

The Procedurally Prudent Investment Process

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Professionals should consider methods of safeguarding investments held within an asset preservation or protection program.

Asset protection strategies will often entail the use of one of the many structures that the law allows, including—but not limited to—inter vivos and testamentary trusts, asset transfers to younger family members, life insurance trusts, family limited and general partnerships, foreign situs trusts, limited liability companies, shareholder agreements, nonqualified deferred compensation agreements, ERISA plans, and individual retirement accounts. The attorney and the planner must design the strategy to ensure that the funding of any of these approaches can withstand fraudulent transfer arguments.

However, asset protection planning does not stop there. Once the initial decision has been made regarding the asset protection structure to be used, then the next critical decision is the prudent investment process that must be adopted and documented. This article describes the process that a settlor, adviser, donee, fiduciary, grantee, or trustee of an asset protection or preservation strategy should follow to prudently manage investment decisions. Managing sound investment decisions is not an easy task, however, and the following process will provide clear steps that are practical, readily identifiable, easily adaptable, and defensible (if attacked). For the process is virtually the same, regardless of asset size or intended use.

While the procedures discussed will not guarantee investment success, they will

significantly increase the odds of building and structuring an investment portfolio that will withstand the test of private and legal scrutiny.

Parties to the Investment Management Process

There are three groups in the asset preservation and protection process that should benefit from this discussion of the prudent investment management process. These include:

1. Grantors, settlors, donors, and others making transfers of assets into trusts (or outright) because guidance is provided on how to safeguard the assets through thoughtful investment management. This prudent process adds a high degree of respect and credibility to the entity within which these assets are managed. The “after the transfer” asset management process can be easily overlooked or at least minimized, because so much time may have been devoted to the structure decision or the administrative requirements necessary to operate the entity on an annual basis (e.g., tax returns, minutes, deeds, asset title, etc.). This lack of strategic planning can result in the piercing of the veil of the entity or voiding the transfer

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if it is shown that the entrusted assets are not prudently managed.¹

2. Advisers (attorneys, accountants, trust officers, and financial planners) that are responsible for recommending strategies that shield a client's assets. The process described subsequently provides guidance on how to evaluate the effectiveness and appropriateness of a proposed or existing investment strategy. The adviser's carefully crafted efforts can be easily rendered moot through the poor implementation of an investment strategy by less than competent investment professionals or fiduciaries.
3. Investment professionals that manage asset preservation and protection portfolios by providing insight into the breadth and scope of services that they should be offering.

For the purposes of this article, the legal requirements for *prudent* investment management are based on the new Uniform Investment Act (Prudent Investor Rule) which has been adopted, or is in the process of being adopted, by most states.² The Prudent Investor Rule, in turn parallels the fiduciary standards for trustees and fiduciaries of qualified retirement plans as codified in the Employee Retirement and Income Security Act of 1974 (ERISA). In both instances, the standard of care is based on the course of action that would be followed by an informed professional investor.

The key concept is that the courts will judge the *process* that was followed in managing the investment decisions—not the ultimate investment results. An examination of case law dealing with breaches of fiduciary conduct center around several themes. These can be classified into the following general categories:

- Failure to follow a structured investment process;
- Ignoring investment provisions in plan/trust documents governing the investable funds;
- Selecting inappropriate asset classes;
- Failure to properly diversify the portfolio; and
- Failure to avoid prohibited transactions and/or involvement in improper conduct.

The Process

Superior investment returns are a result of developing a prudent process or strategy, and then sticking with it. In order for fiduciaries and settlors to manage better (informed) investment decisions, procedurally prudent judgments must replace intuition and/or emotional decisions influenced by market noise, press appointed investment gurus, or product peddlers.

Process is the key to the approach required of fiduciaries by today's prudence standard. Today's standards shift the focus from the specific investments (micro view) to the fiduciary, the portfolio, and its purpose (macro view). A fiduciary will be found to have met the standard by examining the process by which investment choices were decided. In essence, did the actions resemble those of a prudent person engaged in the real world of investments? How were investment strategies developed, adopted, implemented, and monitored in light of the purposes of the investment funds or intent of the transferor?

