Looking for the Exits

A Fiduciary's Sell Strategy Under the Prudent Investor Act

By John Jeffrey Pankauski and Robert E. Conner

The Boston College Center on Wealth and Philanthropy has estimated that $41 trillion to $136 trillion will pass from one generation to the next between 1998 and 2052. Much of this historic and unprecedented transfer of wealth will find its way into trusts and investment accounts to be managed on a discretionary basis. Fiduciaries should be guided by the Prudent Investor Act (PIA) in the investment, management, and administration of such accounts. For purposes of this article, property managed by a fiduciary may be referred to as "assets," "funds," "portfolio," "securities," and similar terms. A fiduciary who has accepted the charge of managing such funds on a discretionary basis may be referred to as "portfolio manager," "investment manager," "money manager," "asset manager," and like terms. Forty-six states have either adopted some form of the PIA or have introduced legislation to do so.

At present, legal scholars and practitioners have provided some commentary about how fiduciaries may, or should, invest and how fiduciaries should act and administer accounts. But there is less substantive guidance that specifically tells a fiduciary what is proper or improper. How is prudence exercised? Are there some specific courses of conduct that fiduciaries must take? What are the best practices?

The purpose of this article is to provide guidance to fiduciaries and practitioners by considering an important aspect of a fiduciary's role: fulfilling the obligation to preserve principal by having a sell strategy as part of an overall investment plan. This article examines the sell strategies appropriate to an investment portfolio including publicly traded equities and fixed income instruments as well as cash. In particular, this article focuses on the use of sell strategies for publicly traded stock.

Defining the Fiduciary

It is important to recognize that the Prudent Investor Act applies not merely to trustees but to any person or corporate entity that manages property for another. Guardians and executors (personal representatives) may be subject to the Prudent Investor Act. Many states have defined "fiduciary" by statute and may require that a written agreement (or other instrument) recognize the existence of the fiduciary relationship. Although broker-dealers and their registered representatives (stockbrokers) have been found to be fiduciaries under varying circumstances under both state and federal law, one bright-line indicator of fiduciary responsibility is the assumption of formal discretionary investment management authority over client assets, thereby invoking the requirements of the Prudent Investor Act.

Delegation of investment authority has significant implications. The one to whom investment authority has been delegated may be referred to in the statutes as an "investment agent" and may, by virtue of such delegation, become a fiduciary. The term "investment *agent*" should not mislead. Even an investment agent who manages funds for an individual, as opposed to a trust, may be a fiduciary, charged with duties higher than those ordinarily ascribed to a mere agent. The investment agent may be required to conform its conduct to the Prudent Investor Act.

As an important procedural issue, some state statutes mandate that an investment agent shall be subject to the jurisdiction of its state courts. Commonly articulated arbitration provisions within new account forms of broker-dealers, banks, or trust companies may require the client to file claims before an arbitration panel. Such an arbitration provision may not be valid unless the client's rights under the statute providing for state court jurisdiction are specifically waived. Absent such specific waiver, the investment agent/fiduciary may remain subject to causes of action that a client may assert against the fiduciary in state court, rather than before an arbitration panel.

In a typical nondiscretionary brokerage account relationship in which the broker recommends suitable stocks to purchase or sell and the client may accept or decline the broker's recommendation, the fiduciary relationship exists only from the moment of the recommendation up to the consummation of the ensuing transaction. Certain state laws and case law to the contrary (California, New York, and New Jersey), the broker-as-fiduciary concept is not necessarily deemed to be continuous.

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Consider instead the circumstance in which a client brokerage account is set up as a formal discretionary account wherein the broker does not merely recommend but acts with total discretion, without need for client approval before each transaction, and directly affects purchase and sale transactions. In such a circumstance, the broker has, according to account-opening documents, taken on the heavier mantle of fully discretionary management of the client's account and, in so doing, has a fiduciary responsibility that is continuous. A decision to hold an existing security position, rather than sell, constitutes an investment decision by a fiduciary and is as much governed by the PIA as if a transaction were executed.

