DELEGATION OF FIDUCIARY POWER UNDER THE CALIFORNIA PRUDENT INVESTOR ACT

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A practical innovation of the Uniform Prudent Investor Act[1] (*UPIA*) is the reversal of the prior law's concept that fiduciaries must not delegate the carrying out of those acts that the trustee might reasonably perform personally[2]. As a practical matter, this traditional view on the delegation of fiduciary powers had a "chilling effect" on the transfer of powers to professional advisers and consultants.[3] The UPIA now encourages fiduciaries to engage in appropriate delegation to qualified professionals. Institutional trustees have long accepted this reliance on professional investment advice.[4] This statutory policy should be adopted by nonprofessional trustees with alacrity, as a means to reduce the fiduciary's potential exposures for unsuccessful investment decisions. Moreover, "a trustee who fails to seek advice with respect to matters about which the trustee lacks skill or knowledge may be liable for failure to exercise proper care in making an investment".[5]

The UPIA also makes total portfolio management the heart of the modern prudent investor rule. In using this approach, the UPIA makes available to trustees a very broad range of investment classes, allowing the investment flexibility so necessary for meaningful asset diversification. This modern theory abolishes the sometimes-artificial prohibition of prior law on "speculative" investments.

The UPIA also enumerates many of the considerations a trustee must make in prudently managing trust assets. These factors include considering general economic conditions and trends, and weighing the tax consequences of asset sales. Another consequence of the UPIA is the pronounced bias toward using the conceptual and methodological structures of modern portfolio theory when managing the total trust portfolio. In addition to general training in economics and financial planning, the UPIA appears to impose a requirement of specific training and experience in modern portfolio theory as a prerequisite for proper investment management by the fiduciary or the fiduciary's agent.[6]

This prerequisite can be difficult to satisfy because apparently few investment professionals have the required education, training, and experience to qualify as experts in modern portfolio theory. According to the Investment Management Consultants Association (*IMCA*) for example, there are fewer than 200 Certified Investment Management Analysts in California.[7] This fact has major implications for the trustee's appropriate delegation of investment powers.

The trustee may need to retain an additional agent for assistance in reviewing the qualifications of persons desirous of being managers of the trust portfolio. Employing an additional professional may appear to be unnecessary expense. Nonprofessional trustees will certainly object to spending trust funds on "yet another advisor." Nevertheless, until the fund

management community has improved its professional standards as an occupational criterion, a trustee may have little choice in order to minimize the trustee's potential liability.

Precisely because the UPIA imposes on the trustee the duty to manage the trust portfolio as a whole, fiduciaries and their advisors need to understand that two threshold opportunities for delegation of trust management powers exist. One opportunity exists in the area of total portfolio design and strategy. This responsibility includes ongoing portfolio administration. Experience in the institutional trust arena has taught that an investment management consultant most often fills this responsibility.

The other opportunity exists with regard to daily investment activity. This activity is what is commonly understood as money management, although under the UPIA this phrase may be a misnomer. Experience in the institutional trust arena has taught that a portfolio manager most often fills this responsibility.

These two tasks are not the same, and the trustee and the trustee's advisor need to understand this difference. The failure to appreciate this distinction can lead to a blurring of the lines of responsibility, which in turn may create unnecessary conflict of interest in trust administration. Conflicts, as many of us are painfully aware, are what lead to litigation.

The trustee must establish a number of requirements to establish the guidelines by which the trust will be managed as a whole. These conditions are generally enumerated an investment policy statement. The establishment of an IPS is an idea whose time has come in the private trust field, now that total portfolio management is the standard for trustees. The establishment and maintenance of these objective performance criteria will often require the expertise of an investment management consultant. Objective portfolio standards, and incorporating these standards into ongoing asset management, should be clearly stated for the trustee by the consultant, and thereafter incorporated into the IPS. Concepts such as time weighted and dollar weighted returns, customized benchmarks, and attribution analysis should play important roles in establishing these standards.

Another important area of responsibility for a consultant assisting the trustee in preparing an IPS is in designing a customized, objective asset allocation structure that considers the interests of both income and remainder beneficiaries. Asset allocation must be specific enough to address historic risk-return relationships and probability theory. Nevertheless, asset allocation must also be flexible enough to accommodate intermediate term trends in capital markets.

