DAUBERT, THE "WELL MANAGED PORTFOLIO,"AND "NET-OUT-OF-POCKET (NOP) LOSSES" ARE NOPs JUNK SCIENCE?

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Proof of damages to the satisfaction of the trier of fact is the end game for all plaintiffs. When faced with a claim of financial advisor misconduct, the investor's attorney must have the ability to not only identify possible causes of action that might provide relief, but to also develop a methodology of proving damages that will not be subject to attack as speculative or otherwise illegitimate.

This article discusses one approach to quantifying damages caused by advisor misconduct.[1] The analytical approach is grounded in the academic research surrounding Modern Portfolio Theory, which considers how a rational investor would use diversification and asset allocation to optimize their portfolio for their particular risk profile and circumstances. That portfolio is, for that individual investor, the "Well Managed Portfolio" ("WMP").[2] I conclude that when tested against the directives of the Supreme Court in *Daubert*,[3] WMP presents a sound basis for assessing damages caused by advisor misconduct, while the industry's commonly used approach

1. Under the facts of a particular case, other methods of assessing damages might be appropriate, including the damages computed based on the methodology set forth by the Uniform Securities Act (the "Act") and many state securities acts ("Blue Sky" Acts), which provides for rescission as the sole remedy. Under the Act, an aggrieved investor is entitled rescind the transactions, tender the securities to the seller, and recover the consideration paid for the securities, plus interest from the date of the payment for the securities to the date of judgment, plus costs and reasonable attorney's fees. While providing a precise monetary remedy, the Uniform Act may not place a defrauded securities buyer in the position they would have been in had the fraud not occurred, since the buyer is entitled to receive only a return of the consideration paid plus statutory interest. Had the portfolio been managed properly, the appreciation may well have been much greater than the statutory interest rate. WMP damages thus provides an alternative measure, under the right facts, for accurately determining the harm caused by advisor misconduct.

2. This damages theory is also sometimes referred to as "Market Adjusted Damages."

3. Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579 (1993).

– "Net-Out-of-Pocket Losses" – not only fails to adequately compensate the investor for their losses, it is also a methodology that ought to be precluded by any thoughtful *Daubert* analysis.

MODERN PORTFOLIO THEORY

Modern Portfolio Theory had its genesis in a paper entitled "Portfolio Selection," by Professor Harry Markowitz, published in 1952 by the Journal of Finance.[4] Markowitz mathematically demonstrated that, based on historical market returns, a diversified investment portfolio can be constructed which has a high probability of achieving a maximum possible expected return for a given level of risk. Thus, it is possible to create a portfolio to match an individual investor's risk-reward tolerance. Markowitz' findings were the basis for subsequent important findings by Merton Miller, William Sharpe, and others, which collectively came to be known as Modern Portfolio Theory ("MPT").[5]

A detailed discussion of MPT is beyond the scope of this article – or the capabilities of this author. Further, it is fair to recognize that MPT has its critics.[6] Nevertheless, while imperfect, MPT offers a serious academic and practical approach to the investment decision-making process.

In sum, MPT focuses on how to construct an investment portfolio. Securities are chosen for the portfolio based on how they interact relative to other securities, rather than on how they perform in isolation. Studies of the long-term returns and volatility (price movement) of securities have found

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4. Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77-91 (1952). Markowitz is currently a Professor of Finance at the Rady School of Management, University of California.

5. In 1990, Markowitz was awarded the Nobel Prize in Economic Sciences, along with Merton Miller and William Sharpe, for his work. *See infra* note 44.

6. Criticisms include the fact that actual financial returns do not follow a normal distribution; that correlations between asset classes are not fixed but can vary depending on external events; that MPT neglects taxes and transaction costs; that investors may not be entirely rational; and that markets are not completely efficient. The utility of MPT was also questioned during the 2008 financial crisis, in which even most diversified investment portfolios suffered significant losses. Markowitz addressed these arguments in *Crisis Mode: Modern Portfolio Theory Under Pressure,* 2 INVESTMENT. PROF., no. 2 (Spring 2009).

that a reasonably predictable range of returns can be determined for each security or classes of securities, expressed in the statistical concept of standard deviation.[7] Securities also have reasonably predicable correlations in their price movements relative to other securities, meaning that some move in tandem (a positive correlation), while others move inversely (a low or negative correlation).[8] Once these historical variables are identified for specific securities, the expected or predicted return (the reward) and volatility (the risk) of any portfolio can be estimated. Using these techniques, an advisor can construct, from the myriad of possible portfolios, a portfolio that will attempt to optimally balance the return an investor seeks with the risk the investor desire to take.[9]

One of the principal tenants of Modern Portfolio Theory is that a diversified portfolio can be constructed for every level of risk as measured by standard deviation.. Thus, investable assets are allocated amongst various categories of market investments, such as U.S. equities, foreign equities, domestic and foreign government bonds, domestic and foreign corporate bonds, domestic and international real estate, commodities, and cash. In turn, those assets should be diversified amongst various issuers within those investment categories.[10] Diversification has long been held to be a duty of a trustee or fiduciary managing assets.[11] The common cliché is to not have "all

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7. Standard deviation measures the dispersion of a set of data around the mean of the data. A "bell curve" is a graphic illustration of a normal distribution of data. With respect to measuring a security's risk, standard deviation measures the range or variation of returns around the security's average returns. In a normal distribution, approximately 68% of data falls within plus or minus one standard deviation of the mean, and 95% fall within plus or minus two standard deviations of the mean. The standard deviation of an investment can give a clue as to the risk associated with achieving its average returns. For example, the SPDR S&P 500 (SPY) had a standard deviation of 14.66, with a return of 7.69%, for the 10 years ending June 30, 2014. *See* Morningstar, *SPDR* S&P 500, http://performance.morningstar.com/funds/cef/ratings-risk.action?t=SPY (last visited Sep. 2, 2014). If that performance persists, that means that there is a 68% probability that SPY could be expected to have a return in any given year of between 6.97% and 22.35%.

8. LAWRENCE J. GITMAN & MICHAEL D. JOEHNK, FUNDAMENTALS OF INVESTING 188-95 (9th ed. 2005).

9. This is often referred to as an "efficient portfolio," which is a portfolio where no additional expected return can be gained without increasing the risk of the portfolio.

