3

Investments

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3.1 The Prudent Investor Rule

I. Overview

§3.1 The objective of this chapter is twofold: (1) to provide a basic survey of investments and (2) to provide a yardstick by which to properly advise clients. It is anticipated that the practitioner will both seek out, on his or her own, basic investment knowledge and, more importantly, be regularly presented with multiple strategies and tactics by professional investment advisors and resources.

In fulfilling his or her investment duties, the trustee must not only understand risk and risk management but also appreciate how much the practitioner's own perspective and the time in which he or she lives influences investment decision making. Most currently practicing senior money managers were raised and trained by individuals whose work careers began during the Great Depression. More importantly, these teachers grew up on bonds even though stocks had higher yields for decades. The concept of stock investing in any meaningful amount was virtually unheard of as recently as 1960. Today's practitioners either carry the experience of their teachers, along with the experience of their own careers, or they are too young to have a perspective of the place from which their profession grew. It is incumbent on investment professionals and, to a lesser degree, trustees and lawyers to be aware of the perspective they bring to their decision making. Knowledge of fads and speculative excesses is critical. An awareness of the tendency of people to find comfort among themselves with things they agree on is crucial. An awareness of the tendency of people to take a very short perspective, to take criticism poorly, and to overestimate their abilities is also critical. Investment management is a profession that, at best, is right half of the time and is viewed (perhaps correctly) by engineers, mathematicians, and accountants as guesswork. In spite of that view, the investment trustee must place himself or herself in the mind of the client, respect and understand the client's wishes, solicit the input of others (some of whom he or she may not agree with), and make decisions for the client that reflect not only the trustee's best judgment but his or her best efforts.

II. Investment Standards

A. Revised Probate Code—Prudent Man Rule

§3.2 Until April 1, 2000, the effective date of the Estates and Protected Individuals Code (EPIC), MCL 700.1101 et seq., fiduciary investment decisions were based on the standard found in Michigan's Revised Probate Code (RPC), MCL 700.1 et seq., and the Trust Fund Investment Act, MCL 555.201—the prudent man rule. The absence of a standard for trust investment in trust documents was common until around World War II; after that investment standards allowing discretionary latitude began to appear in trust documents.

The *prudent man rule*, as reproduced in the RPC, required the trustee to manage assets as follows:

> Except as otherwise provided by the terms of the trust, the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another, and if the trustee has special skills or is named trustee on the basis of representations of special skills or expertise, he is under a duty to use those skills.

MCL 700.813. It should be noted that the RPC imposed a higher standard on professional trustees who have or represent that they have special skills.

The prudent man rule was also codified in the Trust Fund Investment Act. This statement of the rule was somewhat different than the RPC rule:

> In the absence of investment specifications or limitations in the agreement, instrument, or order, trust property or funds shall within a reasonable time be invested … as an ordinarily prudent person of intelligence and integrity, who is a trustee of the money of others, would purchase, in the exercise of reasonable care, judgment, and diligence, under the conditions existing at the time of purchase, having due regard for the management, reputation, and stability of the issuer and the character of the particular securities.

MCL 555.201(1). The act provided a list of permissible investments in the absence of investment specifications or limitations in the trust agreement.

Common to both statements of the rule is that the standard is based on how others would act. The prudent man rule was originally developed in *Harvard College v Amory*, 26 Mass 446, 461 (Pick 1830), in which the duty of the prudent man was to act as *other* trustees would act under like circumstances. At the time, the rule was viewed as great progress for encouraging judgment and allowing trustees to look to their fellow professionals both for their support and their benchmark.

More important, the court cases began to evaluate investment risk in mathematical terms. This was a change from the long-standing practices, such as that in New York State of having an approved list of securities. So long as a trustee bought from that list, in whatever concentration or valuation, the trustee was insulated from criticism. Recognition that something could still go wrong with what was felt to be a solid list of securities caused practitioners to search for other answers.

Investment management under a strict prudent man standard generally can be viewed as limiting when one considers that it

- focuses on highly rated debt instruments, usually A or better;
- focuses on dividend-paying common stocks;
- focuses on individual assets and discourages collective funds or mutual funds;
- is approved by the courts for being diversified; and
- holds mature, established companies with substantial (more than 10 years) operating histories and reflects a minimal amount, if any, of trading activity.

The prudent man standard could be implemented by using one or a combination of three fundamental approaches:

- Buy and sell as others do in similar circumstances.
- Buy and sell from an approved universe of investments (such as those listed in the Trust Fund Investment Act).
- Buy and sell at the level at which the trust beneficiaries feel comfortable.

Of course, relying on beneficiary comfort is risky at best. Therefore, a trustee acting under the prudent man standard had to implement approach 1 or 2 or a combination of the two if the trustee wished to be able to defend his or her actions against an unhappy beneficiary. Note that after April 1, 2000, a reference in the trust to the "prudent man rule," unless otherwise limited or modified, is construed to authorize investments according to the prudent investor rule. MCL 700.1511. See §3.5.

B. Estates and Protected Individuals Code

1. Prudent Investor Rule

§3.3 EPIC adopts a modern investment standard, the *prudent investor rule*, which was first stated as a principle of trust law in the *Restatement (Third) of Trusts: Prudent Investor Rule*. Michigan's enactment of the rule is found in MCL 700.1501–.1512. It is printed in its entirety as exhibit 3.1.

The prudent investor rule originated in the Employee Retirement Income Security Act, 29 USC 1001 et seq., which virtually rewrote the prudent man rule and introduced the important new thought that managers (trustees) should and could diversify risk by evaluating it in the context of the entire portfolio.

Three elements are of particular interest. From the perspective of a prudent investor, an individual trustee may

- hire professionals and delegate previously nondelegable duties to others more qualified in investments (in fact, the trustee may be expected to do so), *see* MCL 700.1510;
- be evaluated for the performance of the portfolio as a whole and less subject to criticism for the single or few investments that do not prove successful, *see* MCL 700.1503(1); and
- be faulted for not using collective or mutual fund strategies since these offer, it is suggested, a lower-cost alternative to individual securities and a means to broadly diversify a small portfolio.

Two issues are reflected in this third element: 1) it is difficult for a small portfolio to properly diversify without incurring proportionately higher transaction costs usually associated with fewer than 100 share purchases and 2) an individual trustee, such as a family member, family attorney, etc., has a far more difficult job doing all the due diligence for individual stock or bond purchases than he or she would have doing due diligence on a mutual fund. In contrast, a corporate trustee with many investment managers and broad access to numerous research services has a somewhat easier task doing stock and bond research and, more importantly, gains economics of scale from that work as it is applied to a large pool of accounts. The cost of fulfilling the trustee's due diligence duty, along with the actual product cost, must be considered by the trustee, who has a duty to incur only costs that are appropriate and reasonable in relation to the trust assets, the purposes of the trust, and the trustee's skills. MCL 700.1508. An individual trustee could spend a disproportionate amount of money to do the background work a corporate trustee does in the normal course of business.

The prudent investor rule and the requirements it places on a trustee can be summarized as follows:

- 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.
- Investment strategies and portfolios should be custom tailored to the needs of each particular account. Factors include trust duration, needs of the beneficiaries (current and remainder), taxes, and risk tolerance.
- The investment process is dynamic; ongoing review and documentation and reaction to changing needs, economic situations, and the like should be evident.
- In light of the higher standard to which a trustee is held and the necessity for a dynamic investment strategy, the process includes the consideration of short-term strategies and techniques along with the long-term investment focus.
- In light of the overall portfolio approach, no particular type of investment, including those previously viewed as speculative, is considered improper per se. The new theme is risk management rather than avoidance.
- The duty to preserve trust assets is broadened to include the preservation of real (inflation-adjusted) value, not just nominal value.
- Diversification is fundamental.
- Pooling (a common trust fund, or CTF) is preferable to active management. Active management is believed to be riskier because of the lack of diversification.
- A trustee is required to move promptly, as markets and taxes allow, toward a formulated plan of disposition and reinvestment, as needed, of the initial trust assets.
- 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. This change reflects the higher standard discussed above and seems to be based on the fact that outside advice is cheaper and the only practicable way to take advantage of newer and more sophisticated techniques.
- Any investment strategy must be cost effective. Except in very large accounts, passive investments (all CTFs) will generally prove more cost effective than active investments, which require extensive research, higher transaction costs, etc.

2. Comparison with the Prudent Man Rule

§3.4 Under the prudent man rule, the silent document had the potential for being the best document in the belief that no rules are the best rules if knowing hands are in control. It also had the possibility of being the worst document as it gave no room for recourse if the trustee did no more than blindly mimic others. In recent years, discretionary language in trusts has given the trustee room to think and an opportunity to use often competing or contradictory views in portfolio construction. It has also increased trustee liability. During the last 25 years, professional money management grew around the idea that scientific, rational methodologies could be developed to control this liability and to end the debate about how to invest by reducing the process to a series of mathematical assumptions. Over all hangs the tension between a trustee's attempt to behave responsibly, the nature of the times in which he or she makes decisions, the needs of the client, and the advent of scientific rationalism.

