

2003 Wisconsin Act 264, “The Uniform Prudent Investors Act” By Gregory D. Wait, CEBS

On April 15, 2004, Governor Jim Doyle signed into law a bill that sets general standards for fiduciaries and allows them greater flexibility when choosing investments. This bill, known as the Uniform Prudent Investor Act (UPIA), mandates that individuals responsible for trust accounts will now be judged on the basis of the performance of the total portfolio, allows them to delegate investment decisions, and requires them to consider the tax consequences of investment decisions.

Wisconsin has been slow to pass a Uniform Prudent Investor Act, as the American Law Institute’s 1992 Restatement (Third) of Trust restated legal principles which should govern trust investments. The Restatement (Third)’s revised standard of prudent investment is known as the “Prudent Investor Rule” and follows the innovations of the Employee Retirement Income Security Act (ERISA) of 1974. In 1994, the National Conference of Commissioners on State Laws approved a model state statute incorporating the principles of the Uniform Prudent Investor Act. At least 38 states had previously enacted some version of the Prudent Investor Rule.

The new law removes much of the common law restrictions upon the investment authority of trustees and empowers fiduciaries to utilize modern portfolio theory to guide investment decisions. A fiduciary’s performance historically could be measured for each investment singly, but performance will now be based on the risk/return characteristics of the total portfolio with a realization that particular investments that would have been viewed as speculative and subject to surcharge under the old law may be sensible, risk-reducing additions to a portfolio viewed as a whole.

Specific language of the Uniform Prudent Investors Rule includes:

1. Fiduciaries owe a **duty to the beneficiaries to comply with the Act**; however, a fiduciary is not liable to the extent that the fiduciary is bound by specific provisions of a will, trust, or court order.
2. A fiduciary shall **invest and manage assets as a prudent investor would**, exercising reasonable care, skill, and caution. A fiduciary’s investment and management decisions about individual assets shall be evaluated, not in isolation, but in the context of the portfolio as a whole and as a part of the overall investment strategy having risk and return objectives reasonably suited to the trust.

3. Fiduciaries shall **consider the following circumstances:** general economic conditions; possible effects of inflation or deflation; expected tax consequences of investment decisions; the role each investment plays within the overall portfolio; the expected total return from income and appreciation of capital; other resources of the beneficiaries; need for liquidity, income and preservation of capital; an asset's special relationship to the purpose of the trust or beneficiaries.
4. A fiduciary shall make a reasonable effort to **verify facts** relevant to the investment and management of assets.
5. A fiduciary shall **diversify investments**, unless special circumstances are better served without diversifying.
6. **Within a reasonable time** after accepting a fiduciary appointment, a fiduciary shall review the assets and implement decisions concerning the retention and disposition of assets.
7. A fiduciary shall invest and manage the assets **solely in the interest of the beneficiaries.**
8. The fiduciary shall **act impartially** if a trust has two or more beneficiaries.
9. A fiduciary may incur only **costs that are appropriate and reasonable** in relation to the assets and purposes of the trust, and skills of the fiduciary.
10. Compliance with the Rule is determined in light of the facts and circumstances existing **at the time of the fiduciary's decision** and not by hindsight.
11. **Delegation of investment and management functions** is appropriate so long as the fiduciary exercises reasonable care, skill and caution in: selecting the agent; establishing the scope and terms of the delegation; periodically reviewing the agent's actions to monitor the performance and compliance with the terms. A fiduciary who complies with the above requirements is not liable to the beneficiaries for the decisions or actions of the agent to whom a function is delegated. By accepting the delegation of a function from a fiduciary, an agent submits to the jurisdiction of the courts of this state.

So, what does this mean to trustees and fiduciaries? Clearly, the *process* involved in making investment and asset management decisions is more complex and sophisticated than was previously required by law. The Uniform Prudent Investors Act assesses the trustee's liability by the investment process, not the outcome. The selection of a portfolio of investments without considering the risk characteristics of the investment can be considered speculation. Therefore, trustees must have in place a process of evaluating investments and a process for selecting and evaluating investment managers to whom they may delegate authority.