10. Gitman & Joehnk, *supra* note 8, at 204.

11. "Diversification is a uniformly recognized characteristic of prudent investment and, in the absence of specific authorization to do otherwise, a trustee's lack of

your eggs in one basket."[12] A portfolio will likely have less volatility (i.e., less extreme price movement) when the investments within it are negatively correlated, and thus individually have different price reactions to economic variables, such as inflation, world events, commodities prices, consumer spending, business investment, or unemployment rates. Indeed, studies have shown that broad asset allocation – not stock selection or market timing – can substantially reduce portfolio volatility without materially reducing returns."[13]

The extensive academic research on Modern Portfolio Theory suggests that an advisor should construct a portfolio by selecting investments that, in combination, would have the best chance of providing the highest probable reward consistent with his client's risk tolerance. To do otherwise is, at minimum, to recommend an "irrational [investment] strategy."[14] More importantly, the failure to select a portfolio consistent with a client's needs,

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diversification would constitute a breach of its fiduciary obligations. *See*, RESTATEMENT (THIRD) OF TRUSTS 229(d)." Robertson v. Central Jersey Bank & Trust Co., 47 F.3d 1268, 1275 (3rd Cir. 1995) (citation in original). "Under the duty of diversification, the trustee should not normally invest all or an unduly large portion of plan funds in a single security, or in any one type of security, or even in various types of securities that depend on the success of one enterprise." Bruner v. Boatmen's Trust Co., 918 F. Supp. 1347, 1353 (E.D. Mo. 1996). *See also*, Whitfield v. Tomasso, 682 F.Supp. 1287, 1301 (E.D.N.Y. 1988) (concentration of between 25% and 89% of the assets in one type of investment violated diversification requirement); Jones v. O'Higgins, No. 87-CV-1002, 1989 U.S. Dist. LEXIS 10537 (N.D.N.Y. Sept. 5, 1989) (putting 90% of portfolio in only 3 stocks would permit finding of lack of diversification, absent showing of special circumstances).

12. Recent vivid examples of the continuing validity of this colloquialism include those investors who where heavily concentrated in "dot com" stocks in the late 1990's, as well as those employees of WorldCom and Enron who kept all of their retirement funds in the stock of their respective companies.

13. Roger G. Ibbotson, et al., *Does Asset Allocation Policy Explain 40%, 90%, or 100% of Performance?*, FIN. ANALYSTS J., 32 (Jan. – Feb. 2000) ("our analysis shows that asset allocation explains about 90 percent of the variablility of a funds returns *over time*)(emphasis in original); Richard P. Booth, *The Suitability Rile, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW 1599, 1605-06 (1999) ("Rational investors diversify. By investing in a diversified portfolio, an investor can eliminate as much as ninety percent of the risk that goes with investing in an individual stock without any sacrifice of expected return.").

14. Booth, *supra* note 13 at 1599, 1606.

circumstances and risk tolerance may form the basis for various causes of action, including breach of fiduciary duty,[15] breach of contract, negligence,

15. Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987) ("The law is clear that a broker owes a fiduciary duty of care and loyalty to a securities investor."); *accord* RESTATEMENT (SECOND) OF AGENCY § 425 (agents who are employed to make, manage, or advise on investments have fiduciary obligations). At least 37 states also recognize that brokers owe fiduciary duties to their customers. Alabama: Chipser v. Kohlmeyer & Co., 600 F.2d 1061, 1066-67 (5th Cir. 1979); Arizona: SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp. 2d 985, 992-93 (D. Ariz. 1998); Arkansas: Greenwood v. Dittmer, 776 F.2d 785, 788 (8th Cir. 1985); California: Duffy v. Cavalier, 264 Cal. Rptr. 740 (Cal. Ct. App. 1989); Colorado: Rupert v. Clayton Brokerage Co., 737 P.2d 1106, 1109 (Colo. 1987); Delaware: O'Malley v. Boris, No. Civ.A. 15735, 1999 WL 39548 (Del. Ch. Jan. 19, 1999); Florida: First Union Brokerage v. Milos, 717 F. Supp. 1519, 1526 (S.D. Fla. 1989); Georgia: Holmes v. Grubman, 691 S.E.2d 196 (Ga. 2010); Hawaii: Unity House, Inc. v. North Pacific Invs., Inc., 918 F. Supp. 1384, 1392 (D. Haw. 1996); Illinois: Martin v. Heinold Commodities, Inc., 643 N.E.2d 734, 738, (Ill. 1994); Indiana: Holtz v. J.J.B. Hillard W.L. Lyons, Inc., 185 F.3d 732 (7th Cir. 1999); Iowa: Cunningham v. PFL Life Ins. Co., 42 F. Supp. 2d 872, 888-89 (N.D. Iowa 1999); Kansas: Denison State Bank v. Madeira, 640 P.2d 1235, 1241, (Kan. 1982); Louisiana: Beckstrom v. Parnell, 730 So. 2d 942, 948-49 (La. App. 1998); Maryland: Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 464 F. Supp. 528, 536 (D. Md. 1978); Massachusetts: Cannistraci v. Dean Witter Reynolds, Inc., 796 F. Supp. 619, 623 (D. Mass. 1992); Michigan: Davis v. Keyes, 859 F. Supp. 290, 294 (E.D. Mich. 1994); Minnesota: McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254, 1258 (8th Cir. 1984); Mississippi: Puckett v. Rufenacht, Bromagen & Hertz, Inc., 587 So. 2d 273, 279 (Miss. 1991); Missouri: Vogel v. A.G. Edwards & Sons, Inc., 801 S.W.2d 746 (Mo. Ct. App. 1990); Montana: Chor v. Piper, Jaffray & Hopwood, Inc., 862 P.2d 26, 32 (Mont. 1993); Nebraska: Woodruff v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 709 F. Supp. 181, 185 (D. Neb. 1989); New Jersey: McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750, 766 (3rd Cir. 1990); New Mexico: Reinhart v. Rauscher Pierce Secs. Corp., 83 N.M. 194, 490 P.2d 240 (N.M. App. 1971); New York: Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2nd Cir. 1999); North Dakota: Ray E. Friedman & Co. v. Jenkins, 738 F.2d 251, 254 (8th Cir. 1984); Ohio: Thropp v. Bache Halsey Stuart Shields, Inc., 650 F.2d 817, 822 (6th Cir. 1981); Oregon: Berki v. Reynolds Sec., Inc., 560 P.2d 282, 285-86 (Or. 1977); Pennsylvania: Merrill Lynch, Pierce, Fenner & Smith v. Perelle, 514 A.2d 552, 561 (Pa. Super. Ct. 1986); Rhode Island: Jonklaas v. Silverman, 370 A.2d 1277 (R.I. 1977); South Dakota: Dinsmore v. Piper Jaffray, Inc., 1999 SD 56, 593 N.W.2d 41, 46 (S.D. 1999); Tennessee: J.C. Bradford Futures, Inc. v. Dahlonega Mint, Inc., 907 F.2d 150 (6th Cir. 1990); Texas: Tapia v. The Chase Manhattan Bank, N.A., 149 F.3d 404, 412 (5th Cir. 1998); Utah: Marchese v. Nelson, 809 F. Supp. 880, 894 (D. Utah 1993); Vermont: Jarvis v. Dean Witter Reynolds, Inc., 614 F. Supp. 1146, 1150 (D. Vt. 1985); West Virginia: Baker v. Wheat First Secs., 643 F.