The trend in investment standards moves from an early standard of *personal judgment* to a trend of *risk awareness* in the prudent man rule and finally to *risk management* in the prudent

investor rule. Expected results also migrate from absolute results to a more quantified, risk-adjusted relative performance.

From a practical standpoint, key parts of the prudent man rule and the prudent investor rule can be contrasted as follows:

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.

The prudent investor rule is a more modern standard by which to measure a trustee's actions. It is a blessing in that it grants broader protections and powers, but these are paid for by imposing more active management of the portfolio on the trustee. A trustee can no longer blindly follow the lead of other trustees or pick investments from an approved universe.

3. Applicability

§3.5 As with the other provisions of EPIC, the Michigan prudent investor rule is a default rule that may be expanded, restricted, eliminated, or otherwise altered by the provisions of the governing instrument. The trustee may act in "reasonable reliance on the provisions of the governing instrument" and incur no liability to the beneficiaries. MCL 700.1502(2).

EPIC provides that certain language in a governing instrument triggers the application of the prudent investor rule:

> The following terms or similar language in a governing instrument, unless otherwise limited or modified, authorize any investment or strategy permitted under the Michigan prudent investor rule:
>
> (a) "Investments permissible by law for investment of trust funds."
>
> (b) "Legal investments."
>
> (c) "Authorized investments."
>
> (d) "Using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of 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 their capital."
>
> (e) "Prudent man rule."
>
> (f) "Prudent trustee rule."
>
> (g) "Prudent person rule."
>
> (h) "Prudent investor rule."

MCL 700.1511.

The prudent investor rule applies to "a fiduciary estate that *exists on or is created after* this act's effective date. As applied to a fiduciary estate that exists on this act's effective date, the Michigan prudent investor rule *governs only a decision or action that occurs after that date*."

MCL 700.1512 (emphasis added). This implementation rule applies to investment decisions and overrides the general implementation rule found in MCL 700.8101(2).

C. Other Standards

1. In General

§3.6 While not adopted as standards in Michigan, the Boston trustee standard and the balanced approach have been applied in other jurisdictions. These standards are reviewed to make the practitioner and the trustee aware of them, keeping in mind that a Michigan trust agreement could apply one of these standards and override the default prudent investor rule.

2. The Boston Trustee

§3.7 A phrase not used in Michigan but a practice nonetheless present in the late 1960s, the *Boston trustee* standard is based on the idea of a family lawyer who does as he or she sees fit based on both the family's trust and his or her assumed detailed knowledge of family matters. It is often seen in Michigan documents when the cotrustee or successor-trustee are named individuals rather than a corporate or professional practitioner. This relationship works well when investing focuses substantially on bonds and real estate and was more common when common stocks were viewed as speculative, as was true well into the 1970s, and little experience or financial analysis training was required or even thought necessary in a trustee.

3. The Balanced Approach

§3.8 This approach focuses on an awareness that stocks appreciate in value but provide little stability in income and valuation and, equally important, that bonds are safer and nearly constant in value and provide a higher, more stable income stream. A mix of 50-50 or 60-40 is thought practical under this approach, as it provides attention to both the income needs of the life interest and a backhanded recognition that capital appreciation could protect remainder beneficiaries from the risk of reduced purchasing power in the future. This approach also requires little beyond a basic understanding of common stocks. However, it fails to acknowledge the effect serious inflation could have on the supposed safety of bonds.

4. Unlimited Discretion Approach

§3.9 Somewhat more common in recent years is trust language granting the trustee "discretion" or "unlimited discretion" with respect to investments. The discretionary language approach allows the trustee to construct the portfolio closer to what typical portfolios look like for individuals in similar circumstances. It differs from the stricter prudent man rule in that it allows the trustee to introduce his or her own interpretation into the portfolio construction, while under the prudent man rule the trustee is expected to merely echo the behavior of other trustees in a similar role.

III. Investment Procedure

A. Initial Review of the Trust

1. Goals of the Trust

§3.10 The first step in the investment process is to read the trust instrument. This is necessary to identify (1) the terms of the trust regarding investment powers, restrictions, and standards; (2) the beneficiaries; (3) the goals established or intended by the grantor; and (4) short- and long-term liquidity needs (estate taxes for example). After this first reading of the trust, the trustee can begin to establish the investment goals to be met.

The trustee must review a myriad of items in determining the investment goals of the trust. The prudent investor rule provides:

> (1) A fiduciary's investment and management decisions with respect to individual assets shall be evaluated not in isolation, but rather in the context of the fiduciary estate portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fiduciary estate.
>
> (2) Among circumstances that a fiduciary *must* consider in investing and managing fiduciary assets are all of the following that are relevant to the fiduciary estate or its beneficiaries:
>
> (a) General economic conditions.
>
> (b) The possible effect of *inflation or deflation*.
>
> (c)The *expected tax consequences* of an investment decision or strategy.
>
> (d) The role that each investment or course of action plays within the overall portfolio, which may include financial assets, interests in closely-held enterprises, tangible and intangible personal property, and real property.
>
> (e) The *expected total return from income and the appreciation* of capital.
>
> (f) Other *resources of the beneficiaries*.
>
> (g) The need for liquidity, regularity of income, and preservation or appreciation of capital.
>
> (h) An asset's *special relationship or special value, if any, to the purposes of the fiduciary estate or to 1 or more of the beneficiaries*.
>
> (3) A fiduciary shall make a *reasonable effort to verify facts relevant* to the investment and management of fiduciary assets.
>
> (4) A fiduciary may invest in any kind of property or type of investment consistent with the standards of the Michigan prudent investor rule. A particular investment is not inherently prudent or imprudent.
>
> (5) A fiduciary who has special skill or expertise, or is named fiduciary in reliance upon the fiduciary's representation that the fiduciary has special skill or expertise, has a duty to use that special skill or expertise.

MCL 700.1503 (emphasis added).

All of these items need to be considered in developing the investment goals of the trust. Unfortunately, most beneficiaries and settlors express investment goals as simply the pursuit of more income, capital gains, and minimal risk. This trinity of income, growth, and risk reduction is difficult to quantify, more difficult to achieve, and subject to outside influence at any time. For example, beneficiaries in pursuit of higher income often desire less-than-investment-grade securities for their higher yield and are unaware that the higher yield reflects higher risk. Conversely, beneficiaries seeking capital appreciation frequently use historic results as harbingers of future results and are blissfully unaware that there is no correlation between past performance and future results. Here, the risk is of inferior returns in the pursuit of superior results, and a particularly high level of risk for each.

Goal setting requires a candid discussion between the trustee and the settlor or beneficiaries of short-term goals, which generally center around disposable income, and long-term goals, which generally center around having more assets. Most individuals understand inflation. Most individuals anticipate that they will need more money tomorrow than they do today. The difficulty of candid goal setting is that it requires delayed gratification. Generally speaking, companies that pay very high dividends rarely show superior appreciation over time. Simultaneously, high-yield bonds or other such fixed-value instruments show no appreciation over time and thus are worth less in real dollars. It is for good reason that professional investment managers believe that bonds and notes are risky in the long run and that stocks are risky in the short run, because of the lack of principal growth in bonds and the immense volatility of stocks.

The trustee's duty, then, is to carefully spell out the risks in pursuing *either* asset class exclusively, both long and short term. The trustee is further obligated to be aware that absolute conflict will exist between remainder beneficiaries looking for a larger portfolio and income beneficiaries looking for maximum current income. The practical solution is to invest in assets with the potential to reproduce themselves, to wit, stocks, and on a periodic basis capitalize some capital gains into income-producing assets. This process can take time, requires the acceptance of relatively less income at the beginning, hopefully in return for more income in the future. Most income beneficiaries forget that they, too, suffer from inflation over time and that their goal and the remainder beneficiaries' goal is the same: overall growth of the asset pool so that it will be on a larger and larger base whatever the commonstock yield.

2. Income Beneficiaries Versus Remainder Beneficiaries

§3.11 The trustee and the practitioner should also keep in mind that the prudent investor rule states, "If a fiduciary estate has 2 or more beneficiaries, the fiduciary shall act impartially in investing and managing the fiduciary assets, and shall take into account any differing interests of the beneficiaries." MCL 700.1507.

Therefore, a trustee must determine if the overall mix of the portfolio provides for both current income needs and capital growth for remainder interests. General guidelines include the following:

- Assume that inflation persists around 3 percent.
- Common stocks have two to three times higher total return than bonds *only* if dividends are not taxed and are entirely reinvested. In brief, stocks grow, bonds don't, and dividends and interest are usually distributed and spent, not reinvested. Accordingly, a proper mix to address both interests is critical.
- Illiquid assets should have a defined role (i.e., growth of value or current income), and that role should be reviewed annually.
- The portfolio should be diversified (i.e., no asset or class of assets should dominate the portfolio). See the discussion of diversification in §3.19.