This contrasts with the more common circumstance wherein a broker may solicit a transaction by a client in a nondiscretionary account by making a recommendation to the client, but the client retains the ultimate decision to accept or reject such recommendations on a transaction-by-transaction basis. Certain state laws to the contrary, current brokerage industry rules (NASD Rule 2310, for example) treat a recommendation as having been made *only* if a transaction ensues. Standards of suitability apply to such broker recommendations, but brokers chronically argue in arbitration that violations of self-regulatory organization (SRO; for example, NASD, NYSE) rules do not give rise to a cause of action. By the same brokerage industry standard, even a solicited nondiscretionary transaction does not give rise to a broker duty to monitor a client securities position after it has been acquired. By contrast, under formal discretionary agreements, a broker, exercising formal discretion, will construct a portfolio of securities positions in keeping with the investment objectives, needs, and risk tolerance of the client.

Managing Discretionary Funds and the Prudent Investor Act

An affliction of many money managers is a preoccupation with the buy decision. Advice and strategies abound on the topic. Over the past decade alone, Wall Street has been taken to task by state attorneys general, academia, and professional investment publications for a dearth of sell recommendations, focusing too frequently on the next transaction rather than the management of an investment portfolio. Many investment houses were loathe to recommend to clients that a particular security should be sold from a portfolio—some even refused to issue a sell research rating on a security for fear of jeopardizing underwriting or corporate finance business with the underlying issuers. It is one reason why brokers are not infrequently characterized as "used stock salesmen" rather than money or wealth managers.

An investment manager assumes a heavier mantle of fiduciary responsibility that is necessarily continuous. Unlike the transient responsibility of a recommending broker servicing a nondiscretionary client account, it does not arise like a phoenix with each new transaction, expiring thereafter. It is, instead, explicitly continuous, encompassing every investment decision—to buy, to sell, to hold—whether effected by conscious decision or by default. Fiduciaries have a duty actively to monitor and manage the portfolio, paying constant attention to its holdings and the ambient investment environment.

So-called "ostrich investing" (in which a money manager buys an asset and then puts its head in a hole in the ground, forgetting about the positions it continues to hold) is fraught with peril. Unfortunately, in this context, ostriches are not extinct. One might even suspect ostriches actually breed in certain banks, trust departments, and investment management and brokerage firms, where discretionary accounts reside.

Because it is understood that investments can appreciate or depreciate, and seldom stay the same, the standard for most fiduciary investment performance is relative to an appropriate benchmark, reflecting client investment objectives and risk tolerance.

The Standard & Poor 500 equity index is the equity benchmark most widely cited as a proxy against which the performance of client stock portfolios is measured. A fiduciary's performance, then, is not a guarantee against loss, but an expectation that the value added by active management will generate a relative out-performance by losing less or making more in any given market environment. If the fiduciary is not going to outperform a benchmark, why have active management and a management fee?

The Prudent Investor Act prescribes standards for a fiduciary's conduct that must be followed in the management of assets, unless those standards are altered by an account opening statement or a trust document so long as the alteration is not against public policy or violative of the law. Among the obligations that a fiduciary assumes when accepting an appointment to manage others' funds are

- to consider the purposes, terms, and circumstances of the investment account (client or beneficiaries);
- to use reasonable skill and caution and also to use special skills or expertise if the fiduciary has, or represents that he or she has, such skills or expertise; and
- to have an investment *strategy* with reasonably suited *risk* and return objectives.

In fulfilling these obligations, fiduciaries must consider the following, among other factors:

- economic conditions,
- inflation and deflation,
- tax consequences, and
- *preservation of capital.*

An oft-quoted maxim has it that the Prudent Investor Act is not a test of performance, but rather of conduct. Proper conduct includes actively monitoring and managing a portfolio against a constantly changing investment landscape. Proper conduct also includes having an investment *strategy*—and making investment decisions as part of that strategy. Fiduciaries may face liability when their conduct falls short of these requirements—when they fail to monitor, or act, or when

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they have no investment strategy for a portfolio. For more on fiduciary liability, see Charles E. Rounds Jr., *Fiduciary Liability of Trustees and Personal Representatives,* Tax Management Portfolio 853 (2003).

Preserving principal requires a continuous evaluation of investment risks. Fiduciary responsibility requires an assumption of risk to secure a reasonably desired return conforming to economic need and, therefore, the investment return objectives of the client. Cash in a pillow or a safe deposit box would be inappropriate, because it would assuredly be diminished by inflation. Risk, therefore, must be undertaken, but prudently. Because the nature of the decision making is continuous, so too is the fiduciary's responsibility.

Sell Strategy

Any investment strategy has an implied time horizon at the end of which the sale of the investment is expected. Consequently, any investment plan requires an exit or sell strategy.

