly aggressive investment strategy, if appropriate data are available.

Illustrative Example of the Before-and-After Method

In fiduciary tort cases related to overly aggressive or overly conservative investment practices, the before-and-after method is often considered and applied in damages measurement analyses.

Overly Aggressive Practices

Overly aggressive investment advisory and management can arise from a trustee or adviser selecting investments that violate the risk tolerance of the beneficiary, selecting assets inappropriate in the context of the portfolio as a whole, implementing an asset allocation inappropriate for the age of the beneficiary, and/or other high-risk trading and investing strategies.

In the case of *Honea v. Raymond James Financial Services, Inc.* ("RJFS"), Honea argued that RJFS breached its fiduciary duty and breached its contract, among other allegations. While the case dealt with numerous legal and procedural challenges, the initial claim brought to the court stemmed from a significant loss of principal by Honea.

Honea "alleged that RJFS engaged in 'abusive brokerage practices' in that her investments were not diversified, 'were far too risky,' and 'were of poor quality.'"

Honea claimed that due to the actions of RJFS, she lost nearly 90 percent of her initial principal balance as RJFS aggressively invested in options and used margin.

The arbitration panel found that the adviser did not make sufficient effort to know his client nor did he understand her investment experience. The arbitration panel found that these failures contributed to losses in Honea's account.

While the case is ongoing, the trial court entered in favor of Honea recouping her losses. Based on account statements provided, it was clear to the trial court when funds were deposited, when investments occurred, and when the resulting losses occurred.

In the RJFS case, a ruling was made in favor of Honea to recoup her losses of principal. Alternatively, it could have been argued that due to the poor management of Honea's investment assets, her losses were (1) actual loss of principal and (2) hypothetical losses of incremental returns from a reasonably managed investment portfolio.

The basic facts of the case are as follows:

- Starting in 1997, Honea opened several accounts and deposited various amounts into those accounts.
- The total amount deposited as of March 30, 2006, was approximately $1.2 million.
- Honea claimed that as a result of the actions of Raymond James, losses of $1.05 million were incurred.
- Honea did not have extensive investing experience.

Based on the foregoing, and to further the illustrative example, we make the following additional assumptions:

- The investment returns sought are assumed to be moderate with a moderate level of risk.
- The account is a taxable account, but for simplicity, a tax-aware strategy was not considered.
- All returns are pretax returns.
- The time horizon is long term.

We further assumed the investment start date was January 1, 1997, and even though funds were deposited over a period of time, we assumed the full $1.2 million was deposited on that date. We based our hypothetical analysis on potential returns that could have been earned from January 1, 1997, to March 30, 2006, based on a moderate asset allocation.

As mentioned previously, a moderate risk portfolio seeking growth and income may incorporate both equities and fixed income.

