

Understanding trustee investment management responsibility

By **Brian Coughlan**
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With a mighty slash, the Arizona State Legislature postponed the new Arizona Uniform Trust Code until January 1, 2006. The new law, which was scheduled to go into effect January 1, 2004, was meant to be a guide for the uniform creation and administration of trusts, and to create a definitive statement of Arizona trust law. In the long run, trustee responsibilities will certainly not decrease, and most likely will continue to become more onerous for those serving in that capacity, so now may be a good time to review the investment responsibilities of a trustee.

Due to recent corporate governance issues, corporate fiduciaries have been faced with progressively increasing levels of accountability and liability. One consequence of this is ERISA's relatively new "prudent expert" standard (a tougher one than the "prudent man" standard that governs pension plan oversight). ERISA's new level of responsibility not only requires a fiduciary to act in a prudent manner, but also to act as someone adept at performing money management duties. This includes setting formal investment policy guidelines, having a formal set of processes and procedures in place for determining correct investment mix, reviewing holdings for suitability and performance, and maintaining a record of all decisions with regard to the plan. Fiduciaries that breach this responsibility may be held liable for any financial loss. As in the corporate arena, the recent proposed changes in trust law are placing more responsibility on individual trustees.

The rules that govern trustee investment responsibility can be found in Chapter 7 of Title 14, Article 6, of the Arizona Revised Statute. They state that a trustee who directs the investments and manages trust assets has a duty to comply with the prudent investor rule. The rule requires that an individual or corporation with the responsibility of overseeing a trust must provide a certain standard of care, and must understand and implement a specific portfolio strategy to ensure that risk and return objectives associated with the trust are met at all times. In addition, the trustee must take into consideration the purpose of the trust, whether that is to generate income, growth, preserve capital or a combination of the three, as well as the terms of the trust, distribution requirements and any other circumstances specific to the trust. The trustee must exercise reasonable care, skill, and caution, which often requires that they have a sufficient level of expertise to fill this role.

For large trusts, the necessary management and due diligence can become complicated.

As with any investment portfolio, the trustee should view the portfolio of investments as a whole, then take the time to understand the specific function of each investment and how it correlates with the goals of the trust. This is best performed by utilizing portfolio management software, frequently examining the portfolio's structure or asset allocation, and making the proper adjustments in allocation where needed to meet the specific needs of the trust. The

specifics of the UTC and prudent man rule require the trustee to synthesize an enormous amount of information on a regular basis. Trustees need to do more than review the investment portfolio at a single point in time. The portfolio allocation should be part of a larger overall strategy where the risk and return objectives correlate with those of the trust. Trustees are responsible for having up-to-date information with regard to risk tolerance levels, goals, and return objectives.

The actual investment management of the trust can take shape in several different ways. If the investments held within the trust are being managed by one of the trustees, that trustee is responsible for the implementation of the proper standard of care. If the trustee has the ability to hire a qualified investment adviser, a professional money management firm may also advise the trust. Accordingly, either trustee or manager must have breadth and depth of experience and knowledge when managing investment portfolios. Evaluating individual investments to ensure a proper fit takes time, care, patience, and above all, experience. According to the Arizona code, when making changes to a trust's portfolio, trustees are required have the following knowledge:

- ▶ Understanding of general economic conditions
- ▶ Possible effect of inflation or deflation
- ▶ Expected tax consequences of investment decisions or strategies
- ▶ The role that each investment or action has within the overall trust portfolio
- ▶ Expected total return from income and capital appreciation
- ▶ Other resources of the beneficiary
- ▶ Need for liquidity, steady stream of income or capital appreciation
- ▶ An asset's special relationship or special value

The ability to bring together these various requirements is often out of reach for individuals, as their ability to access analysts and independent research is often limited. Without this access, the ability to verify com-

pany facts and financials places a trustee in the precarious position of making investment decisions based on inferior or incomplete information.

The current code gives trustees an important responsibility with regard to the investment management of a trust portfolio. Trustees take on the role of a fiduciary, much in the same way as a board of directors oversees a corporation. As we have seen in the wake of corporate scandals, fiduciaries of all types have come under increased scrutiny with regard to the actions they have taken, and are facing increased levels of liability. With this in mind, it would be wise for trustees to ensure that they have the proper understanding and experience if self managing a trust, or engage a professional manager. The trustee should position him or herself like the CEO of a company, whose prime responsibility is to ensure that each part of the organization runs smoothly. This responsibility includes hiring the most suitable people to perform specific tasks, in this case, the money manager and custodian.

Typically a trust company, bank or brokerage firm would act as custodian, and the trustee would either use the in-house investment group at the custodian (if offered) or bring in an independent professional money management firm. The ability of the trustee to separate these functions is powerful, as it

helps avoid conflicts of interest, and ensures that the best firm is hired to perform each task. Should a relationship or service levels deteriorate with the money management or custodial functions of the trust, a change to that one function can be made without changing everything. Thought should also be given to successor trustees and beneficiaries in regard to the flexibility they will have to ensure that trust assets are properly managed and used.

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