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## Trust Portfolios, Part 3

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Last month, we began examining how the Uniform Prudent Investor Act (UPIA) impacts a typical trust. To appreciate the trustees' decision-making processes, we must recognize that the UPIA—to which they are legally obligated—is deeply informed by modern portfolio theory (MPT). For example, the Act requires proper diversification as described by MPT; accordingly, our hypothetical trustees liquidated the two office buildings that comprised Karen's estate. Today, we'll explore other factors they need to consider.

### Risk/Return.

MPT states that potential returns are tied to risk. Guided by that principal, the trustees must balance the beneficiaries' collective requirements for returns with their overall tolerance for risk—including their varying time frames for using trust proceeds. To complicate this requirement, the UPIA specifies risk/return balance as a non-delegable duty that must be undertaken by the trustees—although a qualified consultant may provide guidance. (In general, the UPIA encourages delegation to prudent experts.)

For example, withdrawal portfolios must minimize volatility because of their difficulty in recovering from bear markets. Yet, real growth *requires* exposure to volatility (risk)—suggesting at least a 60% allocation to riskier assets for long-term portfolios. The trustees must balance the needs of those beneficiaries who are withdrawing against those with a long time horizon.

### Summary: Trust Portfolios, Part 3

Balancing risk and return is the goal, but in trusts more 'passive' investments can be prudent.

The trustees must balance the beneficiaries' collective requirements for returns with their overall tolerance for risk—including their varying time frames for using trust proceeds.



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## Asset Allocation.

MPT also assumes that asset allocation—particularly the ratio of risky assets to less risky assets—is the primary determinant of returns. Experts disagree over how big a role asset allocation plays in performance compared to stock picking and market timing. But, because MPT is incorporated into the UPIA, trust investors must accept this proposition.

In designing the allocation policy, the trustees must consider the historical returns and risk of the major asset classes. Next, they should assign fixed percentages to each class and periodically rebalance to maintain the policy—until a change in beneficiaries’ needs dictates a new allocation.

## Diversification.

MPT distinguishes between systematic and unsystematic risk. Systematic or “market” risk results from macro phenomena: business cycles, geopolitical events, inflation. Unsystematic risk is particular to an individual firm or industry. Sufficient diversification virtually eliminates unsystematic risk, leaving primarily systematic risk.

Traditionally, a “diversified” portfolio held 20-35 carefully selected securities. Recent research demonstrates, however, that true diversification requires hundreds or thousands of securities: efficient and systematic exposure to a comprehensive range of major and sub asset classes, capturing returns from all markets.

Since the UPIA literally places “no restrictions” on what a portfolio may hold, trustees or their managers can employ any appropriate vehicle to carry out investment policy. That means our trustees should consider international stocks—as well as value and small cap stocks,

which, research shows, tend to outperform the market over longer time horizons.

## Inflation.

Karen’s trust serves multiple generations of beneficiaries over a long period of time. Accordingly, use of both capital appreciation and income vehicles must take into account the effects of inflation on future purchasing power.

## Total Return.

Trust law distinguishes between capital gains and income. Sales profits cannot be paid to “income” beneficiaries except as discretionary principal payments. But MPT recognizes no such distinction—growth is growth.

The UPIA’s companion law, the Uniform Principal and Income Act, allows “total return” thinking. Statutory guidelines permit trustees to treat principal as income and vice-versa. And, trustees may convert to a “total return trust”—eliminating the principal/income distinction and paying out fixed percentages of the trust’s value to income beneficiaries.

## Efficient Markets.

Legally, trustees may employ either active or passive strategies. However, in embracing the efficient market hypothesis (beating the market is difficult, if not impossible) the UPIA *strongly* encourages anchoring portfolios with passive vehicles, such as index funds. And indexing, being substantially less expensive than active management, goes a long way toward fulfilling the trustees’ cost-control requirement.