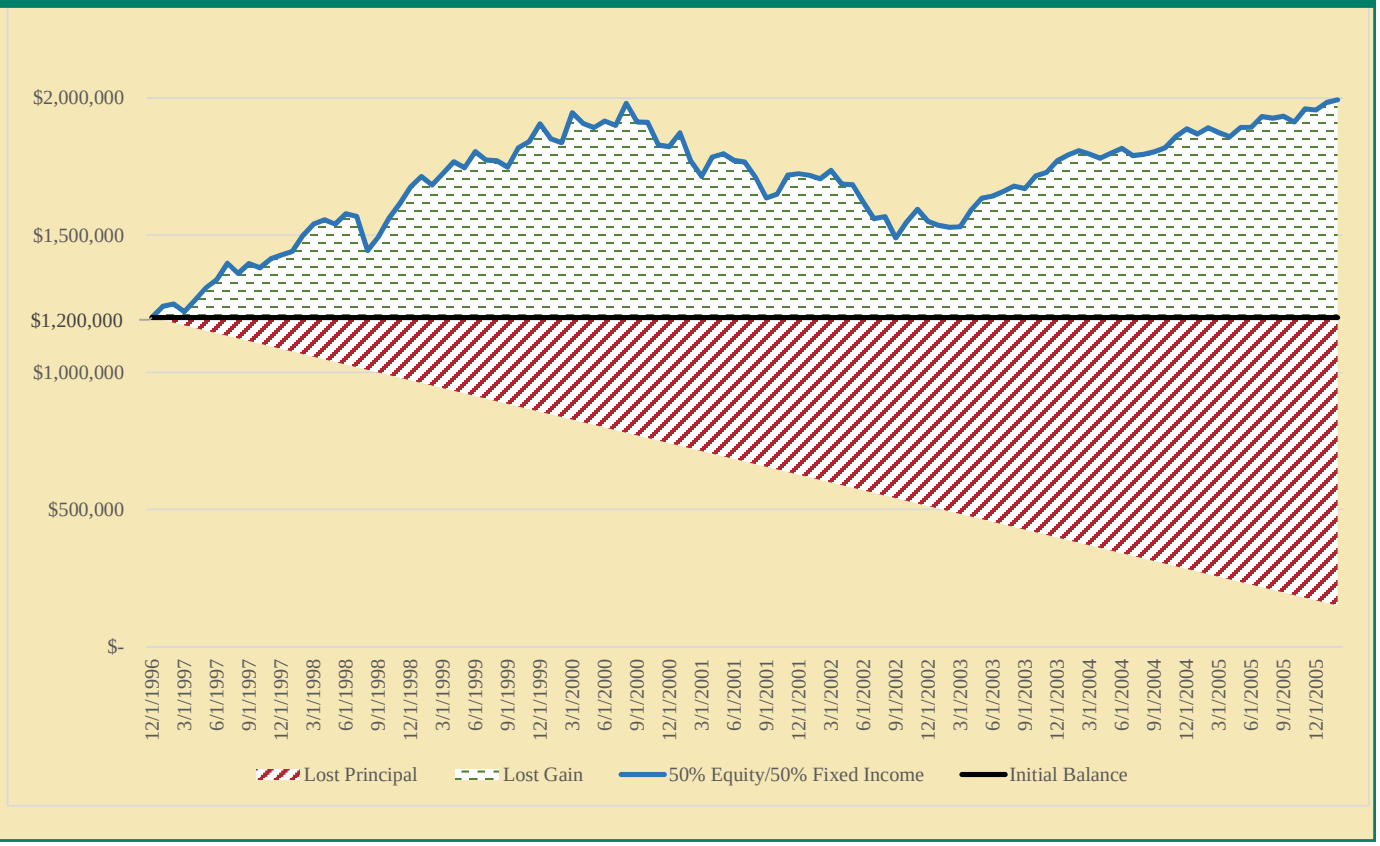
A reasonable portfolio allocation in this hypothetical case could be in the range of 30 percent to 70 percent fixed income allocation and 30 percent to 70 percent equity allocation. Using actual returns for an investment in a 10-year Treasury bond and actual U.S. equity market returns, we estimated portfolio returns of approximately $800,000, depending on the asset mix. Thus, total damages could be represented as the loss of principal of $1.05 million and the opportunity cost of the unearned gain of approximately $800,000 for total damages, or total damages of $1.85 million.

Figure 3 illustrates the losses incurred (assuming a linear decline in account balance) and the opportunity cost of the lost gains assuming various asset allocations.

Overly Conservative Practices

In cases of overly aggressive investing, the allegations will typically revolve around actual losses incurred and the opportunity cost of returns. Overly conservative investing, on the other hand, will typically only focus on the opportunity cost of not implementing a certain strategy.

Figure 3
Illustration of Damages Resulting from an Overly Aggressive Investment Strategy



In the case of a breach of fiduciary duty where the allegation is the assets were managed too conservatively, the allegations will likely focus on a portion of the IPS stipulating some level of expected or desired return on trust assets.

While every situation is different, a common targeted return is a level sufficient to support a reasonable amount of spending (typically about 3 percent of assets) plus inflation as measured by the consumer price index ("CPI") or the personal consumption and expenditures price ("PCE") index.

