Investing from a Fiduciary Perspective:
The Trusts and Estates Version

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Practical Insights From The Trenches

My Background – Trustee, Executor, Investment Advisor to Trusts, Estates, and Beneficiaries

- **Direct**: Served as personal representative for several large, multi-state estates; serve as trustee/co-trustee on a variety of large, complex trusts including some discretionary trusts with dozens of beneficiaries

- **Indirect**: President of BLB&B Advisors managing $1.4bn in assets for clients in more than 40 states and 5 countries, lead advisor on more than $450mm in client assets including numerous engagements for trusts and estates.

What is a Fiduciary?

Various statutory definitions but, in general:

A fiduciary is a person or organization that acts on behalf of another person or persons to manage assets. Essentially, a fiduciary owes to that other entity the duties of good faith and trust. The highest legal duty of one party to another, being a fiduciary requires being bound ethically to act in the other's best interests.

This is a standard of conduct not
a standard of outcome or of performance.

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What are the Duties of a Fiduciary?

Fiduciary duties include:

- a duty of loyalty (act solely in the interest of the beneficiaries)
- a duty not to comingle entrusted property with the fiduciary's personal property
- a duty to inform and account to beneficiaries
  - Uniform Trust Act of 2006
- a <u>duty of impartiality</u> (no favoritism between classes of beneficiaries)
- a <u>duty of prudence</u> (held to an objective standard of care)

Duty of Impartiality

"I leave the residuary of my estate in trust, the income from which shall be paid to my daughter for life. After the death of my daughter, the assets are to remain in trust for my then living grandchildren."

- The daughter wants cash flow (interest and dividends)
- The grandchildren want growth (capital appreciation) – and let's not dwell on moral hazard in the drafting language…
- The fiduciary is stuck in the middle.

IN GENERAL: investments that pay out all of their income cannot reinvest for growth.

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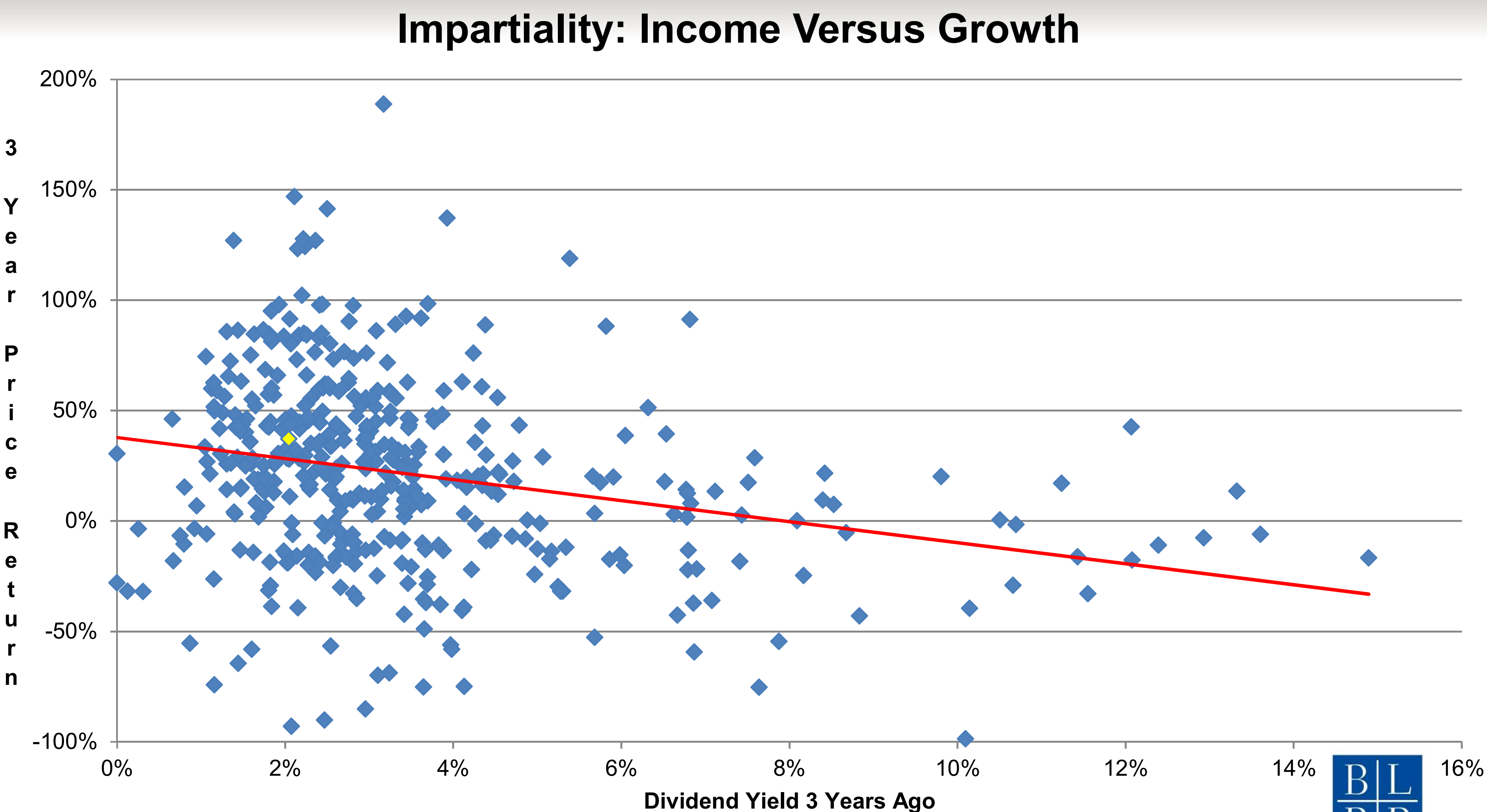
Duty of Impartiality



