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Trustee Challenges: How Differing Beneficiary Needs Complicate Fiduciary and Investment Decisions

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With the increase in estate tax exemptions during 2011 and 2012 (made permanent by the American Taxpayer Relief Act of 2012), as well as the equalization of GST and lifetime gifting limits, many wealthy families have set up additional long-term trusts to benefit their children and grandchildren. With the expected durations of some of these trusts approaching triple digits, one would expect investment policy and strategy to be simple. Trusts with long durations have the ability to sustain much higher risk levels, allowing them to be aggressively invested in potentially higher returning equities and illiquid investments. There are no periods in modern U.S. history where annualized returns over 30 years are negative (from 1926, using the S&P 500 as an equity proxy). *(Figure 1)*

Although past performance is no guarantee of future performance, this fact alone provides Trustees with evidence that over long time periods (greater than 30 years), equities can provide substantially higher returns versus other asset classes, and should be considered for a significant allocation to long-lived trusts. Additionally, according to Ibbotson data, long-term equity returns are generally higher than the worst rolling period returns noted above when long-term government yields are as low as they are today (for example, the 1930-1955 timeframe). Today's investment industry also provides the ability to diversify into global equity portfolios, reducing the risk of long-term underperformance that may occur in any one given market (i.e., Japan).

Although most financial advisors and trustees know these facts, they may not have the appropriate operational and management structures and policies in place to provide them with the confidence to implement sophisticated investment programs that meet multiple and sometimes competing beneficiary needs. Unless there is a well-considered strategy, uncontrollable competing factors or influences such as the current economic environment, co-trustee conflicts and multiple beneficiary needs, may complicate investment and trust decisions. Further, long term thinking has to be given its rightful place in any such strategy. Many trust environments are very fact specific or situational and defy standard solutions. Accordingly, operating policies must be adaptive.

For instance, many investment allocations are currently influenced by short-term outlooks (3-5 years in this instance), especially so in today's uncertain political and economic environment. With concerns about fiscal cliffs, unsustainable debt to GDP ratios and easy global monetary policy which could ignite inflation, many trusts may be positioned more conservatively than they should be. Even if a long-lived trust is established and invested at the worst possible moment, such as the end of 1928 or 1972, the 30 year annualized returns on equity investments are excellent (8.5% and 12% nominal, respectively and real returns both over 5.5%). Even the worst 30 year annualized real returns since 1926 are greater than 4.4%.

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FIG. 1

Long Duration Trust Returns

Length of Rolling Period	30 Years	40 Years	50 Years
% of Rolling Periods with Positive Returns	100%	100%	100%
Worst Rolling Period Return	8.5%	8.9%	7.7%
Best Rolling Period Return	13.7%	12.5%	13.6%

Source: Dimensional Fund Advisors and S&P Index Services Group

In addition, we have seen a recent trend of grantors adding co-trustees, possibly family members, who may not be investment professionals or, could have adverse interests (a child's trust where the parent is also a beneficiary). This could cause a conflict between trustees, especially if the individual co-trustee has current financial needs that may be at odds with the investment allocation that best suits the ultimate beneficiary.

Trustees face multiple conundrums when dealing with multiple beneficiaries. The grantor may be looking over your shoulder, providing "rear view mirror" advice, especially if short-term results are poor. Additionally, in today's economic environment, certain asset classes, such as high quality bonds and Treasuries, that have historically provided stability and safety to portfolios, may offer no real return for decades. Is this considered a prudent investment?

Although laws now allow trustees to invest for total return and the power to adjust provides more flexibility, there are additional ways to increase the ability to meet beneficiary needs. To provide the best structure for investment policy and decision making, and to act in the best interest of all of the beneficiaries in an unbiased fashion, Trustee(s) should have a well-defined operational and administrative structure and process, subject to any guidance in the controlling document. This may include policies and procedures setting forth the acceptable investments, criteria for loan requests and guidelines for discretionary invasions. Some of the additional requirements if there are multiple co-trustees might be managed by a co-trustee delegating matters not involving the exercise of judgment or discretion to a corporate co-trustee. For example, an individual co-trustee may wish to assign recordkeeping responsibilities to a corporate co-trustee and retain an oversight role of these functions. Other predetermined investment strategies and multiple trustee roles and responsibilities can also be defined at the beginning of the relationship and spelled out in one of the following documents:

- Investment Policy Statements setting forth the asset allocation guidelines for the trust
- Structured Delegation of Investment Authority by Co-trustees which grants the Corporate Trustee the ability to manage and realign the investment portfolio based upon pre-determined criteria
- Memorandum of Understanding of Co-Trustees outlining the respective responsibilities of multiple trustees
- On occasions when the trust permits an individual co-trustee to assume responsibility and hold a non-traditional investment in the trust, a process can be put in place for the co-trustees to authorize and monitor the investment. A Corporate co-trustee may be granted the administrative non-fiduciary responsibilities.

The ability to build a broadly diversified portfolio can help alleviate competing needs. If some aspect of the portfolio must produce a certain level of current income, allocations to income producing investments (such as bonds, MLPs and high dividend paying stocks) could be offset by higher return potential, illiquid assets such as private equity and real estate. Properly vetted hedge funds can also play a role in smoothing out the long-term ride for a risk adverse co-trustee, grantor or beneficiary.

Now that we have an understanding of some of the operational and administrative challenges, let's look at an example:

John names you and his long-time friend Bob co-trustees for a trust set up for the benefit of his five year old grandchild Tess. The trust has provisions that allow distribution of income or principal invasion for the benefit of his 35 year old daughter Mary (Tess' mother) pursuant to an ascertainable standard. Bob is a good friend of the family but has no investment or administrative background. The trust will break on Tess' 45th birthday.

Unfortunately, soon after the trust is set up, Mary loses her job and requests distributions to meet daily living expenses for her and her family. How do you adjudicate fairly between Tess and Mary, to meet Mary's current needs, while providing a real long-term rate of return for Tess? What is the right investment strategy to help you meet these competing goals? What is the maximum amount you should consider paying Mary and what policies should you have in place to help Bob and you make these decisions.

First, considering what you know about equity markets and long-term rates of return (noted above), you should have confidence that a strategy with significant allocations to assets which deliver equity like returns should provide the trust appropriate long-term growth. A clearly written Investment Policy Statement setting acceptable assets, guidelines and risk parameters, reflecting the long-term nature of investing will allow for confidence even in difficult markets. Additionally, a Delegation of Investment Authority by Bob to you will give you the ability to manage and realign the investment portfolio according to the guidelines initially established. This should help reduce some of the administrative burden of trying to link Bob in every time rebalancing occurs or a new strategy is added.

Second, given the confidence of a clear and concise long-term investment strategy, distributions to Mary can be considered, without fear of harming Tess' long-term well-being. Setting maximum distribution rates using a long-term view (30 years, not just 3 to 5 or 10 years) generally provides for a reasonable level of payout, even in today's low rate environment. If the current income level generated by the assets is not enough, the power to adjust could be incorporated to increase distributions. Again, history shows that even if Mary is drawing income for a period of time when markets are down significantly, the longevity of the trust should work in Tess' favor to provide significant capital appreciation when she turns 45.

In a worst case scenario, Trust loans, backed by strong policies defining interest rates, payment structures and duration can aid Mary during a difficult period, while protecting Tess' interest. These policies should be discussed upfront between co-trustees, clearly laying out roles and responsibilities in determination of terms and amount of the loan. The loan can be considered a fixed income asset in the trusts asset allocation, allowing the trustee to rebalance accordingly. Once Mary gets reemployed, she can pay off the loan with interest, making Tess' interest whole.

Properly vetted hedge funds can also play a role in smoothing out the long-term ride for a risk adverse co-trustee, grantor or beneficiary.

Conclusion

A well-defined investment strategy and operational structure, clearly written policies and a thorough understanding of roles and responsibilities between co-trustees and other fiduciaries form a strong foundation in managing the competing needs of multiple beneficiaries. These principles will provide trustees with the confidence to implement sophisticated investment programs that will have the ability to meet the financial objectives of different beneficiaries, even if the needs for each individual are completely different and occur over different timeframes. Combined with thoughtful, quantitative and qualitative analysis of available investment opportunities over short and long time horizons, these processes form a strong foundation for proper fiduciary standard of care while ultimately allowing long-lived trusts to serve their multiple purposes.