

Investment Options For Small, Medium & Large SNTs: One Size Does Not Fit All

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1. INTRODUCTION

Special Needs Trusts come in various sizes and present a multitude of investment options. Trustees of Special Needs Trusts must understand the investment process as well as the investment options to ensure that they discharge their fiduciary duties. Financial advisors are money managers having legal responsibility for managing someone else's money. They are also fiduciaries. Often, an important aspect of fiduciary services is investment management. There are approximately 5 million people in the United States who fall into the category of fiduciary.¹

Frequently the trustee of a Special Needs Trust is a family member, but could also be the lawyer drafting the trust. These fiduciaries are required to comply with the provisions of the Uniform Prudent Investor Act (UPIA)², the Principal and Income Act, and statutory and common law provisions relating to conduct as a fiduciary. Family members usually have no background or knowledge in investment management. Family members seldom have any background in accounting or law. Generally, they fail to comply with the provisions of the UPIA, the Principal and Income Act and the requirements of statutory and common law relating to fiduciaries. Absent a misappropriation of funds or a disagreement among family members, these failures go unreported; however, a breach of fiduciary duty has occurred. What litigation does ensue tends to center upon the misappropriation or the family conflict rather than on the fiduciaries failure to adhere to the fiduciary standard of care that is required. Harm to beneficiaries and wards caused by financial mismanagement is much more wide spread than misappropriation.

The Foundation for Fiduciary Studies defines a fiduciary as a person who:

- (1) Manages property for the benefit of another;
- (2) Exercises discretionary authority or control over the assets; and
- (3) Acts in a professional capacity of trust, and renders comprehensive and continuous investment advice.

The statutory foundation for regulating fiduciary conduct are found in the following:

¹ Fiduciary Handbook, Foundation for Fiduciary Studies, 2002.

² For additional information about investment duties under the UPIA see Edward A. Moses et al., "Modern Portfolio Theory and the Prudent Investor Act" ACTEC Journal Vol. 30, No. 4.

- Employee Retirement Income Security Act (ERISA), which deals with qualified retirement plans.³
- Uniform Prudent Investor Act (UPIA). The UPIA has been adopted in 44 states,⁴ a listing of which is attached as Appendix 1.
- Uniform Management of Public Employee Retirement Systems Act (MPERS).

Although the Uniform Law Commissioners completed their work in 1997 and the Act was endorsed by the American Bar Association, to date MPERS has not been adopted in any state, but has been introduced in Wyoming in 2005.⁵

In addition, the duties of fiduciaries are set forth in numerous state statutes as well as state and federal regulations and in case law.

Lawyers serving as trustee should first become designated as accredited investment fiduciaries to ensure that the funds are properly managed.

An Accredited Investment Fiduciary (AIF) is a professional designation awarded by the Center for Fiduciary Studies at the Katz Graduate School of Business at the University of Pittsburgh (CFS). AIF designees have successfully completed a specialized program on investment fiduciary standards of care and subsequently passed a comprehensive examination. “Designees must be able to understand and articulate the legal and regulatory environment surrounding the fiduciary, be able to develop and implement an effective investment management process applying the principles of Modern Portfolio Theory, document a due diligence and, above all, treat their clients with the utmost prudence and care.”⁶ Therefore, an accredited investment fiduciary can assist the probate court by serving as fiduciary when a fiduciary is appointed by a court, such as in certain guardianships. An AIF can also assist the court in evaluating whether an executor, trustee, guardian, or agent under a Power of Attorney have breached their fiduciary duty by failing to follow a prudent investment process. A prudent investment process incorporates a five-step Investment Process, seven Fiduciary Standards of Care, and 27 *Practices* outlined by CFS. Essentially, the AIF can examine the governing documents, financial statements and actions of the fiduciary to make this determination.