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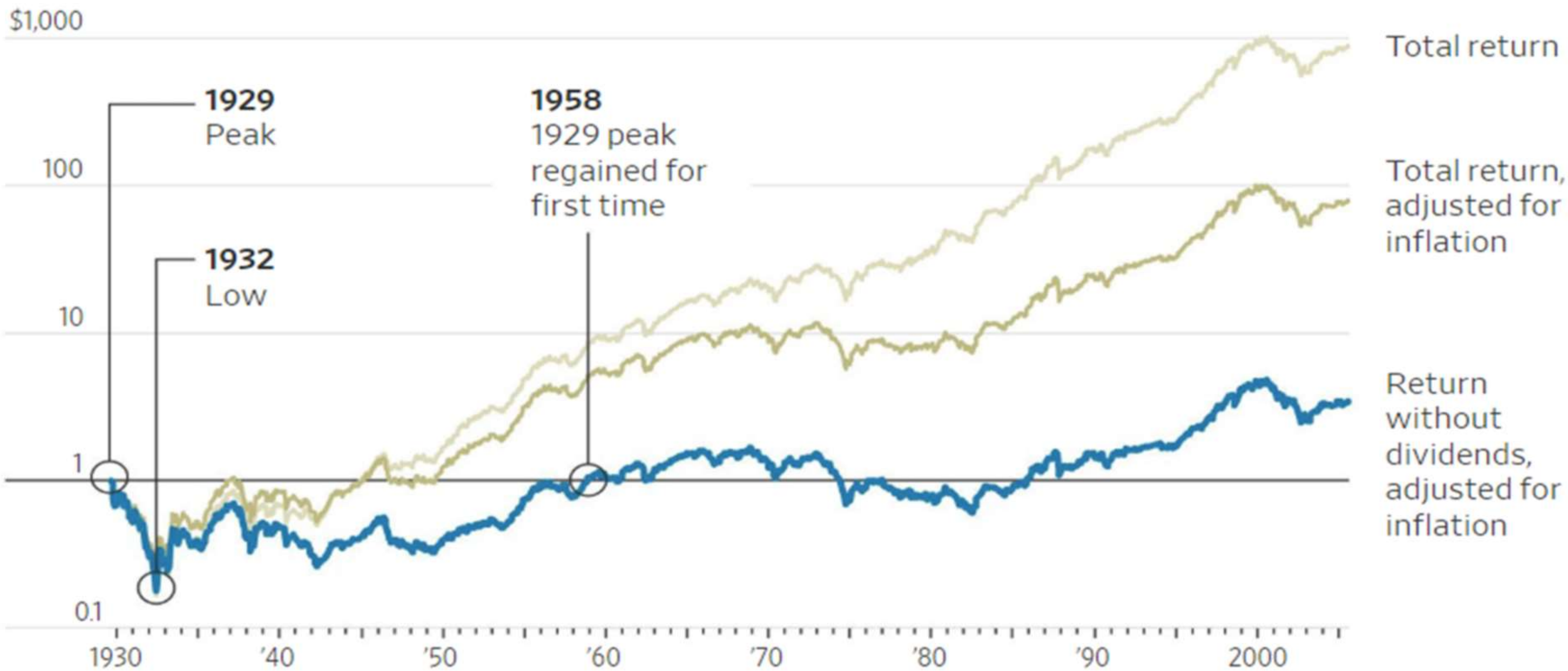
Duty of Impartiality

