

# The Prudent Man

How he came to be.



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BY JOHN ILKIW

**W**oven through the fabric of the Anglo-American financial services industries is the legal construct of the prudent man rule. While ubiquitously referenced, the circumstances leading to its introduction in 1830 by the Harvard College vs. Amory decision and its slow march to become a key standard by which fiduciaries are judged are little understood.

Harvard College, on behalf of itself and the Massachusetts General Hospital, sued the trustees of a \$50,000 personal trust to recover \$12,000 of capital losses from investments made in several bank and insurance companies and two manufacturing companies. The value of the securities declined to \$29,000 from \$41,000. In today's dollars, the capital loss would be about \$180,000.

The two plaintiff organizations were to be equal beneficiaries of the remaining assets of the personal trust upon the death of the trust's initial beneficiary, the wife of the man who had established the trust. The trustees, one of whom had the surname Amory, had been instructed to "...loan the same upon ample and sufficient security, or to invest the same in safe and productive stock, either in the public funds, bank shares of other stock, according to their best judgment and discretion."

Appealing to the "legal list" of safe investments established by the English courts in the wake of the financial debacle of the South Sea Bubble in the early 1700s, Harvard College wanted the trustees to be personally liable for the capital loss. Justice Samuel Putnam of the Massachusetts Supreme Court decided in favour of the trustees and the decision introduced three principles that evolved to form the foundation of pension legislation today.

First, the legal list of safe investments had no applicability to trusts because no investments are "safe." He noted

that so-called safe investments such as mortgages and real estate investments were subject to price fluctuations, and concluded: "Do what you will, the capital is at hazard."

Second, the action of trustees should be judged against how "men of prudence, discretion and intelligence manage their own affairs," not in regard to speculation, but in regard to probable income as well as probable safety of the capital to be invested.

Third, trustees that satisfy the men of prudence standard could not be held liable for capital losses. If this were not the case, no prudent man would offer to be a trustee for fear of having to cover financial losses "which might happen without any neglect or breach of good faith."

The principles first enunciated by Justice Putnam took over 140 years to find their way into mainstream pension legislation. This occurred when President Gerald Ford signed into law the 500-page Employment Retirement Income Security Act (ERISA) on Labour Day in 1974—six days before he granted Richard Nixon a presidential pardon. Putnam's men of prudence had been transformed into "...a prudent man acting in a like capacity and familiar with such matters." Thirteen years later Ontario passed a revised Pension Benefits Act that introduced the gender-neutral prudent person standard and set aside the "legal list" in favour of judging investment risk in the context of the total portfolio. Other Canadian jurisdictions followed suit in the subsequent years.

Let's close with two historical side notes. The asset allocation of Harvard's endowment fund in 1830 was 98.6% in mortgages and real estate and 1.4% in the shares of canal, bridge and barge companies. No wonder Harvard questioned the investment decisions of Amory and his colleagues. In 1937, Justice Putnam's great-great-grandson, George Putnam, founded Putnam Investments. ■

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