A sell strategy must be contextual; it must take into account the backdrop of market events. It needs to be based not only on information particular to an individual security but also on industry, sector, and overall market and economic considerations. A fiduciary can no more sell a security than purchase one in isolation. For example:

- If interest rates are forecasted to rise, it may be inappropriate to retain the same number of shares of rate-sensitive stocks. Preservation of capital may dictate a reduction in portfolio exposure to such interest-sensitive positions.
- If stock X drops Z% on bad news, a disciplined response would be to reconsider the size of the position within the portfolio. Such a reconsideration should articulate a decision to retain, sell, or reduce the position.
- If a stock trails similar stocks in its sector or industry, it may be appropriate to replace it with a better-performing stock.
- If a stock falls Z% and disbursements must be made from the account, the stock may be prudently sold to raise cash or replaced with a less-volatile asset.

A fiduciary must be both active and reactive. A fiduciary must know under what circumstances it may choose to sell an investment and must have the courage to act on such convictions. Fiduciaries cannot freeze. Failure to divest a portfolio of a security whose anticipated return is not warranted by its risk is unjustifiable. The fiduciary, in the face of loss, must determine when enough is enough and sell a security if its risk is too great for the portfolio. A sell strategy, then, should be a strategy of *discipline.* "Discipline" does not mean knee jerk reaction to every untoward market event, but a considered response to unanticipated setbacks.

Particular Sales: Fact Patterns That May Justify a Fiduciary to Sell

It may be helpful to consider three types of sales, as examples, to help demonstrate the implementation of a sell strategy.

Preemptive Selling—a decision by the fiduciary to pare back or eliminate a position within a portfolio. How often has the admonition been heard: "past performance is no guarantee of future profits"? Success also breeds risk. Those stocks within a portfolio that have achieved the greatest performance have necessarily become a greater portion of it and represent a greater percentage of overall portfolio risk. This either can reflect a comparable increase of a given sector or industry as a percentage of the overall market (percentage weighting of an S&P 500 equity portfolio, for example) or can reflect superior (or fortuitous) stock selection within the client portfolio exceeding investment performance for the same sector or industry over the period. If the latter, prudence may require that market exposure of such stocks be reduced through partial sale of such positions. On the portfolio level, this is often termed "rebalancing."

Loss-cutting—a decision by the fiduciary to preserve remaining principal from further decline. If the fiduciary has not sold a position by the end of the day, he or she has effectively purchased it all over again at today's closing market price. Although the interval need not be a single day, this concept is what gives rise to the legal concept of a "second investment decision." In many states, a decision to hold is tantamount to a decision to purchase. Fiduciary responsibilities are seldom, if ever, met by default. Don't let "default" be "the fault" of a fiduciary, especially if you *are* the fiduciary. The foremost justification for loss cutting is that the parameters of the original investment decision have been exceeded. The risk that has materialized since the date and price of purchase is greater than was foreseen. Unless the altered risk/reward circumstance is comfortably understood and is attractive (read: risk justified), it may be more prudent to cut losses rather than persevere in the face of inadequately understood or identified risk.

Asset Allocation—a decision by the fiduciary to reallocate the portfolio assets, either by adopting different industry and/or sector weightings in structuring an equity portfolio—i.e., "rebalancing"—or by reallocating assets to different asset types (stocks vs. bonds, for example). Companies can change their spots. For example, imagine a long-established home improvement manufacturer (XYZ) that opened up a small chain of retail stores 10 years ago; the stores have met with considerable success, causing XYZ to become more of a retail enterprise and less of a manufacturing entity. This leads XYZ to announce a change in its corporate strategy, selling off its manufacturing business to focus attention on its retail business. A fiduciary, mindful that XYZ has changed, sells XYZ shares, replacing them with either a manufacturing company or a retail operator whose potential for appreciation are greater than XYZ's.

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A Look at Some Sell Strategies

Failure to have some kind of strategy for limiting losses and preserving principal violates the fiduciary's duties under the Prudent Investor Act. The Prudent Investor Act provides enough flexibility to the fiduciary to be immune from liability if it is taking reasonable steps to safeguard capital according to a strategy. Fiduciaries are required to have a plan—some type of strategy to guide the client's investments in good and bad times. Such a strategy is not a "wait and see approach," but a well-thought-out, pre-conceived plan of what to buy, hold, and sell under various circumstances.

