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Trust Portfolios, Part 2

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In contrast to investing that is done by the beneficiaries themselves—such as young workers saving for retirement—trust investing often requires taking two paths at once. Trusts typically have multiple beneficiaries, each with different circumstances, demanding portfolios that produce income, growth, or both.

Last month, I introduced the world of trusts and trust investing by outlining the provisions of the Uniform Prudent Investor Act (“UPIA” or “Act”). Now in effect in 43 states, the UPIA governs the investment of trust funds. Today, I want to examine how to

- incorporate this important law into your estate plans,
- serve as or advise trustees under the Act, and
- become a knowledgeable, effective, and UPIA-ready beneficiary.

Objectives of the Act

The prefatory note to the UPIA summarizes “five fundamental alterations in the former criteria for prudent investing.”

- Prudence is applied to the portfolio as a whole, rather than to individual investments.
- The fiduciary’s central consideration must be the tradeoff between risk and return.
- The Act abrogates investment restrictions by type: the trustee can invest in anything that

Summary: Trust Portfolios, Part 2

Trustees must now make two important investment policy decisions: how to strike the proper balance in the portfolio between income and growth.

When you come to a fork in the road, take it.

—Yogi Berra



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plays an appropriate role in achieving the risk/return objectives.

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- Diversification has been integrated into the definition of prudent investing.
- Trustees may prudently delegate investment functions.

A Family Trust

Context facilitates understanding. While every trust arrangement is different, including the language of the trust instrument and circumstances of the beneficiaries, let's explore the case of a prototypical family trust to illuminate the impact of these "fundamental alterations."

Consider the (hypothetical) case of Karen, who dies at the age of 58. A successful realtor, Karen owned two office buildings, together valued at \$7 million—with \$2 million of equity and a \$5 million mortgage. Karen is survived by her second husband, Roger, two children from her second marriage, and a daughter and 3-year-old grandson from her first marriage.

To take advantage of the estate tax exemption—currently \$2 million—Karen had established a trust to be funded initially with the two properties. Her brother, Tom, a CPA, and 54-year-old Roger serve as trustees.

The trust allows property to by-pass Roger and pass to her three children and grandchild. As is typical, the trust sets aside *income* (e.g., interest, dividends, and net rents) for the surviving spouse for his lifetime. Karen's trustees also have discretion to make principal payments to Roger, any of the children or grandchildren according to certain guidelines, such as use for educational expenses.

Following Roger's death, the trust *property*—or remainder—becomes available to the children and grandchild. Karen's trust stipulates that, at Roger's death, 75% of the remainder goes to her children and grandchild—to be held in trust until they reach certain ages—and 25% to a donor advised fund at the local community foundation.

Invested prudently and successfully, the value of the trust upon Roger's death could be two or three times the original value. Plus, there is no imposition of estate tax at Roger's death as there might have been had the property passed to him directly.

Two Major Decisions

The trustees must now make two important investment policy decisions: how to strike the proper balance in the portfolio between income and growth and whether to sell the real estate and diversify the portfolio.

Crafting an investment policy should not be done in secret. Open, honest and authentic interaction among the participants is essential. In this case, that includes the trustees, third-party advisors (if Tom and Roger choose to use them) and the beneficiaries—Roger and Karen's adult children. The process begins with financial planning, which assesses the needs, desires, and risk tolerance of the beneficiaries as the Act requires.

Roger honestly indicates that he requires only a modest income from the trust to supplement his salary now; however, he may need more upon retirement. The remainder beneficiaries, whose interests ripen years—or even decades away—desire long-term growth. Roger, cognizant of his inherent conflict of interest, delegates this decision to Tom, the disinterested trustee.

Income-producing investments and growth investments typically are dissimilar. Investment grade bonds, dividend yielding stocks, and preferred stocks produce income and are considered safer; growth, small company, and emerging markets stocks have much higher expected returns but are riskier.

After consultation—and documentation—Tom decides to deemphasize current income and undertake moderate risk and invest for growth. The trustees will reevaluate this decision in five years as Roger approaches retirement and the needs of the children and grandchild are more apparent.

The office buildings were Karen's pride and joy. Her management expertise contributed significantly to their success as an investment. The leverage from the mortgage adds to the potential gains—and the risk. However, against the standard of diversification established in the Act, the properties are an extremely concentrated investment. Karen did not specify that ownership of the buildings should be maintained—as she could have under the Act. Therefore, Roger and Tom reluctantly decide to sell the real estate. Next, they must invest the proceeds.

Karen's family and trustees have already faced some of the opportunities and challenges in managing a trust portfolio. Next month, I'll wrap up this examination of trusts by looking at the intricacies of establishing and managing a diversified portfolio consistent with the beneficiaries goals and risk tolerance—in accordance with the UPIA.