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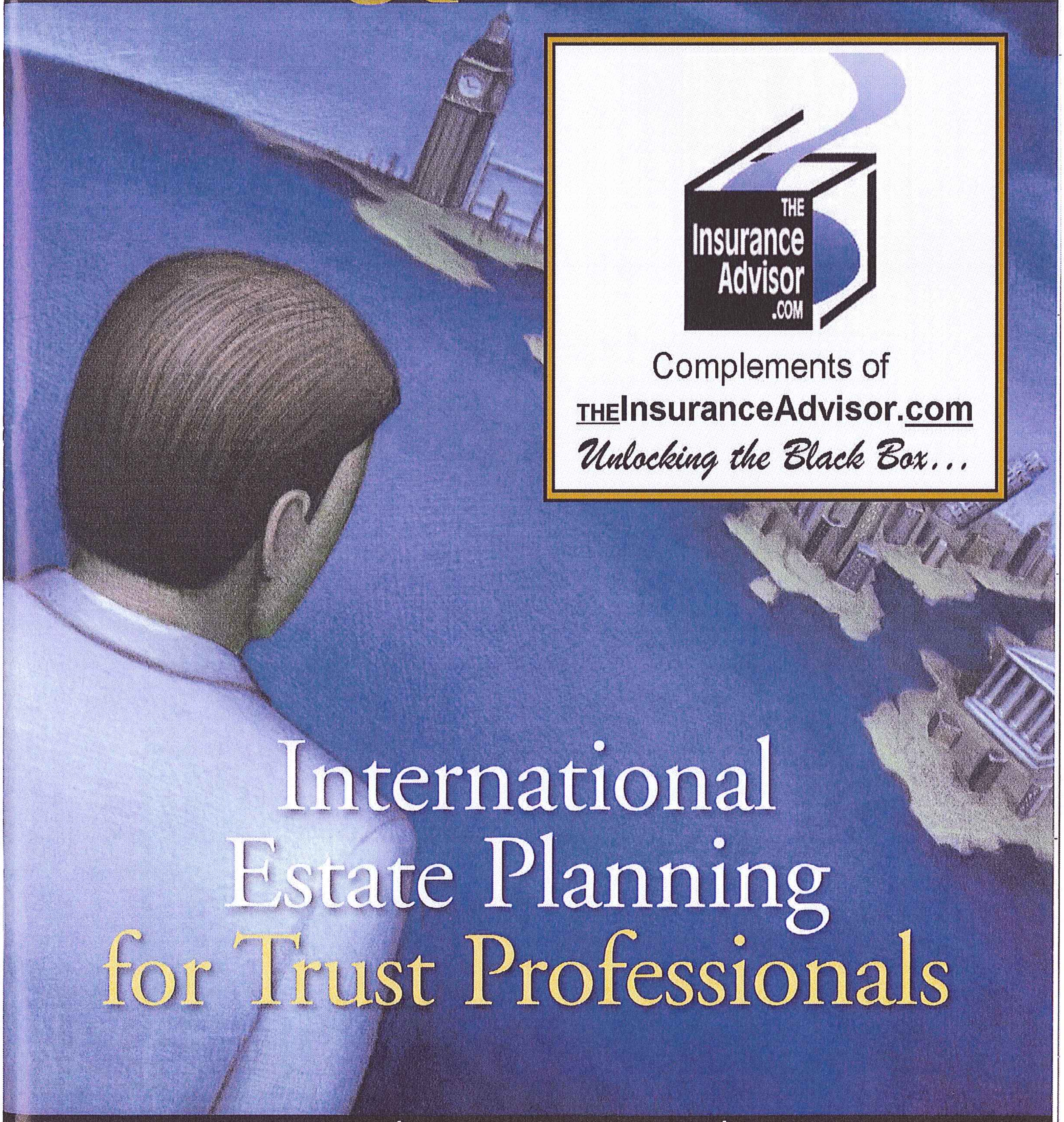

