Principal Versus Income - Legal Issues

I. Duty of Care

A. Duty to invest to achieve objectives of trust (defined by settlor) in light of beneficiaries' needs (anticipated by settlor, but often defined by beneficiaries' circumstances)

1. A trustee shall administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution. UCA § 75-7-804

B. Trust objectives and beneficiaries' idiosyncratic needs determine investment horizon(s).

II. Duty of Impartiality

A. If a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests. UCA § 75-7-803

B. Why do attorneys prefer trusts, if not to manage property over time for the benefit of <u>multiple</u> beneficiaries (transferring property to any type of entity will avoid probate)?

III. Zero Sum Game

A. What is the safest way to avoid acting impartially (at least in making distributions)? Make equal distributions to similarly situated beneficiaries.

B. How many beneficiaries are similarly situated?

C. Most folks opt for equal.

IV. Principal Versus Income

A. UPIA

1. Method of accounting between two categories of trust beneficiaries: those entitled to income and those entitled to principal

2. Whether a particular receipt or disbursement is properly allocable to one beneficiary (income beneficiary) or another (principal beneficiary)

3. This dichotomy is a creature of drafting

a. Concept of perpetual trust, spending only the income, preserving principal for future generations

i. An act of hubris which the rule against perpetuities is specifically designed to prevent

B. UPruIA

1. Trustee must invest trust assets as a "prudent investor," developing a strategy for the entire portfolio and not each asset in isolation (diversification), and should consider economic conditions, possible effect of inflation/deflation, tax consequences, the role each investment plays within the overall portfolio (asset allocation), expected total return, other resources of the beneficiaries, needs for liquidity and income and preservation and appreciation of capital, an assets special value/purpose in relation to the trust purposes. UCA § 75-7-902.

V. Possible Responses

A. Obliterate distinction between income and principal beneficiary

1. But what to do when principal/income distinction is desirable, e.g., QTIP trust in a second marriage of spouses with disparate wealth?

B. Create separate trusts

C. Eliminate zero sum games by creating preferences

D. Expressly grant trustee discretion to invest in accordance with modern portfolio theory

E. Total return trust

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"Balancing the Needs of Income and Remainder Beneficiaries Through Asset Allocation and Investment Management"

Outline:

- The Challenge: Balancing Fiduciary Responsibility
    - Trustees are expected to maintain their fiduciary responsibilities to both current and remainder beneficiaries in a market environment where income is hard to find.
        - Trustees operate under the prudent investor rule for both safety of principal and production of a reasonable rate of return.
        - Safety includes protecting the purchasing power of trust principal from erosion due to inflation.
        - Return includes total return, which contemplates both current income and capital appreciation.
    - In the current low-yield environment, one might argue that investing for total return would violate the trustee's duty of impartiality to the income beneficiary.
    - The Uniform Prudent Investor Act takes a total portfolio approach to risk and return, eliminating restrictions on types of investments, allowing for further portfolio diversification. This reflects a modern portfolio theory and total return approach to fiduciary portfolio management.
        - http://www.uniformlaws.org/shared/docs/prudent%20investor/upia_final_94.pdf
- Capital Markets: Interest Rates and Income
    - It is becoming more and more difficult to find income while trying to manage risk to principal.
        - 10 yr U.S. Treasury yield history
        - U.S. Fixed Income Current Yields and Historical Returns
        - Global Fixed Income Current Yields and Historical Returns
    - Historically, investment managers and trustees could simply increase the allocation to bonds in the portfolio to increase the level of income to current beneficiaries. Today, however, the low interest rate environment does not provide adequate levels of income to current beneficiaries.
    - Asset allocation beyond 60/40.
        - Asset classes
            - Diversification across stocks, bonds and alternative investments.
            - Alternatives can be very helpful if selected properly.
                - For example, while publicly traded REITs can provide a higher level of income, they can also add market risk and increased price volatility to the portfolio. Certain liquid hedge funds, if properly selected, can add diversification of risks, returns, and low correlation with the equity market.
            - Asset allocations focused on generating income requires moving beyond core fixed income.
                - Sub-asset class diversification

