10. INVESTMENT AND MANAGEMENT OF TRUST ASSETS

INTRODUCTION

The trustee's fiduciary duty in investing trust funds is to provide an appropriate return on the assets used to fund a trust. It is important for trustees to be acquainted with the legal principles that are the standards by which they will be judged in the handling of the trust.

Trustees face potential liability if beneficiaries are not pleased with the results of their investing. The trustee can protect him or herself by knowing and following the rules in the investment arena.

PRUDENT MAN RULE

History

Before 1990, a trustee's handling of investments was measured by the so-called Prudent Man Rule. That rule or standard was first articulated in 1830 in the Massachusetts case of *Harvard College v. Amory.* The Massachusetts court advised trustees "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."

Over the years courts throughout the country adopted the above definition as the standard for trustees in the investment of trust funds. The rule was codified in 1935, in *The Restatement of the Law of Trusts* and ratified in 1959, in *The Restatement Second of the Law of Trusts.* The Restatement Second says,

> "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill."

EVOLUTION OF A NEW STANDARD

Modern Portfolio Theory

It was not long after ratification of the Second Restatement of the Law of Trusts that those trustees who felt hand cuffed in their ability to invest like other investors of their day began to criticize the Prudent Man Rule. Their criticism was supported by a large and growing body of literature that was supported by documented and compelling empirical research. Much of this criticism is found in writings that have collectively and loosely come to be called **modern portfolio theory**.

The modern portfolio theory refers to the process of reducing risk in a portfolio through systematic diversification across asset classes and within a particular asset class. It assumes that all investors desire the highest possible returns while bearing the lowest

amount of risk and that public markets are generally efficient. It involves the relationship between risk and reward. To increase the return, an investor must incur more risk.

As court rulings began to deviate from the Prudent Man Rule, many began to speak out for a need to modernize or at least clarify the Prudent Man Rule. So in May of 1990, The American Law Institute substantially revised the Prudent Man Rule and replaced it with revisions collectively referred to as the **"Prudent Investor Rule."** This change was intended to permit fiduciaries to invest in accordance with the modern portfolio theory, which allowed a trustee more latitude for the exercise of investment judgment than did the Prudent Man Rule. In 1992, the American Law Institute published a complete revision of the Prudent Man Rule, entitled *"Restatement of the Law Third Trusts, Prudent Investor Rule."*

PRUDENT INVESTOR RULE

The Prudent Investor Rule grants trustees broader protections and powers, but these are paid for by imposing on the trustee more active management of the portfolio. A trustee will no longer be able to blindly follow the lead of other trustees or pick investments from an approved universe.

The rule states that the trustee is under a duty to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust. The trustee must take into account the best interests of both the income beneficiaries and the remaindermen. This presents unique challenges when a denominational entity is both the trustee and the remainderman.

Further, the rule suggests that the trustee has a list of factors, which must be considered in making investment decisions, including general economic conditions, possible effect of inflation or deflation, the expected total return from income and the appreciation of capital, and other resources of the beneficiaries. The trustee must take tax consequences of investment decisions into account. There is an obligation to diversify assets "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The trustee's obligations are significant, requiring sophisticated approaches to investment that really take into account the right risk to return ratio for the particular trust.

The following is a summary of the key impact of the Prudent Investor Rule on trust administration:

- A trustee must review investment policies on a regular basis.
- A trustee will be held to a higher standard of skill and sophistication in investments to the extent he or she expressly or implicitly represents that he or she has special skills.
- Process and conduct are more important than results for determining if the trustee has discharged the investment duty.
- Overall portfolio strategy and performance are generally more important than the performance of individual assets.

- Diversification is fundamental.
- Permissive or discretionary language in a trust (e.g., retention) does not waive the duties of care, skill, and analysis when deciding to retain or dispose of initial trust assets. Even if the trust mandates retention, there may be situations in which a trustee should petition the court for relief if continued retention could jeopardize the purpose or existence of the trust.
- A trustee is not only authorized but may be required to delegate certain investment responsibilities to properly discharge the trustee's investment duties.
- Any investment strategy must be cost effective. Except in very large accounts, passive investments will generally prove more cost effective than active investments, which require extensive research, higher transaction costs, etc.