It may be helpful to examine various sell strategies found in today's investment world. A cursory review of asset management firms and money managers reveals that many write extensively about their investment processes, but few actually speak to when, or under what circumstances they will sell an investment. Assuming they have a sell strategy, perhaps many choose not to write about it. Others who do write about their sell strategy do not do so at length. The following investment managers' sell strategies are listed at random, without attribution, and are for illustrative purposes only.

- *"I will sell if a stock is capping out, or if I've made my expected profit."* This particular sell strategy is results-oriented on the upside. The manager has a clear view of where it *wants* the stock to go, and where it expects the price to be. It assumes that there is an end point to holding a security—a desired value to a particular stock. When that price is achieved, the fiduciary sells the security unless additional or new information reveals the promise of an additional upside, with reasonable risk to the portfolio. This strategy, with nothing more, is incomplete. It says nothing about what action, if any, the fiduciary will take if the stock does not act as the fiduciary intends. What will the fiduciary do if the stock goes down or stays the same? What if the stock gets ahead of itself by appreciating farther and faster than what was expected? Is such appreciation cause for taking profits that seem to reflect an excess return? Or is the appreciation simply in line with changes in market or economic conditions that require a rethinking of baseline assumptions?
- *"We sell a particular security if there is a fundamental change to the company."* This type of sell strategy is hardly a strategy at all. It does not incorporate perhaps the most important aspect of an investment—value (price). What does the fiduciary do if the stock is losing money but there is no fundamental change? A fundamental change sell strategy would allow a stock to go to zero and not have it sold, as long as there are no fundamental changes to the company. A better approach, in the example of equities, is to list the criteria of why the manager purchased the stock and to sell if the criteria are not met. For example, Company JJP is expected to grow revenues by opening 100 new stores over the next six months and is expected to increase earnings by an annual rate of 15% in each of the next six quarters. If Company JJP only opens one-third of the anticipated new stores, expected earnings will be off significantly if other parts of the company do not make up for this shortcoming. Self-discipline and loss-cutting would suggest that managers should not tolerate a loss beyond a certain point (10%, 12%, 15%, 20%, for example). In the face of a falling value, at *some* point, if the investment is not turning around, a fiduciary must step in, say "enough is enough," and sell. The fiduciary must have a sober, straightforward, and sincere discussion with clients about risk tolerance. This is easier for individual investors in discretionary managed accounts than, say, for trusts. A fiduciary who manages a trust should consult with all beneficiaries and be guided by the relevant state's Prudent Investor Act. A fiduciary must not allow a stock to freefall.
- *"Stocks are sold if they become overvalued, if the fundamentals of the business deteriorate, if a better investment opportunity emerges, and/or if the size or sector weighting grows beyond our stated maximums."* This language does not inform the client of how or when a "better investment opportunity emerges." It also appears to focus on the stock going up but does not explicitly speak to what would be done if a stock stays the same or declines.
- *"[W]e maintain a strict sell discipline, seeking to protect gains by rebalancing when a stock appreciates significantly or exhibits signs of increased volatility, and to limit losses by selling on signs of deteriorating fundamentals or negative earnings surprises."* This sell strategy appears to be focused on the upside as well as the downside, including earnings. It appears to recognize that stocks may need to be sold not only when they just go up in value. Shouldn't there be a downside price target? What if a stock does not have an earnings surprise, but, for whatever reason, the stock's price is going down?

Characteristics of a Prudent Sell Strategy

Every investment purchase implicitly or explicitly contemplates an eventual sale. A fiduciary cannot be deemed to have a comprehensive investment strategy without an articulated sell strategy within it. If a sell strategy is unarticulated, it is unaddressed.

What makes a sell strategy prudent? Are there characteristics that a fiduciary may incorporate in crafting a sell strategy or determining whether the sell strategy is appropriate? How can a sell strategy be constructed to comply with a fiduciary's obligations under the Prudent Investor Act?

A fiduciary's strategies must be prospective rather than reactive. They must focus on incremental, expected return and assumed risk, not past performance. At any point, even on the heels of profitable investing and relative out-performance of valid benchmarks, there can still be too much of a good thing. Significant out-performance may necessitate

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sooner-than-anticipated execution of a sell strategy.

