"Dear Prudence, won't you come out to play?"
- from the song by John Lennon & The Beatles

Cullen Roche just wrote an interesting piece describing stocks as bonds. As ludicrous as this sounds, he uses the analogy to put volatility in perspective.

A bond offers a specific time horizon – like a five-year term – and an expected return, which would be the coupon on the bond. If one purchased the bond at issue for $100, and redeemed it five years later for $100, the annualized return (gross of tax) would equal the coupon rate. The only way an investor errs with bond investing, is if the security was sold during the term if interest rates rose higher than the coupon rate of the bond. The face value of the bond, originally $100, would be lower resulting in a permanent loss of capital.

The stock market, in comparison, doesn't have a long-term horizon but it does have a long-term track record of earning about 7% in profits per year (in the US market). While the cash flows are uneven – and, in fact, are not guaranteed – cash flows will eventually accrue over very long periods of time. The behavioural error, Roche notes, is treating the market like something other than a very long-term bond.

Which is, of course, how we think about investing in companies. Interesting, but that's not what this piece is about.

We have also read, with some fascination, various investment marketing pieces speaking to the Prudent Man Rule. Anyone capable of operating Google can discern that the Prudent Man Rule requires each investment be judged on its own merits and that speculative or risky investments must be avoided. Merriam-Webster's legal definition describes it as "..manag(ing) another's affairs and invest(ing) another's money with such skill and care as a person of ordinary prudence and intelligence would use in managing his or her own affairs or investments".

Jeremy Grantham of GMO in Boston, noted prudent investing "has long been legally defined as doing what others do." We're not sure whether this was serious, or part of his dry British wit, but it's a very appropriate perspective.

The concept of prudence is being tested as investor portfolios – both institutional and retail – continue to take on added risk. A decline in the overall rates of return available, especially on fixed income instruments, has led to increased allocations to alternative investments – in fact, higher risk vehicles and strategies have been used with increasing frequency over the past decade, with the regulatory cover that these are indeed prudent investments (i.e. everyone is doing it).

While long-dated pension funds may be able to withstand the potential volatility and illiquidity of alternative investments, individual investors may not. Yet today's portfolios are being filled with a variety of specialized instruments which may look opportune in the sagacity of a bull market environment, but are yet untested over full cycles (which include the inevitable troughs).

As an example, most investors would consider private equity investment as prudent. However, in an environment where money is pouring in and valuations become stretched, the assumption that private equity will provide a satisfactory return would not be prudent.

Acting with prudence involves understanding and admitting what you simply don't know, and discussing those inherent uncertainties in the context of a particular strategy in concert with its weaknesses and strengths.

Generally speaking, there is insufficient discussion among fiduciaries about what constitutes prudence. At the very least, a robust evaluation of investment beliefs should regularly occur and be debated, thereby forming the basis for investment principles. A fiduciaries duty is not to do what others are doing, but to make decisions in an enlightened way.

So, dear prudence, open up your eyes and look around.

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