or fraud.[16] Moreover, under applicable regulatory directives, a broker has a duty to determine each client's individual risk tolerance before recommending a securities transaction.[17]

Using the precepts of Modern Portfolio Theory leads to a portfolio that is, in theory, suitable and appropriate for an investor. That portfolio has the diversification and asset allocation that, based on historical data and statistical analysis such as standard deviation, would be expected in the future to have risk and return characteristics that are consistent with that individual investor's particular risk profile and circumstances. That portfolio is, for that individual investor, the "Well Managed Portfolio" ("WMP").

There is, however, no singular "right" portfolio, to the exclusion of all others. Given the myriad of investing options, the precepts of MPT can be accomplished using various investment vehicles to supply the diversification and asset allocation required to meet an investor's needs. What MPT does teach, however, is that a portfolio can be the "wrong" portfolio for an investor. For example, if an investor's profile suggests that a portfolio of roughly 60% bonds, 35% equities, and 5% cash is likely to comport with that investor's risk tolerance and income needs, a portfolio of 95% equities and 5% cash is almost certainly unsuitable and inappropriate.

CASE LAW SUPPORT FOR A BENCHMARK "WELL MANAGED PORTFOLIO"

Since the Supreme Court's 1987 decision in *Shearson/American Express Inc. v. McMahon*,[18] the overwhelming majority of disputes between individual investors and their stockbrokers have been resolved by compulsory arbitration, now conducted by the Financial Industry Regulatory Authority (FINRA). The decisions reached by arbitration panels, though publicly available, do not generally give a written rationale for the decision,

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Supp. 1420 (S.D. W.Va. 1986); Wisconsin: Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208, 212 (7th Cir. 1993).

16. Robert C. Port, *Theories of Stockbroker and Brokerage Firm Liability*, 9 GA. BAR J., no. 5, at 12 (2004).

17. FINRA Rule 2111 requires, in part, that a broker-dealer or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile."

18. 482 U.S. 220 (1987).

and are final and not subject to appeal or judicial review except in very limited circumstances.[19] Nor do such arbitration awards have the precedential value of a court decision.[20] As a result, the development of the law in this area has been stagnant, since it is not subject to the continued refinement, analysis, and appellate review that would otherwise have occurred in litigated claims.[21]

Nevertheless, case law as it was developing before *McMahon* certainly foreshadowed the concept of damages based upon comparison to a Well-Managed Portfolio ("WMP"). More importantly, settled law respecting computation of damages unquestionably supports the use of WMP in assessing the damages caused by an advisor's misconduct.

The seminal case is the Second Circuit's decision in *Rolf v. Blyth Eastman Dillon & Co., Inc.*[22] *Rolf* involved a claim that defendant's broker purchased unsuitable securities which rapidly deteriorated in value. With respect to the proper calculation of damages, the Second Circuit directed that the district court should first compute the "gross economic loss" suffered by "subtract[ing] the value of the portfolio on the date when [misconduct ended] . . . from the value on the date when [misconduct started]. . . . The district court should then reduce Rolf's gross economic loss by the average percentage decline in value of the Dow Jones Industrials, the Standard & Poor's Index, or any other well recognized index of value, or combination of

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19. *See*, *e.g.*, 9 U.S.C. § 10 (setting forth grounds vacating an arbitration award); B.L. Harbert Int'l v. Hercules Steel Co., 441 F.3d 905 (11th Cir. 2006), in which the Eleventh Circuit made it clear that it was issuing notice and warning that it is "ready, willing, and able to consider imposing sanctions" on "those who attempt to salvage arbitration losses through litigation that has no sound basis in the law applicable to arbitration awards." *B.L. Harbert Int'l* at 914.

20. *See*, *e.g.*, El Dorado Technical Servs., Inc. v. Union General de Trabajadores de Puerto Rico, 961 F.2d 317, 321 (1st Cir. 1992).

21. "The lack of new cases that would further develop a standard for unsuitable recommendation liability is because almost all unsuitability claims are heard in arbitration." Estate of Ives v. Ramsden, 2008 Wash. App. LEXIS 1 (2007); *see also* The Arbitration Fairness Act of 2007: Hearing on S. 1782 Before the Subcomm. on the Constitution S. Comm. on the Judiciary*,* 110th Cong. (2007) (testimony of Richard M. Alderman) ("[A]rbitrators cannot create or modify the common law. They are bound by existing legal doctrine, essentially freezing the common law of consumer transactions, denying courts the ability to develop and adapt the law.") (footnote omitted).

22. 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039, (1978), *aff'd in part and remanded*, 637 F.2d 77 (2d Cir. 1980).

indices, of the national securities markets during the period [of the misconduct]."[23] The court further recognized that if "the quality of stocks in the portfolio was such that a broad-based index would not be representative of those stocks, then [the district court] may select a more appropriate gauge, perhaps a portion of an index, perhaps a composite of indices, perhaps expert opinion."[24] Rolf thus recognized the legitimacy of "market adjusted damages" -- benchmarking a portfolio to an appropriate market index as a method of computing the damages caused by an advisor's misconduct.

The *Rolf* analysis as was followed by the Fifth Circuit in *Miley v. Oppenheimer & Co.*[25] In *Miley*, plaintiff asserted that his account had been churned.[26] The court instructed district courts to measure damages according to "how the investor's portfolio would have fared in the absence of the such [sic] misconduct."[27] The finder of fact "must be afforded significant discretion to choose the indicia by which such an estimation is made, based primarily on the types of securities comprising the portfolio."[28] The court observed that "in the absence of either a specialized portfolio or a showing by either party that a different method is more accurate," it would be "preferable" for district courts to use "the average percentage of performance of the Dow Jones Industrials or the Standard & Poor's Index during the relevant period as the indicia of how a given portfolio would have performed in the absence of the broker's misconduct."[29] The damages due plaintiff would be "the difference between what [the plaintiff] would have had if the account ha[d] been handled legitimately and what he in fact had at the time the violation ended."[30]

23. 570 F.2d at 50.