It is not just about making money; it is also about how long you take risks to do it. For example, if a fiduciary buys a stock, expecting it to appreciate 30% over two years, but the stock surges 20% in the first three months of holding it, the fiduciary must ask: what is the incremental return and assumed risk *from this point in time* to the end of the original investment horizon? Would adhering to the original holding period be prudent? A decision to hold the stock the remaining 21 months of the original two-year investment horizon to get the last 10% (of the original sale price) would only represent an incremental return of less than 5% annualized on the appreciated value of the stock. Absent strong expectations for the stock's performance, the failure to implement a sell strategy might constitute fiduciary negligence.

What then makes a sell strategy prudent under the Prudent Investor Act?

- *Integrated.* The sell strategy should be part of a fiduciary's overall investment strategy, reflecting its duties to preserve capital and monitor a portfolio—not an afterthought.
- *Foundational.* The sell strategy should have as its foundation a set of criteria that the fiduciary knows it must consider and watch—earnings reports, new store sales, interest rates, or other data. Criteria for each investment must be weighed and monitored.
- *Reasonable.* The decision to exit a stock should be reasonable—neither knee jerk nor slow. Reasonableness should include price or value. A fiduciary cannot be said to be reasonable if it has allowed a stock to drop, for example, 75% without taking action.
- *Realistic.* In the face of bad corporate news and earnings disappointments, many money managers could not believe the dropping stock prices in 2000 and 2001. Fiduciaries cannot be in denial of what is happening. They must be realistic.

Below are some considerations:

- *Specific News.* A fiduciary should have a list of hot button issues that are unique to, and will greatly affect, particular investments or industry sectors that the fiduciary monitors. Interest-rate-sensitive stocks like financials warrant a close watch on interest rates and actions by the Federal Reserve Board. Real estate stocks such as those of housing developers demand that interest rates be monitored, as well as economic data such as housing starts, home buyer statistics, sales of new and existing homes, and prices of raw materials and construction materials. If a company derives substantial revenue overseas, a fiduciary should be monitoring foreign currencies if the company receives payment other than in U.S. dollars or otherwise investigating whether the company has hedged its foreign contracts or accounts receivable.
- *Price Targets and Preconceived Gains.* A fiduciary should have an idea of what an investment should grow to and why. Where should the stock's price be in 12 months, in 24 months, and why? Some managers may be looking to get X% of gain from a stock, and then be done with it—selling it and placing the sale proceeds in another opportunity. An investment in a successfully growing company may allow a manager to revise an anticipated holding period and may likewise allow the manager to increase the price target, if the reward is warranted by the additional risk of holding the appreciated asset.
- *Preconceived Losses.* A fiduciary should have an idea—*some* idea, based on careful thought and analysis (a strategy)—of how much a stock can lose before it is sold. This may vary among different investments and certainly clients' risk tolerances, but there needs to be a strategy. Otherwise, a stock could fall to zero if there is no plan.
- *Avoid "Fundamental Changes" Approach.* The *"I will sell a stock if there is a fundamental change to the company"* strategy is not a prudent sell strategy. Such a thesis sounds less like the proper conduct of a prudent fiduciary and more like generic-macro-corporate speak suggested by a risk manager or policies/procedures employee who knows little about investing and even less of its obligations under the Prudent Investor Act. Investment experts should define the sell strategy—and the strategy should be based on specific criteria affecting an individual stock (and its industry sector) and price. The Prudent Investor Act is based on conduct and not performance—so have a plan. A sell strategy that would allow a stock to go to zero is not a plan. A prudent fiduciary is obligated to preserve principal, and this includes the discipline to limit losses.
- *Communication of Investment and Sell Strategies.* A fiduciary should be capable of explaining its sell strategy as easily as its buy and hold strategy. A fiduciary should also have a complete understanding of the specific criteria that are expected to affect negatively each investment's price and a clear discipline for when it will sell an investment.

An Alternative or Addition to a Sell Strategy: The Case for Hedging

There is a big difference between "being hedged" and "getting clipped."

—Anonymous

Effective hedging requires a valuation of the future, not merely an expectation about it. In the 1930s, the raging debate among pension plan fiduciaries was whether it was prudent to own stocks—at all. By the 1970s, the debate had shifted to whether it was prudent for such plans to hedge with deriva-

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tives such as options. Today, the question is not so much whether, but how, under what conditions, and in pursuit of what objectives. The prudence of hedging, versus an outright transaction in the underlying security, is always a relative valuation judgment. The tools by which to value such alternatives, however seemingly sophisticated, are not better than the soundness of the assumptions on which their use depends. And no sound assumption rests on its laurels and remains unquestioned over time.