Growth of a dollar invested in the S&P 500 at the end of August 1929



Note: Monthly returns plotted on logarithmic scale
Source: Edward McQuarrie, Santa Clara University

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Duty of Prudence

Uniform Prudent Investor Act

- Signed by Governor Ridge on June 25, 1999 (Title 20, Chapter 72)
- The donor's intent controls
- Focus is on the entire portfolio, not specific investments
- The overall investment strategy must be prudent
- Considerations: Size, Duration, Liquidity Needs, Taxes, Terms of Trust, Resources of Beneficiaries
- Explicit duty to diversify *(except for inception assets and only "reasonable" not "complete")*
- Delegation of investment authority is expressly authorized whereas before it was prohibited *(subject to a clearly articulated scope and ongoing reviews)*

Investing the Money

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Investing for Estates

- TOD/POD/Beneficiary Forms: keep them current but do not leave the estate unfunded

- Losses (and loss carryforwards) wiped out: don't let your clients die with them

- Step up in basis: do not miss this opportunity (1 yr hold for spousal transfers) but realize it will take time to act and that material gains and losses can accrue during that period – time is of the essence!

- Foreign accounts/assets: do not forget about FBAR reporting!

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Investing for Estates

§ 3316. Investment of funds. "Subject to his duty to liquidate the estate for prompt distribution and to the provisions of the will…"

- PA allows US Treasury and PA Muni bonds, bank deposits, savings accounts, and money markets
- *Most* wills give more flexibility than this: *"to invest in and purchase any property without restriction to legal investments for fiduciaries"*
- Tenuous position for Executor: short (1-2 yr) time horizon, differing beneficiary needs, near zero interest rates, liability for losses, liability for foregone gains, etc…
- Communication is a powerful prophylactic. You have done this dozens of times, your client may never have done it *and* is grieving, and you have no idea what their investment advisor is doing…

Investing for Trusts

Typically, far more complex than investing for Estates:

- Longer time horizon
  - SECURE Act
- Competing classes of beneficiaries *(watch out for the charitable ones!)*
- More complex governing documents
- More complex taxation issues

Investing for Trusts

§ 7203(a) "a fiduciary shall invest and manage property held in a trust as a prudent investor would, by considering the purposes, terms and other circumstances of the trust and by pursuing an overall investment strategy reasonably suited to the trust."

- All trustees should adopt a written investment policy statement explaining the investment goals and methods they employ and the reasons they are suitable for the trust.

Investing the Money

- **Investment Policy Statement** – Second-most important thing after the money itself and yours is:
  A. What’s an investment policy statement?
  B. A yellowed two page ditto from 25 years ago
  C. Twenty-eight pages of boilerplate that you got from a consultant/Google
  D. A living document reviewed and understood by all relevant parties
- **Do It Yourself vs. Hire The Professionals** – Is your D&O better than my E&O?
- **Communication With Professionals** – We can’t read your mind

Investing the Money

Required Rate of Return = Income Need + Expenses + Inflation + Growth Objective

Ignore or underestimate any of these at your peril.