24. *Id*. at n.22.

25. 637 F.2d 318, 326-27 (5th Cir. 1981).

26. "Churning occurs when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions." Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1416 (11th Cir. 1983); *see also* McNeal v. Paine, Webber, Jackson & Curtis, Inc., 598 F.2d 888, 890 n.1 (5th Cir. 1979).

27. *Miley* at 328.

28. *Id*. (footnote omitted).

29. *Id*.

30. *Id*. at 327.

In sum, a WMP analysis is nothing more than a refined approach to the use of broad indexes to compute damages, as countenanced in *Rolf* and *Miley*. Despite the diversion of most individual investor cases to arbitration, the propriety of computing using indexes or similar benchmarks (sometimes called "market adjusted damages") has been recognized in a host of state and federal courts as appropriate methodologies for quantifying the investors' damages -- the probable value of the investor's account but for the misconduct.[31] In fact, in certain types of trustee[32] and ERISA[33] cases, there is well-established law that confirms the propriety of using this approach.

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31. Williams v. Sec. Nat'l Bank, 358 F. Supp. 2d 782 (N.D. Iowa 2005) ("stock indices are relevant to the determination of damages for mismanagement of investments or trust assets"); In re Drexel Burnham Lambert Group, Inc., 161 B.R. 902 (S.D.N.Y. 1993); In re Thomson McKinnon Sec., Inc., 191 B.R. 976, 987-88 (S.D.N.Y. 1996); *see also* Kronfeld v Advest, Inc., 675 F. Supp. 1449, 1456 (S.D.N.Y. 1987); Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1217-18 n. 13 (8th Cir. 1990); McGinn v Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254, 1257 (8th Cir. 1984); Brabham v. A.G. Edwards & Sons, Inc., 265 F. Supp. 2d 720, 725 (S.D. Miss. 2003); Laney v. American Equity Inv. Life Ins. Co., 243 F. Supp. 2d 1347, 1353-1356 (M.D. Fla. 2003); Winer v. Patterson, 644 F. Supp. 898, 900-01 (D.N.H. 1986) (plaintiff entitled to attempt to prove value of account had it not been churned), *vacated in part on other grounds*, 663 F. Supp. 723 (1st Cir. 1987); Lopez v. Dean Witter Reynolds, Inc., 591 F. Supp. 581, 589-90 (N.D. Cal. 1984); In re Rosenfeld Found. Trust, No. 1664 IV, 2006 Phila. Ct. Com. Pl. LEXIS 394, 107-09 (Phila. Commw. Ct. July 31, 2006); Scalp & Blade v. Advest, Inc., 309 A.D. 2d 219, 232 (N.Y. App. Div. 2003); Brabham v. A.G. Edwards & Sons, Inc., 376 F.3d 377, 382 (5th Cir. 2004); Dasler v. E.F. Hutton, 694 F. Supp. 624 (6th Cir. 1988); Medical Assocs. of Hamburg, P.C. v. Advest, Inc., No. CIV-85-837E, 1989 Lexis 11253, 1989 WL 75142 (W.D.N.Y. July 5, 1989) ("The proper method of calculating damages is to take the initial value of plaintiff's portfolio, adjust it by a percentage change in an appropriate index, during the relevant period, and subtract the value of the portfolio at the end of the period."); Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 773-74 (9th Cir. 1984) ("The recoverable decline in portfolio value is the difference between what [the claimant] would have had if the account ha[d] been handled legitimately and what he in fact had at the time the violation ended.") (quotations and citations omitted).

32. *See, e.g.,* LaRue v. DeWolff, Boberg & Assocs., Inc., 552 U.S. 248, 253 n.4 (2008) ("Under the common law of trusts, . . . trustees are "chargeable with . . . any profit which would have accrued to the trust estate if there had been no breach of trust.") (citing 1 RESTATEMENT (SECOND) OF TRUSTS § 205, cmt. i, § 211 (1957); 3 A. SCOTT, LAW ON TRUSTS §§ 205, 211 (3d ed. 1967)).

33. Since 1979, ERISA regulations have required that a ERISA fiduciary act as a prudent investment manager under the precepts of modern portfolio theory rather

Moreover, a WMP approach to determining damages is consistent with the legal and public policy goal of providing a proper and adequate remedy to a party injured by the actions of another. The long recognized goal of the law of damages is to place the injured party in the position he would have been in had the fraud, tort, breach of contract, or other wrong not occurred.[34] This goal is particularly appropriate when the actions of the wrongdoer harm an asset, and the legal measure of damages is the difference between what that asset is presently worth, and what it would have been worth had the wrong not been committed.[35] A WMP analysis seeks, in fact, to determine

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than under the common law of trusts standard, which examined each investment with an eye toward its individual riskiness. 29 C.F.R. § 2550.404a-1. *See generally*, Laborers Nat'l Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313, 317 (5th Cir. 1999). *See also* DiFelice v. U.S. Airways, Inc., 436 F. Supp. 2d 756, 786 (D. Va. 2006) ("ERISA requires that the prudence of selecting a particular investment be viewed in light of its contribution to the risk and return of the entire portfolio, and not in light of its individual risk."); In re Cardinal Health, Inc. ERISA Litig., 424 F. Supp. 2d 1002, 1020 (S.D. Ohio 2006) ("[A] fiduciary with investment duties must act as a prudent investment manager under the modern portfolio theory rather than under the common law of trusts standard, which examined each investment with an eye toward its individual riskiness."); Donovan v. Bierwith, 754 F.2d 1049, 1056 (2d Cir. 1985) ("[Under ERISA]The measure of loss . . . requires a comparison of what the Plan actually earned on the [investment] with what the Plan would have earned. . . . [T]he district court should presume that the funds would have been treated like other funds being invested during the same period in proper transactions."); Dasler v. E.F. Hutton & Co., Inc., 694 F. Supp. 624 (D. Minn. 1988). (Plan damages computed by reference to what would have been earned if investments had performed according to the S&P 500 Stock Index).

34. *See, e.g.,* RESTATEMENT (SECOND OF CONTRACTS) § 344(a), which states the "remedies under the rules stated in this Restatement serve to protect one or more of the following interests of a promisee: (a) his "expectation interest," which is his interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed."