Often the need most expressed by beneficiaries and least likely to change is for more annual income. The trustee will find that over time this voiced need tends to become more frequently addressed than the unvoiced needs of remainder interests. The natural tendency to construct a portfolio heavily focused on current income (usually under the justification of divining the intent of the settlor) is significant and should be resisted by the trustee.

An annual review by the investment manager of the beneficiary's consumption patterns, for example, may be outside the trustee's written duties, but he or she has that duty. The investment portfolio should reflect a balance when dealing with split-interest trusts and common sense when dealing with trusts constructed for an individual's lifetime. Under the prudent investor rule, a fiduciary must consider "[o]ther resources of the beneficiaries" and has a responsibility to "make a reasonable effort to verify facts relevant" to investment decisions. MCL 700.1503(2)(f), (3).

3. Role of Taxes

a. Income Taxes

i. In General

§3.12 There are two broad classes of taxes to consider: income taxes, which affect the current income beneficiary and the growth of the principal for the remainder beneficiaries, and transfer (gift, estate, and generation-skipping transfer) taxes, which can cause severe liquidity needs

when they become due. Transfer taxes are discussed in §3.15. With respect to income tax issues, a unit trust approach, if permitted by the trust instrument, is often an appropriate way to minimize income tax liability. Investment in tax-free bonds is another common method of income tax avoidance, but the investment trustee should be wary of the pitfalls associated with it, not the least of which is the absence of inflation protection.

ii. Unit Trust Approach

§3.13 The income tax issues in portfolio management can be the easiest issues to resolve. The maximum long-term capital gains tax rate that individuals and trusts are subject to is approximately 20 percent, and the maximum ordinary income and short-term capital gains tax rate for trusts and individuals is about 40 percent. These rates may increase depending on the state of residence, as states also impose a state income tax. The Michigan income tax rate was 4.1 percent in 2002. Thus, if tax must be paid, the generation of current income from dividends and interest is less desirable than the generation of capital gains. The portion of income from bonds and notes, even tax-free income from municipal bonds, is a short-term solution devoid of delayed gratification and represents acceptance of the effects of inflation on the tax-free income stream and the bond that provides it. The astute long-term investor normally seeks ownership in companies that do not declare meaningful dividends (thus subjecting corporate earnings to dual taxation) and, in fact, seeks corporations whose reinvestment in the growth of the business and in the growth of earnings maximizes shareholder value and allows the portfolio to (at times) sell nominal amounts of the stock holding at capital gains rates and distribute the proceeds.

This strategy only works if the trust permits distributions from trust principal for income beneficiaries. The experienced practitioner encourages the use of a unit trust approach with properly chosen safeguards to serve both future and current interests. One such strategy might be to assume a long-term growth of capital of 5 percent and, with the reinvestment of the dividends (however small), a compound total return of principal and reinvested dividends of about 10 percent. This is incidentally the historic record and assumes that corporations paying nominal dividends have a long-term dividend growth rate of about 4 percent. For this example, then, one approach to a unit trust strategy might operate under the following assumptions: (1) a 1 percent annual fee, (2) 3 percent annual inflation, (3) a 5 percent annual payout, and (4) 1 percent annual transaction costs. For solely illustrative purposes, then, the income beneficiaries can anticipate a monthly payout that rises slowly with principal value, and the remainder beneficiaries can anticipate a focus on slowly rising total value. The transaction costs and other such deductible items have the potential to offset the tax payments to a great degree.

iii. Municipal Bonds

§3.14 In an effort to avoid income taxes to the income beneficiaries, many trustees invest in municipal bonds. The risk of tax-free bonds is the tendency of investors to acquire bonds almost exclusively in their state of residence. The reason generally given is that their home state has an onerous income tax rate (e.g., California), which can be avoided by investing in securities in the state. Of course, the penalty is that assets in bonds do not appreciate and that the lower rate being received, chosen because it is tax free, distracts trustees from a more critical analysis.

Two factors should be considered when investing in a single state's bonds. First, there is a real possibility that investing in the tax-free bonds of some other state may have a higher gross yield, and although they might necessitate the payment of a state income tax, the *net* yield might be the same or even better. Achieving the same amount of income and improving the diversification is recommended. Second, it is possible to purchase government or very high quality corporate debt, pay the federal and/or state income tax, and have a higher after-tax income. This occurs when cer-

tain states are perceived to have highly desired or scarce tax-free bonds and local residents bid them up in price without regard to after-tax return.

The trustee is advised to diversify municipal portfolios aggressively; to avoid having more than 10 percent of the portfolio in any single holding; and to be aware that although a municipal bond is insured, there is still the possibility of capital loss. Many investors acquire nothing but insured municipal bonds without recognizing that they are fundamentally purchasing not a municipal bond but the creditworthiness of the insuring corporation. Municipals escrowed in treasuries represent a far safer ultraconservative strategy than private corporate insurance.

Last, it is worth noting that the municipal bond market has yet to reach a full disclosure state in which a seller or buyer may see the last trades of a specific security or a bid-ask matrix (unless the buyer or seller is a registered representative). Very wide spreads exist between the bid and the asking prices, often as much as $3 per 100, and information quoted is based on current yield rather than yield to maturity. The trustee is advised to go very, very slowly in this still inefficient market.

b. Transfer Tax Liquidity Needs

§3.15 The management of assets in a postmortem trust portfolio is heavily influenced by the liabilities of the estate. These same issues can also arise in administering an inter vivos trust relative to gift taxes incurred by the settlor during life. Generally:

- It is incumbent on the trustee to match known liabilities with the money market accounts, treasury bills, and other liquid, short-term quasi-cash instruments. It is inappropriate to leave assets invested in price-volatile assets, however liquid, when known liabilities exist.
- Equally obvious, ultimate ownership defines the objective of the investments. Therefore, the trustee should choose assets to liquidate, to the extent possible, that leave appropriate assets in the trust for the ongoing beneficiaries' enjoyment.

The trustee can and should anticipate for whom the assets will ultimately work and, after reserving for known payouts, should immediately begin to reconstruct the portfolio to the new objectives. The migration process, consisting of the purchase of new assets and the sale of old ones, tends to work smoothly if

- sales are made from concentrated positions first, other things equal;
- sales are then made from individual securities; and
- sales are made last from mutual or collective funds.

The logic is to create diversity during the management process by reducing concentrations first and maintaining the diversified nature of mutual funds until last.

Much the same logic applies with fixed-income assets, except that U.S. Treasury issues are an approved concentration, logically, and credit quality supersedes all decisions. Even a small holding of a poor credit should be sold before almost anything else.

The trustee is often impeded by cost basis issues. Practice has evolved to assume the date-of-death value as the basis, i.e., to not wait for an alternative valuation date to make investment decisions because of the inherent risk of delay. The trustee should be mindful that the gross sale price of an asset in the first six months after a decedent's death is used as the alternative valuation for the sold asset. Therefore, the sale of assets to raise liquidity for estate taxes also "locks in" value for estate valuation purposes.

The trustee should also expect to find an asset allocation favoring the deceased settlor, for example, to find a portfolio consisting heavily, if not exclusively, of bonds. When the trust divides after the settlor's death into trusts for the surviving spouse and children, the trustee should reallo-

cate assets between the remainder interests sooner rather than later. An all-bond portfolio is appropriate for an elderly surviving spouse but hard to defend for mature children when the grandchildren are remainder beneficiaries. Once allocated, however, it is difficult to readjust ratios as beneficiaries grow comfortable with the settlor's design and income stream.

B. Review of Assets—Retention Versus Sale

1. In General

§3.16 The prudent investor rule requires that the trustee review the portfolio on acceptance of the appointment:

> Within a reasonable time after accepting appointment as a fiduciary or receiving fiduciary assets, a fiduciary shall review the assets, and make and implement decisions concerning the retention and disposition of assets, in order to bring the fiduciary portfolio into compliance with the purposes, terms, distribution requirements expressed in the governing instrument, and other circumstances of the fiduciary estate, and with the requirements of the Michigan prudent investor rule.

MCL 700.1505.

Assets in a trust portfolio may be liquid, such as stocks, bonds, or mutual funds; partially liquid, such as mineral rights, real property, or a closely held business, for each of which a market can eventually be found; or virtually illiquid and yet of value, such as stolen property hidden by the settlor and unknown until after death. In each case the trustee, when evaluating the duty to retain, *from an investment perspective*, should attempt to segregate the assets into two categories:

- those likely to remain at about the same value but produce an income stream, e.g., mineral rights, long-term building leases, etc.
- those likely to rise or fall in value in proportion to market forces and not necessarily provide a rising or even constant stream of income, e.g., a taxi cab company, the work of a currently popular artist, or a patent

This broad classification is suggested to assist the trustee's investment decisions by first classifying each holding as likely to benefit the income beneficiaries or the remainder beneficiaries. The trust may contain a power of retention, based on the settlor's assumption of ongoing income or the chance of greater future value. Ascertaining the settlor's intent is critical to the trustee's determination of whether to defend or challenge the document retention language.

