

Managing Investments Under the Michigan Prudent Investor Rule

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Introduction

In my practice, I have encountered many trustees and co-trustees who, because of their lack of familiarity with a body of work known as Modern Portfolio Theory, (MPT) have been lulled into the erroneous belief that the Michigan Prudent Investor Rule (MPIR) merely increases the former standard of prudence by degrees, when in fact it totally revolutionizes the standard. MPIR does not elevate the standard of prudence to superior investment performance. It sets the new standard to ". . . a standard of conduct, not outcome or performance".

The language of MPIR can appear benign to the unsuspecting fiduciary, causing him or her to underestimate their exposure to surcharge and / or loss of trusteeship.

An enormous amount of wealth currently resides in trusts that will be distributed to a new generation of contingent beneficiaries (adult children) as the original beneficiaries (parents) expire. In many cases, death of the parent(s) will trigger a review by the children of their deceased parents' trust investments. Due to various forces listed below, it is likely that over the next decade many trustees and co-trustees will be placed in the position of having to defend themselves against allegations of imprudence under MPIR brought by these contingent beneficiaries.

- Because of the extraordinary investment returns of the past few years, some of these contingent beneficiaries (especially the unknowledgeable ones) will have unrealistic expectations regarding returns earned in the parent's trust prior to their death.
- Mass media and the Internet have educated many people about investment matters. As a result many contingent beneficiaries are confident enough to challenge the adequacy of a trustee's or co-trustee's investment performance they deem to be sub-par.

A fiduciary's first line of defense against allegations of imprudence under MPIR is being able to document his or her adherence to the new standard of conduct. He or she is not required to deliver superior performance. I recommend that trustees follow the discipline of a process designed to demonstrate adherence to the new standard. In addition to meticulously following a process, it is of utmost importance that fiduciaries maintain written records of their adherence to the process.

I have designed an 11-step process that takes the trustee through all of the necessary steps. However, in the outline presented on the following pages, entitled the "Frank

Method", the sub headings and discussion points do not cover all concerns or issues that may arise. Instead the sub headings and discussion points of the outline have been included for the express limited purpose of discussing some, but not all, of the compliance issues within the 11-step process that may be encountered by fiduciaries of small trusts.

The "Frank Method": An 11 Step Process for MPIR Compliance

I. Carefully review the trust in order to understand the settlor's intentions and objectives.

In order for a trustee to translate a settlor's wishes into suitable investment objectives (both risk and return) for the trust, he or she must become familiar with the settlor's intentions and objectives.

II. Learn and understand what the beneficiaries hope to receive in order to determine the investment objectives (both risk & return).

By involving all trust beneficiaries in the process, the trustee reduces the risk of creating a plan that is unsuitable.

Case study: Twin sisters are the beneficiaries of separate educational trusts established by their grandparents. Without knowing that one of the sisters expects to attend medical school (a four year program followed by various residencies) while the other sister expects to attend law school (a three year program followed by employment), their trustee is not able to design an investment program suited to each one's unique needs.

III. Determine the Beneficiaries' Risk Tolerance.

The subjective pain threshold and tolerance for portfolio volatility felt by each beneficiary is that beneficiary's risk tolerance. Once determined, the trustee must translate that subjective pain threshold into the quantifiable statistic of standard deviation. Knowing each beneficiary's acceptable level of portfolio standard deviation is the first step in designing a compliant portfolio.

IV. Determine the Trust's Risk Tolerance

Quantifying a beneficiary's subjective pain threshold fails to accommodate the fact that portfolio rates of return are not generated at uniform annual rates throughout the life of the trust. Where an average investment return of 10% per annum is required to accomplish a trust's goals, traditional analysis assumes that each year the return will be 10%, when in fact we know that will never happen. A more likely scenario is that future annual returns could fluctuate between minus 60% and plus 60% with a geometric mean rate of 10% and a probable standard deviation in excess of 20%. Furthermore the

sequence of the future returns cannot be predicted. Volatility of annual returns, especially in the early years, can materially impact the trust's ability to achieve its goals. It can negatively impact trust goals where there is a significant probability that annuity type periodic distributions will bankrupt the trust before its purpose is fulfilled. It can positively impact trust goals by proving 100% probability of achieving trust goals with less risk.

In order to calculate and manage this type of risk (standard deviation), the trustee must subject projected portfolio variables (i.e. rate of return and standard deviation; amount and timing of trust distributions; rate of inflation; and the tax rates, if a complex trust) to a computerized modeling technique known as Monte Carlo Simulation.

V. Develop a risk management plan that minimizes "uncompensated" risk and takes advantage of "super-compensated risk.

A. Minimize "uncompensated" risk.

According to Modern Portfolio Theory, all investors are subjected to two kinds of risk, "compensated" and "uncompensated" risk. An investor can not avoid "compensated" risk because it is present in all investment activity. Risk adverse beneficiaries gladly accept lower rates of return when their risk is reduced correspondingly. Beneficiaries with low pain thresholds for risk will gladly accept greater risk where the opportunities for higher returns exist. Whatever choice is made, the beneficiary is "compensated" for the amount of risk assumed. The technical name for "compensated" risk is market or systematic risk.

On the other hand, "uncompensated" risk is easily avoided via diversification, and therefore does not have to be assumed by anyone. Uncompensated risk consists of individual stock risk or specific risk; stock group risk or extra market risk; and when dealing in foreign securities, specific country risk. A trustee must never allow a trust or its beneficiaries to assume uncompensated risk. Failure by a trustee to diversify out of "uncompensated" risk is imprudent.