Such activity logically precedes the selection of investments or funds or portfolio managers. It is also logical that a trustee with a desire to delegate the fiduciary responsibility for such an undertaking selects an objective third party, and not relies on a portfolio manager to do this work. Use of a third party professional such as a consultant in preference to a portfolio manager makes sense when it is the portfolio managers work that is being measured, evaluated, and assessed.

The investment management consultant should also be to assist the trustee in ensuring that the objective portfolio standards are established, and then that they are met by the portfolio managers. The consultant should also assist the trustee in evaluating the portfolio's day-to-day

investment activity. Expected performance, based on asset class history, must be projected, and the risks of portfolio components not meeting their expected returns must be considered and integrated into investment strategy.

The portfolio or fund manager [sometimes referred to as "money manager"] has a different focus of activity and responsibility. Acting on a discretionary basis, the portfolio manager makes day-to-day decisions on the individual securities/assets in the investment portfolio. Buy, hold, sell, reorganization tender decisions, and typically the voting of proxies, are exercised by portfolio managers. In the world of institutional trusts, the portfolio manager does not have the responsibility of developing a comprehensive, in-depth, need based investment strategy customized for the trustee. The primary business of portfolio or fund managers is to make decisions about individual securities, and the particular portfolio under their aegis, in a manner consistent with their firm's stated investment philosophy and process. This philosophy and process ought to be consistent with the investment policy of the trustee. This consistency is something that should be discovered early on in the search process.[8]

The selection of portfolio managers who handle the day-to-day investment activity is itself subject to standards of fiduciary prudence.[9] The process of selecting and evaluating portfolio managers is often referred to as a "manager search." Manager searches are part of the normal responsibilities of the consultant in the institutional trust world, and should become a normal step in the development of modern trust administration that aims to comply with the UPIA.

Prior to the UPIA, trustees, like many private investors, selected a fund or manager on the basis of recent track record, or because of a pre-existing relationship with a given financial institution, or due to a recommendation from a friend or contact whose opinion the trustee respected. This process is engaged in at the trustee's peril in an investment world governed by the UPIA.

In contrast to the casual approach of many nonprofessional trustees, a consultant typically will access a database with dozens, if not hundreds, of managers in every investment style as a preliminary step toward developing a "short list". The data examined will typically include information as to how the managers' portfolios have performed over time, an important consideration in risk management for the portfolio as a whole. Collecting this information from the database is not an end point for competent consultants, but a link in the due diligence chain of management activity. This due diligence often extends to on-site visits to the manager, telephone interviews with existing clients, and portfolio attribution analysis. Once the trustee has retained managers, it should be the responsibility of the consultant, not the managers, to calculate net portfolio returns, performance measurement, and evaluation.

Trustees and their advisors rightfully should be concerned with the cost of separating the consulting and portfolio management functions in trust administration. After all, cost management is a critical fiduciary responsibility of the trustee. The trustee has a duty to incur only those "costs that are appropriate and reasonable in relationship to the assets, overall investment strategy, purposes, and other circumstances of the trust."[10] The apparent need and opportunity to delegate must be balanced with this responsibility to control costs. The Probate Code requires the trustee to assess the cost and benefit of the various services associated with delegation of trust administration.

For trusts with liquid assets of not less than $2 million, a consultant may be in a position to bring a greater number of institutional quality portfolio managers, representing many styles of management, to the trustee at a lower overall management fee than the trustee could expect to obtain directly. Some of the larger "full service" brokerage houses even offer the equivalent of consultant services for trusts whose liquid assets begin at $500,000.

Depending upon the range of services needed by the trustee and the desired mix of trust assets, a comprehensive management fee may be equivalent to (if not less than) the internal expenses associated with a broad mix of mutual funds. This estimate includes all consulting and portfolio management fees, and trading and custodial expenses. A cost-benefit analysis may lead trustees to the conclusion that the hiring of a competent investment management consultant is an entirely prudent and economical act of delegation.

How would a trustee, or the trustee's counsel, be able to locate an investment management consultant? The lack of credentials in this field was noted earlier in this article. Nevertheless, some consulting associations have developed certification programs in modern portfolio theory. These groups include the “Certified Investment management Analyst” designation, or CIMA, offered by the Investment Management Consultants Association, through the Wharton School. Another designation is the “Certified Investment Management Consultant” designation offered through the Institute for Investment Management Consultants.