At issue is the trustee's duty to challenge retention authority if it is appropriate to do so. Imagine a portfolio filled only with long-term bonds of a single, publicly traded corporation whose business is being gradually eroded by new products, as happened to the rail systems of some East Coast cities when cars became available to the average wage earner. Similarly, imagine a portfolio solely invested in IBM common stock, or U.S. Steel. The asset need not be the whole portfolio; the issue is long-term potential versus short-term return. A mineral lease with high current income and a short expected life may be perfectly appropriate as a bond-like substitute and should not be viewed as part of the equity portfolio. On the other hand, undeveloped land with no current income potential may be perfectly appropriate if retained as part of the equity portfolio.

The power to retain therefore carries with it the duty to assess both the role the asset plays in the portfolio and the likelihood that the role can be sustained.

The trustee directed to retain specific common stocks faces a more difficult challenge because there will be (numerous) other, published opinions about the stocks in question, often contradicting each other. Here, as in the case of the less marketable assets, the basic questions apply:

- Is the holding a concentration (i.e., greater than 10 percent of the portfolio)?
- Is the holding part of the families' other wealth, outside of the portfolio in question?
- Is the nature of the stock such that it provides competitive current income, or is the stock assumed to have growth potential?
- Is there a likelihood of failure (of the asset becoming worthless)?

The trustee may be tempted to accept the protection of retention language and move on, but the trustee wearing the hat of the investment manager is obligated to explore long-term viability in light of information or circumstances now available that may not have been available to the settlor. In any case, the power to retain carries with it the explicit duty to test the assumptions, from an investment perspective, that led to the settlor's decision to retain in the first place.

It is not uncommon to find documents with retention language so broad that they allow any action the trustee wishes, e.g., "The trustee is directed to retain XYZ asset so long as, in the trustee's opinion, such an action is appropriate and in the best interests of my family," or written to challenge logic, "The trustee is directed to retain XYZ asset without regard to valuation, effect on the portfolio, portfolio income, or the family's wishes." Nonetheless, the trustee acting in the role of investment manager, or supervising the activities of an outside investment manager, should regularly challenge the viability of retention and, most important, assemble the *balance* of the portfolio to reflect a retained asset.

Assets that do not match the investment goals of the trust or that are not of sufficient quality should be liquidated in a tax- and investment-sensitive manner. The resulting liquidity can then be invested in appropriate assets that meet the goals of the trust.

2. Investment in Funds of the Corporate Trustee

§3.17 Unless the trust instrument provides otherwise, a corporate trustee generally may not invest in the assets of that corporation. Furthermore, neither individual nor corporate trustees may invest in a business owned by the trustee because such investment would represent a conflict of interest or an act of self-dealing. See the discussion of conflicts of interest in §2.15. However, a trustee may deposit trust funds in a bank operated by the trustee. MCL 700.7401(2)(f). The purpose of the general prohibition is to avoid any appearance of impropriety or conflict of interest.

Much the same issue applies around retention. Absent specific direction by the trust instrument or a court order, it is appropriate for a corporate trustee to dispose of its own shares in an orderly, tax-sensitive manner. If a cotrustee or a beneficiary has personal reasons for wanting to retain the shares of a corporate trustee, a nominal holding (less than 1 percent of the portfolio) might be appropriate, but even then the corporate trustee should obtain written indemnification from the cotrustee or beneficiary every year or two. Note that this applies only to retaining existing holdings, not to new investment.

More common than the presence of stock in the trustee corporation is the presence of the trustee bank's certificates of deposit as part of a trust's assets when the account is opened. Absent a specific direction to retain these assets, they should be disposed of by maturity or earlier if there is no penalty involved in premature termination. The presence of a particularly attractive yield does not invalidate the inherent conflict.

However, if the trust document does not prohibit it, and if the corporate trustee complies with any consent requirements imposed by EPIC, the corporate trustee may invest in CTFs issued by the corporation. MCL 555.103. CTFs are pooled investment accounts that are created by a financial institution for its trust customers. These are no longer a common investment vehicle as many financial institutions have shifted to mutual funds managed by the fiduciary's investment department.

C. Investing the Assets of the Trust

1. In General

§3.18 Once the trust's investment goals have been established and the trustee has reviewed the assets for their suitability to those goals, the trustee must invest the assets appropriately. Nonconforming assets should be liquidated and the proceeds invested to achieve the investment goals of the trust. As noted above, diversification of the assets to minimize risk and address the needs of the income and remainder beneficiaries must also be implemented.

2. Diversification

§3.19 Trustees subject to the prudent investor rule are required to diversify investments unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. MCL 700.1504. Investment professionals recognize that diversification strategies are the most effective means to increase or decrease risk. Most diversification strategies are based on choosing investments (1) that are negatively correlated with each other, that is, when one is rising in value the other is likely failing, and (2) that are driven in opposite directions by outside phenomena. A simple example of the latter would be when rising interest rates caused an increase in the price of gold and a decrease in stocks and bonds. Negatively correlated assets might be exemplified by two consumer products whose combined share of the market is relatively fixed, as with milk consumption; thus, an increase in the sales of one company's product (skim milk) adversely affects the sales of another company's product (whole milk).

The investment professional must be aware of how individual assets in a client's portfolio interact with each other and, equally important, have sufficient assets of different types in the portfolio to provide some stability. An example is to have perhaps 15 to 20 common stocks in different industries to offer an opportunity that some will be performing quite well while others are lagging.

Diversification has a time component. As there is clear evidence no one can successfully time entry and exit into or out of any market with any degree of repeatable certainty, the trustee is free to invest or divest positions in phases (or all at once) to suit the circumstances. Two examples illustrate:

- *Dollar averaging* remains one way to commit capital gradually but surely, while avoiding to a great degree the extremes a single bad day could create. It is not as effective as committing all at once, however.
- Committing half of an existing position to a tender offer at a price well above the recent market leaves the trustee in the position of defending either outcome: withdrawal or completion of the tender. In such a case, the trustee could alternately sell half of the position in the open market on announcement of the tender, diversifying uncertainty by half.

A multitude of mistakes are committed under the flag of diversifying a portfolio. Some of the most common include the following:

- The portfolio holds a large number of different municipal bonds (diversified), but they are all general obligations of the same state. A variation is the state-diversified municipal portfolio in which all the instruments have the same credit enhancement, e.g., MBIA Insurance Corporation or Financial Guaranty Insurance Company, which leaves the investor exposed not to the credit of the state but to the ability of the insurance company to pay in the event of a default; the investor is tied to the insurer. A portfolio *can* be all one state; diversity might be achieved with water, school, and general obligation bonds, for example.

- The portfolio uses an index fund, a mutual fund of common stocks that emulates the Standard and Poor (S&P) 500, as a means to provide stock diversity. The S&P 500 and all index funds built to copy it are heavily influenced by less than two dozen large companies, which create more than a third of the performance. These companies are substantially all classified as "large capitalization growth" and are absolutely a nondiversified, style-specific investment for the holder of an index position. Indexing is an appropriate method only if this style is the goal.
- The portfolio has a long list of stocks, but virtually all are in the same industry, such as Internet stocks. In this situation, sector risk can easily wipe out the risk dispersion that having many different holdings implies, or it may be precisely the *compound* risk desired.
- The portfolio acquires more than about 50 or 60 stocks across, perhaps, eight or nine of the ten widely-recognized industries, e.g., consumer durables, utilities, metals, etc. At some point, excess diversification will neutralize any incremental return active management may offer.
- The trustee assumes that a bond-stock blend of, say, 50-50 with the stocks heavily focused on current income (high-yield common) is diversified, when, in fact, the portfolio is likely to be primarily influenced by changes in the level of inflation and interest rates, rather than economic growth or decline.

The trustee attempting to increase risk may use these techniques but must be cognizant of the appropriate level of risk. In conclusion, diversification contains within its very act the potential of an increase in risk. The trustee should seek a clear explanation of the logic process behind any diversification theory and be prepared to challenge the assumptions on which it is based.