The benchmark of risk in today's market is volatility, otherwise known as the variability of return. Just as a difference of opinion is often cited as the reason why markets trade, so too do futures markets, where expectations about future prices and the volatility of expected returns is quantified. Hedging cannot safely be employed by any fiduciary without an understanding of the critical assumptions underlying the concept and the specific assumptions entailed in applying it to a given security, sector, industry, or market.

Two things may be regarded as true in managing a portfolio at market risk: time passes and prices change. The more one is expected to dominate the other, the more one type of hedge appears more attractive than another. In markets expected to be relatively calm, the passage of time will be less rewarded by asset price appreciation.

Conversely, in markets expected to be dominated by significant price movements, such movements are expected to have a more dramatic effect on a portfolio's value than the slow and steady price creep of equities steadily offsetting inflation. In such times, a fiduciary's use of hedging may more aptly be directed to paying for downside protection rather than selling upside participation. It may be more effective to draw a line in the sand below which market risk cannot hurt a portfolio or individual sector or position rather than sell away the upside that is the ultimate justification for the risk assumed.

Hedging has the unheralded but unavoidable characteristic of forcing a decision regarding the quantification of risk and reward over a given investment/risk horizon. Such decisions can only be assumed prudently on a thoughtful and informed basis, but they offer the advantage of gauging the merit of the decision based on identifiable parameters and timeframes. A discipline arises from an understanding of the moving parts that need to be considered. Indeed, one benefit from considering hedging alternatives is a more finely articulated rationale for either continuing to hold a position, with or without adopting an available hedge, or simply selling it. A sell strategy can only be one by virtue of such a reflective discipline.

Rather than an alternative, a companion to a sell strategy is the effective use of hedging devices. Purchasing derivatives and other hedging products to protect the downside of individual investments, sectors, or parts of a portfolio, or even the entire portfolio, is becoming increasingly common and need not be used only for large stock concentrations.

Although a thorough consideration of hedging within a portfolio is beyond the scope of this article, suffice it to say that the use of puts, calls, and options can be an important part of an investment strategy under the Prudent Investor Act. Hedging is one method available to fiduciaries to preserve principal and reduce risk. In 2006, fiduciaries who do not make at least the consideration of hedging one of a host of portfolio investment options do so at their own risk. Fiduciaries should be reasonably well versed in the costs, methods, and pros and cons of hedging.

A hedge transaction is any transaction that results in the reduction of risk. Risk reduction in itself is not an investment objective. If it were, investors would all go to T-bills. But with the passage of the Prudent Investor Act, fiduciaries understand that capital preservation is one objective—but not the only one—of the fiduciary.

Underperformance (versus long-term inflation) is one of the driving forces behind equity investment and the management of long-term assets. Hedging represents a measure, short of outright sale, that serves to adjust a perceived risk/reward relationship.

Hedging's mere availability does not compel its use any more than the cost of an insurance policy would compel buying auto or home insurance. Instead, as an investment alternative to, companion to, or part of, a sell strategy, the use of hedging instruments requires more than a nodding acquaintance with terms and definitions; it requires a mindset, a hedging mentality. That said, the use of derivative instruments, such as options, can be a prudent tool for a fiduciary. Derivatives can introduce a disciplined sell strategy by defining parameters over an investment time horizon. Hedging a long-term investment position over a near-term interim period may be prudent when the specific risk-expected events are of concern. For example, a drug company with attractive long-term expected earnings growth may be a desirable core holding for a portfolio but may nonetheless have the interim risk of an upcoming FDA approval or a trial date involving litigation over an existing product's purported side effects. Rather than sell an entire holding to avoid such specific risks, hedging offers an alternative to address the interim risks while not abandoning the otherwise attractive longer term.

Pulling the Trigger: What May Make a Fiduciary Sell?

Discipline is crucial to an effective sell strategy. Decisions to sell are more difficult, even for the veteran manager, than decisions to buy. Selling at a loss is the hardest decision of all yet the most important to ensure adherence to a strategy when things go wrong.

