Background

The Minnesota Orchestral Association (MOA) is a nonprofit organization dedicated to maintaining the Minnesota Orchestra in Minneapolis Minnesota. In December 1993, the MOA had an endowment of approximately $45 million. The endowment is critical to the survival of the Orchestra. Like many U.S. orchestras, the Minnesota Orchestra is unable to generate sufficient revenue from ticket sales to cover their operating expenses. Thus they rely on a draw from the endowment to cover their annual operating deficits.

The trustees of the MOA decided to divide the endowment into three equal parts. One third of the endowment (the bond portfolio) was to be invested in short to intermediate term bonds. The objective of the bond portfolio was to preserve capital while generating sufficient current income to cover the Orchestra’s operating deficits. In addition, the bond portfolio was to be invested in liquid securities so that they could be sold if the need for cash arose. One third of the portfolio (the equity portfolio) was to be invested in equities. The investment objective of the equity portfolio was to match the return on a diversified index of common stocks, such as the S&P 500. The final third of the endowment (the speculative portfolio) would be invested in riskier equities and other investments such as real estate. The speculative portfolio would be actively managed with the objective of long-term capital appreciation.

In August 1993, the trustees of the MOA, unhappy with the performance of their bond portfolio manager, hired Piper Jaffray, a Minneapolis based money management firm, to manage their bond portfolio. The assets of the bond portfolio, approximately $18 million, were transferred to Piper Jaffray on approximately August 30, 1993.
By May of 1994, the value of the MOA bond portfolio had fallen to about $11 million. The trustees, concerned about the performance of the bond portfolio, called an emergency meeting. At this meeting, they decided to replace Piper Jaffray with yet another bond portfolio manager. The trustees requested that Piper Jaffray liquidate their holdings as quickly as possible. Following these instructions, Piper Jaffray began liquidating the portfolio, and as securities were sold, the proceeds were transferred to a new bond portfolio manager.

Arbitration

The MOA trustees believed that Piper Jaffray mismanaged their bond portfolio, and that Piper Jaffray breached its fiduciary obligation to the MOA. Under the terms of the contract between the MOA and Piper Jaffray, disagreements of this kind were to be resolved through binding arbitration. For this arbitration, the NASD chose a panel of three arbitrators to assess the merits of the case, and determine a monetary damage award if appropriate. The arbitrators are reasonably knowledgeable and sophisticated about investment practices in general, but they are not likely to be experts in fixed income portfolios, and almost certainly are not experts about collateralized mortgage obligations (CMOs).

You can assume that the following facts have been established by witness testimony or by documents produced in the arbitration:

1. The MOA gave Piper Jaffray written guidelines on the management and objectives of the bond portfolio. Piper Jaffray signed a statement acknowledging that they received the investment guidelines and agreed to abide by them. The investment guidelines included: a) The objective of the portfolio is high current income with the preservation of capital; b) The assets of the portfolio will not be invested in derivative securities; c) The portfolio will be diversified.

2. Piper Jaffray represented that this portfolio was comparable to a bond portfolio with 3 to 5 year maturities.

3. The benchmark returns against which Piper Jaffray measured its performance were the Salomon Brothers Investment Grade Bond Index and the Lehman Brothers Government/Corporate Bond Index.

4. The MOA bond portfolio composition at the end of each month from August 1993 to December 1994 are provided in the Excel workbook titled Holdings.xls. All of the cash flows associated with the CMO securities purchased by Piper Jaffray on behalf of the MOA are reported in the Excel workbook Cashflow.xls. Both of these worksheets can be found on the FIN 434 web page.
Your Role as an Expert

You have been hired by the plaintiffs in this arbitration (the MOA) as an expert on fixed income portfolios and on CMOs. Your assignment is to write an expert report that will be submitted to the arbitration panel. The first part of your report should focus on the issue of liability. You should analyze the MOA bond portfolio, discuss whether there are any differences between this portfolio and a portfolio that is appropriate given the circumstances of the MOA, and give your expert opinion about whether Piper Jaffray breached its fiduciary obligations. The second part of your report should focus on damages. For this part of your report, you should assume that the panel finds in favor of the MOA on the question of liability, and give your expert opinion about the appropriate damage award that should be granted to the MOA as compensation for their losses.

As you write this report, you should keep the following point in mind. Lawyers are advocates for their clients, but expert witnesses are not. Even though you were hired and are paid by the MOA, the arbitration panel expects you to present a scientific analysis. If you make claims that are not substantiated, or if your report is clearly biased to favor your client, the arbitration panel will likely disregard your opinions in their deliberations.