Uniform Code of Fiduciary Conduct

The step-by-step process described as follows incorporates both modern investment management theory and the legal elements of fiduciary conduct—those standards codified under the Prudent Investor Rule and ERISA. There are a

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number of common threads that are woven into the fabric of these two statutes, and from them one can derive a "uniform code":

1. *Prepare an Investment Policy Statement (IPS) and document all investment decisions.* The IPS should be viewed as the business plan for the investment program, and a summary or minutes of all investment meetings should be kept.
2. *Diversify the portfolio according to the specific risk/return profile of the participants and beneficiaries.* Fiduciary portfolios should not be managed in a cookie-cutter fashion. Each portfolio will have unique cash flow requirements, legal restrictions, and risk and return objectives that will differentiate one portfolio from another.
3. *Hire prudent experts to manage the investments.* New fiduciary standards make it clear that it is not the desire nor the intent to have the fiduciary actually *make* investment decisions—that is the proper role for professional money managers. The role of the fiduciary is to *manage* the overall investment process, which includes performing the due diligence and selection of professional money managers.
4. *Control and account for investment expenses.* The fiduciary has a responsibility for ensuring that each of the individual components of the investment program are reasonably priced, and that no one service vendor is being unduly compensated. Cost components include expense ratios of mutual funds, money manager fees, custodial costs, consultant's fees, and fees for brokerage transactions, including the use or existence of "soft dollar" payments.
5. *Monitor the activities of service vendors.* It is not enough that the fiduciary follow a due diligence process in selecting a money manager. On an ongoing basis the manager must be monitored to ensure that the manager adheres to stated and agreed on investment strategies.

6. *Avoid prohibited transactions and conflicts of interests.* There are many associated prohibitions, but the more common breaches include using the entrusted assets for unrelated business purposes or for the personal benefit of a "party in interest."

If you map out the Uniform Code into a course of action, a five-step *process* emerges, as appears in Exhibit 1. The five steps are highly integrated; no single step can be effectively implemented without drawing on information developed in the previous step.

Step 1: Analyze the Current Situation.

Investment decisions should never be managed in isolation or in a vacuum. All factors that may have a bearing on the decisions should be identified, analyzed, and integrated into the process, including the determination of the portfolio's objectives. The portfolio's investment objectives specify the results that the investor would equate with a successful investment program, and should quantify the results expected to be achieved over a specified time horizon. For example, a common objective is to produce a total rate of return exceeding the rate of inflation by a certain amount.

