

The Investment Process Required by the Uniform Prudent Investor Act

by Eugene F. Maloney

We have analyzed the investment process required of trustees under those state statutes regarding the investment responsibilities and liabilities of trustees, which generally are known as "prudent investor" statutes. The common theme of these statutes is their directive that the trustee focus on the trust portfolio as a whole, revising the traditional notion of trust law that assessed each asset in isolation. While granting broad investment powers to trustees, these statutes impose significant new duties on professional trustees which, if inadequately performed, could result in liability to the trustee regardless of the positive returns of trust portfolios.

The professional trustee is now required to conduct an ongoing investment process that is, in substance and procedure, more complex and sophisticated than was previously required by law. It is arguable that asset allocation is the single most important task in this process. Furthermore, this emerging investment process may well establish the foundation for a standard by which not only professional trustees will be measured, but all financial intermediaries who provide professional investment advice, including financial planners.

The Uniform Prudent Investor Act

Until recently, the investment authority of trustees in most states was governed by a standard known as the "Prudent Man Rule." This standard was originally formulated as a general statement of care, skill and caution that would allow trustees the flexibility appropriate to particular circumstances. However, its utility was gradually eroded by case law and influential treatises such as the Restatement of Trusts (Second), which developed a host of sub-rules deeming certain investments and techniques as "speculative," and presumptively imprudent. Despite important developments in financial markets and financial theory, a justifiable fear of liability discouraged trustees from investment strategies that would maintain or increase the purchasing power of trust portfolios. Many modern practices as to optimal methods of investment management were not allowed by the Prudent Man Rule as it was developed by the courts.

Thus, elements of the Prudent Man Rule gradually came to be viewed as detrimental to the long-term interests of trust beneficiaries. The Employee Retirement Income Security Act (ERISA), enacted in 1974, had as one of its central purposes a public policy of ensuring the adequate investment returns necessary for defined benefit plan participants. While based in large part on traditional principles of trust law, ERISA recognized the limitations of these principles in portfolio management and thus departed somewhat from the Prudent Man Rule by setting a standard of prudence to govern pension investments that is more attuned with economic reality and important academic developments in financial theory. ERISA rejects a per se rule as to imprudent investments and provides a safe harbor from liability if the fiduciary has given "appropriate consideration" to the facts and circumstances of the investment and its relationship to the needs of the pension plan. It is process oriented rather than rule oriented.

A successful effort to revise trust investment law in the same way is nearing completion. The American Law Institute's 1992 Restatement (Third) of Trusts restated the legal principles which should govern trust investments with the purpose of reconciling trust investment law with changes in investment practices. The Restatement (Third)'s revised standard of prudent investment is known as the "Prudent Investor Rule" and follows the innovations of ERISA. In 1994, the National Conference of Commissioners on State Laws approved a model state statute incorporating the principles of the Uniform Prudent Investor Act (UPIA) Restatement (Third) of Trusts.

At least 38 states have enacted some version of the Prudent Investor Rule, and it is expected that most, if not all, of the other states will do so in the near future. Some of these statutes preceded the UPIA and the Restatement. However, most are based on the UPIA and, therefore, we will use the UPIA for purposes of this analysis.

The UPIA fundamentally changes trust investment law.¹ It emphasizes the portfolio as a whole and the interplay between risk and reward. The UPIA has no categorical restrictions. A trustee can choose any investment, but there is no "safe" investment that protects a trustee from liability. The UPIA disavows the emphasis in prior law on avoiding "speculative" or "risky" investments. In contrast, traditional trust law emphasizes the duty to "preserve principal" at all costs and to avoid "speculation." Because each investment was considered on its own merits without regard to the portfolio as a whole, a trustee could become a guarantor of risky investments, even if it picked many more winners than losers. Under the UPIA, a trustee must determine the appropriate risk profile for a trust and then develop and

implement an investment strategy for the portfolio. It must be able to justify the reasonableness of that strategy and the prudence of each investment as it relates thereto.²