If we assume the same facts and circumstances as the RJFS case in our hypothetical damages example, but we assume the asset manager did not follow the agreed on IPS stipulating a return sufficient to maintain purchasing power, the damages analysis would change somewhat.

Let's assume the IPS stipulates that assets must increase at a sufficient rate to maintain purchasing power only. In this case, the assets need to grow in line with either the CPI or the PCE index (historically, about 2 percent to 3 percent per year). In this case, the trustee may consult with an outside adviser to determine an appropriate investment strategy.

The trustee may be accused of following an overly conservative investment policy if the trustee:

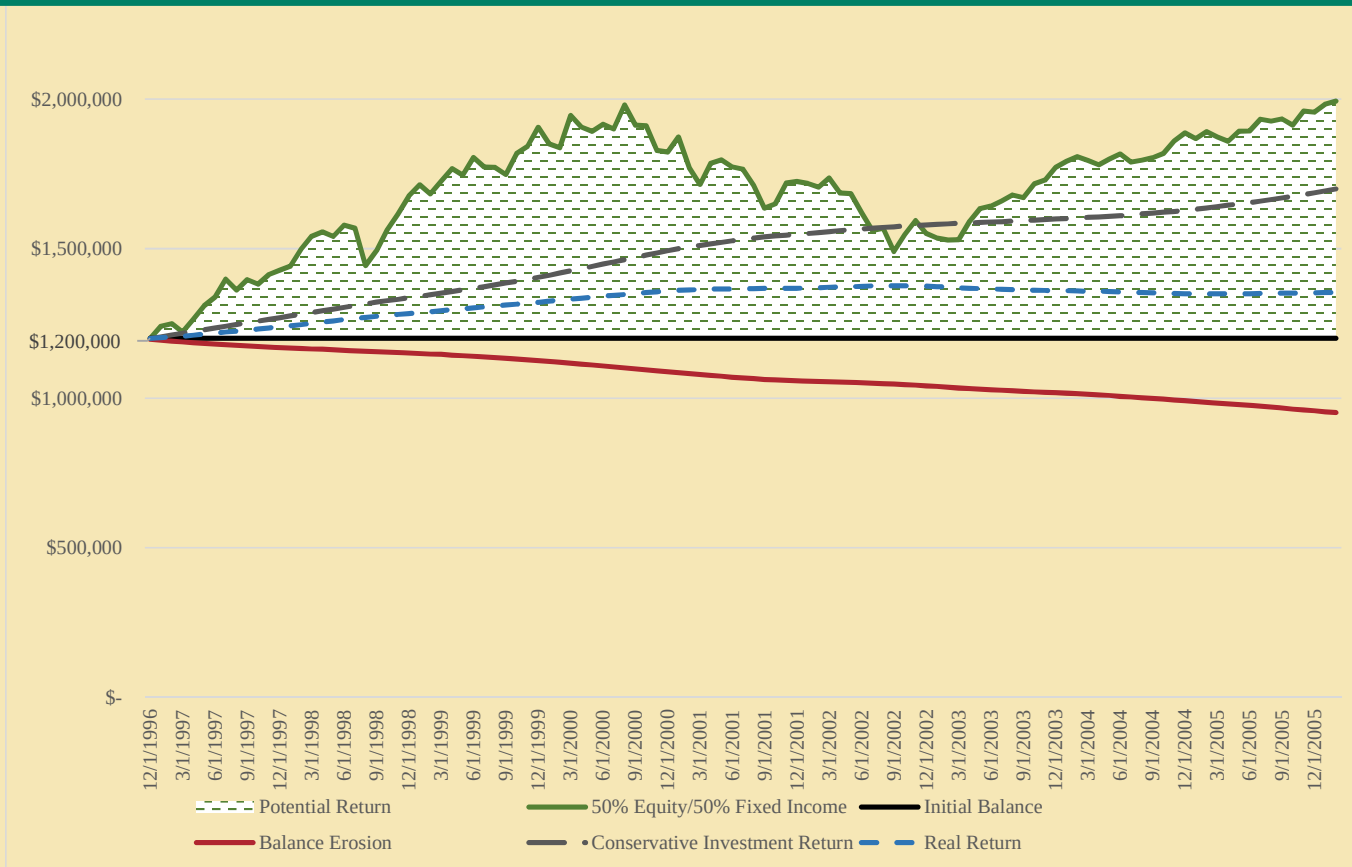
1. receives poor advice or
2. does not seek any advice and
3. invests in a low risk asset or
4. does not invest the assets at all and earns a correspondingly low return (such as a money market fund).

