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Trustees: Investment Philosophy and Investment Policy Statements

Part 3 of 4-Part Series

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Every trust should have a stated approach to investment management, recognizing a trustee's personal biases might be at odds with the trust's investment needs.

The Prudent Investor Act is predicated on a belief that there is no ability to efficiently capture market alpha, or outperformance of a benchmark, through active management. It favors an index-based approach to trust management where low fees and strong adherence to a portfolio's benchmarks ensure the trust will keep pace with its asset allocation. Under this belief, the focus is on strategic asset allocation with tactical tilts in the portfolio balance to reflect market conditions. The strategy is executed through exchange-traded funds (ETFs), option overlays and capital protected strategies.

Trustees or Private Trust Companies (PTCs) who believe in active management will have to explain how this approach benefits the portfolio and enhances the trust, such as through a diversified investment allocation. Moreover, the trustee is responsible for ongoing review and oversight of the investment manager and needs to articulate the timeframe for achieving such performance. The trustee must also be willing to fire that manager if necessary.

Furthermore, the trustee needs to recognize the long-term nature of the trusts they will be managing. Strategic asset allocations allow for long-term focus of portfolios. However, with the dislocations in the market post the Great Financial Crisis of 2008, many pundits question whether "modern portfolio theory" makes sense. The trustee will need to understand the differences between an *efficient investor mindset* and a *behavioral finance approach*. They also need to recognize that sector or other "bets" may not be appropriate for a trust portfolio.

A trustee must employ a standard of care: The Prudent Investor Act requires a standard of conduct, not outcome or performance. A trustee's performance is judged on whether they exercised reasonable care, skill, and caution in the overall investment process—not on the appropriateness or riskiness of individual holdings and income yield.

Investment Policy Statements

Once the investment approach is identified and articulated, each trust must have a formal written Investment Policy Statement (IPS). The IPS sets forth the investment philosophy and typically addresses several topics, including:

- The time horizon of the trust and its impact on investment selections
- Trust distribution or income requirements and the attendant impact on investments
- Risk tolerance of the trust and trust beneficiaries
- Incorporating large concentrated positions into the asset allocation
- Diversification or hedging strategy to mitigate the risk
- Performance benchmarks for the trust and each asset class
- Restrictions on asset allocation to force rebalancing of trust portfolios
- Timing or manner of portfolio rebalancing

Investment Policy Statements may also reflect trust-specific techniques. For example, if the grantor of a grantor trust has retained the power of substitution, the IPS might outline the impact on trust management. The Prudent Investor Act imposes a duty on trustees to pursue an overall investment strategy with reasonable risk and return objectives to meet present and future distribution requirements. In constructing a portfolio investment strategy, trustees must consider the risk tolerance of the trust and the beneficiary's relevant circumstances.

Also, not broadly understood, trustees are required to diversify assets unless the trustee reasonably determines it is in the best interest of all the beneficiaries not to diversify. If you are a trustee and intend to retain concentrated positions without a diversification strategy, proceed with caution.

Consider Beneficiary Wishes

Although the Prudent Investor Act does not specifically address ESG (environmental, social and governance) investments, we are seeing more beneficiaries request these investment strategies in their trusts. With sufficient historical data now available to measure ESG performance, a prudent investment advisor can implement ESG investments in a trust portfolio while honoring the long-term investment goals and objectives and adhering to the Prudent Investor Act.

At Cerity Partners, our dedicated Family Office team has helped many families with their trustee and fiduciary needs. For more information on our fiduciary and trustee services, please contact a Cerity Partners advisor. We'd be delighted to assist you.

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Susan is a Partner in the New York City office with more than thirty years of experience serving as a senior director in trust, wealth management and family office advisory firms, and as a personal fiduciary advisor to individuals and families. She helps large families and family offices evaluate and establish Private Trust Companies (PTCs) and develops family office governance and operating structures, including fiduciary policies and procedures.

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