35. *See* Affiliated Ute Citizens v. United States, 406 US 128, 155 (1972) (holding that plaintiff should be awarded the difference between the "fair market value of all [he] received and the fair value of what he would have received had there been no fraudulent conduct."); Levine v. Futransky, 636 F. Supp. 899, 900 (N.D. Ill. 1986) ("this Court holds that Plaintiffs suffered damages even though the investment portfolios incurred a net gain. Plaintiffs may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold.").

the expected value of the investor's portfolio, given actual market conditions, had the unsuitable or improper investing activity not taken place. WMP damages thus provide an automatic adjustment for both upward and downward market movements during the relevant time frame that is unrelated to the advisor's misconduct.[36]

Using a WMP measure of damages thus directly rebuts the argument that the damages sought are "speculative." A WMP computation necessarily takes into account the actual market risk to which the investor would have been exposed had he or she been invested in a portfolio suitable for their particular circumstances. Significantly, *Miley* rejected the argument that use of a market index would render a WMP calculation improperly speculative. Although "the inherent uncertainties of the operation of the stock market

36. "*Rolf* laid no stress on the direction of the shift of the stock market in fashioning its market adjusted damage formula, and the defendants have not advanced a reasoned basis for enabling this Court to do so. Obviously, as in *Rolf*, where the securities market is in decline over the relevant period, a decline in a plaintiff's particular portfolio is partially attributable to market forces (instead of the defendant's fraud) and the plaintiff's recovery should thus be reduced accordingly to reflect his 'actual damages.'" *Rolf*, supra, at 84. "By the same token, as in this case, where a plaintiff's portfolio declines in value notwithstanding an overall rise in the market, such plaintiff's actual injury is not limited to the simple decline in value of his securities but encompasses also damages occasioned by the failure of such securities to keep pace with the market -- as they otherwise generally would have. His compensatory recovery should therefore be augmented accordingly." *Medical Associates*, 1989 U.S. Dist. LEXIS 11253, at * 6-7. *But see* Clark v. John Lamula Investors, Inc., 583 F.2d 594, 604 (2d Cir. 1978) ("Although the facts of *Rolf* required the gross economic loss to be offset by an amount which reflected the effects of a bear market, no such offset is appropriate here. The damages in *Rolf* were for fraudulent mismanagement and there was evidence in the case that even properly managed securities would have declined in value because of market conditions. In this case, damages were awarded because appellants fraudulently induced appellee to buy unsuitable securities. Appellants will not be permitted to avoid making appellee whole merely because upon discovery of the fraud she happened to sell the securities in a declining market. Similarly, they cannot be heard to complain when making appellee whole requires them to pay out more than they received from their dealings with her."); Levine v. Futransky & E. F. Hutton & Co., 636 F. Supp. 899 (N.D. III. 1986) ("this Court holds that plaintiff suffered damages even though the investment portfolio incurred a net gain. Plaintiff may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold."). *Levine* at 900.

make exact implementation of this elementary legal theory impossible, . . . neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages in a case."[37] This conclusion is well supported in the law.[38]

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37. Miley v. Oppenheimer & Co., 637 F.2d 318, 327 (5th Cir. 1981).

38. It is well settled that any uncertainty in proving damages is resolved against the wrongdoer. "The rule which precludes the recovery of uncertain damages applies to such as are not the certain result of the wrong, not to those damages which are definitely attributable to the wrong and only uncertain in respect of their amount. . . . Where the tort itself is of such a nature as to preclude the ascertainment of the amount of damages with certainty, it would be a perversion of fundamental principles of justice to deny all relief to the injured person, and thereby relieve the wrongdoer from making any amend for his acts. In such case, while the damages may not be determined by mere speculation or guess, it will be enough if the evidence show the extent of the damages as a matter of just and reasonable inference, although the result be only approximate. The wrongdoer is not entitled to complain that they cannot be measured with the exactness and precision that would be possible if the case, which he alone is responsible for making, were otherwise." Story Parchment Co. v. Patterson, 282 U.S. 555, 562-63 (1930). *See also* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 781 (3rd Cir. 1976) ("In these cases the risk of uncertainty as to the amount of damages is cast on the wrongdoer and it is the duty of the fact finder to determine the amount of the damages as best he can from all the evidence in the case. If this were not so, [the securities laws] could be violated with impunity in any situation in which the violation does not cause out of pocket loss.") (internal citations omitted); Donovan v. Bierwith, 754 F.2d 1049, 1056 (2d Cir. 1985). ("Where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these. The burden of proving that the funds would have earned less than that amount is on the fiduciaries found to be in breach of their duty. Any doubt or ambiguity should be resolved against them. This is nothing more than application of the principle that, once a breach of trust is established, uncertainties in fixing damages will be resolved against the wrongdoer."); *Medical Associates*, 1989 U.S. Dist. LEXIS 11253 ("The defendants' contention that the use of an 'appropriate market index' . . . is overly speculative is entirely misguided. If a market index is not too speculative for purposes of reduction of a plaintiff's recovery (as in *Rolf*), the same index can hardly be too speculative for purposes of enhancement thereof. A degree of uncertainty is of course unavoidable by use of an index, but 'neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages in a case.'") (citing to *Rolf* and *Miley*).

DAUBERT AND WELL MANAGED PORTFOLIO DAMAGES

The Supreme Court's recent decisions tightening the admissibility of expert witness testimony suggest that an argument should be made that (unless statutory "Blue Sky" damages, or another recognized common law method of calculating damages are being sought), anything *other* than market adjusted damages may be improper and subject to exclusion. The *Daubert*,[39] *Kumho Tire*,[40] and *Joiner*[41] cases directed that federal district court judges should be the "gatekeepers" of evidence, and must evaluate proffered expert witnesses with a two-pronged test of admissibility to determine expert's testimony is "relevant to the task at hand" and that it rests "on a reliable foundation."[42]

For securities arbitrations, state and federal rules of evidence are inapplicable, so it is illegitimate to assert that a strict *Daubert* analysis applies.[43] However, to the extent that arbitrators should be concerned about the fairness and integrity of the arbitration process, they, too, should view with caution and suspicion damages that might properly be characterized as "junk science" or otherwise unreliable.

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39. Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579 (1993).

40. Kumho Tire Co., Ltd. v. Carmichael, 526 U.S. 137 (1999).

41. Gen. Elec. Co. v. Joiner, 522 U.S. 136 (1997).

42. *Daubert*, 509 U.S. at 584-87; *Kumho*, 526 U.S. at 141; *Joiner*, 522 U.S. at 141. Fed. R. Evid. 702 has been amended in an attempt to codify and structure elements embodied in the "Daubert trilogy." Fed. R. Evid. 702 provides that "A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if: (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue; (b) the testimony is based on sufficient facts or data; (c) the testimony is the product of reliable principles and methods; and (d) the expert has reliably applied the principles and methods to the facts of the case.