- **Income Need:** Gross Income? Net Income? Discretionary?
- **Expenses:** Expenses can be controlled. Low is good, lower is better.
- **Inflation:** Has averaged 3.27% over US history, 2% over the last 20 years.
- **Growth Objective:** Who/what are the remaindermen and what do they expect? If it's zero, say so. *Remember the Rule of 72.*

Investing the Money

Strategic Allocation	Percent in Equities	Downside Risk	Strategic Allocation Risk Range	Average Return
Aggressive Growth	91%	-14.9%	-9% to -19%	8.0%
Moderate Growth	81%	-13.1%	-8% to -17%	7.6%
Conservative Growth	73%	-11.6%	-7% to -15%	7.3%
Aggressive Growth & Income	62%	-10.0%	-5% to -13%	7.0%
Moderate Growth & Income	54%	-8.2%	-4% to -11%	6.6%
Conservative Growth & Income	44%	-6.2%	-3% to -9%	6.1%
Aggressive Income	33%	-4.6%	-2% to -7%	5.7%
Moderate Income	25%	-2.8%	-1% to -5%	5.0%
Conservative Income	12%	-0.9%	0% to -3%	4.2%

Required Rate of Return = Income Need + Expenses + Inflation + Growth Objective

Required Rate of Return = I.N. + 1.5% + 2.5% + G.O. →

Beneficiary expectations (income + growth) need to be less than 4.0%/yr or we have a problem!

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Lessons for a Lifetime of Investing

1. Have a plan - buy quality investments, broadly diversify among them, and hold them.

2. Asset Classes Rotate
3. Rebalance! Rebalance! Rebalance!
4. Market timing doesn't work

5. Stocks for the Long Term

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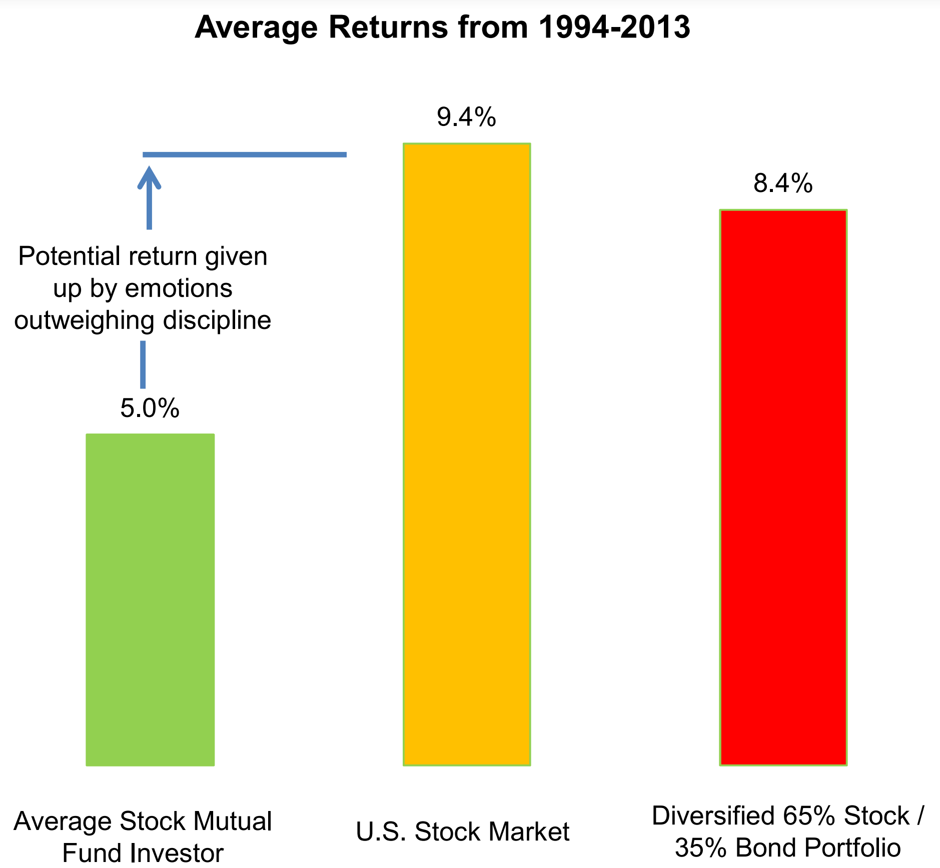
Have a plan…and stick to it!