International Estate Planning for Trust Professionals

Prudent Investor and TOLI | Fiduciary Cross-Selling | Reading Indentures

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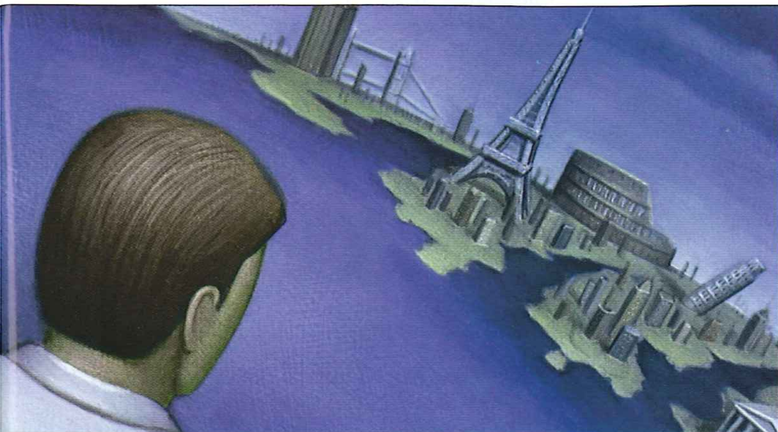

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The Prudent Investor and Trust Owned Life Insurance (TOLI)

PART 1

The adoption by most states of the Uniform Prudent Investor Act (UPIA) has far-reaching effects on trust drafting and administration.[1] One of the often overlooked consequences of the Prudent Investor Act is its effect on the administration of irrevocable life insurance trusts (ILITs). This article will address the unique (and often opaque) nature of life insurance as an investment and the effects the Prudent Investor Act can have on trustee ownership of life insurance. Part 1 reviews the theoretical underpinnings of the Prudent Investor Act and discusses the ways these theories can adversely affect how trustees invest for particular families. It then explores the Prudent Investor Act itself, and the types of drafting and administration issues it engenders.

Part 2 looks at the nature of life insurance as an investment, focusing on the factors that go into pricing insurance products and the effects of those factors on policy performance. Finally, Part 3 looks at trust administration of ILITs. What follows is the first part of a three-part series tackling the prudent investor and trust-owned life insurance. Look for parts 2 and 3 in future issues of ABA Trust & Investments.

Christopher P. Cline and Barry D. Flagg

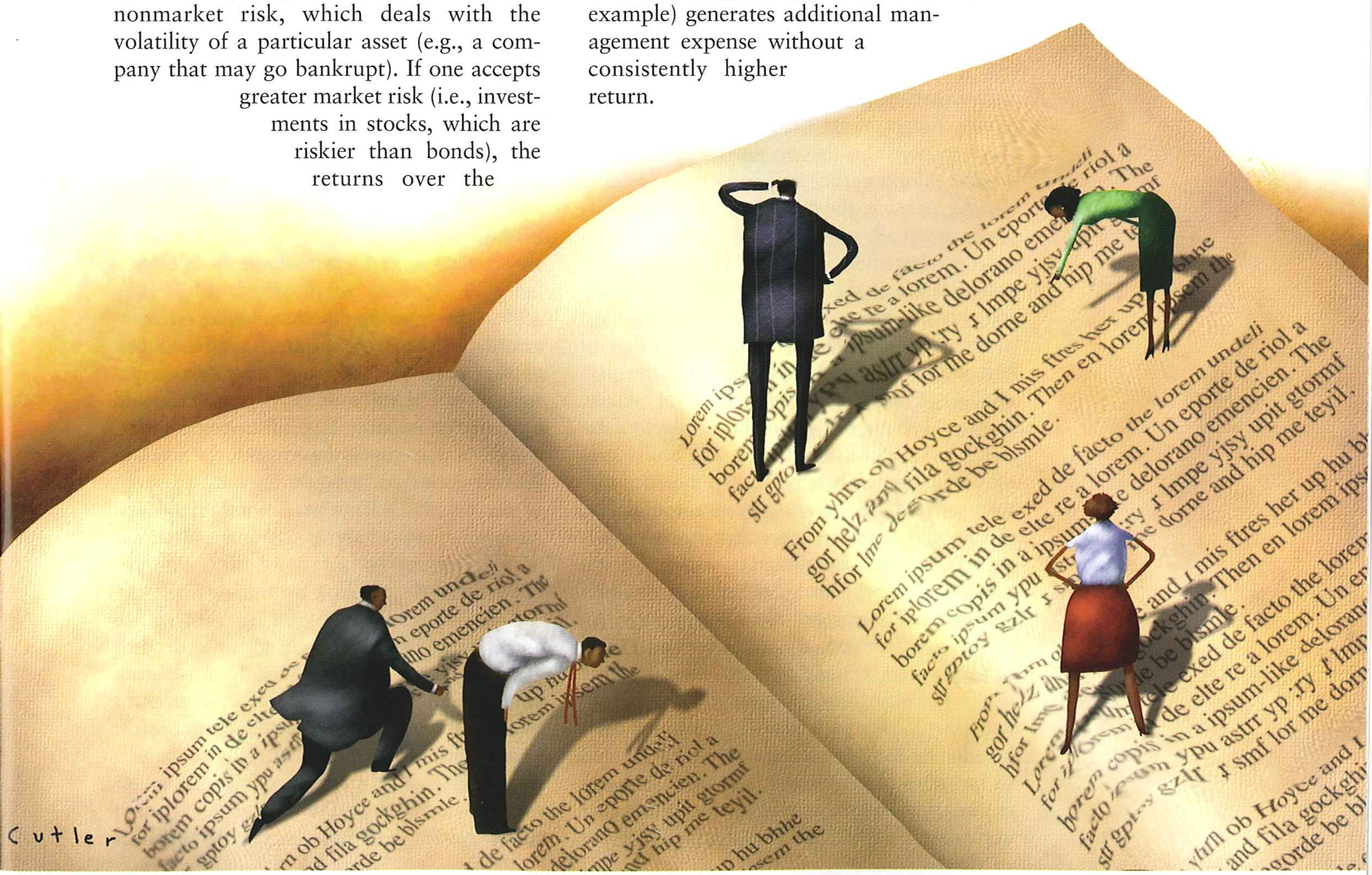
MODERN PORTFOLIO THEORY, THE *RESTATEMENT (THIRD) OF TRUSTS* AND THE PRUDENT INVESTOR ACT

