Trustees should be aware that investing in fund of funds (FoFs) potentially can result in a lack of diversification—the opposite of what they are trying to achieve through this strategy. The authors explain some of the pitfalls of FoFs and review several court cases involving fiduciary responsibility to diversify.

Defending Trustees Against Failure to Diversify Claims

by Jonathan M. Cerrito and Michael R. Daum

Touted as a tool for diversification, fund of funds (FoFs) investment strategies have a flip side that multiemployer plan trustees need to be aware of. This is true regardless of whether trustees delegate investment authority to an investment manager,[1] share fiduciary responsibility with an investment consultant or retain sole responsibility for all investment decisions.

FoFs generally achieve greater diversification of assets because they reallocate a plan's capital among a portfolio of underlying funds. Risk is spread among a larger base of investments than the plan would otherwise hold.

However, overlapping may occur where FoFs duplicate ownership of the same security or use the same investment manager through several different portfolio funds.

Given the difficulty of tracking an FoF's overall holdings, overlapping may not be easy to detect, and the potential for underlying investment manager duplication may not be apparent without due diligence that runs through the portfolio funds. When

overlapping occurs, years of established case law and guidance—and particularly the double-edged sword of the ultimate investment rule: Diversify to minimize risk—may take on a new light in defending trustees against investigations and claims brought by the U.S. Department of Labor (DOL) for failure to diversify. This article provides a framework of how the diversification rules of the Employee Retirement Income Security Act (ERISA) of 1974, as amended, apply to FoFs.

What's an FoF?

An *FoF* is an investment strategy to hold a portfolio of other investment funds rather than investing directly in stocks, bonds or other securities. There are different types of FoFs including fund of hedge funds, fund of venture capital funds, private equity fund of funds and mutual fund of funds. A fund of hedge funds, for example, will invest in a portfolio of other hedge funds with the underlying portfolio choices selected by the FoF's investment manager. In turn, each portfolio hedge fund may have several underlying investment managers.[2]

FoFs generally are structured as limited liability partnerships comprised of a general partner, who manages day-to-day operations and is usually the investment manager, and limited partners.[3] The general partner conducts due diligence on potential investment fund candidates and selects the menu of underlying investment funds. Underlying investment funds within an FoF may have multiple investment managers, and the general partner does not necessarily conduct due diligence on each of them. Plans investing in the partnership become limited partners. In exchange for a capital commitment, limited partners have the right to share in the partnership's income and profits (known as an *interest*).

Who Is the Responsible Fiduciary?

FoFs may or may not be structured as a vehicle that holds plan assets subject to ERISA. Some FoFs are designed to avoid holding plan assets and thus refuse to accept ERISA fiduciary responsibility. In these cases, unless the investment is made by or upon the recommendation of an ERISA fiduciary,[4] trustees remain solely responsible for the investment of plan assets and directly liable for any breach of ERISA's duty to diversify those assets. When investing in FoFs whose general partner accepts ERISA fiduciary status as an *investment manager*,[5] trustees are relieved of liability for acts or omissions of the general partner including any failure to diversify assets of the FoF.[6]

Regardless of whether trustees retain the responsibility for investing plan assets, share responsibility with an investment consultant or delegate discretionary authority to an investment manager, it remains prudent practice for trustees to monitor the diversification of plan assets. This prevents trustees from potentially being held liable for a breach of their continuing duty to monitor the appointment of the investment manager in the case where the manager breaches the duty to diversify. In this regard, trustees may remain liable if continuing the appointment of an investment manager violates ERISA's general duty of prudence.[7] Trustees often hire investment consultants, in part to advise on the selection and continued appointment of a particular investment manager.

Overview

Under ERISA, fiduciaries have a duty to diversify investments so as to minimize the risk of large losses, unless it is clearly prudent not to do so.[8] In a court challenge, if DOL can show that the portfolio, on its face, is not diversified, then the fiduciary will be required to show that it was "clearly prudent" not to diversify in order to escape liability.[9] Whether the portfolio is diversified or nonetheless clearly prudent is "analyzed from the perspective of what both parties acknowledge as their purpose; to reduce the risk of large loss,"[10] and is "evaluated at the time of the investment without the benefit of hindsight."[11]

Despite its diversification requirement, ERISA provides no further guidance as to the proper allocation of assets or even what constitutes large losses. Furthermore, because a prudent fiduciary must consider the particular facts and circumstances, the requirement to diversify cannot be stated as a fixed percentage.[12] Courts assessing ERISA's diversification requirement do so on a case-by-case basis.[13]