Source: Lessons from a Lifetime of Investing
www.mulberrycommunications.com

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Asset Classes Rotate

Best Performer

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
U.S. Fixed 8.43%	Global ex-U.S. Fixed 22.37%	Emerging Markets 55.82%	Emerging Markets 25.55%	Emerging Markets 34.00%	Emerging Markets 32.17%	Emerging Markets 39.38%	U.S. Fixed 5.24%	Emerging Markets 78.51%	Small Cap 26.85%
High Yield 5.28%	U.S. Fixed 10.26%	Small Cap 47.25%	Dev ex-U.S. Equity 20.38%	Real Estate Funds 20.15%	Dev ex-U.S. Equity 25.71%	Real Estate Funds 14.84%	Global ex-U.S. Fixed 4.39%	High Yield 58.21%	Emerging Markets 18.88%
Real Estate Funds 4.64%	Real Estate Funds 4.57%	Dev ex-U.S. Equity 39.42%	Small Cap 18.33%	Dev ex-U.S. Equity 14.47%	Small Cap 18.37%	Hedge Funds 12.56%	Cash Equivalent 2.06%	Dev ex-U.S. Equity 33.67%	Real Estate Funds 15.26%
Cash Equivalent 4.42%	Hedge Funds 3.04%	High Yield 28.97%	Global ex-U.S. Fixed 12.54%	Hedge Funds 7.61%	Large Cap 15.79%	Dev ex-U.S. Equity 12.44%	Real Estate Funds -10.70%	Small Cap 27.17%	High Yield 15.12%
Hedge Funds 4.42%	Cash Equivalent 1.78%	Large Cap 28.68%	Real Estate Funds 12.00%	Large Cap 4.91%	Real Estate Funds 15.27%	Global ex-U.S. Fixed 11.03%	Hedge Funds -19.07%	Large Cap 26.47%	Large Cap 15.06%
Small Cap 2.49%	High Yield -1.37%	Global ex-U.S. Fixed 19.36%	High Yield 11.13%	Small Cap 4.55%	Hedge Funds 13.86%	U.S. Fixed 6.97%	High Yield -26.16%	Hedge Funds 18.57%	Hedge Funds 10.95%
Emerging Markets -2.61%	Emerging Markets -6.16%	Hedge Funds 18.44%	Large Cap 10.88%	Cash Equivalent 3.06%	High Yield 11.85%	Large Cap 5.49%	Small Cap -33.79%	Global ex-U.S. Fixed 7.53%	Dev ex-U.S. Equity 8.95%
Global ex-U.S. Fixed -3.75%	Dev ex-U.S. Equity -15.80%	Real Estate Funds 8.28%	Hedge Funds 9.64%	High Yield 2.74%	Global ex-U.S. Fixed 8.16%	Cash Equivalent 5.00%	Large Cap -37.00%	U.S. Fixed 5.93%	U.S. Fixed 6.54%
Large Cap -11.89%	Small Cap -20.48%	U.S. Fixed 4.10%	U.S. Fixed 4.34%	U.S. Fixed 2.43%	Cash Equivalent 4.86%	High Yield 1.87%	Dev ex-U.S. Equity -43.56%	Cash Equivalent 0.21%	Global ex-U.S. Fixed 4.95%
Dev ex-U.S. Equity -21.40%	Large Cap -22.10%	Cash Equivalent 1.15%	Cash Equivalent 1.33%	Global ex-U.S. Fixed -8.65%	U.S. Fixed 4.33%	Small Cap -1.57%	Emerging Markets -53.33%	Real Estate Funds -30.40%	Cash Equivalent 0.13%