The primary duty of the fiduciary is to *manage* a prudent investment process without which the components of an investment plan cannot be defined, implemented, or evaluated. Statutes, case law, and regulatory opinion letters dealing with investment fiduciary responsibility further reinforce this important concept.”⁷ CFS has developed 27 *Practices* defining a prudent investment management process. Each *Practice* is grounded in citations to legislation, case law, and/or regulatory opinion letters that serve as the basis for the *Practice*. In addition to the 27

³ 20 U.S.C.A. Ch. 18.

⁴ National Conference of Commissioners on Uniform State Laws, www.nccusl.org, January 29, 2005.

⁵ *Id.*

⁶ www.cfstudies.com

⁷ *Id.*

Practices, there are seven uniform fiduciary standards of care. In addition CFS has developed a five-step investment management process and a *Practices Matrix*. The five-step investment process and the uniform fiduciary standards of care frame the prudent investment process. The 27 *Practices* provide details to the process.

The five-step Investment Process is:

- Analyze the current position
- Diversify
- Prepare an Investment Policy Statement
- Implement policy
- Monitor

The seven Uniform Fiduciary Standards of Care are:

- Know standards, laws and trust provisions;
- Diversify assets to specific risk-return profile of client;
- Prepare an Investment Policy Statement;
- Use “prudent experts” (money managers) and document due diligence;
- Control and account for investment expenses;
- Monitor the activities of “prudent experts”; and
- Avoid conflicts of interest and prohibited transactions.

2. FIVE-STEP INVESTMENT PROCESS

It is important that Probate Judges who are deciding whether there has been a breach of fiduciary duty know what the fiduciary should have been doing, what is the standard of care.

2.1. Analyze the Current Position

All fiduciaries must begin by analyzing and reviewing the current situation including all of the documents pertaining to the establishment and management of investments. The fiduciary then establishes definitive goals and objectives. The fiduciary examines the limits and constraints of the trust documents or other documents and statutes and of the individual client. Five *Practices* flow from analyzing the current position:

2.1.1. No Self-Dealing. Fiduciaries and parties in interest are not involved in self-dealing. A party in interest includes any friend, business associate, or relative of the fiduciary. If a fiduciary even thinks he has a conflict of interest he probably does.

2.1.2. Applicable Law. Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements.

2.1.3. Awareness of Duties. Fiduciaries must be aware of their duties and responsibilities. While the fiduciary may and often does delegate certain decisions to professional money managers, the fiduciary may never delegate responsibility for:

- Determining investment goals and objectives;
- Approving asset allocation strategy;
- Approving a written investment policy statement;
- Approving appropriate money managers;
- Monitoring investment activities; and
- Avoiding conflicts of interest and prohibited transactions.

2.1.4. Written Agreements. Services agreements and contracts must be in writing and must not contain provisions that conflict with the fiduciary standards of care.

- A fiduciary must seek investment advice from investment advisors or money managers, if the fiduciary lacks the requisite knowledge.
- All contracts and service agreements must be reviewed at least every three years.

2.1.5. Schedule of Cash Flow. There is documentation to show timing and distribution of cash flows and the payment of liabilities. The fiduciary must prepare a schedule for the portfolio's cash flows for the coming five-year period, develop a time horizon. A time horizon is the point in time where more money is flowing out of the portfolio than is coming in from contributions or growth. A time horizon of less than five years is considered "short." A short-time horizon is implemented with fixed income and cash, whereas a long-time horizon can be prudently implemented across most asset classes. It is good practice to set aside 120% of the anticipated disbursement in cash or short-time fixed income instruments.

2.2. Diversify

The single biggest factor in achieving investment success is asset allocation. Technology is available to assist a fiduciary in optimizing an asset allocation. The optimizer requires three inputs:

- *Expected Return* – The modeled return assumption that will be used for each class of assets.
- *Standard Deviation* – The probable level of variability each asset class will exhibit.

- *Correlation Coefficient* – The estimate of the degree to which each asset class will perform relative to another.

Diversification leads to the development of five *Practices*.