43. FINRA Rule 12604(a) ("The panel will decide what evidence to admit. The panel is not required to follow state or federal rules of evidence").

A WELL MANAGED PORTFOLIO ANALYSIS IS RELEVANT AND RELIABLE IN DETERMINING AN INVESTOR'S DAMAGES

WMP damages derived from the principles of Modern Portfolio Theory are unquestionably a relevant and reliable method of demonstrating the probable losses suffered by an investor.

First, there can be little debate that evidence proffered to address the extent and measure of financial loss suffered by an investor is "relevant" in a proceeding where an investor claims they have suffered damage by the actions of a broker or financial advisor. Under Fed. R. Evid. 401, "[e]vidence is relevant if: (a) it has any tendency to make a fact more or less probable than it would be without the evidence; and (b) the fact is of consequence in determining the action."

Moreover, a Well Managed Portfolio analysis derived from the principles of Modern Portfolio Theory is product of reliable principles and methods. In ascertaining whether expert testimony is reliable, a court can consider a number of factors, including (i) whether a theory or technique can be or has been tested; (ii) whether it has been subjected to peer review and publications; (iii) whether, in respect to a particular technique, there is a high known or potential rate of error and whether there are standards controlling the technique's operations; and (iv) whether the theory or technique enjoys general acceptance within a relevant scientific community. *See, e.g.,* Quiet Tech. DC - 8. Inc. v. Hurel-Dubois U.K. Ltd., 326 F.3d 1333, 1341 (11th Cir. 2003).

Modern Portfolio Theory is not novel or untested. Its principal theorists have received Nobel Prizes.[44] It has been subjected to decades of peer review and critique, and although thoughtful critics remain, it has been widely accepted as a viable investing strategy for managing risk and return. Thus, it has been embraced by the Uniform Prudent Management of Institutional Funds Act (UPMIFA),[45] the Uniform Prudent Investor Act (UPIA),[46] and the

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44. Press Release, The Royal Swedish Academy of Sciences (Oct. 16, 1990), http://nobelprize.org/nobel_prizes/economics/laureates/1990/press.html (last visited Sept. 2, 2014) (stating that the 1990 Alfred Nobel Memorial Prize in Economic Sciences Nobel Prize in Economic Sciences was being awarded to "Harry Markowitz . . . for having developed the theory of portfolio choice; [to] William Sharpe, for his contributions to the theory of price formation for financial assets, the so-called, Capital Asset Pricing Model (CAPM); and [to] Merton Miller, for his fundamental contributions to the theory of corporate finance."),.

45. The 1996 revisions to the UPMIFA included revisions to Section 3, entitled *Standard Of Conduct In Managing And Investing Institutional Fund*. The purpose of

Restatement (Third) of Trusts;[47] and its fundamental principals have been adopted and are used by major universities to manage their endowments.[48]

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the revisions was to "adopt[] the prudence standard for investment decision making. The section directs directors or others responsible for managing and investing the funds of an institution to act as a prudent investor would, using a portfolio approach in making investments and considering the risk and return objectives of the fund. The section lists the factors that commonly bear on decisions in fiduciary investing and incorporates the duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable. *Thus, the section follows modern portfolio theory for investment decision making.*" NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT (Draft, August 25, 2004) (emphasis added), http://listserv.fundsvcs.org/cgi-bin/wa?A3=ind0411&L=FUNDSVCS&E=base64&P=217358&B=------_%3D_NextPart_000_01C4C36C.0C86AB85&T=application%2Fmsword;%20name=%22Aug2004draft%5B1%5D.doc%22&N=Aug2004draft%5B1%5D.doc&attachment=q (last visited Sept. 2, 2014). UPMIFA has been adopted in all States except Pennsylvania, as well as the District of Columbia and the Virgin Islands. *See* LEGISLATIVE FACT SHEET - PRUDENT INVESTOR ACT SUMMARY, THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, http://uniformlaws.org/LegislativeFactSheet.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act (last visited Sept. 2, 2014).

46. The Uniform Prudent Investor Act "does not encourage irresponsible, speculative behavior, but requires careful assessment of investment goals, careful analysis of risk versus return, and diversification of assets to protect them. It gives the trustee the tools to accomplish these ends. *UPIA requires trustees to become devotees of 'modern portfolio theory*' and to invest as a prudent investor would invest 'considering the purposes, terms, distribution requirements, and other circumstances of the trust' using 'reasonable care, skill, and caution.'" PRUDENT INVESTOR ACT SUMMARY, THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, http://uniformlaws.org/ActSummary.aspx?title=Prudent%20Investor%20Act (last visited Sept. 2, 2014). (emphasis added). The UPIA thus provides that the "trustee's investment and management decisions respecting individual assets are evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." UNIFORM PRUDENT INVESTOR ACT §2 (1994), http://www.uniformlaws.org/shared/docs/prudent%20investor/upia_final_94.pdf (last visited Sept. 2, 2014). Legislative Fact Sheet - The Uniform Prudent Investor Act has been adopted in 43 states and the District of Columbia. http://uniformlaws.org/LegislativeFactSheet.aspx?title=Prudent%20Investor%20Act (last visited Sept. 2, 2014).

47. RESTATEMENT (THIRD) OF TRUSTS § 227 (1990). *See generally*, Robert J. Aalberts & Percy S. Poon, *The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 AM. BUS. L. J. 39 (1996).

NET OUT-OF-POCKET DAMAGES ARE "JUNK SCIENCE."

A favorite position of the defense bar is that an aggrieved investor should only recover their "net out-of-pocket" (NOP) losses, i.e., the difference between all sums deposited with the investment advisor, less dividends/interest received, less the ending balance of the account. A similar defense strategy is to claim that profits and losses should be "netted," so that any profits are offset against losses in the accounts.