Major Points of the UPIA

1. The standard of prudence applies to the trust as a whole rather than to individual investments, with a realization that particular investments that would have been viewed as speculative and subject to surcharge under old law may be sensible, risk-reducing additions to a portfolio viewed as a whole.
2. The overall investment strategy should be based upon risk and reward objectives suitable for the trust. These objectives will vary widely, depending on the circumstances in each trust arrangement. A trust for an elderly widow of modest means will have a lower risk profile than a trust for a wealthy young person. However, both trusts will be concerned with preserving the real purchasing power of the trust and the effects of inflation on that power, a factor that was often ignored under prior law.
3. There is a duty to diversify unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms of the governing instrument. The UPIA has so enhanced the long-standing duty to diversify as to fundamentally change it. While prior law also stressed diversification, it did so on a more limited basis, stressing diversification within an asset class without also stressing diversification across asset classes.
4. No particular investment is inherently prudent or imprudent. The premise of the rule is that trust beneficiaries are better protected by increasing the trustee's responsibilities and powers than by per se restrictions or safe harbors.
5. A corporate fiduciary or paid professional advisor acting as fiduciary is accountable under a special investment skills standard.
6. Delegation is permitted, encouraged and in some cases required. The UPIA reverses the anti-delegation rule of prior law. This change recognizes that prudent investing may require the use of outside expertise in some circumstances by both professionals and non-professionals.
7. The trustee's liability for improper conduct will be measured by reference to the total return that should have been expected from an appropriate investment program. Thus, a positive return will not necessarily protect a trustee from liability.³

The UPIA and Modern Portfolio Theory

One cannot read the UPIA, the Restatement (Third) and the commentary thereto, as well as the various state legislative histories, without concluding that modern portfolio theory is the intellectual underpinning of the UPIA.⁴ The UPIA is clearly the result of a consensus about the significance of modern portfolio theory and the realization that the law and the markets should have similar views regarding prudent investment practices. While the UPIA is a process-oriented rule, it is not merely procedural. Much of the investment process required by the UPIA relates to substantive tasks that require a familiarity with modern portfolio theory; a professional trustee is presumed to have this knowledge. As the Restatement (Third) makes clear, a trustee who strays from the basic tenets of modern portfolio theory must carry a burden of persuasion as to the reasonableness of his or her actions.

There are no universally accepted and enduring theories of financial markets or prescriptions for investment to provide clear, specific guidance to trustees and courts. Varied approaches to the prudent investment of trust funds are permitted by the law. This does not mean, however, that the legal standard of prudence in trust law is without substantive content or that there are no principles by which the fiduciary's conduct may be guided or judged. A trustee's approach to investing must be reasonably supported in concept and must be implemented with proper care, skill and caution. Furthermore, although competing theories of investment provide some conflicting signals, they also offer some consistent themes.⁵

Another prominent commentator has reached the same conclusion: "The field is sufficiently well-developed and scientifically grounded that no financial advisor should feel safe in ignoring its teachings."⁶

Modern portfolio theory refers to the process of reducing risk in a portfolio through systematic diversification across asset classes and within a particular asset class.⁷ It involves the relationship between risk and reward. It assumes that all investors desire the highest possible returns while bearing the lowest amount of risk and that public markets are generally efficient. To increase the return, an investor must incur more risk.

A well-diversified portfolio minimizes the risk that a particular investment will not perform well (firm-specific risk) and leaves a portfolio exposed only to market risk. Investors without an efficiently diversified portfolio are exposed to unnecessary risk, which will not be compensated by the market.⁸

Thus, modern portfolio theory focuses on portfolio selection rather than simply buying securities viewed as undervalued. Having determined their risk tolerance, investors should then assemble an optimal portfolio along what is called the "efficient frontier," which maximizes potential returns at the desired level of risk.

While major advances have been made in understanding financial markets and the investment process, there are many unsettled areas. For example, there is disagreement about the degree of efficiency of public markets. Thus, modern portfolio theory and the UPIA allow for many alternative strategies.