2.2.1. Tolerance for Risk. A risk level has been identified. What is the client’s tolerance for risk? An investment strategy can fail by being too conservative or too aggressive. One strategy is to analyze possible investment outcomes over a one, three and five-year period. Analyze the worst case and the best case. The fiduciary then must determine if the investment results will enable the fiduciary to cover short and long-term liabilities and meet client objectives.⁸

2.2.2. Expected Return. An expected modeled return to meet investment objectives has been identified. After examining the trust documents, spending policies, and/or actuarial reports, a fiduciary must establish a minimal investment return expectation or requirement. The expected return is modeled based on current and historical information. Most investment professionals utilize a risk premium model that starts by calculating the premium each asset class has earned over the risk-free rate of return. The premium is adjusted based on economic scenarios that may impact the asset class over the next five years. The premium is then added to the anticipated risk-free rate of return over the next five years to come up with a final modeled return.

2.2.3. Time Horizon. An investment time horizon has been identified. There is a hierarchy of decisions from most to least important:

- What is the time horizon of the investment strategy?
- What asset classes will be considered?
- What will be the mix among asset classes?
- What sub-asset classes will be considered?
- Which managers/funds will be selected?

It is extremely important to know the client’s time horizon so that sufficient monies are available to meet the client’s needs.

2.2.4. Asset Classes/Risk. Expected asset classes are consistent with identified risk, return and time horizon. The question is will the client’s goals be met with the proposed asset allocation.

2.2.5. Asset Classes/Number. The number of asset classes is consistent with the portfolio size. Four factors dictate the number of asset classes within a portfolio:

- Size of the portfolio;
- Investment expertise of the investment decision-makers;

⁸ For additional information see Edward A. Moses et al, “Using a Trust’s Investment Policy Statement to Develop the Portfolio’s Appropriate Risk Level” ACTEC Journal, Spring 2005: page 251.

- The ability to monitor strategies; and
- Sensitivity to investment expenses. More asset classes usually mean higher portfolio expenses.

Typical asset classes include the following:

- Cash
- Stocks
- Bonds
- Large Blend, Multi-Sector Fixed End Cash
- International Equity Blend
- Small Blend
- Intermediate Fixed
- Mid-Cap Blend
- Large Value, Large Growth
- Emerging Markets
- Real Estate
- High Yield Fixed
- International Bond

2.3. The Investment Policy Statement

The Investment Policy Statement (IPS) is one of the most critical functions of a fiduciary. In the author's experience an IPS is seldom done. The IPS is the business plan for achieving the client objectives. The IPS should be in writing.⁹ By utilizing such a plan the fiduciary:

- Avoids unnecessary differences of opinion
- Minimizes missteps due to lack of clear guidelines
- Establishes a basis for measuring compliance
- Establishes clear expectations

The IPS leads to the development of five *Practices*:

2.3.1. Sufficient Detail. There is detail to implement a specific investment strategy. The plan must have sufficient details so that a third party may implement the strategy, but be flexible enough to be implemented in a dynamic financial environment.

2.3.2. Duties Defined. The Investment Policy Statement defines the duties and responsibilities of all parties involved, including an investment committee, an investment consultant, the custodian, and a separate account manager, where applicable.

⁹ For additional information about preparing an IPS see Jack Gardner, How to Write an Investment Policy Statement (Columbia, MD: Market Place Books, 2003)

2.3.3. Diversification/Rebalancing. The Investment Policy Statement defines diversification and rebalancing guidelines. The asset allocation is a specific mix of asset classes that meets the mutually-agreed upon risk/return profile. Five factors must be considered:

- (T) Tax status
- (R) Risk level
- (E) Expected return
- (A) Asset class preference
- (T) Time Horizon

If assets are omitted for a specific reason, they should be identified in the IPS. Because markets are volatile, the portfolio must periodically be rebalanced. Asset classes should be rebalanced when they are plus or minus 5%. Normally this rebalancing is done once or twice a year.

2.3.4. Due Diligence/Investment Options. The Investment Policy Statement defines due diligence criteria for selecting investment options. The fiduciary should investigate the merits of money managers in the context of the needs of the investment strategy.