Comparison of the Prudent Man Rule with Prudent Investor Rule

Prudent Man Rule	**Prudent Investor Rule**
Each investment is inherently prudent or imprudent.	No investment is itself prudent or imprudent but part of an overall strategy of market risk.
The propriety of investment decisions is reviewed with hindsight.	The propriety of investment decisions is reviewed when the decision is made.
The trustee is subject to a standard of risk awareness.	The trustee is subject to a standard of risk management.
The trustee may not delegate investment responsibility.	The trustee may responsibly delegate investment responsibility.

Uniform Prudent Investor Act

The National Conference of Commissioners on Uniform State Laws, a non-profit unincorporated association comprised of state commissions on uniform law from each state, completed the Uniform Prudent Investor Act (UPIA) in 1994.

The commissioners, all who are members of the bar, come together for one purpose- to study and review the laws of all of the states to determine which areas of law should be uniform. The commissioners promote the principle of uniformity by drafting and proposing specific statutes in areas of the law where uniformity between the states is desirable. The commissioners can only propose a uniform act to each state. No uniform law is effective until a state legislature adopts it.

With regard to the area of investment law, the commissioners determined that, although most states had state investment laws reflecting the modern portfolio theory, a uniform law was needed in the area of investment law based on the new consensus reflected in the Restatement of Trusts 3d, e.g. Prudent Investor Rule. The American Bar Association and American Bankers Association adopted the Uniform Prudent Investor Act and began to promote it among the 50 state legislatures.

> "This act removes much of the common law restriction upon the investment authority of trustees of trusts and like fiduciaries. It allows

> such fiduciaries to utilize modern portfolio theory to guide investment decisions. A fiduciary's performance is measured on the performance of the whole portfolio, not upon the performance of each investment singly. The act allows the fiduciary to delegate investment decisions to qualified and supervised agents. It requires sophisticated risk-return analysis to guide investment decisions."
>
> http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp

Check the Uniform Law Commissioners website quoted above for a list of jurisdictions that have adopted or introduced legislation to adopt the Uniform Prudent Investor Act.

It should be noted that the UPIA is a default standard. It applies only in the absence of another standard for the fiduciary articulated in the trust instrument.

Practical Considerations in the Management of Assets

1. **A trustee must first develop an investment strategy.**
   The strategy should have two major components:
   (1) Creation of an asset allocation model, i.e. the percentage of equities v. bonds.
   (2) Construction of a portfolio for each segment chosen.

2. **Written investment policy for each trust.**
   Investment policy statements are important for three reasons:
   (1) The policies are necessary for a fiduciary to fulfill his or her responsibilities. Fiduciaries are legally held to a prudent investor standard. To ensure that the fiduciary is investing according to the prudent investor standard well-reasoned investment policies that provide for formal asset allocation guidelines and benchmarks against which to compare results are necessary.

   (2) It is sometimes difficult for a trustee to resist the outside pressure to jump on the "hottest" investment vehicle. Written policy guidelines provide the investment discipline to protect the trust from market-driven departures from a sound long-term policy.

   (3) An investment policy serves as the guideline for all of the "players" in the fiduciary process. Both income and the remainder beneficiaries will understand what the goals and objectives are when it is in writing.

3. **Consideration of delegating of investment functions to the professionals.**
   The trustee must exercise reasonable care, skill, and caution in:
   (1) selecting an agent;

   (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trusts; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

4. **Periodic review of assets and rebalancing of each portfolio.**
This may be the most important requirement of trust management once the trust is first invested. A regular review will save the trustee even in down markets and bad times. This will generally meet the duty of care required of a prudent investor.

INVESTMENT SUB-COMMITTEE

An investment sub-committee, as a committee of the governing board or as a sub-committee of the Trust Management Committee, could be established to develop investment strategy and policy that conforms to the requirements of the trust, state law, and the Prudent Investor Rule.

The Committee's terms of reference could be:

Develop overall investment strategy and policy
Develop individual investment policy for each trust
Determine the appropriate asset allocation
Review performance quarterly

The Committee should include both denominational employees and nondenominational employees.

The Committee reports to the Trust Management Committee or the governing board.

UNRELATED BUSINESS INCOME TAX RULES

An exempt organization is not taxed on its income from an activity that is substantially related to the charitable, educational, or any other purpose that is the basis for the organization's exemption. Such income is exempt even if the activity is a trade or business. However, in order to prevent unfair competition between exempt organizations and commercial businesses the exempt organization is subject to tax on its income from an unrelated trade or business. Therefore, the trustee must be careful when investing that he or she does not subject the charity or trust to tax liability as a result of generating unrelated business income.