The UPIA and the Investment Process

In a sense, the UPIA "deregulates" trust investments. The UPIA rejects generalizations and labels as inappropriate to the complicated process of trust investing. A trustee can choose any investment for a trust and not be responsible for the performance of the investments if the trustee has properly conducted the process required by the UPIA.

The UPIA assesses the trustee's liability by the investment process, not the outcome. Under prior law, the investment process was also an important element in assessing trustee liability, but evidence of careful deliberation was usually sufficient to protect a trustee, as long as the trustee had avoided investments that could be deemed "speculative."

However, the process required by the UPIA includes important substantive elements. Unlike other process rules, such as the business judgment rule, it includes requirements as to how the business—investment management for trusts—is to be conducted. A trustee must be familiar with modern portfolio theory to conduct the process. A trustee who does not incorporate these concepts into its investment process probably will not be saved by an otherwise impressive paper trail.

UPIA Section 2(f) charges a trustee with special skills or expertise to use those skills or expertise. This is familiar law but the comment thereto implies that all professional trustees will be held to a single high standard that will not vary by location or amount of assets under management. The notion seems to be that the basic tools and knowledge necessary to manage risk in a professional manner are available to any professional, wherever located. Smaller organizations in rural locations will probably be held to the same standards as their larger counterparts.

The UPIA's protection from liability depends upon the trustee's ability to demonstrate that it has met this heightened standard. A trustee is at risk, even with a positive return, if the trustee cannot demonstrate that it conducted a thorough and ongoing process for each trust, incorporating the current standards in the investment management industry (including risk and return assessment and efficient portfolio selection).⁹

It is important to recognize that this process imposes considerable new responsibilities on professional trustees, and is a significant departure from prior law.¹⁰ A professional trustee should not remain in the business unless it has the resources required by the UPIA process and that it can prove its compliance.

The UPIA recognizes that the key task of the trustee is to manage risk in order to realize the trust's objectives.¹¹ The UPIA Official Commentary states that Section 2 is "the heart of the act" and that it is intended to sound "the main theme of modern investment practice, sensitivity to the risk/return curve." Prior law emphasized the avoidance of risk but modern portfolio theory has established that, without risk, there will be no rewards. The UPIA requires a trustee to take on the level of risk appropriate to the trust and to manage the risk.

Under the UPIA, risk is managed through efficient diversification. Trust law has long required it. However, prior law

required little more than not putting all your eggs in one basket. UPIA Section 3 greatly enhances the duty of diversification. It is clear that the Restatement (Third) and the UPIA require that diversification be systematic and that it eliminate uncompensated risk.¹²

Prudence is not self-evident under the UPIA. Section 8 states that the trustee's liability will be assessed "in light of the facts and circumstances existing at the time of a trustee's decisions and not by hindsight." Thus, the trustee must be prepared to carry a burden to justify each investment in relation to a portfolio strategy that the trustee has developed as suitable for the risk level appropriate to each particular trust.

The trustee's investment process under the UPIA can be viewed in three steps. The trustee must first evaluate the needs and purposes of the trust and determine the appropriate risk level. The trustee must then decide on an appropriate long-term investment policy suitable for that level of risk. Finally, the trustee must implement that policy through a strategy of selecting individual investments.

Evaluation

Some trusts require income, while others are oriented toward total return. As trusts differ considerably in their risk-bearing capacities and needs, a trustee must determine the appropriate risk profile for each trust through a detailed and systematic process. The plain language of the UPIA compels this conclusion. Section 2 requires that the trustee consider the "purposes, terms, distribution requirements and other circumstances of the trust" and develop "an overall investment strategy having risk and return objectives reasonably suitable to the trust." It provides a non-exclusive list of the factors a trustee must consider: general economic conditions, possible effects of inflation or deflation, expected tax consequences of investments and distributions, the role of each investment in the portfolio, the expected total return of the portfolio, and the liquidity and income needs of the beneficiaries. While trustees have always been charged with a familiarity with the purposes and needs of a trust, the UPIA increases that duty.¹³

A trustee cannot simply label a trust as having a "conservative" risk profile and proceed accordingly. It must conduct and document a process to gather, record and analyze information about each trust's time horizons, cash flow needs, risk aversion, tax status, intentions and other factors, not only at the trust's inception, but on an ongoing basis. A primary purpose of this exercise is to generate the information necessary for a trustee to determine the "efficient frontier" for each trust.