The Prudent Investor Act is rooted in modern portfolio theory and the *Restatement (Third) of Trusts*. The "prudent investing" concept was overhauled in 1992 with the publication of the restatement. Academics, trustees, and advisers sought to eliminate arcane trust investment rules in favor of "modern portfolio theory."[2]

Modern Portfolio Theory and the Restatement

Although this article is far too brief to cover the intricacies of modern portfolio theory, two crucial concepts must be recognized. First, the nature of risk must be considered. There is market risk, which deals with market volatility (e.g., the stock market) and nonmarket risk, which deals with the volatility of a particular asset (e.g., a company that may go bankrupt). If one accepts greater market risk (i.e., investments in stocks, which are riskier than bonds), the returns over the long term should be greater. However, nonmarket risk generates no additional return because one can avoid it by diversifying investments. This concept of risk puts at least two burdens on an investor: (1) determining the acceptable level of volatility (the level of market risk) in exchange for the hoped-for return; and (2) diversifying the portfolio in accordance with the chosen level of market risk to avoid nonmarket risk.

The second important concept is that of market efficiency, which assumes that asset information is disseminated efficiently and therefore all assets are priced more or less correctly. An investor's best strategy, in that case, is to invest passively through index funds, which should perform as the market does as a whole, because no investor should be able to consistently outperform the market. If markets are efficient, most active management (picking particular stocks, for example) generates additional management expense without a consistently higher return.



The restatement, which applies investment principles to trustees of private trusts, incorporates modern portfolio theory. It adopts the concept of risk,[3] distinguishing between market and nonmarket risk, and at least implies that a trustee breaches its fiduciary duty to preserve capital if it selects a level of return that allows inflation to erode the trust property's value. In other words, a trustee can get in trouble by playing it too safe: It must accept a certain amount of market risk and avoid nonmarket risk by diversifying investments.[4]

The restatement also adopts, to some extent, the efficient market theory.[5] Further, the restatement specifically prohibits a trustee from incurring unreasonable costs in managing and investing trust assets.[6] In other words, the restatement can be read for the proposition that passive asset management (for example, through the use of index funds) is generally a more prudent investment choice than active management.[7] Because the Prudent Investor Act is based on the restatement and modern portfolio theory, the act also can be read as adopting the same concepts.

As an aside, the question of whether markets are actually efficient may not be as settled as the restatement implies. The equity value rollercoaster of the last five years has caused many to question the validity of the theory. An alternate view of market valuation is that of behavioral finance, which considers the psychology of investing. Under behavioral finance, investor behavior is often the product of biases,[8] or "rules of thumb," by which investors make decisions. These biases can include judgments based on stereotypes, overconfidence, the inability to properly account for new information, aversion to ambiguity, and emotional and cognitive problems.[9] Such bias can lead investors to be seriously influenced by such factors as loss aversion and regret over past decisions. Swayed by these factors, investors cause prices to stray from fundamental values, potentially for long periods of time, making markets inefficient.[10] Inexperienced investors tend to be more confident that they will beat the market than experienced investors (a fact that in hindsight should be self-evident, given all of the day trading that went on five years ago). Wall Street strategists are more prone to gambler's fallacy, while individual investors are more prone to betting on trends.[11]