3. Particular Investments

a. Stocks

§3.20 A trustee investing in stocks should diversify investments according to the following guidelines:

- At least 25 and preferably not more than 60 or so stocks should create appropriate diversity.
- A heavier concentration of stocks generally appears in the more aggressive, i.e., risk-oriented, portfolios, unless the trustee consciously wishes to have the increased risk of concentrated holdings.
- Of the ten major S&P 500 industry groups, representation in eight or more will give diversity to sector risk, unless the trustee wishes to have that risk present.
- An understanding of the size of the companies being purchased, as the following table illustrates, will alert the trustee to the portfolio's "style" influence or "style" of return potential. In the table, market capitalization is an indicator of company size and is calculated by multiplying the number of shares outstanding times the price per share. Earnings potential tends to vary inversely with company size:

Style name	*Market capitalization*	*Earnings growth* (5 years from 1998)
Large cap	$89 billion	14.7
Mid cap	8 billion	15.2
Small cap	2 billion	18.6
S&P 500	70 billion	14

- A careful trustee will be alert to the risk of a common element in most of the stocks held. Examples include stocks well diversified by industry but exposed uniformly to labor costs, stocks heavily dependent on the service sector or the military but otherwise diversified, and stocks possessing very high (or low) exposure to export factors.

b. Bonds

§3.21 The factors to evaluate when building a bond portfolio include the following:

- Although longer-term bonds (greater than 20 years) tend to have high yields, they are more volatile in price when interest rates change. Key to any bond portfolio, then, is defining
  - the longest and shortest acceptable maturity and
  - the amount to be allocated to each year within that time frame.

  A level or laddered maturity (equal amounts will mature each year) allows the trustee to dampen swings in interest rates and thus income; neither the highest nor the lowest rates will fully affect the portfolio over its life.
- The trustee should diversify by industry, in the case of taxables, and by state, in the case of municipals, with no more than 30 percent in any one industry or state.
- Diversifying bonds is costly (commissions), so if an actively managed portfolio is desired, a no-load fund is likely more efficient. Generally, anything less than $1,000,000 per issue is viewed as an odd-lot and priced (and commissioned) accordingly, often up to 3 percent more than a round lot of $1,000,000.
- Odd amounts (e.g., $17,000 or $82,000) are virtually unsalable for what is paid for them and should be kept, other things equal.
- Although a bond from a state other than the taxpayer's is subject to local tax, its coupon may be high enough to justify the tax and gain diversity in the process.
- The few dollars of income gained by dropping down in quality is seldom justified; the risk of total loss for a modest income increase is not logical. That said, some lower-tier credits have the potential of being upgraded in rating. Here again, the trustee manager should turn to expert advice.

c. Mutual Funds

§3.22 Pooling money with others to achieve certain economies of scale can be seen in insurance (Lloyds of London), shipping (the Spanish fleet), and finance (mutual funds), among many others. In this regard, the prudent investor concept anticipates that trustees will recognize and use processes that control cost, provide diversity, and, on balance, benefit the trust account. On the surface, the concept is clear, but to paraphrase a French management theory, "It's great in practice, but it'll never work in theory." Pooled investment assets are a part of every investor's portfolio, but practical pluses and minuses do exist.

A common trust fund or mutual fund offers advantages of scale in

- researching possible investments, i.e., *attracting* ideas;
- trading (brokerage) costs and buying power;
- administration and accounting efficiencies;
- attracting talented employees;
- minimizing fees as a percentage; and
- in the case of mutual funds, daily liquidity (many common trust funds are also moving to daily entry and exit).

Mutual funds, in particular, offer portability, collateral features, and educational materials.

Equally importantly, some features of both common and mutual funds may *not* be desired:

- Many mutual funds find it difficult to stay true to their style when performance slips, and this style shift can seriously disrupt tax *and* investment strategies.
- Trading activity in mutual funds of upward of 200 percent turnover in the pursuit of performance virtually eliminates the lower capital gains tax rate to unit holders.
- Costs have risen to, in some cases, 2 to 2.2 percent of assets, while industry averages are less than 1.5 percent.
- Common funds do not give the collateral, daily entry and exit ability, and portability that mutual funds do.
- Many believe that quarter-to-quarter performance reporting influences investment decision making and prevents long-term thinking.

Although the wide variety of mutual funds does offer the trustee significant assistance in matching client objectives to available products, it is increasingly clear that mutual funds are in a performance race, and that does and will affect net, after-tax, total return.

The trustee using money market mutual funds should ask the following questions:

- Is the fund allowed to borrow to leverage its return, and how much?
- Does the fund limit its investments to A-1 or P-1 ratings with A-2 or P-2 not over 10 percent?
- Does the fund limit its average maturity to a range of 10 to, perhaps, 60 days at the extreme, and does no single asset within the mutual fund exceed one year maturity or more than 1 to 3 percent of the fund?
- Do fund fees fall between 20 and 70 basis points, i.e., 20/100 of 1 percent to 70/100 of 1 percent?
- Does the use of derivatives within the fund generally not exceed 10 percent of the fund assets so exposed?

On balance, the competition for public money leads money market funds to often stretch risk—to lever, to use derivatives, etc.—to pick up two-, three-, or four-tenths of a percentage point. The trustee should be aware of (widely) published mutual fund yields and, particularly, current average yields. Risk and return are related, and only the most sophisticated of investors should seek the highest possible short-term returns.

d. Derivatives

§3.23 *Derivative* is a generic term that refers to all financial products derived from or tied to basic assets such as stocks, bonds, or commodities. Put and call options, for example, are derivatives based on underlying common stock. Stock-, bond-, commodity-, and currency-based derivatives are effective, proven tools for managing exposure to risk and implementing a variety of strategies and, in the case of commodities, have been in use for thousands of years. Derivatives can be used as stand-alone instruments (naked) or in conjunction with existing holdings (covered).

In general, derivatives are used for three basic strategies:

- to compound or enhance an existing position
- to add the asset class to the portfolio under a specific asset allocation strategy
- to manage risk to offset expected return by accepting lower returns in return for less risk

A simple example of the second strategy would be the use of a stock index future such as S&P 500 futures to supplement an already concentrated portfolio that needs diversity. Equally common is a

strategy to, for example, add additional country weight to a foreign stock portfolio. This would be an example of the first strategy.

Most trustees, however, tend to sell covered calls as their typical derivatives strategy. In this situation, a trustee may decide, for instance, that he or she wishes to sell 1,000 of 10,000 shares of a stock and pay the gains tax. This decision might be based on a desire to reinvest in bonds and create current income. One interim strategy would be to sell 10 calls (1 call = 100 shares) on the stock at a price slightly higher than the existing price. If the stock goes higher, the trustee keeps the call proceeds and delivers the stock—a sale takes place. If the stock does not move higher, the trustee can deliver the call proceeds to his client as supplemental income. In this example, the derivative (the call option) is a covered call, as there is an underlying asset equal to the derivative position. In both cases, income is enhanced.

It is also fair to characterize this act as prudent, as one would also characterize buying put options to protect a large stock position or gold options to protect a large bond portfolio. Numerous strategies exist that prudent trustees may use to immunize (hold constant) or risk manage (prevent downside movement) portfolios. In recent years, however, wide pricing disparities have arisen between the underlying asset (e.g., all stocks in the S&P 500) and the synthetic equivalent. Pricing models of options, of which Black-Scholes and Cox-Ross-Rubenstein are best known, are themselves subject to wide pricing variances because of the volatility possible between the commencement and expiration dates. (They do a better job with European options, which allow exercise only at expiration.) The point is that the complexity of the area should not deter the trustee from use but should alert the trustee to seek professional advice.

Transaction costs, bid-ask spreads, volatility, and interest-rate swings are but a few of the factors that the trustee must contend with to use this tool efficiently. Derivatives are not inherently bad or cost prohibitive, but they do represent great potential to magnify losses and gains. More than a few current examples in the popular press are evidence that management itself is unfamiliar with the effect derivatives can have on the balance sheet. As a general guideline, then, trustees should use derivatives only against existing positions when selling and only to the extent the trustee understands the cost of taking a position when buying, for example, an S&P index future. In all cases, expert counsel is advised.

e. Real Estate

§3.24 Most investment professionals treat raw land like a common stock. The concept is that there is appreciation or depreciation potential and likely no current income. Conversely, a 30-year lease to a major utility may constitute a quasi-bond-like instrument with nominal appreciation potential (all things equal) but stable, predictable income. In both cases, valuation is a function of, in part, both potential and liquidity. Illiquid assets (assets not easily bought or sold and subject to appraisal in the process) should command a discount in price for those inherent impediments.

Real estate can also have an income component if it is rented commercial property. The question with such holdings is whether the net rental (after costs for insurance, utilities, taxes, etc.) combined with the future appreciation makes the investment a proper choice for the portfolio. From an income tax standpoint, deductions for interest, expenses, and depreciation should be factored into this analysis. Furthermore, there is an income component of a residential real estate holding, for example, a residence held in trust in which the surviving spouse lives. The trustee needs to factor in the costs of maintaining the residence versus the increased income needs of the surviving spouse if he or she is forced to rent or buy a new home.