2011	2012	2013	2014	2015	2016	2017	2018	2019
Real Estate Funds 14.96%	Emerging Markets 18.23%	Small Cap 38.82%	Large Cap 13.69%	Real Estate Funds 13.95%	Small Cap 21.31%	Emerging Markets 37.28%	Real Estate Funds 7.36%	Large Cap 31.49%
U.S. Fixed 7.84%	Dev ex-U.S. Equity 16.41%	Large Cap 32.39%	Real Estate Funds 11.46%	Large Cap 1.38%	High Yield 17.13%	Dev ex-U.S. Equity 24.21%	Cash Equivalent 1.87%	Small Cap 25.52%
High Yield 4.98%	Small Cap 16.35%	Dev ex-U.S. Equity 21.02%	U.S. Fixed 5.97%	U.S. Fixed 0.55%	Large Cap 11.96%	Large Cap 21.83%	U.S. Fixed 0.01%	Dev ex-U.S. Equity 22.49%
Global ex-U.S. Fixed 4.36%	Large Cap 16.00%	Real Estate Funds 12.90%	Small Cap 4.89%	Cash Equivalent 0.05%	Emerging Markets 11.19%	Small Cap 14.65%	High Yield -2.08%	Emerging Markets 18.44%
Large Cap 2.11%	High Yield 15.81%	Hedge Funds 9.73%	Hedge Funds 4.13%	Hedge Funds -0.71%	Real Estate Funds 7.79%	Global ex-U.S. Fixed 10.51%	Global ex-U.S. Fixed -2.15%	High Yield 14.32%
Cash Equivalent 0.10%	Real Estate Funds 9.79%	High Yield 7.44%	High Yield 2.45%	Dev ex-U.S. Equity -3.04%	Dev ex-U.S. Equity 2.75%	High Yield 7.50%	Hedge Funds -3.19%	Hedge Funds 9.31%
Hedge Funds -2.52%	Hedge Funds 7.67%	Cash Equivalent 0.07%	Cash Equivalent 0.04%	Small Cap -4.41%	U.S. Fixed 2.65%	Hedge Funds 7.12%	Large Cap -4.38%	U.S. Fixed 8.72%
Small Cap -4.18%	U.S. Fixed 4.21%	U.S. Fixed -2.02%	Emerging Markets -2.19%	High Yield -4.47%	Global ex-U.S. Fixed 1.49%	Real Estate Funds 6.66%	Small Cap -11.01%	Global ex-U.S. Fixed 5.09%
Dev ex-U.S. Equity -12.21%	Global ex-U.S. Fixed 4.09%	Emerging Markets -2.60%	Global ex-U.S. Fixed -3.09%	Global ex-U.S. Fixed -6.02%	Hedge Funds 1.25%	U.S. Fixed 3.54%	Dev ex-U.S. Equity -14.09%	Real Estate Funds 4.39%
Emerging Markets -18.42%	Cash Equivalent 0.11%	Global ex-U.S. Fixed -3.08%	Dev ex-U.S. Equity -4.32%	Emerging Markets -14.92%	Cash Equivalent 0.33%	Cash Equivalent 0.86%	Emerging Markets -14.57%	Cash Equivalent 2.28%

Worst Performer

Source: Callan Institute

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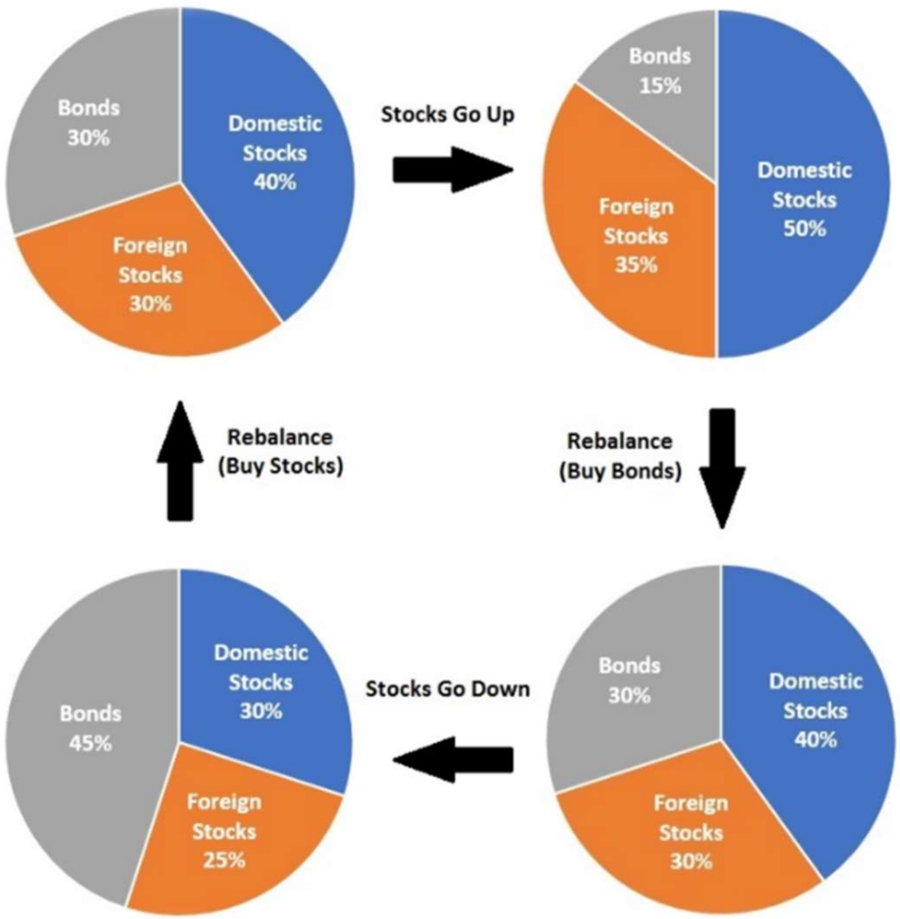
Rebalance! Rebalance! Rebalance!