What red flags exist that may make a manager sell or begin to think about selling—or at least question his or her original thesis for purchasing an investment? What would cause a money manager to refrain from purchasing additional shares, sell some shares, or sell an entire position? Below are some examples that may cause a manager to monitor a position with heightened sensitivity, perhaps justifying a sale.

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- *Cautionary Announcements.* "On a conference call with analysts this morning, the CEO of the ABC Company announced that overseas revenues are expected to slip for the current quarter and the next quarter. This would not have an effect on overall earnings for the quarter or the year, said the CEO, who reiterated that the company's projected earnings numbers are still in line with the street's expectations." (So-called "growth" investors generally seek to invest in companies whose growth prospects (earnings) are greater than its peers, its industry or sector, or the overall market. Often, a growth company's expected increased earnings are built into a higher share price. If earnings disappoint, support for a stock can be lost. If increased earnings were fueling the increasing stock price in the past, and now earnings are not as desired, managers must re-examine the risk-return for that security.)
- *Earnings Warnings.* "The CEO of the ABC Company announced today that it did not believe the company would meet analyst's earnings expectations of 45 cents a share for the current quarter, due in part to slower-than-expected growth at its new products division. The slower growth was blamed on the hurricanes of last year. The company is adamant, however, that it is still on track to make its earnings target for the entire year."
- *Earnings Disappointments.* "The CEO of ABC Company, in speaking with analysts today, announced that this quarter's earnings came in shy of analysts' expectations. Although the street was hoping for 45 cents a share, ABC earned 40 cents a share, off more than 10%. The CEO, disappointed with the quarterly performance, believes that the fiscal year targets will still be reached because of its service department, which has been experiencing amazing growth."
- *"Growth Engine" Sputters.* "The service department of ABC Company, once the engine that was responsible for driving the company's earnings and stock price up exponentially, is slowing down. The CEO of ABC held a press conference today to announce that the super-growth service department was experiencing 'super growth but not like it has enjoyed in the previous two years.' The revised growth rate and expected earnings numbers of the service department caused analysts to revise their numbers for the entire ABC Company to new levels. The CEO also took time to try to support its lagging stock price, which has been decidedly downward for the past three months, on heavy volume, well below the moving 200-day average."
- *Corporate Reshuffling.* "The ABC Company announced today that its CEO had resigned in a desire to spend more time with her family. This comes two weeks after we know the CFO left ABC 'to pursue other opportunities.'"

Conclusion: The Prudent Investor Act—It's Not Just for Buying Anymore

Fiduciaries are obligated—indeed they *agree*—to invest prudently according to their state's form of the Prudent Investor Act and other rules of fiduciary conduct. The governing instrument, such as a trust or account opening document, may alter these rules if properly disclosed, assented to, and not against public policy.

A fiduciary agrees to comply with some of the highest standards and most rigorous duties imposed by the law. Inherent in a fiduciary's duties are the obligations to preserve principal, monitor the account on an ongoing basis, and limit losses. Indeed, diligent monitoring is a fundamental principle of sound management. Management is not merely about what to buy but includes sound and reasoned analysis on what to hold and what (and when) to sell.

Although many fiduciaries choose, for whatever reason, to focus on the purchasing of securities, it is mandatory that great attention be given to monitoring a portfolio and having an articulated plan for limiting losses—a sell strategy.

A fiduciary's approach to selling investments should be an integral part of the fiduciary's investment thesis—his or her required *strategy.* Members of investment and oversight committees within corporate fiduciaries should have a clear understanding of a sell strategy as well as the risk tolerance of a particular client. The committees, along with the individual portfolio managers and account administrators, should provide the ongoing oversight to ensure that the Prudent Investor Act and regulatory duties are being satisfied. These committees, administrators, and portfolio managers should be monitoring the accounts and questioning losses.

A fiduciary's sell strategy under the Prudent Investor Act may be thought of as "the three Ds"—duty, diligence, and discipline. A fiduciary must recognize its *duty* to preserve principal and have a course of conduct that effectuates a reasonably prudent investment strategy based on risk and return. A fiduciary must have the *diligence* to be vigilant and to monitor, on an ongoing basis, individual investments, industry sectors, and the myriad investment, financial, and nonfinancial factors that affect the value of investments. Finally, a fiduciary must have the *discipline* to act on its convictions and to exercise care in the conduct of investment decision making that it has promised to others, and that is required under the Prudent Investor Act. It is not possible to satisfy the burden of fiduciary responsibility without a sell strategy. ■

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