In all instances, the trustee is wise to seek professional real estate counsel and should be aware of how real estate is factored into the analysis of the total portfolio and its effect on the diversification of risk.

f. Oil and Gas Properties

§3.25 Oil and gas properties share virtually all of the characteristics of other illiquid investments in terms of potential appreciation or depreciation and inherent illiquidity. Oil and gas carries with it a "wasting asset" concept that the cash proceeds from an oil property, for example, represent the gradual liquidation of that property and should be viewed as encroachments on the principal value of the portfolio. Professional appraisal and management are strongly recommended.

Oil and gas properties also contain environmental contamination risks, which should be factored into the trustee's decision about the appropriateness of such assets to the trust portfolio. See the discussion of environmental issues in chapter 9.

g. Collections and Personal Property

§3.26 Most professional trustees recognize that closely-held businesses and personal collections of everything from art to automobiles require both appraisal and management. The trustee is cautioned that collections, businesses, and other personal property can sharply fluctuate in value and, more important, are highly subjective in their liquidity. Trustees are advised to be cautious about the permanence of any assumptions when these holdings become greater than 5 or 10 percent of the total assets. Too many artists' works have been ignored for decades in spite of the high hopes of the investor; too many practices have fallen to worthlessness on the death of a founder. Of particular concern are medical and legal practices, which often lose value in a very few months after death, since they are heavily based on personal relationships.

D. Ongoing Review

1. Trends, Perceptions, and Valuations

§3.27 A regular review assures the trustee of a defendable position if challenged and an opportunity to review with interested parties the assumptions behind investment objectives and the choice of trust assets held. More important, review provides the trustee with a regular opportunity to assemble outside opinions concerning all assets held in the investment portfolio and to seek out changes in trends, perceptions, and valuations.

- *Trends:* A regular review gives the trustee an opportunity to assess whether an asset can now be sold more easily because of a change in the market for that asset. Examples include real property in the path of new development, common stock now widely popular, and artwork previously not viewed as collectable.
- *Perceptions:* Parties of interest will often view an investment portfolio differently as their needs, assumptions, and other circumstances change. Impatience, for instance, with the lack of dividends from a growth stock may easily lead to a review of the *entire* investment portfolio.
- *Valuations:* Wide fluctuations in the value of assets, from a collector's Ferrari to Internet stocks, require at least an annual review by the trustee for disposition and acquisition. The investment management process includes a refined valuation process of all prior decisions and assumptions.

After reviewing the changes in the trends, perceptions and valuations, the trustee must apply these to the trust portfolio.

2. Portfolio Review

§3.28 The trustee should take the following basic steps to review a portfolio that consists of individual stocks and bonds to see whether the reasons for holding the individual securities persist. Stocks should be reviewed to determine whether

- the earnings expectations of the firm remain intact, in the eyes of most analysts;
- the valuation is not viewed as excessive (e.g., it departs from its historic profits and earnings range);
- the holding has grown to a disproportionate amount of the portfolio (most professionals trim holdings over 10 percent back to that figure); and
- if purchased for its dividend, the payment record and the record of regular increases is intact.

In the case of bonds:

- Is the rating provided by a recognized agency (Moody's, S&P, etc.) unchanged or improved?
- Is the market price (yield) comparable to bonds of similar quality and maturity, or does a pricing dichotomy exist?
- Have concentrations by state (in the case of municipal bonds) or industry (in the case of corporate bonds) crept into the portfolio? Normal management practice is to keep concentrations to less than 30 percent of the bond portfolio, sell overpriced issues, and buy into other less pricey areas. With municipals, it is often possible to buy out-of-state bonds, pay the state tax, and give up little or no after-tax income while gaining diversity.

The trustee should also consider the following:

- Are the needs of the parties at interest substantially changed, or have new objectives arisen?
- Is the information assembled for the review from a well-developed source? It is customary to review, especially for concentrated holdings, more than one opinion and to look for a coherent, organized process behind the design of the whole portfolio.

Professional money managers generally ascribe to a specific style or methodology and benchmark their strategic decisions against that process. It is no less incumbent on the trustee acting as investment advisor to do the same, to have a defined style. A clear *description* of the benchmark in place should be part of the assessment process of all information collected. See the discussion in §3.29.

E. Performance Measurement

§3.29 In an effort to establish uniformity in reporting and to provide full disclosure and fair representation by investment managers, several major associations publish guidelines for portfolio measurement. Three major associations include the Investment Management Consultants Association, the Investment Counsel Association of America, Inc., and the Association for Investment Management and Research (AIMR, the successor to the Financial Analysts Federation). The dominant influence is from AIMR members, and many hold a CFA (chartered financial analyst) designation.

At first glance, portfolio measurement may seem straightforward. For example, assume you begin January 1 with $100,000, and during the month you earn $5,000. The monthly return would be 5 percent. Continuing, you begin February with $105,000 and during the month lose 5 percent, or $5,250. What would the January-February return be? The arithmetic return equals 0 percent (-5 and +5), even though your account now totals $99,750. The geometric return would be -0.25 percent, a more accurate reflection of true performance. The preferred methodology for calculating returns involves calculating monthly returns (5 percent, -5 percent), and geometrically linking them together (generating the -0.25 percent). Although monthly returns are preferred, quarterly returns are acceptable.

A closer look at the actual calculation of individual period returns is important. There are two methodologies: time-weighted and dollar-weighted. The primary difference between the two is the effect that cash inflows and outflows have on performance. For example, assume beginning the year with $100,000 in a portfolio that produces a 1 percent return for each of the first, second, and third weeks of January. At the beginning of the fourth week, add $250,000 to the account. Performance during the fourth week is -3 percent. The time-weighted calculation treats each of the four weekly returns equally, resulting in a monthly return close to zero. The dollar-weighted calculation weighs the -3 percent for the fourth week more heavily than the others since the assets during this week totaled $350,000 versus $100,000 for the others. This results in a negative overall return for the month. Which method is more accurate? It depends. Although the manager did not have control over the fourth week's cash flow, it did materially affect the investor's return. Time-weighted calculations more clearly illustrate the manager's input, while dollar-weighted measurements can distort the manager's contribution under the influence of large deposits or withdrawals. One can argue that a portfolio without meaningful deposits or withdrawals (income is spent, not reinvested) should be dollar-weighted because the true cash-to-cash return from the owner's viewpoint is clearly presented. The pension industry, therefore, may wish to use a time-weighted measure while the trust industry could make a case for using a dollar-weighted measure.

For marketing purposes, investment management firms often combine the above results for their clients into one composite return. What does this return represent? Is it safe to assume (1) that all of the firm's accounts with that objective are included and (2) that client accounts no longer under management are included?

The first question addresses the issue of selection bias, which could occur if the manager had discretion to include in a composite only those accounts that had done well over the period. The second question addresses the issue of survivorship bias. Poor-performing accounts create disappointed clients who close or reduce their accounts, reducing their role in the composite. Over long periods of time, the composite becomes biased in an upward direction since only the winners are measured. The same is true for mutual fund companies: Badly performing funds are closed promptly; good funds attract deposits and become, in part, self-fulfilling.

Within the measuring process, there are guidelines for considering many additional issues. A trustee should look at the following factors in evaluating an investment return:

- the subtraction of transaction costs and fees
- the uniform treatment of income
- closing versus average price on the date of valuation
- combining similar-objective accounts into one composite
- most important, the dispersion of returns within the composite of "similar" accounts (An average can hide an extreme dispersion of results.)

As one small example of the difficulty of reaching true "apples to apples" comparisons, consider how the following 13 firms were measured in the S&P 500 for 1988:

S&P Performance Comparison
Dispersion of Calculations: 1988

Salomon	16.34%	S&P	16.61%
Barra	16.48	Mellon	16.64
CDA	16.50	Vestek	16.65
Russell	16.50	WFIA	16.72

S&P Performance Comparison
Dispersion of Calculations: 1988

Lipper	16.55	Wilshire	16.83
Merrill Lynch	16.57	Bankers Trust	16.84
SEI	16.60		

The range of 50 basis points may allow a manager to hit (or miss) the next higher quartile—and this is just the S&P 500.

To make the point, then, performance calculation should use simple arithmetic formulas to calculate compound percent-change, weighting the outcome of such formulas according to the time they were in the portfolio, and display the outcomes as a rate of return. *Measurement* to a body of standards is straightforward; *evaluation* is the next topic.

A benchmark is a measuring stick, ideally used to measure the difference, if any, between luck and skill. To be meaningful, a benchmark should be closely related to the measured portfolio in terms of investment characteristics. From our previous points, an initial benchmark question is, What method was used to calculate the benchmark's rate-of-return of numbers, and by what body of standards?