The intellectual basis for the language of the UPIA is derived from the Modern Portfolio Theory (MPT), first introduced in 1952 by Harry Markowitz in a 14-page paper that empirically demonstrates the risk/return behavior of financial markets. The basic conclusion of MPT is that investors must consider risk as well as expected return when making investment decisions for a portfolio. As Modern Portfolio Theory is clearly a part of the underlying definition of prudence in the UPIA, trustees must have an understanding of MPT concepts.

In a basic form, the trustee's investment process under the UPIA can be viewed as including the following five steps:

Evaluation—The trustee has a duty to consider the requirements of the trust before making any investment decisions. Some trusts require income, while others are oriented toward total return. The trustee should have a detailed and systematic process for determining the appropriate risk profile of the trust, and is required to consider the purposes, terms, distribution requirements and other circumstances of the trust. All specific circumstances outlined in item 3 above must be considered. It is important to document the information analyzed in the evaluation process.

Asset Allocation—The trustee, based on the requirements of the trust, must create a long-term asset allocation structure for the portfolio to achieve the particular objectives over a designated time period. Every investment is part of an asset class, either explicitly or implicitly. Asset classes have quantifiable risk characteristics, which can be evaluated in the context of their position in the total portfolio to determine risk/return tradeoffs. Not every asset class is mandatory, nor are there a minimum number of asset classes that must be included in a portfolio. However, the trustee's process should at least reflect the consideration of various asset classes. Modern Portfolio Theory guides the mix of asset classes in a portfolio to an "efficient frontier" which implies a maximum expected return for a given level of risk. Again, the process of determining an appropriate asset allocation strategy should be clearly documented.

Investment—The trustee has a duty to diversify investments in the portfolio. Once an appropriate asset allocation is determined, the trustee may select investments that will achieve the strategic allocation. Investments should further be diversified by sector or industry within an asset class. If the trustee does not have sufficient expertise or the desire to select specific investments, they have a responsibility to delegate these decisions to professional money managers. Just as the trustees need a process for evaluating the trust requirements and determining the asset allocation strategy, they should follow a comprehensive due diligence process in order to select professional investment managers. This process cannot simply be based on the historical returns posted by the managers, but must include an analysis of risk-adjusted returns, performance versus peer groups and market indices, expenses associated with the manager's approach, the stability of the overall organization, the tenure of the portfolio manager, and the manager's adherence to their investment strategy. Because of the duty to control costs, both active and passive investment management approaches should be considered. Prior to the evaluation of professional managers, a written Investment Policy Statement should be in place which outlines the objectives of the trust, asset allocation strategy, manager selection process, security guidelines and restrictions, and an ongoing measurement process.

Implementation—Once the asset allocation strategy decided upon, and the investments or selection of professional managers is determined, the trustees must properly implement the strategy. This may involve negotiating with custodians or professional investment managers for favorable terms or fees, and coordinating the activities involved with the movement of trust assets. The trustees have a duty to control and account for all costs associated with managing trust assets throughout the process. Contracts with custodians or professional investment managers must be thoroughly reviewed, and all potential conflicts of interest should be recognized.

Ongoing Evaluation—On a regular basis, trustees must evaluate the management of trust assets, including the performance of any professional investment managers to whom responsibility is delegated. The due diligence factors considered when selecting money managers, custodians, and other service providers can be used as the basis for monitoring the activities of the trust. It is generally considered prudent to review the performance of the overall portfolio and the specific professional investment managers on a quarterly basis, versus appropriate market indices and peer groups. Again, it is important to document the results of the quarterly performance reviews.

In summary, the new Uniform Prudent Investor Act sets clear standards for trustees and fiduciaries, and enhances the concept of *prudence is process*. A trustee's conduct is reflected in process; and conduct, not performance determines prudence. In addition, conduct cannot be judged in hindsight, so documentation of the reasons for making asset management decisions at the time of the decision has increased importance. In the end, the goal of the new Act is improved long-term returns for beneficiaries, commensurate with the risk level as determined by the terms of the trust.

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