An investor's net out-of-pocket losses are neither a reliable nor relevant basis for assessing damages because the NOP calculation fundamentally ignores the essential legal requirement of damages analysis – to place the

48. "Modern Portfolio Theory is at the heart of the investment philosophy of the [the endowment funds of Harvard and Yale] and is the foundation upon which their portfolios are constructed." Richard Brazenor, *Investing Like the Harvard and Yale Endowment Funds* (2008), ADVISOR PERSPECTIVES, http://www.advisorperspectives .com/newsletters08/Investing_Like_the_Harvard_and_Yale_Endowment_Funds.htm l (last visited Sept. 2, 2014). "Yale and Harvard divide their endowments into seven broad asset classes: domestic stocks, foreign stocks, fixed income, absolute return, private equity, real assets and cash. . . . [T]his aggressive move away from traditional assets was rooted in academic research suggesting that investors can earn a higher long-term rate of return with less risk by diversifying beyond the traditional mix of stocks and bonds." James B. Stewart, *A League of Their Own*, SMARTMONEY MAG., (Sept. 26, 2007). While it is true that some of these endowments suffered significant losses in the 2008 financial crises, those losses were arguably due to a change in investment philosophy by those endowments that altered the Modern Portfolio Theory approach. *See, e.g.*, CENTER FOR SOCIAL PHILANTHROPY TELLUS INSTITUTE, EDUCATIONAL ENDOWMENTS AND THE FINANCIAL CRISIS: SOCIAL COSTS AND SYSTEMIC RISKS IN THE SHADOW BANKING SYSTEM, A STUDY OF SIX NEW ENGLAND SCHOOLS, (2010), http:/www.tellus.org/publications/files/endowmentcrisis.pdf (last visited Sept. 2, 2014) (suggesting that by "embrac[ing] a ***new model*** of investing that relies on radical diversification of endowment portfolios into illiquid, riskier asset classes: private equity and venture capital, hedge funds, and various "real assets," such as oil, gas, and other commodities, private real estate and timberland. . . . endowment managers generated high returns for a time—but at the cost of intensifying colleges' exposure to the rampant volatility of the global capital markets.") (emphasis added); THE YALE ENDOWMENT MODEL OF INVESTING IS NOT DEAD, KEATING INVESTMENTS, LLC (2009) (arguing that "the melt down at certain endowments had nothing to do with purported flaws in modern portfolio theory. Instead, the breakdown was caused by a failure to model for truly extreme events.") http://bdcv.com/wp-content/uploads/2011/08/Yale_Endowment_Model_is_Not_ Dead.pdf (last visted Sept. 2, 2014).

injured party in the position they would have been in "but for" the wrongdoer's misconduct. Every investor is seeking whatever level of return is suitable for them – from the elderly widow whose level of risk merits only bank CD investments to the Gen-X investor who purchases to highly risky start-up IPOs. Certainly, if all of the interest earned on the CDs was lost due to an advisor's malfeasance, there could be little serious debate that a full recovery would be not only the principal CD investment, but the expected interest as well. Losses sustained in equity, bond, or other investments due to advisor misconduct should be subject to the same damages analysis. Benchmarking actual returns to a Well Managed Portfolio will identify any capital appreciation and income the investor would have enjoyed "but for" the advisor's defaults. ***In sum, the NOP calculation fails to acknowledge the fundamental reason people invest – to attempt to secure a return on principal***. Instead, the NOP analysis wrongly asserts that a return ***of*** principal is a sufficient remedy.

Courts have rightly rejected NOPs as a legitimate basis for computing damages. As one court has observed with respect to a claim that profits and losses should be "netted," (which would return the investor only their net out-of-pocket damages) "[i]f the . . . methodology espoused by [the brokerage firm] were adopted, it could serve as a license for broker-dealers to defraud their customers with impunity up to the point where losses equaled prior gains."[49] Another court pointedly observed that such defense claims can rightly be characterized as "low risk larceny," where "heads the dishonest broker-dealer wins and tails everyone breaks even."[50]

If the measure of damages were NOPs, a broker's misconduct would be excused as long as the ending net value of the account did not fall below the amount originally invested.[51] No brokerage firm, bank, insurance company or other financial institution would, if they (rather than the public investor) suffered damage, accept an analysis that rejected any possibility that they

49. Kane v. Shearson Lehman Hutton, Inc., 916 F.2d 643, 646 (11th Cir. 1990). *See also* City of San Jose v. Paine Webber Jackson & Curtis Inc., No. C 84-20601, 1991 WL 352485 , 1991 U.S. Dist. LEXIS 8318 (N.D. Cal. June 6, 1991) ("The cases seem to indicate, however, that the securities laws do not limit a plaintiff's recovery to mere out of pocket losses…").

50. *Miley*, 637 F.2d at 332 (5th Cir. 1981) (citing STUART C. GOLDBERG, FRAUDULENT-DEALER PRACTICES, § 6.5 (1978)) (damages for churning).

51. *See* Davis v. Merrill Lynch, 906 F.2d 1206, 1218 (8th Cir. 1990) ("securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested.").

would have enjoyed a return on invested capital. Such a methodology for assessing damages not only is violative of the fiduciary duties owed by a broker to his customer, and fails to place the investor in the financial position they would likely have been in but for the broker's misconduct, but it also severely undercuts the deterrent purposes served by the securities laws.[52] If anything, those whose dispute the legitimacy of a WMP analysis based on MPT are advocating that the fact finder accept "junk science."[53]

USING MODERN PORTFOLIO THEORY AND THE WELL MANAGED PORTFOLIO TO PROVE DAMAGES.

Rolf, *Miley*, and their progeny approved the use of appropriate stock market benchmarks, such as the Dow Jones Industrial Average or the S&P 500, to determine damages caused by investment advisor misconduct. Modern Portfolio Theory, which was in its infancy when *Rolf* and *Miley* were decided, can be used to develop one or more hypothetical Well Managed Portfolio. Once an investor's level of risk tolerance is established, a portfolio can be logically and fairly constructed to effectively allocate the assets and diversify the investments consistent the investor's risk profile..[54] The WMP

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52. In *Randall v. Loftsgarden*, 478 U.S. 647, 664 (1986), the Supreme Court rejected a netting analysis based on the deterrent purpose of the securities laws: "This deterrent purpose is ill-served by a too rigid insistence on limiting plaintiffs to recovery of their 'net economic loss'." *See also City of San Jose,* 1991 WL 352485 at *3 ("The cases seem to indicate, however, that the securities laws do not limit a plaintiffs recovery to mere out of pocket losses."); Levine v. E. F. Hutton & Co., 636 F. Supp. 899 (N.D. III. 1986) (Gains in an account cannot be used to offset the losses where there is a breach of fiduciary duty or a fraud).

53. "In view of the widespread acceptance - by courts, fiduciaries, legal scholars, finance researchers, and the financial communities themselves - of market-adjusted damages and/or the use of indices or similar benchmarks for evaluating performance, it is the industry's defense which should "properly be viewed with skepticism" and which should have to undergo the trials of a *Kumho Tire* challenge, especially in the context of fraud or fiduciary related claims." C. Thomas Mason, *Challenging Experts In Securities Arbitration*, SECURITIES ARBITRATION 2000, 814 (Practicing Law Institute ed., 2000) (quoting Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579, 594 (1993)).