Courts, DOL and academia generally accept modern portfolio theory as the investment industry standard by which to judge a fiduciary's investment decision.[14] Specifically, since 1979, DOL has used modern portfolio theory to assess "the role the investment . . . plays . . . in the plan's investment portfolio" and *"[t]he composition of the portfolio with regard to diversification."*[15] Case law, as sparse as it is, is to the same effect. According to modern portfolio theory:

> [I]nvestors appropriately measure risk and return as the combined risk and return profile of a portfolio of investments, and not the risk/return characteristics of an individual security included in the portfolio. Because investment returns on different assets are not perfectly correlated with each other, a portfolio of investments is less risky than the average risk of the individual investments. In fact, seemingly risky securities may be portfolio stabilizers and actually may lower the risk of the overall portfolio. *Thus, according to modern portfolio theory, diversification among a variety of assets is an important means to control portfolio risk.*[16]

As such, the diversification requirement should be analyzed based on investments as a whole and not whether a specific investment (assuming the plan has more than one) is diversified.[17] In this regard, a fiduciary should consider:

- The purpose of the plan
- The amount of the plan assets
- Financial and industrial conditions
- The type of investment, whether mortgages, bonds or shares of stock or otherwise
- Distribution as to geographical location
- Distribution as to industries
- The dates of maturity.[18]

Ultimate Investment Rule

Whether plan assets are sufficiently diversified is determined by examining the ultimate investment of the assets.[19] For example, for efficiency and economy plans may invest all of their assets in a single bank or other pooled investment

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fund. Congress intended that, in this case, the diversification rule be applied to the plan by examining the diversification of the investments in the pooled fund.[20]

DOL has applied this concept in guidance pertaining to investments of a large percentage of plan assets into a single collective investment fund. In the case of a fiduciary investing in a limited liability partnership, all underlying investments *of* the partnership—rather than the investment *in* the partnership—should be considered the investments of the plan for ERISA diversification purposes.[21] This is important because most FoFs are organized in this fashion, and when assessing the diversification of a plan's investment in an FoF, or the overall diversification of the FoF itself, DOL and courts will look at the underlying investments of the plan or FoF.

At first glance, it would appear that the ultimate investment rule would shield fiduciaries who invest a large percentage of plan assets in a single FoF. This would generally be the case, because for diversification purposes the rule instructs courts to observe the underlying investments of the FoF in addition to any other plan investments. If, however, a fiduciary invests in an FoF with overlapping, undiversified underlying investments, which potentially overlap further with non-FoF plan investments, the ultimate investment rule could instead lead to a breach of the fiduciary duty to diversify.

In *Bruner v. Boatment's Trust Co.*, the court rejected a fiduciary's argument that an investment of between 77% and 91% of the plan's assets into a single guaranteed investment contract (GIC) should be deemed diversified under the ultimate investment rule, even though underlying assets of GICs are generally diversified.[22] The court instead used the ultimate investment rule as a sword, finding a lack of proper diversification because the underlying investments of the GIC were concentrated in low-quality junk bonds.[23] The fiduciary was put on notice that the underlying investments were not diversified.[24] The fiduciary was ordered to pay to the plan the difference between the performance of the portfolio and the hypothetical results that the plan would have achieved had its assets been properly diversified.[25]

Clearly Prudent Not to Diversify

Failure to diversify plan assets is not a breach of fiduciary duty under ERISA when such failure is clearly prudent.[26] The legislative history makes clear that the phrase *clearly prudent* is not intended to infer a more stringent standard of prudence than that normally associated with plan investments.[27] Instead,

> by using this term it is intended that in an action for plan losses based on breach of the diversification requirement, the [DOL's] initial burden will be to demonstrate that there has been a failure to diversify. The [fiduciary] then is to have the burden of demonstrating that this failure to diversify was prudent.[28]

Although Congress encourages diversification, the law recognizes that it may be prudent, under certain circumstances, not to diversify investments.[29] In determining whether the fiduciary acted prudently, courts look at the totality of the circumstances.[30] Generally, a court will find that it was clearly prudent not to diversify when the fiduciary can show that the overweight investment did not create an undue risk of large loss relative to the needs and risk appetite of the plan. In addition, important factors often include the fiduciary's expertise and knowledge of the particular investment and a general inquiry into whether the fiduciary acted in the same manner as an objectively prudent investor would in the same situation.

