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OUTSIDE COUNSEL

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Portfolio Options Expanded for New York Trusts

The enactment on June 19, 2001 of the Uniform Principal and Income Act, EPTL 11-A-1 and the additions to the Prudent Investor Act of sections 11-2.3(b)(5) and 11-2.4 of the EPTL are the most recent steps New York has taken to allow fiduciaries to fully adopt contemporary investing techniques commonly referred to as "Modern Portfolio Theory."

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Since 1995, New York trustees have been guided by the Prudent Investor Act[1] which made sweeping changes in the way fiduciaries manage trusts. Without the new additions however, trustees have struggled to achieve the benefits of investing for total return using Modern Portfolio Theory as conceived by the framers of the Prudent Investor Act.[2]

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Since the early 19th century, the Prudent Man Rule first detailed in a Massachusetts Supreme Court case, *Harvard College v. Amory*,[3] held that a fiduciary had the duty to "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to *speculation*, but in regard to the permanent disposition of their funds, considering the probable outcome, as well as the probable safety of the capital invested." (Emphasis added.)

The so-called "Prudent Man Rule" quickly became the gold standard for fiduciaries and was seen by many fiduciaries and their counsel as a mandate to preserve capital and avoid risk. While not actually defining risk, the application of the Prudent Man Rule was applied to each investment of a portfolio separately.

The New York cases of *King v. Talbot*[4] and *McCabe v. Fowler*[5] are the seminal cases enunciating the Prudent Man Rule

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in this State. The *King* court held that the duty of a trustee was to preserve the fund and to procure income for the income beneficiary. In that case, Judge Woodruff said that by no means should a trustee speculate, invest in an uncertain manner nor invest on the basis of a rise in the market.[6] The executor in *King* violated his duty to the cestui que trust when he invested in various railroad stocks.

The court in McCabe in finding an executor was not liable for surcharge in entrusting bonds to an agent while it confirmed the earlier analysis in *King* by saying an executor or trustee is required to "avoid all extraordinary risks in the investment of the money of the estate, and to keep the same safely."[7]

Whereas decisions rendered by the courts under the Prudent Man standard evaluated prudence in relation to the overall objectives of the trust and the makeup of the portfolio, the courts did not discuss the concept of risk per se, rather, the analysis centered on either the prudence of the investment decision making, or the actual performance of the investment.

In summary, the Prudent Man Rule told fiduciaries that a good portfolio is a collection of good individual investments, prudently chosen, with emphasis on safety.

Risk in Modern Portfolios

Modern portfolio theory, first articulated by Harry Markowitz in the early 1950s,[8] approached investment decision making very differently from the Prudent Man concept. First, Mr. Markowitz evaluated investments from the perspective of "risk" rather than prudence. Second, Mr. Markowitz believed investments needed to be analyzed not individually only, but in context of a collection of assets viewed together — a "portfolio".

Mr. Markowitz defined a risky asset as one with uncertain future returns, as opposed to a risk-free asset, namely a U.S. Treasury security, whose returns are considered certain and therefore free of risk.

In terms of measuring risk, modern portfolio theory posits that each investment has an expected rate of return[9] and actual returns can and do deviate from expected returns. This deviation has two components: systematic risk, also called market risk, related to overall economic factors that affect all investments and unsystematic risk related to the unique factors of an individual investment. Modern portfolio theory primarily endeavors to measure unsystematic risk.[10]

Modern portfolio theory focuses on evaluating risk when two or more assets are combined into a portfolio. Portfolios, like individual assets, have variance between the expected returns and the actual returns, which can be measured and predicted. Two (or more) risky assets, however, will also behave in a certain way in relation to each other. This behavior is known as "covariance" or the measure of the degree to which two assets move together.[11]

This measurement of covariance is the key to reducing the risk of a portfolio of risky assets by the use of "diversification". By combining assets in a portfolio that have the proper covariance, it is possible, according to modern portfolio theory, to diversify away all of a portfolio's unsystematic risk. Such a portfolio is considered to be the optimal portfolio, offering the greatest return for the targeted level of risk.