Having done the proper basic accounting to calculate return between two points in time, the trustee must decide if the results are good, bad, or indifferent. For example, there is strong historical evidence that small company stocks do better than mid-sized company stocks and better still than very large company stocks. In fact, Ibbotson Associates ranked by capitalization the compound return and volatility of all U.S. stocks into 10 decile groups and found the following for 1926 through 1994:

Decile	*Compound return*	*Volatility*
Decile 1: Very large capitalization	9.3%	20.0%
Decile 2: Somewhat large capitalization	10.7	24.7
Decile 3–5: Mid-capitalization	11.4	26.8
Decile 6–8: Small capitalization	11.7	31.8
Decile 9: Micro capitalization	12.0	39.6
Decile 10: Quark capitalization	13.8	49.4

These returns were significantly different during various shorter time periods within this 68-year view. What is observed is only that size and return are related over long periods of time. Note again that volatility of 49.4 percent for a 13.8 percent compound return means returns varied from 63.2 to -35.6 percent (13.8% ± 49.4%).

After size, the second most important element of return is whether the stock is a growth stock or a value stock. All three major benchmark providers—S&P 500, Wilshire, and Russell—produce benchmarks of growth and value indices. Subtle definitional differences exist, but most benchmark providers agree on the major differences between a growth stock and a value stock and the fact that their performance varies inversely.

The issue, then, is that comparing a portfolio that has a defined and consistent style (mid-capitalization value) to the broad market (S&P 500) will not convey the most information for the owner of the portfolio.

A second issue stems from the first: Is a good benchmark an index that captures the performance of a group of managers who follow the same style? The Callan Associates data measure performance, by style, of groups of managers that Callan inspects for accurate classification and grouping into a benchmark. This is preferable to comparing a portfolio to a broad market index like the S&P 500 or the Dow Jones Industrial Average, and even preferable to comparing it to subindexes like the S&P 400.

Having come to a point, then, where the trustee can begin to compare the arithmetic calculation of a portfolio to a composite of managed portfolios of similar style and assuming that everyone is following basically the same rules on data assembly and calculation, can the trustee assume accuracy? No. A few more factors enter into attribution analysis:

- Are all returns—the trustee's and the other managers'—net of fees and transaction costs?
- Were the styles constant for the entire measurement period?
- Is the measurement period meaningful?
- If all of these tests are met, did the managers assume the same risks?

Risk, defined here as the variation of returns around the long-term return, is different in each portfolio. A trustee who analyzes each stock in a given portfolio and calculates its price volatility against the broad market could determine how much more or less price volatile each stock was compared to the broad market. The portfolio in aggregate, then, would have an index of price volatility composed of all of the stocks in it, and the trustee could say whether it was more or less price volatile, over time, than the market. If the portfolio achieved a return of, say, 12 percent per year for five years and had an index of risk of 1.5 times the broad market, would we say the manager did a good job if the broad market return is 11 percent? Our answer is "no," because having taken 50 percent more risk than the market, we would expect to see at least 50 percent more return. Thus, a return closer to 16.5 percent (1.5 x 11%) would be acceptable while 12 percent would not.

The issue is measurement. This risk index, or *beta,* of stocks and portfolios can be measured many ways. Beta is influenced by, and influences, many other factors. The goal at this point is to stress that even if style and capitalization samples are found and carefully constructed into a benchmark, the daily activities of each manager are constantly changing the beta of not only the portfolio but of each portfolio in the universe. Unfortunately, few benchmarks regularly calculate (or report) beta.

In the next area of inquiry, the trustee finds an explanation of what caused superior or inferior returns. At issue is *attribution*: What did the manager do that caused the results achieved? The managers' actions generally fall into three areas of behavior:

- how the portfolio was allocated to each sector or industry (over or under the benchmark universe)
- how the stocks in each sector or industry did relative to other stocks in that group
- how risky each stock was relative to the market

For example, suppose the trustee is evaluating a manager with a mid-capitalization style who focuses on growth. Assume the trustee has assembled a benchmark containing similar managers, evaluated their data for conformity to a standard, and found that the trustee's manager consistently follows the style he or she is compared to and takes the same level of risk (has the same beta) as the universe. After a lengthy period of time, we find that the manager consistently outperforms (is above the median return of) his or her peer group. We would like to know how the manager did it. Did the manager own hundreds of stocks with very low turnover? Were the manager's allocations

among industries or sectors of the economy virtually identical to his or her peers' but his or her stock selections superior? Or did he or she overweight a few sectors with big bets and win big? Were the manager's returns uniformly (however slim) better each year, or did it all happen in one time period with one big bet? In brief: Is a methodology at work, or is the manager occasionally lucky?

These and other questions are part of manager analysis: What is the manager doing that causes these returns? It can be seen, then, that not only is benchmark creation a difficult issue but that the actions of the manager are equally difficult to analyze.

The trustee should stress consistency of style. He or she cannot predict if a style will be in or out of favor among investors at a particular time. The trustee also cannot assume that his or her peers are equally consistent—often they are not.

The trustee is left, then, with the following guidelines about performance measurement:

- The methods of arithmetic calculation should be uniform.
- The benchmark should be relevant to the style being measured.
- The manager's performance should be at least generally surveyed for consistency of style, consistency of return, and the key attribution factors (industry and stock "bets"). Of these, consistency of return is probably the best indicator of consistency of style.
- The time frame involved should be lengthy—more than five years.
- The S&P 500 average is not a relevant index for managers with a developed style.

The trustee can survey a great deal of data and become terribly tangled in measurement, attribution, sample size, style analysis, and reporting periods. What may really matter is what the client thinks of all this: Is the client's "you didn't beat the S&P 500" a challenge or a question? In either case, the trustee must be prepared to discuss relevancy when performance is discussed. Furthermore, any performance evaluation would be flawed without incorporating the client's investment goals and objectives. Often the client wants only consistently positive returns, which is yet another topic, as are bond performance, international indices, and portfolios with multiple styles.

Consistently reporting results against benchmarks like Callan or Lipper Universe data is basic. Beyond that, perhaps the last words should be Peter Bernstein's:

> The bottom line is that performance measurement without bogeys makes no sense but performance measurement with bogeys makes only a little bit of sense most of the time. Instead of poring over the details of performance measurement data, we would be better to shift our attention to identifying and tracking a manager's style, which is an important and feasible objective and one that rests on firmer foundations than does measuring the manager's performance relative to a bogey.

"Performance Evaluation, Benchmarks, and Attribution Analysis," address at AIMR Conference, Toronto, Nov. 16, 1994.

IV. Professional Investment Advisors and Corporate Trustees

A. Brokerage Firms

1. In General

§3.30 The issue of brokerage fees is more than cost-per-share or the percent markup on a bond, partnership interest, or load mutual fund. Four factors should influence the trustee when selecting a brokerage firm:

- the financial health of the brokerage firm as measured by the presence of the required capital, the size and frequency of litigation, the growth of the firm, and the profitability of the firm (Exposure to abnormal levels of hedge fund, derivative, Third World, and other forms of high-risk positioning should be evaluated.)
- the ability of the firm to make a market in a wide selection of stocks and bonds, both as a firm willing to take on large positions and to find, with minimal disruption, large positions for the trustee
- the actual transaction cost per share or markup per bond
- the reputation of settling trades on time with few, if any, fails

Obviously, a broker making a market (that is, willing to buy and sell a given security at any time) sees both what is being bid and what is being asked for a given stock. In this spread between bid and asked is part of the profit-making nature of the firm and, to the buyer or seller of the stock, a cost. Focusing only on cost per share, then, distracts the trustee from also paying attention to the actual price paid versus the day's high and low for the stock. A trade above the prevailing price for the day may well be justified for a thinly traded stock (lacking any real volume that generates a narrow spread) and may well be justified if significant other services are being provided to the trustee. These services may include timely research, performance measurement, or highly detailed monthly statements. In all cases, the trustee is obligated to know both what true transaction costs are and the value of services provided compared to other providers of the same services. Given the amount of research and the plethora of quote services available on the Internet, the trustee may be hard pressed to justify paying full retail brokerage per share, plus the spread. This would depend on the total amount of fees charged by the trustee for both the trustee's investment services and the brokers. If the trustee has delegated investment duties, or a portion of them, to a broker, the total investment fees are what should be measured for reasonableness.

Cumulative transaction costs can approach 1 percent of total market value annually. This amount tends to appear in actively managed portfolios—portfolios with 50 to 75 percent turnover. A trustee focused on a taxpayer viewpoint, of a trust for individuals, needs to be aware that high turnover and thus high broker costs are difficult to overcome with performance and form the basis for the oft-stated view that few managers can outperform an index fund.