Asset Allocation

Asset allocation is the long-term structuring of a portfolio to achieve particular objectives over an extended period of time.¹⁴ It is the investment policy that precedes investment selection.¹⁵ Every investment can be classified within a certain asset class. Whether explicit or implicit, every investment is part of an asset allocation. Every investment is the result of a determination that the asset class is itself appropriate for the portfolio.

The trustee makes long-term policy decisions in the asset allocation process about the types of investments appropriate for the purposes and risk profile of each trust. As asset classes have quantifiable risk characteristics, just as individual investments do, it is a distinct process from the selection of individual investments.

There are various views about asset classes but they would seem to include

Large-cap, medium-cap and small-cap equities

Foreign equities with the same subdivisions but further subdivided by region and market development

U.S. government and agency obligations (all debt instruments would be further subdivided by maturity)

Asset-backed securities

Tax-free municipal debt

Foreign sovereign debt

U.S. corporate debt (investment grade and high-yield)

Foreign corporate debt

Venture capital

Real estate

Cash equivalents

UPIA Section 2's requirement that the trustee develop an "overall investment strategy" to "incorporate risk and return objectives reasonably suitable to the trust" and UPIA Section 3's enhanced diversification requirement underscore the importance of the asset allocation process under the UPIA. The starting point of diversification is the consideration and selection of asset classes appropriate to the risk profile of each trust.

There is significant economic research concluding that most of the return of investments in a particular asset class is a result of the basic decision to invest in that asset class.¹⁶ The added value by the selection of a particular asset within the class is minimal.

While delegation of the investment function may sometimes be appropriate, it seems unlikely that a professional trustee could delegate evaluation and asset allocation in ordinary circumstances, given UPIA Section 2(f)'s professional trustee standard and UPIA Section 7's requirement that the trustee minimize costs. Thus, "asset allocation" is one of the trustee's principal responsibilities under the UPIA. A prominent law professor who acted as reporter to the UPIA project is of the same view:

Increasingly, the main work of the fiduciary investor will be what has come to be called asset allocation. The trustee will form a view of the needs, resources, and risk tolerances of the beneficiaries of the particular trust. The trustee will then decide what proportion of the portfolio to invest in what classes of assets. These choices will take the form of allocating the trust assets among large, diversified portfolios, primarily mutual funds and bank common trust funds.¹⁷

No particular asset class is mandatory, nor are there a minimum number of asset classes that must be considered.¹⁸ However, the trustee's process should at least reflect consideration of alternative asset classes.¹⁹ While a trustee could invest in a single asset class, the trustee must be prepared to justify that decision.²⁰ Informed diversification and risk management means more than just multiple baskets. The trustee must also determine the right amount to put in each basket.²¹

Asset allocation is not just a pie chart illustrating the categories of a portfolio. It should be a formal, ongoing recorded process which, based on the trustee's considered evaluation of each trust and the principles of modern portfolio theory, guides the selection of investments for the trust's portfolio to its "efficient frontier."²² Intuition, unsupported conclusions and mere labels will not meet the standards of the UPIA.²³

Investment

Prior law looked at each investment in isolation while the UPIA looks at the entire portfolio.²⁴ While the trustee can invest in "any kind of property or type of investment consistent with the standards" of the UPIA, each investment must have a role in a well-diversified, efficient portfolio. Thus a trustee cannot simply buy securities it believes to be undervalued unless it has considered (and recorded in some meaningful way) how those securities fit into the portfolio plan based on an evaluation of the needs and purposes of the trust. Thus, under the UPIA, investing is part of a process rather than an independent function.

Since optimal diversification may require participation in large portfolios, a professional trustee may be required to use pooled investments in certain circumstances.

Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries and having other differences in their qualities. Broader diversification, however, is usually to be preferred in trust investing. Broadened diversification may lead to additional transaction costs, at least initially, but the constraining effect of these costs can generally be dealt with quite effectively through pooled investing....Hence,

thorough diversification is practical for nearly all trustees.²⁵

Conclusion

There is, as of yet, little case law regarding the UPIA. Because of its significant changes from prior law, it is possible that it may take some time for the case law to develop. However, the Restatement (Third), comments to the UPIA, ERISA case law and other formative materials provide a wealth of background as to its intended purposes.

The UPIA sets a more demanding process-direct standard for professional trustees than that of prior law. While the trust investment process has always been important, the UPIA adds substantive elements. A paper trail will be of little value unless it reflects an understanding and consideration of risk in accordance with the basic tenets of modern portfolio theory. The UPIA should protect a trustee who observes this process but puts at risk a trustee who does not, regardless of the success of the portfolio.

A Final Thought

A substantial percentage of the American workforce are either direct or indirect participants in the securities markets. This has come about in a period when the domestic equity markets in particular have risen dramatically. It would be a fool's errand to expect that this growth will continue indefinitely. At such time as the inevitable correction occurs, it is not unreasonable to assume that the methods used by financial intermediaries—be they investment advisors, trustees, financial planners or brokers who dispense investment advice in return for compensation—will be examined retrospectively. In all likelihood, the standard to which their conduct will be held will be the UPIA. At such time as this examination takes place, one can expect an outcome transparent to a determination made by an appellate court in New York:

It was not shown in any instance that the losses resulted from imprudence or negligence. There was evidence of attention and consideration with reference to each decision made. Obviously, it is not sufficient that hindsight might suggest that another course might have been more beneficial; nor does a mere error of investment judgment mandate a surcharge. Our courts do not demand infallibility, nor hold a fiduciary to prescience in investment decisions.²⁶

Endnotes

1. "[C]omplex notions of this new standard are, in part, counterintuitive to traditional notions of prudence," W. Brantley Phillips, Jr., Note, "Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts," 54 Wash. & Lee Law Review 335, 384 (1997).
2. It should be noted that the UPIA is a default standard. It applies only in the absence of another standard articulated in the trust instrument for the fiduciary.
3. The UPIA does not itself address remedies, but the Restatement (Third) of Trusts (1992) does at Sections 205 and 208-211, and suggests a "total return" measure of damages to reflect the gains or losses that reasonably should have been expected from an appropriate investment program. See Edward C. Halbach, Jr., "Trust Investment Law in the Third Restatement," 27 Real Prop., Prob 8 Tr. J 407, 459 (1992). It seems likely that states that have enacted the UPIA will adopt this standard of damages as the UPIA would seem to be toothless without it.
4. See Prefatory Note to UPIA and Introduction to Restatement (Third) of Trusts.
5. Restatement (Third) of Trusts, Section 227, comment f (1992).
6. Jonathan R. Macey, An Introduction to Modern Financial Theory, (American College of Trust & Estate Counsel Foundation), 1991, p. 94. See also Katherine L. Babson, Jr., "Trustee Investment Decision-Making In Accordance With the Uniform Prudent Investor Rule," ALI-ABA Course of Study—Representing Trust and Estate Beneficiaries and Fiduciaries, 1998, p. 94.
7. A leading introductory text on modern portfolio theory is R. A. Brealey, An Introduction to Risk and Return from Common Stocks, (2d ed. 1983). See also Restatement Third of Trusts: Prudent Investor Rule Sec. 227 (1992),

comments e through h, and General Note on comments e through h.

8. See comment to UPIA Section 3. "Modern portfolio theory divides risk into the categories of 'compensated' and 'uncompensated' risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture." In the case of compensated risk, "the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks.... Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk."