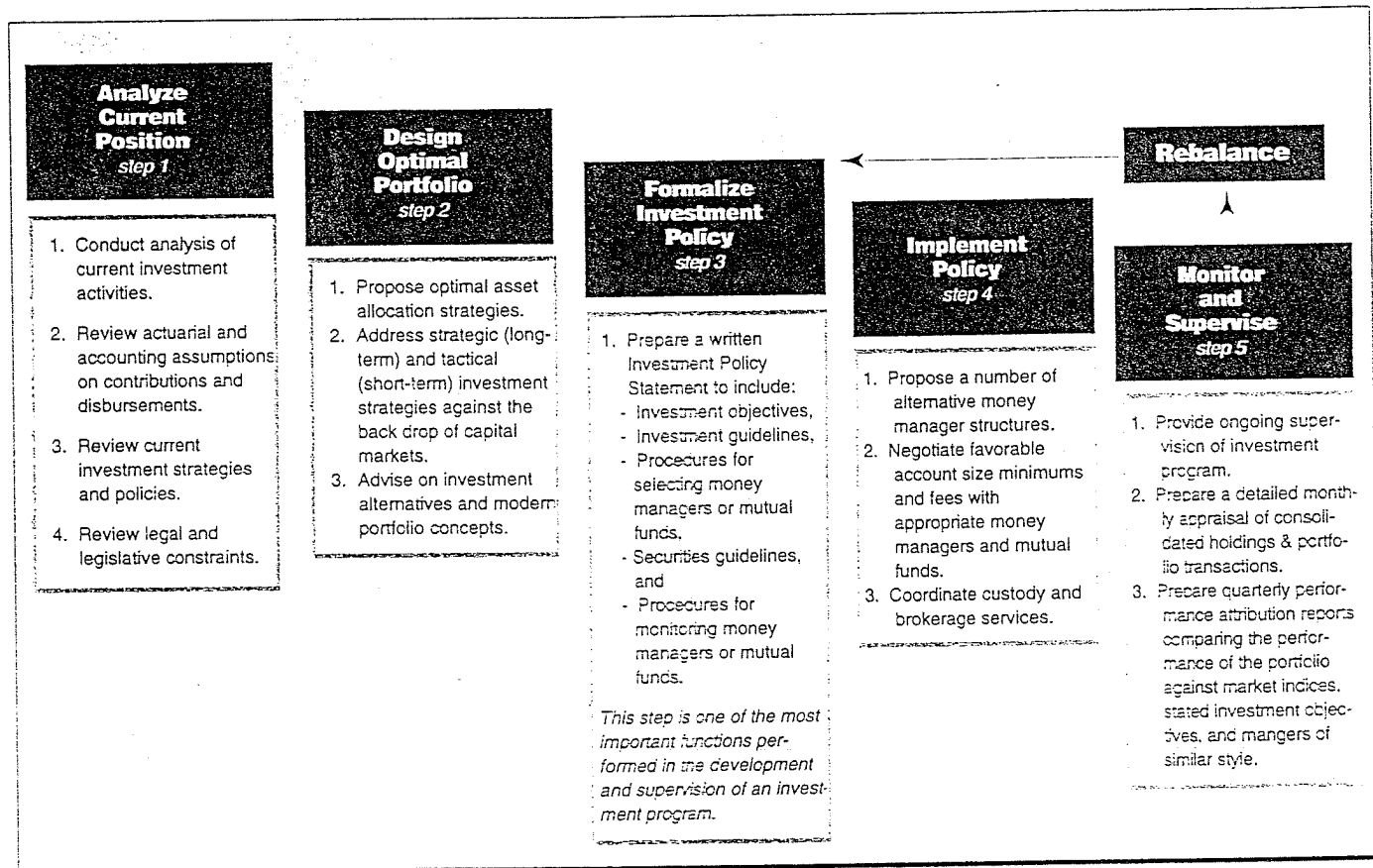
Step 2: Design Optimal Portfolio. A portfolio's asset mix or "asset allocation" refers to the percentages that are invested in various asset classes, such as domestic stocks, domestic bonds, cash, real estate, international stocks, and international bonds. The investor's choice of an asset mix outweighs all other decisions in terms of the ultimate impact on a portfolio's investment performance.

The investor's role is to choose the appropriate combination of assets that "optimizes" risk and return objectives. We use the acronym "RATE" to define the key investor-specific inputs:

- *R Risk tolerance of investor.* There are many different ways to define risk, but

"The role of the fiduciary is to manage the overall investment process."

EXHIBIT 1 Steps in the Investment Management Process



the most effective way may be to simply ask, "How much money are you willing to lose in a given year?"

- **A Asset class preferences.** One should consider the broad asset classes (equities, fixed income, and cash) as a starting point, and then add to the list those asset classes in which they can afford to invest. For instance, would the size of the portfolio justify an allocation to foreign bonds, which have relatively high transaction costs and currency risk?
- **T Time horizon of investment objectives.** The investor's choice of time horizon is often the key variable in determining the ratio of equity to fixed income investments. Even if the investor has a very high risk tolerance, the investor

should not invest in stocks if the money is needed next year.

- **E Expected or desired rate of return.** When investment objectives are identified, either a specified rate of return is determined (for example, 9%), or a relative rate of return is established (for example, exceed the rate of inflation by 5%).

Typically, an investor's risk and return objectives are mutually exclusive of one another. The investor wants to assume a minimal level of risk: "I never want to lose money in any given year." However, the investor also wants a relatively high rate of return: "I want to earn at least 9% on my money." In this example, a risk level of "no losses in a given year" has a return expectation of 7%. The return expectation

of 9% carries with it a potential loss (worst case scenario) in a given year of -8.5%.³

Step 3: Formalize Investment Policy Statement. This is the most important step in the process. It is also the most glaring omission. There are a number of excellent reasons why a well-written IPS is so important.