Assuming the same initial funds and start date as the RJFS case, we can illustrate the opportunity cost of funds being invested in an overly conservative manner.

Assuming the funds are uninvested and earn no or low returns, the purchasing power of the initial balance is eroded by inflation. However, if the funds are invested in low risk assets, purchasing power can be maintained as presented in Figure 4.

As can be seen in Figure 4, by leaving the funds uninvested, inflation erodes the purchasing power

Figure 4
Illustration of Damages Resulting from an Overly Conservative Investment Strategy



over the time period. However, even with a low-risk investment strategy, the purchasing power can be protected.

Total damages in the illustrative example in the case of overly conservative investment management can be thought of as:

1. the loss of purchasing power and
2. the opportunity cost of unearned real capital appreciation.[11]

In this case, the assumed beginning balance was $1.2 million, but at the end of 10 years, inflation would have eroded the purchasing power to $900,000. In addition, investing conservatively in a risk-free bond[12] would have provided a return of approximately $750,000, or 3.8 percent annually.

In real terms (that is, deducting inflation from the return), purchasing power would have hypothetically improved somewhat, providing a real return of approximately $165,000 over the investment period.

In this hypothetical example, the damages are both of the following:

1. Lost purchasing power of approximately $300,000
2. Lost opportunity cost of real investment returns of $165,000

The sum of these two measurements indicates total damages of approximately $465,000.

Summary and Conclusion

This discussion provided a general overview of, and addressed various issues pertaining to, claims of breach of fiduciary duty due to overly aggressive or overly conservative investment strategy employed by investment management trustees.

Further, this discussion presented various metrics and methods of analyzing both:

1. the validity of breach of fiduciary duty claims and
2. any potential damages that may have resulted if such a breach is found to have occurred.

Both trustees and analysts should consider the information in this discussion in order to understand the potential for breach of fiduciary duty claims resulting from overly aggressive or overly conservative investment strategies employed by trustees and any potential damages resulting from said alleged breach.

Notes:

1. Definition of "fiduciary duty" by Cornell Law School Legal Information Institute.
2. Definition of "trustee" by Cornell Law School Legal Information Institute.
3. "Assessing your risk tolerance," U.S. Securities and Exchange Commission, www.investor.gov [accessed on March 14, 2019].
4. Michael McMillan, "Performance Measurement: The What, Why, and How of the Investment Management Process," Enterprising Investor Blog (June 1, 2012), www.blogs.cfainstitute.org.
5. Note that this assumes the initial value of the subject portfolio of assets is the same as the benchmark.
6. Fady F. Bebawy, "A Primer on the Fundamental Elements of Economic Damages Analysis," Willamette Management Associates *Insights* (Summer 2018): 3–14.
7. Ibid., 11.
8. Nancy J. Fannon and Jonathan M. Dunitz, *The Comprehensive Guide to Lost Profits and Other Commercial Damages* (Portland, OR: Business Valuation Resources, 2014), 223.
9. Ibid., 225.
10. Ibid., 226.
11. Real capital appreciation is the difference between nominal returns (the rate of return calculated by comparing the ending balance to the beginning balance) and the inflation rate.
12. Assuming reinvestment of coupon payments monthly at the then-prevailing interest rate and all bonds held to maturity (i.e., no price appreciation or depreciation is realized).

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