54. The exponential advances in computing also permit a more rigorous MPT analysis to take place, as large data sets can be easily analyzed. The Center for Research in Security Prices (CRSP), part of the University of Chicago's Graduate School of Business, has collected extensive historical data on securities prices.

can then be used as a benchmark to contrast with the portfolio created by the broker, and vividly illustrate that the actual portfolio was wholly inappropriate for the investor's particularized risk profile.[55]

As an example, the claimant's expert, after an analysis of the investor's present and future needs, circumstances, net income, net worth, time horizon, investment knowledge, attitude toward risk, and other relevant factors, may conclude that a "60/40" portfolio (60% equities, 40% bonds/cash) would be appropriate.[56] Within the equity and bond allocations, the holdings would presumably be diversified among large capitalization equities, small capitalization equities, growth equities, value equities, international equities, real estate investment trusts, corporate bonds, government bonds, and cash equivalents, in accordance with what MPT suggests is the appropriate mix for that investor's risk profile. Generally, the more aggressive an investor – i.e., the more risk they are knowingly willing to take on – the proportion of equities securities in their portfolio will be higher.

Once the appropriate allocation and diversification is determined, a range of options are available to construct a "well managed" and suitable portfolio.[57] One approach is to construct a portfolio using index funds, such

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CRSP provides six databases: CRSP US Stock Database; CRSP US Indices Database; CRSP US Treasuries Database; CRSP US Survivor-Bias-Free Mutual Funds Database; CRSP/COMPUSTAT Merged Database, and the CRSP/Ziman Real Estate Data Series. Center for Research in Security Prices, http://www.crsp.com (last visited Sept. 2, 2014).

55. *See generally* Charles Hunter & Lawrence Melton, *A Measure of Quality and Quantity - Market Adjusted Damages as Proof of the Broker's Failure to Diversity - a Casual Connection Between Malfeasance and Damages*, 14 PIABA B. J. 8 (Fall 2007); Jeffery Schaff & Michele Schaff, *Expert's Corner: Advanced Analytics - Effectively Portraying the Actual Risk and Return Profile of Your Client's Portfolio*,10 PIABA B. J. 20 (Fall 2003).

56. Often, the large brokerage firms will have published their own recommended asset allocation models, which provide a useful benchmark of what the firm thought suitable with respect to an investor's risk profile. Not surprisingly, these asset allocation models often suggest an allocation vastly different than the advisor selected.

57. Widely accepted industry practices and regulatory publications call for the advisor to periodically review their customer's circumstances so that adjustments can be made to asset allocations to ensure a suitable investment strategy is being employed. *See* FINRA, REGISTERED REPRESENTATIVES, OBLIGATIONS TO CUSTOMERS, http://www.finra.org/Industry/Compliance/Registration/Qualifications Exams/RegisteredReps/Brochure/P009867#_(last visited Sept. 2, 2014) ("Because a customer's financial status is constantly changing, account records should be updated

as those provided by Vanguard®, Fidelity®, Barclays®, and others.[58] Indeed, Wall Street firms often compare their own mutual funds or recommendations to the performance of an index such as the S&P 500, implicitly suggesting that such a benchmark is appropriate one against which to test a customer's actual returns. Alternatively, mutual funds can be used to construct the benchmark portfolio. For example, for an investor who wished to invest for growth (but not speculation), the analysis might utilize a well-established growth-oriented mutual fund. Another option is to use the brokerage firm's own "in-house" mutual funds as a benchmark against which to measure the actual performance of a client's account. Further, companies such as Morningstar and Thomson Financial have extensive historical data on index and mutual fund performance, which also can be used to develop a benchmark well managed and suitable portfolio.

The ready availability of software programs such as Microsoft Excel, as well as proprietary software – none of which was available in the pre-computer days of *Rolf* and *Miley* -- allows the chosen benchmark WMP data to be accurately compared to the actual performance of the account. The comparison should cover the same time frame as the period in which the advisor handled the account, so the WMP is subjected to the same market forces as existed during relevant time period. Further, the WMP should take into account any new deposits into the account, and any withdrawals made, again to replicate the actual cash flows occurring in the account, and any effect that would have had on performance of the portfolio.[59]

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whenever necessary. . . . Just as your customer's financial position may change, your customer's investment objectives may change as well. You should, therefore, review your customer's investment objectives periodically, and make a written record of any changes as they occur.").

58. For example, Vanguard® has a "Balanced Fund Index Fund" (VBINX), that "invests roughly 60% in stocks and 40% in bonds by tracking two indexes that represent broad barometers for the U.S. equity and U.S. taxable bond markets. The fund's broad diversification is important, because one or two holdings should not have a sizeable impact on the fund." Vanguard Balanced Index Fund, *at* https://personal.vanguard.com/us/funds/snapshot?FundId=0002&FundIntExt=INT (last visited Sept. 2, 2014).

59. It would be inappropriate to suggest that the WMP analysis "always" take into account deposits or withdrawals, since there might be fact patterns where to do so would be improper. For example, if the investor was convinced by their advisor to take the money out to invest in some speculative adventure promoted by the advisor, or if the advisor simply stole money from the account, then a WMP analysis ought not to reduce the benchmark portfolio by those withdrawals.

By developing one or more WMP benchmarks based upon an individual plaintiff's needs, goals, and risk tolerance, using actual historical data to plot the performance of those WMP's over the relevant time period, and recognizing the actual cash flows into and out of the account, any claim that the damages are "speculative" or are the result of a "cherry picked" portfolio, are objectively refuted. Coupled with *Daubert*-like challenges to the industry's misguided use of NOP's, an investor would have a rational and reasonable basis to claim that the damages suffered at the hands of the firm and advisor are the difference between the actual portfolio's results, and what a thoughtful Well Managed Portfolio would have accomplished.

WMP analysis will often provide a stark and vivid illustration of the damages caused by the advisor misconduct. Simply graphing the actual performance of the portfolio, compared to a WMP, will amply demonstrate for the fact finder the significant losses suffered at the hands of the advisor. (Illustration Nos. 1 and 2). When coupled with evidence showing the fees, commissions, and charges incurred by the investor for such gross mismanagement, as well as the often aggressive marketing and promotional materials used to convince investors that an advisor and firm have the knowledge and expertise to properly manage assets, WMP can provide a compelling argument for the recovery of the actual damages caused by advisor incompetence or misconduct.