Source lynalden.com/asset-allocation/

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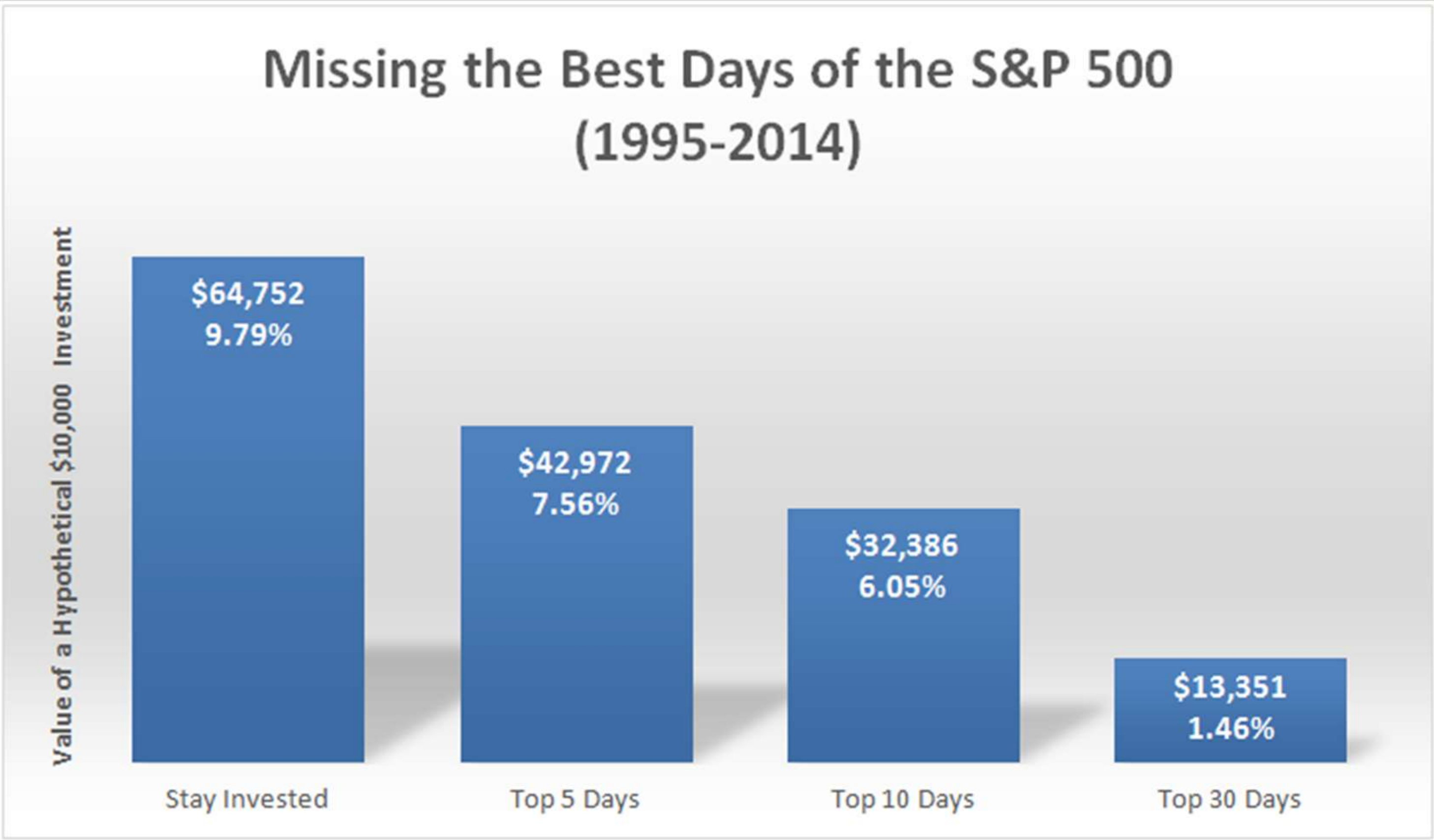
Market Timing Doesn't Work