2.3.5. Monitoring Criteria. The Investment Policy Statement defines monitoring criteria for investment options and service vendors. Certain activities should be done periodically:

- *Monthly* – The custodian’s statements should be reviewed for accuracy and to determine if the money managers are obtaining the best execution on trades.
- *Quarterly* – A performance report should be prepared indicating how well the selected managers and/or funds are performing relative to objectives against peers and against an appropriate industry index.
- *Annually* – The IPS should be reviewed and modified as needed.

2.3.6. Controlling Expenses. The Investment Policy Statement defines procedures for controlling and accounting for investment expenses. Procedures to control investment expenses must be reduced to writing. There are generally four types of expenses:

- Money manager fees
- Trading costs
- Custodial charges
- Consulting and administrative costs and fees

2.3.7. Socially Responsible Strategies. The Investment Policy Statement defines appropriately-structured, socially-responsible investment strategies (when applicable). Mission-based investing or socially-responsible investing may never be utilized if they reduce the

portfolio's total return. This would be a breach of fiduciary duty. A socially-responsible investing strategy can be used as a secondary screen if the investments are equally attractive, then social factors may be utilized. However, under the Uniform Prudent Investor Act there are three possible exceptions:

- Authorization in a trust document.
- Donor direction.
- A reasonable person would deduce from the foundation/endowment's mission statement that socially responsible strategies would be adopted.

2.4. Implement Policy

Generally a fiduciary should delegate investment decisions to professionals unless the fiduciary has the expertise. The fiduciary must develop a due diligence process to select and monitor the investment options.

The four *Practices* are:

2.4.1. Manage the Process. The investment strategy is implemented in compliance with the required level of prudence. The primary role of the fiduciary is to manage the investment process. The professional money manager should make the investment decisions. The following factors pertain to due diligence with respect to selecting investment options:

- Performance relative to peer group
- Performance relative to assumed risk
- Inception date of product
- Correlation to peer group
- Assets under management
- Holdings consistent with style
- Expense ratios or fees
- Stability of the organization

The fiduciary should consider using indexes in those market sectors that receive the most attention from securities analysts, such as Large Cap Core. It is difficult to beat the indexes, if the money management makes sense in the far edges of growth and value with mid-cap and small-cap stocks. Fiduciaries can use a combination of indexes and money managers/mutual funds.

2.4.2. Safe Harbor. The fiduciary is following applicable "safe harbor" provisions. There are five generally recognized safe harbor rules:

- Use prudent experts to make investment decisions

- Demonstrate that the prudent expert was selected by following a due diligence process
- Give the prudent expert discretion over the assets
- Have the prudent expert acknowledge their co-fiduciary status
- Monitor the activities of the prudent expert

2.4.3. Portfolio Size. Investment vehicles are appropriate for the portfolio size. The question is at what point is there a migration from mutual funds to separate account managers? CFS suggests the following guide:

- Accounts less than \$300,000 use mutual funds
- Accounts between \$300,000 and \$30,000,000 use both mutual funds and separate account managers
- For portfolios greater than \$30,000,000 the operative term is cost efficiency.

2.4.4. Service Providers. A due diligence process is followed in selecting service providers, including the custodian. The custodian holds securities for safekeeping, reports on holdings and transactions, collects interest and dividends, and effects trades, if required.

2.5. Monitor

Investment strategy requires alterations only if the underlying factors change (i.e., tax status, risk tolerance, expected return, asset class preferences, and time horizon). However, a monitoring program must be in place to evaluate whether objectives are being achieved.

2.5.1. Investment Performance. The fiduciary must monitor the investment manager. Periodic reports compare investment performance against an appropriate index, peer group, and IPS objectives. On a quarterly basis the fiduciary must evaluate the manager's performance with respect to IPS, changes in the investment philosophy or personnel in the manager's organization, and any regulatory agency proceedings affecting the manager.