In some cases, courts have found that a seemingly undiversified portfolio was nonetheless clearly prudent under the circumstances. In *Etter v. J. Pease Construction Co.*, an investment of 88% of the plan's assets into an industrial real estate venture was clearly prudent.[31] The court stressed how one of the trustees had past successful experience in the local real estate market and, while the other investing trustees were not "sophisticated investors," they too had some knowledge of and experience in the local market.[32] Further, it was noted that all of the trustees conducted careful research into the venture, which included visiting the site, inquiring with local developers and considering other area properties.[33] Finally, although courts are directed to focus only on what was known to the trustees at the time of the investment without the benefit of hindsight, the court appeared influenced to some degree by the fact that the trustees sold the plan's interest in the property 18 months after purchase, obtaining a 97% return on the investment.[34]

Similarly, in *Jones v. O'Higgins*, an investment manager's investment of over 90% of the plan's assets into just three stocks was clearly prudent.[35] The manager followed an aggressive, yet established in the industry, contrarian strategy, in which he would invest in large corporations at or near their all-time lows.[36] The court noted that the trustees were aware of and approved the strategy before hiring the manager and throughout his tenure.[37] Further, the manager was able to provide a "thorough and well[-]reasoned rationale" for his choice of the particular three stocks.[38] Finally, the court noted that the manager testified that two of the three stocks had risen greatly in value since the date the manager was relieved of his duties by the trustees.[39]

However, maintaining an undiversified portfolio that is nonetheless *clearly prudent* is not easy. For instance, in *Meyer v. Berkshire Life Insurance Co.*, a fiduciary breached the duty to diversify when he invested 90% of the plan's assets into "conservative income products."[40] This approach resulted in a rate of return around just 3% during a 14-year span.[41] The investment was not clearly prudent because experts stated that even the most extremely conservative prudent portfolio would invest only 80% of its funds in such conservative products. At no time did the fiduciary conduct an analysis with regard to the participants' goals, ages, assets or liabilities to determine the appropriate type of portfolio to match their specific needs.[42]

Likewise, in *Brock v. Citizens Bank of Clovis*, investment of nearly 82% of the plan's assets in six mortgages secured by commercial property primarily located in a single county was not clearly prudent.[43] Even though each loan standing alone was prudent, taken together, the investments were not clearly prudent; an economic downturn in the area could severely affect repayment of the loans and the value of the security backing them.[44] In addition, there was no secondary market for the loans, so it would have been difficult for trustees to get out of the investments if their value dropped or trustees needed capital to take advantage of better opportunities.[45]

Conclusion

In the context of FoFs, trustees do not violate ERISA's diversification rule solely by investing a significant portion, or even all, of a plan's assets into a single FoF. However, the fact that FoFs generally hold a portfolio of underlying funds that hold a diversified portfolio of securities is by itself insufficient to satisfy the requirement; the inquiry will focus on the specific FoF at issue.

Although there are varying degrees of accountability depending upon whether trustees delegate, share or retain investment responsibility, trustees should monitor the holdings of portfolio funds and the identity of portfolio managers, either themselves or through an investment consultant, to avoid the duplication of investments and investment entities. This would include an investigation of the FoF and its underlying investments to assure that there is not significant overlap and to match the investments to the goals of the plan. However, given the crossroads of protecting proprietary information and fiduciary obligations, FoFs and portfolio funds may resist disclosure. At best, this information may not be available in real time. Caution should be exercised if such information cannot be obtained.

Assuming the ability to obtain such information, trustees must pay particular attention to make sure that the underlying assets are not overlapped, either by themselves or in combination with the plan's other investments, to the point of being undiversified. While a lack of diversification can be obvious in cases where portfolio funds hold large portions of the same security, trustees—through investment consultants—should dig deeper. For example, overlapping holdings of the same type of security, such as stocks in the same industry, short-term bonds or similar mortgages, may result in the FoF failing to be properly diversified. Likewise, an FoF may not be diversified if the underlying funds' assets overlap in a more abstract way, such as by containing too many "conservative" or "risky" investments, or by having too much exposure to a particular fund manager or enterprise. Any concerns can be alleviated by making sure that the FoF is invested in portfolio funds that have a variety of investment strategies and underlying holdings.

At the same time, it is important for trustees to establish a second line of defense to a diversification challenge by making sure that the investments concerning the FoF are clearly prudent. Although this inquiry depends on the surrounding circumstances, it is always important that any risks pertaining to the FoF investment are addressed with due diligence and looked at in relation to the objectives of the plan. It is incumbent on trustees to have proper knowledge about any investment decision, especially in the context of FoFs. In addition, trustees should obtain as much information about the funds and their underlying investments as possible, not only to prevent overlapping, but also to be assured that the investments are proper considering the goals of the plan. While a risky investment may be better absorbed by a plan that does not anticipate distributions for a long time, the same investment may not be prudent if the plan is required to make distributions in the near future or is underfunded. **B&C**