Finally, investor psychology (both individual and professional) is not given adequate consideration, even if market efficiency theory and not behavioral finance theory, can be proved correct. For example, John C. Bogle, founder and former chairman of the Vanguard Group, reviewed the history of the mutual fund over the past 50 years and noted some remarkable changes.[12] In his view, the mutual fund industry has changed from one that stressed stewardship to one stressing salesmanship, in which short-term gains were more important than long-term strategies. As a result, although "the stock market provided an annual return of 13 percent during the past 20 years, and the average equity fund earned an annual return of 10 percent, the average fund investor, according to recent estimates, earned just 2 percent per year." In other words, even if the markets are efficient, and passive investment in index funds is the best approach, the average investor simply isn't following those rules.

For instance, $1 invested in the S&P 500 in 1926 would have grown to $1,114 by 1996. However, if the same dollar was invested but the investor got out of the stock market during the 35 best months of the period (a total of 840 months), the dollar would have grown to only $10,. Expressed differently, 99 percent of the growth during that 70-year period occurred during only 4 percent of the months. Miss those months, and you miss your appreciation. Investors, in other words, have to hang around for 96 unproductive months, waiting for the big one.

The disparity between market return and investor return, taken with the need to stay in a market for the long term, demonstrates a need for continued guidance for many investors. If an investor takes comfort knowing the person or institution managing his or her money, that investor might maintain an investment strategy more consistently, resulting in less investment turnover

This concept of actively managing trust holdings is all the more important for trust-owned life insurance (TOLI) holdings where expenses are considerably greater than in the investment world when changing from a fixedinterest oriented product like universal life and whole life to a product where asset allocations can be balanced.

and therefore higher returns. Such consistency can be far more important in achieving higher overall levels of return than whether a client chooses passively or actively managed funds. Indeed, it could be argued that if done consistently, following the advice even of a financial planner with a slightly second-rate actively managed portfolio will generate higher returns on trust investments than following a passive mutual fund approach if the investor gets skittish and pulls out of the market during one of those crucial months.

This concept of actively managing trust holdings is all the more important for trust-owned life insurance (TOLI) holdings where expenses are considerably greater than in the investment world when changing from a fixedinterest oriented product like universal life and whole life to a product where asset allocations can be balanced. For instance, up until the late '70s and early '80s, TOLI holdings consisted predominantly of whole-life products. However, when prevailing interest rates soared, many whole-life TOLI holdings were exchanged for universal-life products offering the promise of higher policy interest crediting rates. Of course, the promise of then-high prevailing interest rates, that were typically guaranteed for only 30 days but used on premium computations for 30-plus years, did not hold up. As such, because of the considerable expense involved in making such a change in ILIT holdings, and because many universal-life products were based on an unreasonable expectation as to the expected policy earnings rate, many universal-life holdings purchased in the 1980s are in jeopardy of lapsing without value and without paying the expected death claim.

To seemingly add insult to injury, on the heels of falling interest rates in the late '80s but rising stock market performance in the early-to-mid '90s, the response of the insurance industry in many cases was to promote an exchange from universal life to variable life. Once again, the exchange was reactionary to then-current but not sustainable market conditions, and premium computations were predicated on the expectation that then-prevailing high market earnings rates, which were not guaranteed at all, would continue for 30 or more years. Of course, such then-current but historically high earnings expectations proved unreasonable, and because of the considerable expenses involved in again making such a change in ILIT holdings, many variable-life holdings purchased in the 1990s are in jeopardy of lapsing without value and without paying the expected death claim.

Both of the above situations are clear examples of where ILIT trustees would have been far better served by following the advice of a financial planner and setting reasonable expectations as to the appropriate return on trust cash value assets, even if with a slightly second-rate portfolio of actively managed product(s). Both situations also certainly contributed to the current state of TOLI holdings reported in the April 1999 issue of *Trusts & Estates* magazine, where a survey of TOLI holdings reported that TOLI death benefits can be increased by 40 percent or more, or TOLI premiums can be reduced by 40 percent or more, in 65 percent to 85 percent of singlelife and survivorship trustowned policies, respectively.

Given this experience over the past 20-plus years, it is no wonder ILIT trustees may be hesitant to take further action to comply with requirements of the Prudent Investor Act. However, we will discuss "The Problem with Illustrations" in Part 2, that contributed to the above situation; then provide guidance for how ILIT trustees can go about setting reasonable expectations as to the appropriate rate of return on trust cash value assets in Part 3; and also better understand the expenses involved in proactively managing TOLI holdings in Part 2.

