Understanding the Trustee's Duty to Diversify

Anodos Advisors

Duty to Diversify… Unless There's Reason Not to

It's hard to be a trustee because there are rarely black and white rules one can follow. Instead there are shades of gray created by the unique terms, conditions, distribution requirements, and other considerations the trustee must balance. The Uniform Prudent Investor Act directs, "In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." In this memo we will explore those cases when exception to this duty applies…when it is prudent not to diversify.

Hypothetical Fact Pattern

Consider the following fact pattern: A trust holding a single undiversified asset – a large single tenant commercial property worth $4.0m with a long-term, financially stable tenant. The property has a mortgage of $2.0m at a low interest rate with a balloon payment due in 7 years. The property has appreciated over the last decade at a rate of 4% per year. The net income from the property, available for distribution to the beneficiaries. is $200,000 per year. The trustee receives an unsolicited offer to sell the property for $5.0m which is $1.0m more than a recent appraisal value of the property. The basis in the property is low and if sold would generate $1.0m in tax liability.

To Diversify or Not to Diversify… That is the Question

Given these facts, what should a prudent trustee acting in good faith do? Is it better to sell the undiversified asset, pay the tax and have a more liquid, professionally managed and diversified portfolio? Or is it better to retain this single asset? Reasonable minds can differ.

The Reasons to Not Sell:

If the trustee decides to hold the asset, they are encouraged to create a record memorializing their rationale for that decision. Following is a review of several of factors that could support the trustee's decision NOT to sell.

1. The current net income from the investment accomplishes the distribution requirements needed to meet the trust purposes.

2. The historic appreciation of the property over the last 10 years suggests that future appreciation will protect the trust from the erosive effects of inflation.

3. The trust does not currently need high liquidity.

4. The property is well insured to protect against the risk of concentration of the trust in a single asset.

5. The $1.0m tax liability from the sale of the property would unnecessarily erode the corpus of the trust, which is inconsistent with the trustee's duty to preserve and protect the trust assets.

The Reasons to Sell

If, instead, the trustee decides to sell the property in order to diversify the assets of the trust, they are encouraged to create a record documenting their rationale for making that decision. That memo might include the following factors as rationale for the decision to sell.

1. The trustee has an affirmative obligation to diversify the trust assets.

2. If interest rates rise in the next five years, the market value of the property with a long-term lease would be expected to be negatively affected.

3. If interest rates rise in the next five years, the required refinance when the balloon payment comes due, could have an adverse effect on the projected cash flow of the property.

4. In the trustee's judgment, it is more prudent to incur the tax liability and realize the gain from many years of holding this appreciated property than it is to leave the trust concentrated in this single asset.

5. The trustee, relying on advice of a qualified investment advisor, believes that the long-term performance of a liquid portfolio of diversified stocks and

bonds will produce an income and appreciation experience comparable to that of the current real estate asset.

Precatory Instructions

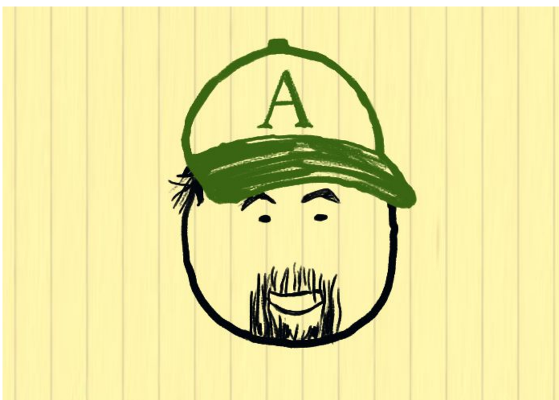
Some trustee are stymied by the precatory instructions (undocumented wishes) of the deceased settlor. It doesn't matter that Grandpa told the trustee to keep the property. The trustee still has a duty to diversify unless the settlor and their attorney were smart enough to proactively absolve the trustee of this duty by recording as much in the trust document. In other cases, the beneficiaries themselves have a strong familial relationship with a particular trust asset that is in conflict with the trustee's duty to diversify. Short of court reformation of the trust instrument, the trustee is not absolved of their duty to diversify the trust despite the beneficiaries' wishes. There are many instances where the beneficiaries persuade the trustee to retain the concentrated interest in "Grandpa's ranch" and then, when financial fortunes change, the beneficiaries bring suit against the trustee for failing to diversify. The dead settlor is not the trustee nor are the opinionated beneficiaries. Only the trustee has the authority to make this important determination.

Reasonable Minds Can Differ

You will notice that the decision to diversify (sell concentrated assets) and the rationale for not diversifying (retaining the concentrated assets) can each be thoughtfully made; compelling arguments to support these contradictory conclusions can be made. The example above merely illustrates why it is important for a trustee to document the rationale for the decisions they make. It is of particular value if the trustee is able to point to the opinion of experts they have relied upon as they deliberated on the decision. It is possible, even likely, that someone will disagree with the decision the trustee makes. In anticipation of this possibility the trustee will take the time to develop and maintain a document library which demonstrates they have acted prudently and in good faith as they exercise their discretion in the administration of the trust assets.

About Anodos

Anodos helps capital owners develop and manage an investment governance process. For many of our clients this oversight responsibility is not merely a subject of curiosity, but a duty they are obligated by statute to fulfill on behalf of the beneficiaries and organizations they serve. What makes Anodos unique is this is all we do. We don't manage money, sell insurance, or accept referral fees. We don't have a horse in the race.



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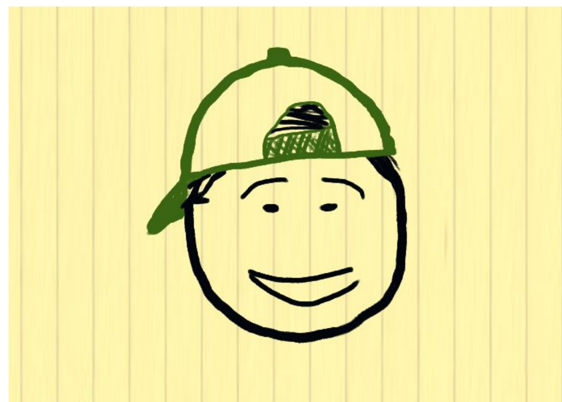
Josh is a recognized content expert on the issues of fiduciary duties relating to the management and oversight of trust assets. He lectures extensively on the policies and procedures for conducting
investment manager audits to CPAs, attorneys, and professional fiduciaries throughout the country. Josh is Managing Partner at Anodos Advisors and a licensed attorney. Prior to founding Anodos in 2005, Josh worked for fifteen years as an investment advisor with Mercer Advisors.



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Ryan has been with the firm since its inception in 2005 and holds the Chartered Financial Analyst and Certified Financial Planner designations. He is a Partner and has over 10 years of experience conducting performance attribution and other statistical analysis relevant to the investment experience. This work ensures accountability, adherence to investment parameters, and clarity of expectations between clients and their managers.