Unrelated business income (UBI) is gross income received from an unrelated trade or business, regularly carried on, that is not substantially related to the organization's fulfilling its exempt purpose or function except that the organization needs the profits derived from this activity. The following features characterize UBI:

Trade or business – the term "trade or business" generally includes any activity carried on for the production of income from selling goods or performing services.

Regularly carried on - Business activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.

Not substantially related - A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose. Whether an activity contributes importantly depends in each case on the facts involved.

In computing unrelated business taxable income (UBTI) certain types of income are generally excluded when figuring the UBTI. All dividends, interest, annuities, and other investment income are excluded in computing unrelated business taxable income, unless the income is derived from debt-financed property as discussed below. Additionally, a specific deduction of $1,000 is allowed. Thus, it is possible for an exempt organization, including a charitable remainder trust, to have some UBI without the related tax. Since church organizations receive mineral rights as gift or bequests from time to time, it is important to note the royalties from such mineral rights are excluded from UBTI; however income received from a mineral interest where the exempt organization shares in development costs is includable in UBTI. Certain income and gains derived from debt financed property are also included in UBTI.

The organization's unrelated business income tax (UBIT) and related surcharges is computed using normal corporate rates. As of 2007, a charitable remainder trust that has UBTI is subject to a 100% tax on the income.

PARTNERSHIP INCOME

An organization may have unrelated business income or loss as a member of a partnership if the partnership is regularly engaged in a trade or business that is an unrelated trade or business with respect to the organization; or if the partnership has income from debt-financed property as discussed below. If the partnership has either, the organization must treat its share of the partnership income or loss as if it had conducted the business activity in its own capacity as a trust, even if the trust does not receive any cash or other distributions from the corporation. Also, any capital gains from the sale of an S corporation stock are taxable. The partnership income and deductions to be included in the organization's unrelated business taxable income are figured the same way as any income and deductions from an unrelated trade or business conducted directly by the organization.

Example. An exempt educational organization is a partner in a partnership that operates a factory. The partnership also holds stock in the corporation. The exempt organization

must include its share of the gross income from operating the factory in its unrelated business taxable income. However, since all dividends, interest, annuities, and other investment income are excluded in computing unrelated business taxable income, it may exclude its share of any dividends the partnership received from the corporation.

INCOME FROM DEBT-FINANCED PROPERTY

Investment income that would otherwise be excluded from an exempt organization's unrelated business taxable income must be included to the extent that it is derived from debt-financed property. The amount of the income is proportionate to the debt on the property.

Debt-financed property is any property held to produce income for which there is **acquisition indebtedness** at any time during the tax year or during the 12-month period before the date of the property's disposal, if it was disposed of during the tax year. It includes rental real estate, tangible personal property, and corporate stock.

Acquisition indebtedness is the unpaid amount of debt incurred by an organization:

(1) When acquiring or improving property.
(2) Before acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement, and
(3) After acquiring or improving the property if:
    a. The debt would not have been incurred except for the acquisition or improvement, and
    b. Incurring the debt was reasonably foreseeable when the property was acquired or improved.

S CORPORATION INCOME OR LOSS

An organization that owns S corporation stock must take into account its share of the S Corporation's income, deductions, or losses in figuring unrelated business taxable income, regardless of the actual source or nature of the income**.**

For example; the organization's share of the S corporation's interest and dividend income will be taxable, even though interest and dividends are normally excluded from unrelated business taxable income.

Charitable remainder trusts are not permitted to be shareholders of an S-corporation.

NAD INVESTMENT POLICIES

Policies for the investment of denominational funds within North America may be found in section S 85 of the North American Division Working Policy (the "Red Book").

DEFINITIONS:

Bonds - a debt investment, with which the investor loans money to an entity (company or government) that borrows the funds for a defined period of time at a specified interest rate.

Equities - another name for stock or shares. It is a share in the ownership of a company. Stock represents an ownership interest in the company’s assets and earnings.

Mutual funds- a security that is a collection of stocks and/or bonds. It gives investors access to a well-diversified portfolio of equities, bonds, and other securities. Income is earned from dividends on stock and interest on bonds. A fund pays out nearly all income it receives over the year to fund owners in the form of a distribution.

Fiduciary – person, company or association holding assets in trust for a beneficiary charged with the responsibility of prudently investing money for the beneficiary’s benefit.

Small Cap – shorthand for small capitalization stocks or mutual funds holding such stocks. Small cap stocks usually have a market capitalization (number of shares outstanding multiplied by the stock price) of $500 million or less.