2.5.2. Decision Makers/Changes. Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers. The fiduciary must evaluate the money manager with respect to:

- Staff turnover
- Organizational structure
- Level of service provided

- Quality and timeliness of manager’s reports
- Quality and timeliness of manager’s response to requests
- Investment education

2.5.3. Best Execution, Soft Dollars, Proxy Votes. Control procedures are in place to periodically review policies for best execution, soft dollars and proxy voting.

2.5.4. Fees. Fees for investment management are consistent with agreements and with the law. CFS has proposed that the 75th percentile be a reasonable cutoff with respect to expenses. If the manager or funds expense ratio is at the 75th percentile, the fiduciary should be concerned about a potential breach.

2.5.5. Finder’s Fees. Finder’s fees, 12b-1 fees, or other forms of compensation that have been paid for asset placement are appropriately applied, utilized and documented.

3. TECHNOLOGY

Through the Center for Fiduciary Studies an AIF has access to technology. In order for an AIF to perform at a maximum level in managing the investment process and implementing the five-step Investment Process, the seven Fiduciary Standards of Care and the *27 Practices* it is necessary to utilize technology. The Center for Fiduciary Studies provides various Fiduciary Analytics online. These services are available by subscription for a monthly fee. These analytics are interactive web-based tools. The tools include the following.

3.1. Asset Allocation Optimizer

An Asset Allocation Optimizer is useful in determining how assets must be allocated to achieve the desired return. Asset classes are listed as follows:

- Large-Cap Equity
- Mid-Cap Equity
- Small-Cap Equity
- International Equity
- REITs
- Global Fixed Income
- Broad Fixed Income
- Intermediate Fixed Income
- Short-Term Fixed Income
- Money Market

3.2. Mutual Fund Analyzer

The Mutual Fund Analyzer customizes a search in accordance with stated criteria. The criteria include:

- Analyze data as of a certain date (selected by AIF)

- Search results by Fund name
- Broker availability

The optimizer then does a Peer Group Search to determine whether the Fund passed the peer group comparison test. The user selects the peer group to which the Fund should be compared. Apples should always be compared with apples.

Broker availability lists all of the major brokers (i.e., American Express, Fidelity, etc.). The software displays a fiduciary score. Peer groups include such criteria as the following:

- Large Blend
- Large Growth
- Large Value
- Mid-Cap Blend
- Mid-Cap Growth
- Mid-Cap Value
- Foreign Blend
- Foreign Growth
- Foreign Value
- High-Yield Bond
- High-Yield Municipals

The software compares the selected Fund to peer groups based on a number of criteria, including U.S. Stocks, Bonds, cash, International Stock, 12b-1 Expense Ratio, Alpha Sharpe Standard Deviation, etc.

3.3. Separate Account Analyzer

The Separate Account Analyzer performs virtually the same functions as the Mutual Fund Analyzer, but it analyzes the separate account managers relative to peer group rather than mutual funds relative to peer group.

3.4. Investment Policy Statement Generator

The Investment Policy Statement Generator asks certain questions including the following:

- Sponsor
- Portfolio type (i.e., personal trust)
- Portfolio sub-type
- State of domicile
- Tax ID

- Approval date
- Current assets
- Time horizon
- Modeled return
- Modeled loss
- Safe harbor compliance options
- Investment options
- Strategic allocation
- Date portfolio started
- Investment goals and objectives
- Provides socially responsible investment options
- Utilize investment advisor
- Utilize separate accounts manager
- Include Appendix A: Risk/Return Modeled Assumptions of Broad Assets Classes

The IPS Generator then assists in making an asset allocation. By adjusting the bar for more or less risk the program selects various asset allocations under the proposed column. The model output changes accordingly. The program then generates a 14-page Investment Policy Statement, a sample of which is attached as Appendix 2.