Where the Prudent Man Rule was concerned with merely a good portfolio, made up of a collection of good investments chosen prudently, modern portfolio theory identifies an optimal portfolio whose behavior can be analyzed with respect to how the individual investments act as a whole. This is an important point of divergence from the old Prudent Man Rule.

For example: Say the death of a grantor results in a trust being created with a corpus made up of 50 percent in fixed income securities and 50 percent in equity — shares of one stock — General Electric. Under the Prudent Man Rule, the fiduciary could justify not diversifying the GE stock on the basis that it was a prudent investment in a company that has outperformed the Standard and Poor's 500 index over the long term, and it is likely to continue to do so.

According to modern portfolio theory, however, the strategy cannot be justified. Looked at as a whole, the equity portion of the portfolio is not optimal since it is invested in only one asset and, as such, exposes the beneficiaries to much more risk when compared to a diversified portfolio.

An immediate problem arose, however, when applying the Prudent Investor Standard to New York trusts and it had to do with traditional rules for classifying income and principal. Under those rules, a trustee's attempts to create an optimal portfolio could be stymied by the mandate to balance the needs of the income beneficiary with those of the remaindermen.

Say a trustee, in keeping with the Prudent Investor Standard, may believe it prudent to create a portfolio of 80 percent equities, diversified so as to reduce risk and 20 percent debt to generate income. While the growth of the equities may be sufficient so the trust can return enough to the remaindermen to outpace inflation, the dividends from the equities and the interest from the debt portion may not be sufficient for the needs of the income beneficiary. Stewards of non-trust assets have solved the problem by selling some of the assets and distributing realized capital gains. When those gains are long term it can even allow a tax saving. Trustees could not always employ this method.

This problem was addressed in the amendment to the Uniform Principal and Income Act [UPIA] (1997) by the adoption of a new Section 104: Trustees Power to Adjust.

The new section enables a trustee to "adjust between principal and income to the extent the trustee considers nec-

essary if the trustee invests and manages trusts assets as a prudent investor."[12] The section was adopted, according to the Prefatory Note to that Act, "to provide a means for implementing the transition to an investment regime based on the principals embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of 'income' as traditionally perceived in terms of interest, dividends and rents."

The new bill EPTL Article 11-A adopts the UPIA, effective January 1, 2002, but places the power to adjust in a new provision of EPTL 11-2.3,[13] thereby allowing for, among other solutions, the ability to "reclassify" realized capital gains as income for the purposes of distribution to income beneficiaries. This was an important step needed to allow New York fiduciaries to fully implement modern portfolio theory in the disposition of trust assets.

The second step encouraging implementation of modern portfolio theory is new EPTL 11-2.4. This provision now allows trustees to opt for a fixed definition of income by providing a 4 percent unitrust amount to be considered net income for trust purposes.[14] The 4 percent figure applies to the first three years of the trust followed by a formula commencing in the fourth year which calculates an average based on value over the history of the trust.[15] The details of this aspect of the statute are too lengthy to be discussed in this article. The new provision is elective and does not apply to estates.[16] The unitrust approach can be utilized if agreed to by all interested parties or ordered by the court upon application.[17]

The unitrust provision facilitates the implementation of modern portfolio theory by creating a relatively fixed definition of income — the unitrust amount — which the statute has ordained as a reasonable balance between principal and income. Given this safe harbor trustees now can concentrate on creating optimal portfolios managed to attain goals of risk and return responsive to the ebbs and flows of the market. Trustees will, under this portion of the new statute, be able to use modern portfolio theory to build a portfolio designed to grow at an annualized rate equal to the unitrust percentage plus an additional amount to pay costs and outpace inflation.