Large Cap – stocks usually have a market capitalization of $1 billion or more.

Blue Chip Stock – common stock of a nationally known company that has a long record of profit growth and dividend payment and a reputation for quality management, products, and services.

Junk bond – bond with a credit rating of BB or lower by rating agencies. Junk bonds are issued by companies without long track records of sales and earnings, or by those with questionable credit strength.

SUMMARY

Uniform Prudent Investor Act

Trustees of trusts and like fiduciaries have been subject to rules severely restricting the types of investment modalities in which they can invest the assets of the trusts that they administer and manage. Interest bearing instruments -- safe income -- of limited kinds (no junk bonds) are the limit of risk permitted or thought to be permitted under the traditional rules. Protect the paper value of the principal at all costs is the mandate for trustees. In addition, a trustee's performance is rated by the performance of each and every investment, singly, and not on the performance of the whole of the portfolio. And trustees have been precluded from obtaining professional investment help.

The result for trusts is modest income production at best without regard for the erosion of a trust's assets by inflation. Can it be that these rules miscalculate the real risk and actually jeopardize the assets of a trust rather than provide for their protection?

The answer is yes. And a remedy is now at hand in the Uniform Prudent Investor Act (UPIA), promulgated by the Uniform Law Commissioners in 1994. The adoption of this act by the state legislatures will correct the rules, based on false and damaging premises, that now govern the actions of trustees.

By no means does UPIA turn trustees into unrestrained speculators. It provides rules governing investment that, in fact, result in greater protection for the trust's assets while providing a prospect of better income. UPIA 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."

The trustee has a list of factors which must be considered in making investment decisions, including "general economic conditions," "possible effect of inflation or deflation," "the expected total return from income and the appreciation of capital," and, "other resources of the beneficiaries." The trustee must take tax consequences of investment decisions into account. There is a positive obligation to diversify assets "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The trustee's obligations are significant, requiring sophisticated approaches to investment that really take into account the right risk to return ratio for the particular trust.

In addition, a trustee's performance in UPIA is measured by the performance of all the assets together. A loss with respect to a single asset does not mean that the trustee has violated his or her fiduciary responsibilities. The act takes the truly holistic approach to investment practices.

In return for these obligations, UPIA removes any restrictions upon the types of investment modalities which may be chosen in a trust's portfolio. It is quite possible, for example, to hold positions in high-interest bonds (junk bonds) or mutual funds investing in such bonds, in a diversified portfolio, if such an investment meets the needs of the particular trust in light of the risk/return analysis specific to that trust.

One of the boons to trustees of smaller trusts is the ability to invest in mutual funds. Mutual funds reduce investment risk by diversifying their portfolios. By using mutual funds, a trustee of a trust that does not have a large enough corpus to effectively diversify its assets can enhance diversification of the trust's portfolio to limit the trust's risk of loss.

UPIA also permits the trustee to delegate investment and management functions "that a prudent trustee of comparable skills could properly delegate under the circumstances." Careful selection of the agent and careful, periodic review of the agent's actions are part of the trustee's responsibility when delegating authority. An agent has a responsibility of reasonable care in conducting the delegated business of the trust.

Why is it that the prudent man rule of prior law may, in fact, jeopardize the assets in a trust? Some of the instruments in which trustees have been able to invest have become more volatile in price. Treasury bonds, for example, long thought to be safe investments, now fluctuate considerably in value with the fluctuation of interest rates. The former so-called safe investment may not be so safe anymore. In contrast, common stocks have shown consistently better returns over the years than bonds -- yet trustees have been prevented from investing in common stocks. Stocks have been historically safer investments, therefore, in diversified portfolios than bonds have been. Trusts have been deprived of return at some greater risk by the antiquated rules that govern investment of their assets.

By far the most insidious damage to trust assets comes from inflation. If trustees cannot invest in modalities that exceed the rate of inflation in return, the inevitable result is diminution of the corpus of the trusts they manage. The beneficiaries of trusts so restricted lose in all ways, both with respect to income and principal.

The UPIA provides rules that can be modified or waived in the trust agreement. Any person who wishes to put property in trust and who wants to provide different standards of conduct for the trustee is permitted to do so under UPIA.

UPIA provides a reasonable approach to the investment of trust assets that better meets the needs of beneficiaries while preserving trust assets. It should become the law in every state as soon as possible.

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