9. A Washington appellate court has held that under the Washington prudent investor statute a trustee could be liable notwithstanding an acceptable investment return if the trustee's investment process did not meet the standards of the statute. *Matter of Estate of Cooper*, Wash. App. Div. 3, 1996, 913 P.2d, 393, review denied 928 P.2d, 414.

10. ". . . [T]he new rule increases the oversight and administrative burdens of fiduciaries," Rozlyn L. Anderson, "The Prudent Investor Rule: Planning Implications For the Millennium," *PLI 29th Annual Estate Planning Institute Course Handbook*, September 1998, p.552.

11. See Restatement (Third) of Trusts, Section 227 comment e: "Therefore the duty of caution does not call for the avoidance of risk by trustees but for their prudent management of risk."

12. See Restatement (Third) of Trusts, Section 227 comment e, "Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill." See comment to UPIA Section 3: "The object of diversification is to minimize this uncompensated risk of having too few investments."

13. The New York statute lists other factors such as the size of the portfolio, the nature and estimated duration of the fiduciary relationship, related trusts, beneficiaries' other income and resources. *McKinney's Consolidated Laws of New York*, E.P.T.L. 11-2.3.

14. James McDonald, "Consideration of Asset Allocation in Trust," *Trusts and Estates*, April 1991, pp. 51–52.

15. "An investment policy...is a decision with an indefinite (though not infinite) horizon, taken with regard to the ability to assume investment risk. The investment policy task is to determine how much risk to take as a matter of principle, independent of the current outlook, over a horizon far longer than the expected 'half-life' of any strategy," Douglas A. Love, "Investment Policy vs. Investment Strategy," *Financial Analysts Journal*, March–April 1977, p. 22.

16. Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower, "Determinants of Portfolio Performance," *Financial Analysts Journal*, July–August 1986, p. 39. The study statistically demonstrated that over an extended period of time, almost 94 percent of the difference in portfolio management results was attributable to asset allocation, rather than market timing and individual asset selection. See also Gary P. Brinson, Brian D. Singer and Gilbert L. Beebower, "Determinants of Portfolio Performance II: An Update," *Financial Analysts Journal*, May–June 1991, pp. 40–48 (updating the original study with additional data and arriving at the same conclusion).

17. John H. Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 *Iowa Law Review* 641, 655 (March 1996). The commentary to the Restatement (Third) supports this view; see also Section 227, comment f.

18. See Restatement (Third) of Trusts, Section 227, comment f. "There is no defined set of asset categories to be considered by fiduciary investors. Nor does a trustee's general duty to diversify investments assume that all basic categories are to be represented in a trust's portfolio."

19. "Limiting asset allocation to high quality U.S. equities and U.S. bonds has meant missing out on many categories of assets which have historically provided higher returns," McDonald, *supra*, note 14, p. 52. See also Langbein, *supra*, note 17 at pp. 659–660 on foreign securities as appropriate investments. See also Babson, *supra* note 6, p. 88.

20. "To the extent that an investment strategy involves...a departure from an efficiently diversified portfolio, that strategy should be justifiable in terms of special circumstances or opportunities or in terms of a realistically evaluated prospect of enhanced return," Halbach, *supra*, note 3, p. 434.

21. Roger C. Babson, *Asset Allocation* (Business One Irwin), 1990, p. 125.
22. "To allocate assets with skill, the fiduciary or his advisor must understand risk, time horizons and the correlation of asset classes," Anderson, *supra*, note 10, p. 557.
23. "The trust investment manager is ill advised to rely simply upon comfortable, accepted guidelines or historically accepted asset classifications; the investment world is now much more complicated....," McDonald, *supra*, note 14, p. 55.
24. One observer put it succinctly: "Remember this prudent investor axiom: no investment is considered in isolation but as part of the totality. In this regard, individual investments are like watch parts: in concert, they drive the operation of the whole," Anderson, *supra*, note 10, p. 552.
25. Restatement (Third) comment f. See also Langbein, *supra*, note 17, p. 655.
26. *In re OnBank and Trust Co.*, 90 N.Y.2d 725, 665 n.y.s.2d 389, 688 N.E.2d 245, 1997.

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