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Prudently Investing Trust Portfolios, Part 1

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You won't often read a financial column that is of keen interest to buttoned-down CPA's and lawyers—as well as trust funder ski bums.

Resuming our focus on fiduciary investing; this month's column opens a window on the murky world of trust funds.

An enigma to many, trusts have become the vehicle of choice for estate planners and their clients—and not just the extremely wealthy—to pass on property to their beneficiaries. Tens of trillions of dollars in assets are currently held in trust and that number is expected to increase dramatically in the decades ahead.

Conceived and executed properly, trusts are extremely effective tools for family wealth preservation and enhancement. When established or managed poorly, however, trusts may frustrate the intent of an estate plan and cause diminished lifestyles, discord, and needless expense to surviving family members.

The last decade has brought a revolution to the legal standards governing the investment of trust portfolios. It is evident that numerous trustees of existing trusts—whether out of ignorance or self interest—have not implemented these changes. In addition, many people in the process of establishing their estate plans today do not sufficiently grasp the new standards: this gap in knowledge affects both trustee selection and the substance of their documents. Advisors, clients, and beneficiaries must become more knowledgeable to effectively participate in these

Summary: Prudently Investing Trust Portfolios, Part 1

Trusts have become the vehicle of choice for estate planners and their clients to pass on property to their beneficiaries.

For beneficiaries who are minors, financially naïve, or those with special needs, a trust is an ideal mechanism for providing for loved ones.



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relationships—ones that will have enormous impact on their lives.

What is a Trust?

Trusts have been used for a millennium, dating to eleventh-century England. Essentially, a trust is a simple construct, creating a legal relationship between three parties: the trustor (or settlor), who establishes the trust; the trustee, who manages the trust; and the beneficiary(ies). Specific property—which can be anything from land, securities or intellectual property, such as a patent—becomes the subject of the trust. The trustee is the legal owner of the property, subject to a fiduciary duty to manage it for the exclusive benefit of the beneficiary.

The two main types of trusts are the living trust, generally created by and for the benefit of the settlor during his or her lifetime and the testamentary trust, established in a will, to come into existence after the death of the settlor. Upon the death of the settlor of a living trust, it functions virtually the same as a testamentary trust, to carry out the estate plan of the settlor.

Why Consider Trusts?

For beneficiaries who are minors, financially naïve, or those with special needs, a trust is an ideal mechanism for providing for loved ones. A responsible third-party is appointed to manage assets and make distribution decisions on behalf of beneficiaries who lack the capacity or skills to handle this responsibility themselves.

Sophisticated trust beneficiaries may achieve advantages as well. Most trusts have “spendthrift” provisions, rendering trust assets beyond the reach of the creditors of a beneficiary. This may liberate entrepreneurs to assume business risk without having to worry that a reversal might completely compromise their lifestyle or decimate a family’s wealth. And the

settlor can be more certain that family wealth will be available for the education or support of grandchildren. Good planning can also take in to account an inheritor’s possible marital difficulties or divorce.

Estates large enough to be subject to the federal estate tax typically utilize trusts to save significant amounts of tax.

Regardless of the purpose for setting up a trust, they can contain special provisions to suit the situation. For example, beneficiaries might be given the power to remove and replace the trustee under certain circumstances.

The Prudent Investor Rule

In 1992, the American Law Institute published the Restatement 3rd of Trusts (Prudent Investor Rule). This scholarly compendium summarizes the basic legal rules governing the investment of trust property. The purpose of the Restatement was to reflect the updating of trust investing by incorporating modern portfolio theory into the law of trusts. Restatements of the Law are a well known source of legal authority cited by courts in their daily decision making. Now in effect in 43 states, including Colorado, the Uniform Prudent Investor Act (UPIA) is a statutory codification of the common-law Prudent Investor Rule.

Trustees generally are required to exercise ordinary prudence in all matters and conduct their duties with reasonable care, skill and caution. Investment prudence further requires conformance to a surprisingly specific, yet flexible, set of standards set forth in the Act.

In a substantial departure from prior law, the UPIA turns our attention away from individual investments to focus instead on the portfolio as a whole. Thus, the emphasis of prudent invest-

ing is on elevating the conduct and behavior of the investor.

The crux of the Prudent Investor Rule is that fiduciary investing is a process which results in the adoption of a comprehensive portfolio strategy reflecting the risk and return objectives of the trust. The two most critical components of the process are:

- knowledge of and incorporation of the circumstances of the various beneficiaries, and
- a thorough understanding of the way financial markets work.

In my next column we will drill down into the specifics of the laws governing trust investing. In addition to describing how the law impacts this type of investing, I'll also look at how—ideally—it works in practice and what to keep in mind as a settlor, trustee, or beneficiary.