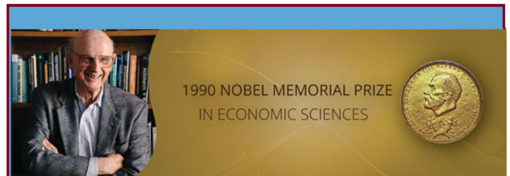
Here’s to Your Wealth

Discussions for financial health and well-being

July 2023

In 1823, John McLean died, and in his will he left $50,000 to Jonathan Amory and Francis Amory in trust. They were to loan or invest the money “in safe and productive stock, either in the public funds, bank shares, or other stock, according to their best judgement and discretion” (Harvard college v. Amory, 2022, para. 2). The income generated was to be paid to Mr. McLean’s wife, and upon her passing, the funds would be donated to Harvard College and Massachusetts General Hospital. The trustees purchased stock in incorporated manufacturing companies and insurance companies. Francis Amory, the surviving trustee, was eventually sued by both remaindermen because the accounts showed a loss.

The case worked its way up to the Massachusetts Supreme Judicial Court. In his finding, Justice Samuel Putnam wrote, “All that can be required of a trustee is, to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested”, (Harvard college v. Amory, 2022, para. 5). From this ruling was the birth of the prudent man rule. Courts have since used this ruling to ascertain whether a trustee

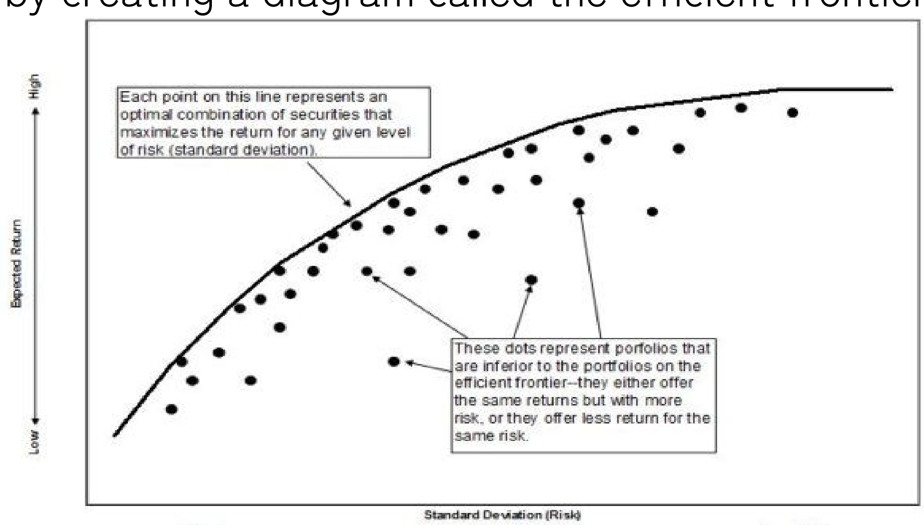


“In choosing a portfolio, investors should seek broad diversification, Further, they should understand that equities--and corporate bonds also--involve risk; that markets inevitably fluctuate; and their portfolio should be such that they are willing to ride out the bad as well as the good times.”

Harry Max Markowitz (August 24, 1927 – June 22, 2023) invested as a "prudent person" would invest his/her own money, while considering the needs of the beneficiaries, preserving the corpus and the income created.

Viewing investments this way became the standard for over 100 years, until John Burr Williams wrote *The Theory of Investment Value* in 1937. In his book, he developed the idea that investments have intrinsic value and that share prices should reflect profits. Some 20 years later, Harry Markowitz, while reading William's book, developed a thesis that would go on to change investment theory in a major way. While Markowitz agreed that intrinsic value is an important way to evaluate an investment, he began to wonder how a portfolio of investments work together. Markowitz posited that a portfolio of all railway companies is not really diversified because companies in the same industry tend to move together.

This seems obvious today, but in 1959, when Markowitz wrote *Portfolio Selection* this was an entirely new way of thinking about portfolios and diversification. Through complex mathematical equations, he was able to show that an optimal portfolio could be constructed where returns would be maximized for its given level of risk. He developed the use of standard deviation as a measure of risk. He showed that adding or removing investments impact a portfolios risk/return profile. He showed this visually by creating a diagram called the efficient frontier.



Decades later, based on Markowitz's work, the Uniform Prudent Investor Act (UPIA) was introduced to correct shortcomings of the prudent man rule. Now, an investment is judged in the context of the overall portfolio, trustees need to balance risk and return, diversification is mandatory, any investment that helps meet the goal of the trust can be considered, and investment management can be delegated to investment professionals.

While there has been debate over whether standard deviation is the appropriate measure of risk, there is no arguing that the theories and mathematical concepts that Markowitz developed has changed the way we think about portfolios (Grossman, 2023). Specifically, he developed Modern Portfolio Theory whose principles include risk and return, diversification, and correlation (Lau, 2023). For his work, Markowitz won the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel in 1990. He passed away on June 22, 2023 at the age of 95, but his legacy will continue to shape the field of investment management well into the future.

Wishing you good health and good wealth.

References

Grossman, A. M. (2023, July 2). He got us to diversify. HumbleDollar. https://humbledollar.com/2023/07/he-got-us-to-diversify/

Harvard college v. Amory. (2022, July 9). Wikipedia, the free encyclopedia. Retrieved July 24, 2023, from https://en.wikipedia.org/wiki/Harvard_College_v._Amory

Lau, J. (2023, April 26). The prudent investor rule and UPIA: Intro to trustee investing. Prudent Investors. https://www.prudentinvestors.com/blog/the-prudent-investor-rule-and-upia-intro-to-trusting-investing/

Michael St. Onge, CIMA®, CPWA®
SENIOR VICE PRESIDENT
INVESTMENT OFFICER

603.527.3234
michael.stonge@bnh.bank