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        - Geographic allocation
        - Credit quality diversification
        - Duration diversification
    - Consider complementing a fully diversified investment portfolio with income generating investments.
        - Income strategies have to be well understood and allocations should be tactical in nature, because stretching too far for income can result in taking on excessive risks (credit risk, market risk, duration risk, etc.).
        - Income strategies include, but are not limited to:
            - High Dividend Equities
            - Dividend Growth Equities (notably not just high dividend equities)
            - Preferred Equities
            - Infrastructure
            - Master Limited Partnerships (MLPs)
            - Option Strategies
            - Convertible Bonds
            - Real Estate
            - Private Credit
- Documentation: The Investment Policy Statement
    - Investment Policy Statements
        - Investment Policy Statement – A mutual agreement between the investment manager and the investor/trustee summarizing how the account will be managed.
            - Investment policy statements often include: investment objective, time horizon, types of investments to be used, investment restrictions and/or constraints, asset allocation target and range from target, risk tolerance, liquidity needs, distribution requirements, tax policy, monitoring, frequency of reviews, etc.
            - Provided both the investment manager and the investor/trustee with a document for guidance and future reference.
            - Encourages effective communication between the investment manager and the investor/trustee.
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BALANCING NEEDS OF INCOME AND REMAINDER BENEFIARIES - DOUG WELLS, ALBION FINANCIAL GROUP

1. The role of financial advisor
    a. Advice: Work with trustee to provide clarity
        i. Financial modeling of various portfolio alternatives
            1. Asset allocation changes can have a big impact
        ii. Real world experience
        iii. Goal – good decisions over time
            1. Prudent investor rule and impartiality
    b. Investment Management
        i. Strategic
            1. Asset Goals
                a. Preserve or grow inflation-adjusted value of principal
                b. Produce reasonable trust accounting income
            2. Specific investment tools within account
                a. The importance of liquidity
        ii. Tactical
            1. Distributions, rebalancing & account management
            2. Investment changes as the world changes
                a. Ex: Bonds use to be frequent income tool. Less so today.

2. Fiduciary duty to both income and remainder beneficiaries
    a. Set distribution amount (ie, 5% per year)
        i. Invest for total return, risk tolerance & predictability/dependability of distributions
            1. Corpus – Maintain & grow purchasing power (Inflation + over LT)
            2. Distributions – predictability often important
    b. Trust accounting income distributions
        i. Caution: how is "income" defined?
            1. MLPs often ~80% ROC
        ii. Invest for income and growth
            1. Higher income allocation, less growth allocation
            2. Volatility concerns
                a. Corpus: Long term time horizon
                b. Income: Predictability year to year

3. Trust language and flexibility - often gives trustee additional flexibility
    a. "Power to Adjust" – broadens definition of income
    b. "Unitrust Distribution" – set distribution to a set percentage of principal

4. Why distribution rules and asset allocation matters (Monte Carlo on one case study)

Display 3
Total Wealth—Year 30 (Median, Real, After-Tax)*

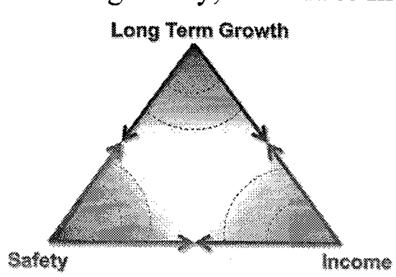
Strategy	Income Beneficiary	Remainder Beneficiary
Current Allocation Income Distribution	$1.3M	$1.6M
Current Allocation Unitrust Distribution	$1.5M	$1.4M
60% Stocks / 40% Bonds Income Distribution	$1.5M	$1.8M
80% Stocks / 20% Bonds Unitrust Distribution	$1.8M	$2.0M

*Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. Data does not represent past performance and is not a promise of actual or range of future results. See note 12, supra, for details.

   a. Source: November | December 2009 ABA Trusts & Investments

5. Family dynamics
   a. Who is the Trustee
   b. Who are the income beneficiaries?
      i. If mom & dad
         1. Big estate – likely wants to minimize income distributions
         2. Small estate – income is important part of mom & dad's cash flows

6. Balancing Safety, Growth & Income



7. Investment tools & allocations (typically in range of 50/50 to 80/20)
   a. 30% Growth stocks (yield: 0-2%)
   b. 30% Income stocks (~3.2%)
   c. 20% Hybrids (REITs, MLPs, BDCs) – 6%
   d. 20% Short term, high quality bonds (2.5%)