3.5. Investment Fiduciary Assessment Questionnaire (IFAQ)

This online questionnaire enables the AIF to analyze how well a fiduciary is fulfilling defined investment fiduciary practices and identify ways to improve the long-term performance. This should be of interest to judges who are attempting to measure the performance of trustees, guardians or other fiduciaries. It measures the fiduciary's understanding of their roles and responsibilities and the ability to carry out their duties. The template asks a series of approximately 75 questions that are important in grading the fiduciary and how well he or she serves. In addition to the questions there are sections pertaining to the following:

- Auditing the IPS

- Auditing the trust document
- Auditing progress with an accountant
- Auditing custodial and brokerage statements
- Auditing separate account managers
- Auditing mutual fund performance
- Auditing asset allocation strategies
- Auditing implementation of strategy
- Auditing performance reports and monitoring progress

Finally, the module contains a final report worksheet reporting findings.

3.6. Mutual Fund Family Fiduciary Rankings

This is an historical look at mutual funds and how they have performed with respect to standard deviation and ranking within a peer group.

4. MONTE-CARLO SIMULATION PROGRAMS

Suppose the trustee has developed an appropriate asset allocation and investment policy, committed the policy to writing in an IPS, and has retained a money manager to implement the IPS. The beneficiary then requests that the trustee make a large discretionary distribution or expenditure, for example the purchase of a new home. How does the trustee determine if the expenditure or distribution is prudent, i.e. the remaining trust assets will support the beneficiary's anticipated needs for his or her lifetime? The failure to make this inquiry would be a breach of the trustee's fiduciary duties to the beneficiary.

The trustee could develop a spread sheet projection projecting trust asset values after anticipated distributions assuming a constant average rate of return on investments and inflation. In the real world, assuming a constant average rate of return means that the trust's chances of achieving its goals are typically only about 50%. To be on the safe side and improve this rate of success, the trustee could assume a rate of return of one or two standard deviations below anticipated average rates of investment return. However, this projection is not satisfying to the beneficiary or the trustee, since both of them are aware that investment rates of return are not constant. The beneficiary will expect a rate of return at or above average rate of returns. However, the trustee knows that it is just as likely in any year that the trust investments will have a return below average then above average. Additionally, it makes a significant difference if the below average returns are in the early years of the trust administration rather than in the later years.

An alternative to using a spread sheet and assuming a constant rate of investment return is the use of Monte-Carlo Simulation software. Although not provided by the CFS, this software is readily available. The software generates a large number of possible outcomes by generating a random investment return in each period. The generated rates of return for each period are used to increase (or perhaps decrease) the trust principal. The principal is then reduced by the amount of expenditures or withdrawals. Each possible outcome is called a realization. Successful realizations occur when the trust principal will support the anticipated trust expenditures or

withdrawals for the beneficiary's life expectancy. The probability of success is computed by dividing the number of successful realizations by the total number.

Monte-Carlo software typically requires the trustee to input the following data (most of which should be found in the trust's IPS):

- Time horizon (generally the beneficiary's life expectancy)
- Number of realizations (the larger number the greater the accuracy of the approximation)
- Trust principal
- Anticipated trust withdrawals or expenditures
- Investment annualized rate of return
- Standard deviation of the investment
- Inflation rate
- Portfolio expenses
- Income tax rate

The accuracy of the Monte-Carlo approximation of the success rate depends on the number of realizations and the accuracy of the chosen values for investment return and standard deviation. Using Monte-Carlo approximation of success rates, the trustee can determine if the trust's investment policy and anticipated distributions are compatible.

5. CONCLUSION

Trustees and the lawyers advising them should be aware that the duties of a fiduciary extend well beyond avoiding misappropriation of funds and family conflicts. Fiduciaries must comply with the Uniform Prudent Investor Act and the Income and Principal Act, as well as the statutory and common law standards for fiduciaries. Simply having the fiduciary post a bond does not begin to address these larger issues. A lawyer serving as trustee or advising a trustee should consider taking the Accredited Investment Fiduciary course either on-line or in person at the Katz Graduate School of Business at the University of Pittsburgh. After completing the course both the trustee and the lawyer will have a much clearer understanding of the fiduciary's duties with respect to managing the investment process.