Source: Standard & Poor's and Wealth Management Systems. Example based on the hypothetical performance of a $10,000 investment between 1/1/1995 and 12/31/2014. Return represented by total return of the S&P 500, an unmanaged index generally considered to be representative of the U.S. stock market. Past performance is not a guarantee of future results. This is a hypothetical example used for illustrative purposes only and excludes important factors like transaction costs and management fees. You cannot invest directly in an index.

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Reasons to Sell

Data Source: StockCharts.com. S&P 500 Total Return

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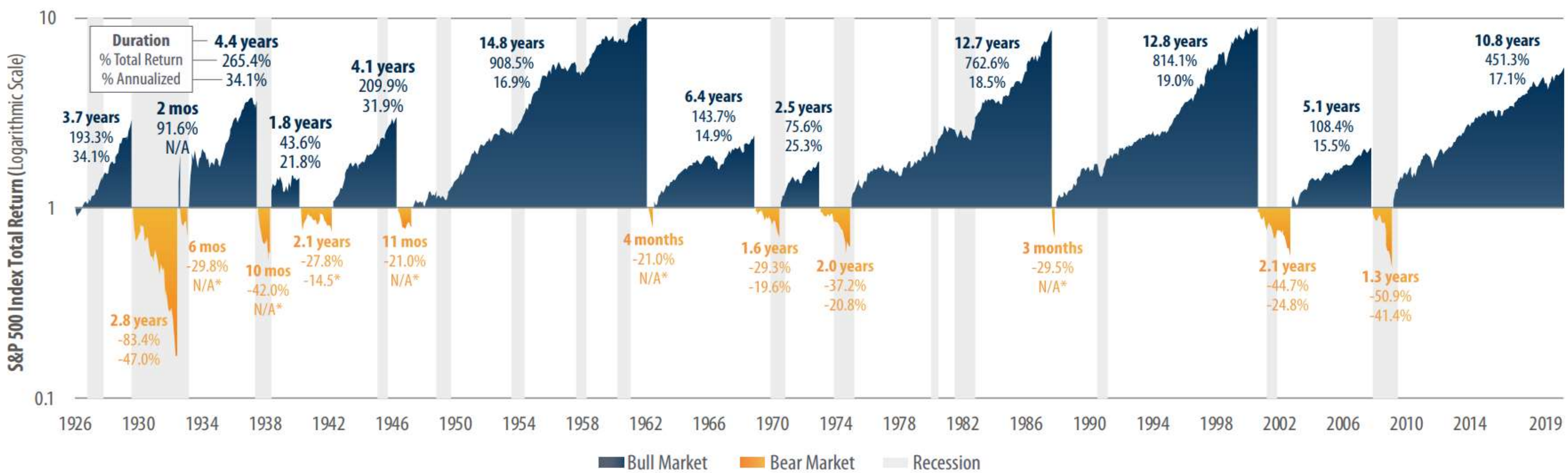
Stocks for the Long Term

This chart shows the historical performance of the S&P 500 Index throughout the U.S. Bull and Bear Markets from 1926 through 2019. Past performance is no guarantee of future results, however reviewing the history of the market makes a compelling case for investing for the long term

- The average **Bull Market** lasted 6.6 years with a cumulative total return of 339%.
- The average **Bear Market** lasted 1.3 years with an average cumulative loss of -38%



Source: First Trust Advisors L.P., Bloomberg. Returns from 1926 - 2019. *Not applicable since duration is less than one year.

These results are based on monthly returns–returns using different periods would produce different results. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results.

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Summary

- Fiduciaries owe an incredibly high duty of care and loyalty to those they serve.
- Most individuals and many institutions are not fully equipped to achieve the legal standard prescribed for the role.
- While you may not *be* a fiduciary, you will frequently *represent* one.
- Communicate, communicate, communicate (and then document).
- Many aspects of successful investing go against what *Homo sapiens* are hardwired to think and do.

Summary

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