Regardless of the presence of a credential, any consultant should be able to demonstrate the ability to integrate various financial disciplines and approaches. In short, a strong financial planning background would appear to be essential. The design of in-depth strategy could also call for strong economic analysis capability, or immediate access to it.

Beyond individual designations and experience, trustees should look for depth of organizational support for the consultant, including information management systems and technical personnel. The consultant should at a minimum do the following for his or her compensation:

- Analyze the current and prospective needs of trust beneficiaries with the trustee;

- Develop and maintain a customized asset allocation structure based on the needs of the trust beneficiaries;

- Prepare and maintain a written investment policy statement for the trustee, to be used as a management guide for the range of trust administration issues;

- Conduct due diligence on portfolio management organizations;

- Conduct portfolio manager searches for the trustee and provide objective recommendations to the trustee;

- Measure and evaluate portfolio manager performance, and total portfolio performance, and provide objective recommendations to the trustee; and

- Educate the trustee as necessary in portfolio management.

SOME DRAFTING ISSUES

The preceding discussion has approached the delegation issue from the administration perspective. The authors have assumed that many trusts will "mature" without their language ever having been revised to reflect the provisions of the UPIA. Looking forward, however, provides planners with opportunity to address the delegation problem directly.

In view of the general principles that govern delegation of the investment responsibility, drafters should analyze this problem with a two-pronged approach. First, should a trustee be appointed specifically to exercise power over the trust investments? Second, should any trustee with responsibility for investments be allowed to delegate?[11]

Nominating an "investment trustee" assumes the participation of a professional in the financial services business. This approach has the appeal of easing the burden on the nonprofessional trustee. This approach is unlikely to reduce costs, however, as even an "investment trustee" will be required to use due diligence in the employment of portfolio managers.

Allowing delegation appears sensible if the trustee is not a professional. As the preceding discussion sought to make clear, a nonprofessional who fails to delegate may be taking a cure that will be worse than the disease.

SUMMARY

Two major conceptual breakthroughs of the California Uniform Prudent Investor Act have major implications for the appropriate delegation of power. The first has to do with managing trust assets as a whole, in a relatively “open-ended” universe of investment alternatives, i.e. “modern portfolio management”. The second deals with the affirmation of the principle of delegation to appropriately qualified professionals. Now that trustees have a fiduciary obligation to carry out modern portfolio management, it is important for them to recognize that there are two major opportunities for the delegation of trust management powers. The first is the retention of an appropriately qualified investment management consultant to assist in creating and maintaining the conditions of modern portfolio management. The second is the hiring of one or more likely multiple portfolio managers to handle day-to-day buy, sell, hold decisions over an individual portfolio, or sub-component of the whole portfolio. While cost control will always be a central feature of fiduciary responsibility of prudent trust management, trustees will find that the retention of a consultant need not add to total trust administration expense, and in fact may help lower it.

ENDNOTES

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[2] CIMA, CFP, Senior Vice President - Investments, Consulting Group, SALOMON SMITH BARNEY, WALNUT CREEK CA; THE views expressed by the author are his own, and do not necessarily reflect those of the Consulting Group or SALOMON SMITH BARNEY.
[1] California Probate Code §§16045 ***et seq.***
[2] *See e.g.* Probate Code §16012.
[3] "The Uniform Prudent Investors Act—What It Means for Fiduciaries, Consultants and Advisers", Julie Allecta, the 1996 Association of Professional Investment Consultants, June 8, 1996, Dallas, Texas.

[4] Probate Code §16052, and ERISA code §§402 [c] [2-3], 405 [a].
[5] *See* "A Trustee's Crime and Punishment: Managing Fiduciary Liability Under the California Uniform Prudent Investor Act", J. Hartog and P. Sanderson, *California Trusts and Estates Quarterly*, Vol. 4, No. 2, Summer, 1998.
[6] Probate Code §16047.
[7] IMCA is considered one of the country's major professional trade associations concerned with advanced training and continuing education for investment management consultants; for example it sponsors the CIMA certification program that is administered by the Wharton School of Business, University of Pennsylvania.
[8] Donald B. Trone, et. al., The Management of Investment Decisions, Irwin Press, 1996, pp.249-250.
[9] Probate Code §16052 (a).
[10] Probate Code §16052.
[11] *See* Jerold Horn, "Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts" 33 Real Property, Probate and Trust Journal 1 (Spring, 1998)