Case law clearly references the development and maintenance of an IPS as a critical fiduciary function.⁴ One of the first documents that a creditor-plaintiff or auditor will likely request is the IPS. The lack of an IPS, or a poorly written IPS, is prima facie evidence that other aspects of the investment program may also be deficient.

The IPS provides logical guidance during implementation of an investment strategy. Often intelligent investors make the mistake of entering into periods of emotionally driven binges of buying and selling because they have no formal guideposts to mark their investment boundaries. The IPS also ensures continuity of the investment strategy (and intent) if the settlor were to die or become incapacitated.

One expert adviser has written "investment policies must be simple, forthright, and understandable to a competent stranger."⁵ The IPS should do all of the following:

- Detail the desired investment mix and management structure;
- Provide a strategy for automatically rebalancing the assets;
- Provide for clear and enforceable performance standards for money managers; and
- Define the duties and responsibilities for all parties involved in the management of the portfolio's assets.

Step 4: Implementation. Once the IPS has been drafted, searches are commenced to select appropriate money managers (including mutual funds). The fol-

lowing are key tenets to implementing a successful investment strategy:

- *When selecting money managers or mutual funds, consider using specialists, not generalists.* Over the last 20 years, large institutional portfolios have transitioned almost completely from single-balanced managers to multiple-manager (specialist) investment programs.
- *When asset size permits, take advantage of diversifying between different investment styles within an asset class.* For example, diversifying the equity component of a portfolio between "growth" and "value" styles.
- *Notwithstanding the aforementioned, keep the implementation strategy simple.* Overdiversifying a portfolio will increase costs and make implementation and monitoring of the portfolio more difficult.
- *Follow a due diligence process when interviewing and selecting managers.* If there is no structure to the selection process, the investor will have a very difficult time determining the most appropriate manager.
- *Be assured of "best execution" for all transactions.* The largest expense, next to money manager fees, are transaction costs. The investor should know who is receiving compensation from transactions, and what percentage of the transactions are being used by money managers to pay for research and other services (soft dollars).

Step 5: Monitoring and Supervision. The truly effective investor or fiduciary realizes that a crucial element of the decisionmaking process is establishing appropriate performance measurement standards. The most common mistake is the failure to compare money managers to appropriate peer groups, or comparing managers to benchmarks that may be totally irrelevant.

Monitoring the specific performance of money managers and service vendors

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includes an analysis of not only what happened but also why it happened. The analysis combines the disciplines of performance measurement—the “science”—with performance evaluation—the “art.” Performance measurement is primarily a technical accounting function that computes the return of the total portfolio and component parts. Performance evaluation uses the information generated by performance measurement to determine what contributed, or detracted, from the portfolio’s return.

Conclusion

Regardless of portfolio size, only by following a structured process can one be certain that all critical components of an investment strategy are being properly

and prudently implemented. Without following a process, the fiduciary can be deemed to have breached his or her duties, regardless of whether the decisions ultimately proved to be correct. ■

¹See Sections 227 - 229 of the Restatement Third of Trusts—Prudent Investor Rule—(1990) and comments thereto; Section 156 of the Restatement Second of Trusts (1957); *Anderson v. Abbott*, 61 F. Supp. 888 (1945); *First NW Trust Co. v. IRS*, 622 F.2d 387 (8th Cir. 1980).

²As of December 1, 1995, The Uniform Investment Act (Prudent Investor Rule) has been adopted by Alabama, California, Delaware, Florida, Georgia, Illinois, Iowa, Kansas, Minnesota, Montana, Nevada, New York, South Carolina, Tennessee, Virginia, and Washington.

³Based on capital markets expectations developed by Callan Associates Inc., with a statistical level of confidence of 90%.

⁴ERISA § 402(b)(1) and Third Restatement § 227 comment d, p. 14.

⁵J.W. Guy, *How to Invest Someone Else’s Money* (Irwin Professional Publishing, Burr Ridge, IL, 1994), p. 75.