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Endnotes

1. Within the meaning of Section 3(38) of the Employee Retirement Income Security Act of 1974, as amended.
2. Total assets in funds of funds reached a peak of $1.4 trillion in the second quarter of 2008 and stood at $913 billion in the first quarter of 2010. Today, funds of funds account for approximately 40% of all assets invested in hedge funds. Stan Luxenberg, "Hedge Funds Struggle Amid Manager Scandals," *TheStreet*, June 8, 2010, www.thestreet.com/story/10775197/2/hedge-funds-struggle-amid-manager-scandals.html.
3. FoFs may also be organized as limited liability companies (LLCs). If the fund uses an LLC structure, accepted investors are referred to as *members* and the entity that manages the LLC is the *managing member*.
4. Such as an investment manager or investment consultant.
5. Within the meaning of ERISA §3(38).
6. See ERISA §§405(d) and 402(c)(3).
7. ERISA §405(c)(2)(A).
8. 29 U.S.C. §1104(a)(1)(C), ERISA §404(a)(1)(C).
9. *In Re Enron Corporation Securities, Derivative & ERISA Litigation,* Civil Action No. H-01-3913 (September 30, 2003) (quoting *Metzler v. Graham,* CA-5 (1997), 112 F.2d 207, 20 EBC 2857 (5th Cir. 1997)).
10. Id.
11. Id.
12. H.R. Rep. No. 93-1280, 93rd Cong., 2nd Session at 304-305 (1974).
13. *Brock v. Citizens Bank of Clovis,* No. Civ. 83-1054 BB, 1985 WL 71535 at *3 (D.N.M. 1985), aff'd, 841 F.2d 344 (10th Cir. 1988).
14. *DiFelice v. Fiduciary Counselors, Inc.* 398 F. Supp.2d 453, 467 (E.D. Va. 2005).
15. Id. (quoting 29 C.F.R. §2550.404a-1).
16. *DiFelice* at 467 (emphasis added).
17. *Young v. General Motors Investment Management Corp.*, 46 EBC (BNA) 2278, 2009 U.S. App. LEXIS 9792 (2d Cir. 2009). Note, however, that the requirement may be analyzed only as to the specific investments of a particular fiduciary in the case where that fiduciary is responsible only for plan assets that are not interchangeable with assets controlled by other fiduciaries in separate funds. *GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc.*, 895 F.2d 729 (11th Cir. 1990).
18. H.R. Rep. No. 93-1280, 93rd Cong., 2nd Session at 304-305 (1974).
19. Id.
20. Id.
21. Advisory Opinion 81-13A (January 16, 1981). Note that DOL has also issued opinions stating that the ultimate investment rule should apply when assessing the diversification of mutual funds, real estate investment trust and guaranteed investment contracts. See Advisory Opinion 78-30A (December 7, 1978); Advisory Opinion 75-93 (November 4, 1975); and Advisory Opinion F-2980A (March 4, 1985).
22. 918 F. Supp. 1347, 1354 (E.D. Mo. 1996). The percentage of plan assets invested in the contracts fluctuated as a result of required contributions and distributions that were paid into and from the remaining plan assets. Id. at 1352. For the majority of the period that the fiduciary was responsible for investing plan assets, the percentage varied between 87% and 91%. Id.
23. Id. at 1354.
24. Id.
25. Id. at 1355.
26. 29 U.S.C. §1104(a)(1)(C), ERISA §404(a)(1)(C).
27. H.R. Rep. No. 93-1280, 93rd Cong., 2nd Session at 304-305 (1974).
28. Id.
29. 29 U.S.C. §1104(a)(1)(C), H.R. Rep. No.

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93-1280, 93rd Cong., 2nd Session at 304-305 (1974).

30. *Brock v. Citizens Bank of Clovis,* No. Civ. 83-1054 BB, 1985 WL 71535 at *3 (D.N.M. 1985), aff'd, 841 F.2d 344 (10th Cir. 1988).

31. 963 F.2d 1005, 1008, 15 EBC 1741 (7th Cir. 1992).

32. Id. at 1011.

33. Id. at 1008.

34. Id.

35. 1989 WL 103035 at *8, 11 EBC 1660 (N.D.N.Y. 1989).

36. Id. at *2.

37. Id. at *2.

38. Id. at *8.

39. Id. at *7.

40. 250 F.Supp.2d 544. 554 (D. Md. 2003), aff'd, 372 F.3d 261 (4th Cir. 2004).

41. Id. at 553-54.

42. Id. at 554.

43. 1985 WL 71535 at *1 (D.N.M. 1985), aff'd by, 841 F.2d 344 (10th Cir. 1988).

44. Id. at *3.

45. Id. at *4.

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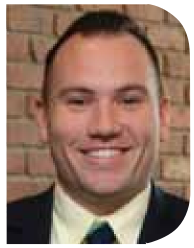

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