2. Soft Dollars

§3.31 The Securities and Exchange Commission (SEC) allows brokerage firms to pay corporate trustees for products and services directly related to investment decision making by that corporate trustee. Many corporate trustees receive back from brokerage firms a credit or share of the commission dollars (soft dollars) that the corporate trustee generates with that broker. Under every test of logic, these credits are the property of the accounts that generate the trade. The SEC rules, 15 USC 78bb(e), allow the advisor, in this case a corporate trustee, to purchase research, quote services, data files, and the like from third-party vendors and to pay, through the broker, with these credits. So long as the items or services purchased are used to make investment decisions and, specifically, *not* used to do billing, do accounting, audit, or in any way administer the trust, they are approved.

The trustee, then, should be aware, particularly when dealing with very large accounts, of what his or her advisor (if one is employed) is using these credits for and, more important, be sure that the advisor can demonstrate an understanding of and apply the SEC rules. The trustee should also be aware that the exchange rate is not 1 to 1 and is, at this writing, about 1.5 to 1. In practical terms, this means that an advisor who wants to purchase a $50,000-per-year research service will need to use $75,000 of credits or soft dollars to do it.

3. Discount Brokerages and Internet Trading

§3.32 The recent popularity of using discount brokers and, of late, Internet-based brokerage, because of the ostensibly very low fees does not obviate the need for all of the tests that apply to selecting any broker. The trustee should be particularly aware that two common types of brokers seem to be in broad use:

- brokerage vendors who only trade a specific number of times each day and collect trades in between
- vendors who trade immediately on the receipt of an order

Trustees should be aware of the range of a security's stock price on a given day and, accordingly, aware of whether the client paid the asking price or something closer to the bid. At issue is the sometimes very wide spread on over-the-counter stocks. In addition, very popular smaller stocks (e.g., Internet stocks or software stocks) can have very wide spreads and very wide price swings on a given day. Put another way, the use of such brokers might not be cheaper at all.

B. Corporate Trustees

§3.33 The pros and cons of a corporate trustee generally center around the degree to which personalized, client-specific service can be provided. Many functions such as statement rendering, asset custody, performance measurement, and securities trading can be provided equally well by either large or small vendors. It is for this reason that many attorneys, CPAs, and others embrace the idea of serving as trustee. Oftentimes the discipline-specific professional does bring a very high level of personal care and awareness of family needs.

Unfortunately, the degree of skill needed to maintain professional-caliber performance in the law, taxation, and investments is rarely present in the same individual. This, plus a lack of clear succession and backup, usually leads most individuals to retain a corporate trustee who has both breadth and depth. The responsible corporate trustee recognizes that individuals and families have preferences for attorneys, CPAs, etc., and will seek to work with them. Recent competitive needs have caused all practitioners, both private and corporate, to greatly improve their interpersonal skills. The practitioner is therefore encouraged to recognize which function he or she can best perform, which function the corporate trustee can best perform, and how these skills can be used to meet the requirements of Michigan's prudent investor rule.

In the area of investment advisory skills, the trustee, whether private or corporate, has the option of evaluating large and small firms. Here again, breadth and depth are far more important than last year's numbers for a few showcase accounts. More important, investment management for private individuals is noticeably different than, for example, investment management for a pension plan. Issues around tax planning, income or capital growth goals, nontraditional investments, and multiple time frames are but a few of the elements a corporate trustee may be more familiar with. Last and perhaps most important, a corporate trustee represents both a history of results and continuity into the future. A well-structured corporate trustee should be able to convey to the family attorney that it not only understands their shared client's needs but can implement, critique, and originate solutions. In the area of investments, in particular, the corporate trustee has the unique advantage of size to attract the vendors of information, talented individuals (increasingly so) and capital to support its growth.

As noted above, the final determination is almost always the quality of one-on-one service once the plan is in place. In the area of investments, however, an additional component of experience or perspective is doubly important.

Exhibit 3.1
The Prudent Investor Rule

700.1501 Short title; definitions

Sec. 1501. (1) This part shall be known and may be cited as the “Michigan prudent investor rule”. This part prescribes the Michigan prudent investor rule.

(2) As used in this part:

(a) “Governing instrument” includes, but is not limited to, a court order.

(b) “Portfolio” means all property of every kind and character held by a fiduciary on behalf of a fiduciary estate.

700.1502 Prudent investor rule

Sec. 1502. (1) A fiduciary shall invest and manage assets held in a fiduciary capacity as a prudent investor would, taking into account the purposes, terms, distribution requirements expressed in the governing instrument, and other circumstances of the fiduciary estate. To satisfy this standard, the fiduciary must exercise reasonable care, skill, and caution.

(2) The Michigan prudent investor rule is a default rule that may be expanded, restricted, eliminated, or otherwise altered by the provisions of the governing instrument. A fiduciary is not liable to a beneficiary to the extent that the fiduciary acted in reasonable reliance on the provisions of the governing instrument.

700.1503 Portfolio strategy; risk and return objectives

Sec. 1503. (1) A fiduciary’s investment and management decisions with respect to individual assets shall be evaluated not in isolation, but rather in the context of the fiduciary estate portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fiduciary estate.

(2) Among circumstances that a fiduciary must consider in investing and managing fiduciary assets are all of the following that are relevant to the fiduciary estate or its beneficiaries:

(a) General economic conditions.

(b) The possible effect of inflation or deflation.

(c) The expected tax consequences of an investment decision or strategy.

(d) The role that each investment or course of action plays within the overall portfolio, which may include financial assets, interests in closely-held enterprises, tangible and intangible personal property, and real property.

(e) The expected total return from income and the appreciation of capital.

(f) Other resources of the beneficiaries.

(g) The need for liquidity, regularity of income, and preservation or appreciation of capital.

(h) An asset’s special relationship or special value, if any, to the purposes of the fiduciary estate or to 1 or more of the beneficiaries.

(3) A fiduciary shall make a reasonable effort to verify facts relevant to the investment and management of fiduciary assets.

(4) A fiduciary may invest in any kind of property or type of investment consistent with the standards of the Michigan prudent investor rule. A particular investment is not inherently prudent or imprudent.

(5) A fiduciary who has special skill or expertise, or is named fiduciary in reliance upon the fiduciary's representation that the fiduciary has special skill or expertise, has a duty to use that special skill or expertise.

700.1504 Diversification

Sec. 1504. A fiduciary shall diversify the investments of a fiduciary estate unless the fiduciary reasonably determines that, because of special circumstances, the purposes of the fiduciary estate are better served without diversifying.

700.1505 Duties at inception

Sec. 1505. Within a reasonable time after accepting appointment as a fiduciary or receiving fiduciary assets, a fiduciary shall review the assets, and make and implement decisions concerning the retention and disposition of assets, in order to bring the fiduciary portfolio into compliance with the purposes, terms, distribution requirements expressed in the governing instrument, and other circumstances of the fiduciary estate, and with the requirements of the Michigan prudent investor rule.

700.1506 Loyalty

Sec. 1506. A fiduciary shall invest and manage fiduciary assets solely in the interest of the beneficiaries.

700.1507 Impartiality

Sec. 1507. If a fiduciary estate has 2 or more beneficiaries, the fiduciary shall act impartially in investing and managing the fiduciary assets, and shall take into account any differing interests of the beneficiaries.

700.1508 Investment costs

Sec. 1508. In investing and managing fiduciary assets, a fiduciary may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the fiduciary estate, and the skills of the fiduciary.

700.1509 Reviewing compliance

Sec. 1509. Compliance with the prudent investor rule is determined in light of the facts and circumstances that exist at the time of a fiduciary's decision or action, and not by

hindsight. The prudent investor rule requires a standard of conduct, not outcome or performance.

700.1510 Delegation of investment and management functions

Sec. 1510. (1) A fiduciary may delegate investment and management functions provided that the fiduciary exercises reasonable care, skill, and caution in all of the following:

(a) Selecting an agent.

(b) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the governing instrument.

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

(2) A fiduciary who complies with the requirements of subsection (1) is not liable to the beneficiaries or to the fiduciary estate for a decision or action of the agent to whom the function was delegated.

(3) In performing a delegated function, an agent owes a duty to the fiduciary estate to exercise reasonable care to comply with the terms of the delegation. If an agent accepts the delegation of a fiduciary function from a fiduciary that is subject to the laws of this state, the agent submits to the jurisdiction of this state's court.

700.1511 Language invoking standard of prudent investor rule

Sec. 1511. The following terms or similar language in a governing instrument, unless otherwise limited or modified, authorize any investment or strategy permitted under the Michigan prudent investor rule:

(a) "Investments permissible by law for investment of trust funds".

(b) "Legal investments".

(c) "Authorized investments".

(d) "Using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of 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 their capital".

(e) "Prudent man rule".

(f) "Prudent trustee rule".

(g) "Prudent person rule".

(h) "Prudent investor rule".

700.1512 Application to existing fiduciary estates

Sec. 1512. The Michigan prudent investor rule applies to a fiduciary estate that exists on or is created after this act's effective date. As applied to a fiduciary estate that exists on this act's effective date, the Michigan prudent investor rule governs only a decision or action that occurs after that date.