The new bill, and its adherence to the Prudent Investor Rule, requires fiduciaries to change their perspective and gives them the flexibility to do so. Specifically, fiduciaries will be judged on their conduct in managing the assets, not the performance of any particular security.[18] Should trustees choose not to delegate investment oversight to professions as allowed in the Act,[19] it would seem, even within the confines of modern portfolio theory, there is neither the obligation nor the expectation that trustees meet or better some benchmark such as the S&P 500. Rather the test will be, according to the Standard: has the trustee formulated appropriate objectives for the trust, stated them for the record, developed a strategy for accomplishing the goals and monitored how well the portfolio is meeting them.

In the recent case of *Matter of Chase Manhattan Bank*, Judge Preminger pointed this out to the guardian ad litem in holding that the principal guardian "misapplies the test by which the Trustee's standard of care is judged, focusing on performance rather than conduct."[20]

To ensure compliance with these proposed changes, Trustees may want to document certain following steps when overseeing trust assets.

b. An investment strategy, encompassing objectives for growth and income, time horizons, tax considerations, overall economic issues, risk tolerance, asset allocation, frequency of review, liquidity, diversification and criteria for selection and retention of assets taking into consideration the specific needs of beneficiaries;

c. Guidelines for how the source of distributions will be allocated with respect to income, realized capital gains or principal;

d. Investment monitoring and control procedures;

e. Duties and responsibilities of various parties.

2. Monitor the performance of the portfolio on a regular basis to determine whether the portfolio is meeting the specific expectations set forth in the policy statement.

3. Document course changes as they occur, including the rationale for making them.

The new legislation significantly changes how assets are selected and managed. Given the latitude of the Prudent Investor Standard and the new power to adjust between principal and income and the unitrust approach, trust portfolios could include investments previously considered off limits so long as they fit with the modern portfolio theory strategy. On the other hand, allocation of trust assets according to the old Prudent Man guidelines, no matter how conservative they may seem, may no longer be justifiable in light of the new complexities of securities markets.

In the final analysis, trustees will be held accountable for their conduct in administering the trust portfolio rather than its performance. Accordingly, Trustees who memorialize their actions and their rationale in a well-constructed set of documents should be better prepared to prove compliance with not only the spirit, but also the letter of the Act.

(1) EPTL 11-2.3 as enacted 1995.
(2) Summary Memorandum 11.2.3(b)(1) in support of the Prudent Investor Act.
(3) 1830
(4) 40 NY 76 (1869).
(5) 84 NY 314 (1881).
(6) *King* at 86
(7) *McCabe* at 317
(8) Harry Markowitz, "Portfolio Selection", *Journal of Finance* 7, no. 1 (March 1952).
(9) Expected rates of return are calculated using a variety of methods which are not the subject of this article.
(10) Perhaps the best known measure of unsystematic risk is "variance", also known as the "standard deviation of expected returns." Variance is a statistical measurement of how much actual returns vary or differ from expected returns among a group of assets. Imagine a dartboard with the expected return being the bulls-eye. As actual returns accumulate, they appear as darts clustered in some fashion around the bulls-eye. Greater distance from the bulls-eye equals greater variance. Each asset has a variance that can be computed and, using probability theory, predicted.
(11) A positive covariance means that the rates of return for two investments tend to move in the same direction at the same time — when one goes up, the other goes up and when one goes down the other goes down. A negative covariance means the rates of return for two investments tend to move in opposite directions at the same time — when one goes up the other goes down and vice versa. The strength of this co-relationship can also be measured.
(12) UPIA (1997 Section 104 (a).
(13) EPTL 11-2.3(b)(5)(A).
(14) EPTL 11-2.4(b)(1).
(15) EPTL 11-2.4(b)(2).
(16) EPTL 11-2.4(e)(1).
(17) EPTL 11-2.4(e)(1)(B); 11-2.4(e)(2).
(18) Support Memorandum for Bill A11683 (EPTL 11-2.3) Summary provision 7.
(19) EPTL 11-2.3(b)(4)(C).
(20) *New York Law Journal*, Apr. 25, 2000 p. 27 (NY Cty Surr.).