The Prudent Investor Act

The prefatory note to the Prudent Investor Act states that, relying on the restatement, it makes five significant changes to the law of trustee investing. First, the prudence standard "is applied to any investment as part of the total portfolio, rather than to individual investments." Second, a trustee's primary consideration in investing is the tradeoff "between risk and return." Third, categorical restrictions on types of investments are eliminated; a trustee may "invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing." Fourth, investment diversification is incorporated as an integral part of prudent investing. Finally, trustees can delegate investment and management functions.

Under Section 1 of the Prudent Investor Act, the prudent investor rule is a "default rule" that may be expanded, restricted, or eliminated by the trust terms, but which must be followed if not overridden. Section 2 sets forth the trustee's standard of care: A trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." In other words, a single investment approach for all trusts is inappropriate. Investments are judged under Section 2(b) in the context of the trust portfolio as a whole and as a part of an overall strategy, after evaluating risk and return objectives. So, as the comments to that section point out, a trust "whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth." Section 2(c) lists some circumstances a trustee must take into account when developing an investment strategy: general economic conditions, inflation, expected tax consequences, the beneficiaries' other resources, beneficiary needs for liquidity, and an asset's special relationship or special value, if any, to the trust purposes. Finally, Section 2(f) states that a trustee with special skills or expertise has a duty to use them.

Section 3 requires a trustee to diversify trust investments unless, because of special circumstances, the purposes of the trust are better served without diversifying, such as holding an undiversified block of low-basis securities with built-in gain or retaining a family business. Under Section 4, a trustee must, within a reasonable time after accepting the trusteeship, review the trust assets and decide whether they are appropriate investments in light of the factors just discussed. In other words, a trustee cannot simply rely on the fact that a predecessor held these assets, even if the predecessor was the grantor.

Sections 5 and 6 set out the trustee's duties of loyalty to and impartiality among the beneficiaries. Section 7 states that a trustee may only incur costs in investing and managing trust assets that are appropriate and reasonable. Section 8 provides that compliance with the prudent investor rule "is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." As the comments point out, "[t]rustees are not insurers ... . Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard."

Section 9 provides that a trustee who properly delegates investment and management functions is not liable for the decisions or actions of the agent to whom the function was delegated. This section reverses the former trust law that imposed a rule of nondelegation and "is designed to strike the appropriate balance between the advantages and the hazards of delegation." Further, "the trustee must balance the projected benefits against the likely costs" of delegation, and "take costs into account." So, for example, if a trustee's regular compensation schedule assumes that the trustee will manage investments, "it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager." ti

The second part of this three-part series, to appear in the March/April 2007 issue of ABA Trust & Investments, *will address*

factors that determine life insurance pricing, performance, and suitability.

[1]See, e.g., Hoisington, Modern Trust Design: New Paradigms for the 21st Century, 31st Annual Phillip E. Heckling Institute on Estate Planning, Ch. 6 (1997); Horn, Prudent Investor Rule, Modern Portfolio Theory and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust, 33 Real Property, Probate & Trust Journal 1 (Spring 1998); Wolf, Total Return Trusts—Can Your Clients Afford Anything Less?, 33 Real Property, Probate & Trust Journal 131 (Spring 1998).

[2]See, e.g., Macey, An Introduction to Modern Financial Theory (2d ed. (1998); Malkiel, A Random Walk Down Wall Street (6th Ed. 1996).

[3]See, e.g., Restatement (Third) of Trusts, § 227, cmts (b)(h) (1992).

[4]Id. At § 227, cmt g.

[5]Restatement (Third) of Trusts, Ch. 7 (Introduction, pp. 6-7; Reporter's Notes, pp. 75-76) (1992).

[6]Id. At § 227(c)(3).

[7]See, e.g.,Horn, supra at fn. 2, pg. 17.

[8]Shefrin, Beyond Greed and Fear, 13 (Harvard Business School Press, 2000). This book synthesizes the work of several academics in the area of behavioral finance.

[9]Id. at Ch. 2.

[10]Id. at 42.

[11]Id. at 52.

[12]All of Mr. Bogle's remarks are contained in "The Mutual Fund Industry in 2003: Back to the Future," delivered January 14, 2003, to the Harvard Business School Association of Boston. Transcript available at www.vanguard.com.

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