B. Maximize "super-compensated" risk.

"Super" compensation for assumed risk is achieved when investments are diversified across poorly correlated asset classes and sub-classes and styles. The major equity asset classes consist of US Stocks; Foreign Stocks; and Real Estate Equities. Sub classes consist of large capitalization; mid capitalization; and small capitalization stocks. Each sub class can be further categorized into growth, value, or balanced styles. Because of economic fundamentals no one major asset class, style or sub-class of equity investment can permanently out perform or under perform any other major asset class, style, or sub-class. However, much of the time, in the short-term, returns by class, style, and sub-classes are

negatively correlated to one another. No one category can deliver a superior or excess returns relative to the other categories for very long. According to the laws of supply and demand within the capitalistic model, when a category's projected returns are perceived to be superior, a new supply of equities is created until demand is satisfied. Often supply expands beyond satisfied, until it reaches saturated.

Case study: Recent activity in the dot com / technology sector is illustrative. Shortly after demand for technology stocks drove valuations (and hence returns) substantially higher than those of other categories, a flood of new dot coms IPOed until the market was saturated. As a result, technology values (returns) are no longer superior. It is interesting to observe that the rush to create supply was so overwhelming that most of the dot coms rushed to IPO had no underlying business value.

VI. Develop an overall investment strategy, designed for total return.

Calculate annual return requirements as a percentage return over and above the annual rate of inflation (e.g. 6.25% over inflation as defined by the CPI). Thus, the target rate of return for a year in which the CPI increases 2.75%, would be 9%. Thinking about required returns in this way allows the beneficiary to better understand how the trustee is addressing his or her needs.

A. Construct a composite benchmark designed to achieve the trust's goals.

Correctly determining a composite benchmark is the first step of managing trust investments. Armed with historical risk (standard deviation) and rates of return data from the universe of benchmarks, the trustee constructs a composite benchmark that fits the beneficiaries' unique profile. According to investment management theory, a benchmark should be used as the compass or roadmap allowing trustees to chart the course of their trusts, before beginning the journey. While the journey is underway, the trustee must continuously forecast all components in the benchmark mix, projecting risk and return values and then thoughtfully stray from the benchmark, when and where appropriate, using mean-variance portfolio optimization software, in order to achieve the best possible risk adjusted rate of return. Instead, many trustees mistakenly use benchmarks, only after the trip has ended, as a ruler to measure how well (or poorly) the portfolio performed.

VII. Prepare a written Investment Policy Statement (IPS).

The best way to document that the investment decisions of a trustee were made:

". . .as a part of an overall investment strategy having risk and return objectives reasonably suited to the fiduciary estate."

is to put the strategy in writing. It is a requirement under the Uniform Fiduciary Standards of Care and a "best practice" for investment professionals to prepare a written document that quantifies the investment objectives of: risk tolerance; liquidity needs; and the target rate of return necessary to achieve the trust's purpose. The document also specifies how investment decisions are to be made and provides a schedule for periodic reviews of the document, itself, and for monitoring performance. This document is known as an Investment Policy Statement or (IPS). (See exhibit 1, sample IPS).

Even though not required by the Michigan Prudent Investor Rule, a written IPS should be created and utilized in the investment governance of every trust. Because it is a requirement of the Uniform Fiduciary Standards of Care and a considered a "best practice" by the investment advisory profession, the absence of an IPS could imply imprudence.

VIII. While implementing the plan, exercise reasonable care, skill, and caution in the selection of outside portfolio managers or advisors.

Passive investments are attractive vehicles for trust investments because of low cost, ease of replicating many different benchmarks, and reduced ongoing monitoring requirements. Because of these attributes passive investment vehicles are ideal candidates for prudent investment delegation. However, when selecting an index mutual fund, trustees must be careful that the tax "overhang" does not negate its other advantages. A new type of passive investment vehicle known as exchange-traded-funds (ETFs) (e.g. Amex Spiders) eliminates the tax overhang problem and has fees as low as 9 basis points, as well as other advantages.

Where the additional costs of actively managed investments can be justified, the trustee should consider the use of both active and passive managers. Following is a recommended process for selecting active portfolio managers, whether separately managed accounts by investment advisors or mutual funds.

A. Research and compile a list of top quartile portfolio managers.

Identify portfolio managers who best replicate the specific risk / return specifications for each element of the composite benchmark, as discussed above in step VII. A computer screening process should be used to eliminate outside portfolio managers who based on their peer group, perform at a sub par level. Many Internet sights are available to assists in this task.

Case Study. The trust's composite benchmark includes a 20% equity allocation to the S&P/BARRA Mid-Cap Growth Index. The trustee conducts a search to find investment funds managed by experienced investment managers who have consistently delivered top quartile risk adjusted performance when compared to all other managers within the US Growth / Mid-Cap Equity peer group.

B. Eliminate from consideration managers / funds that fail other criteria.

Eliminate from consideration outside portfolios that fail to satisfy the trust's non-risk / return criteria (e.g. required minimum investment exceeds amount available to invest, advisory fees charged exceed set limit, internal organizational problems, allows style to drift by more than 20% of holdings, etc.).

C. Prepare questionnaires and Requests for Proposal (RFPs).

Prepare questionnaires and RFPs for distribution to the money managers remaining on the "short list" and as a guide for the trustee to compare trust requirements to mutual fund prospectuses. In addition, the trustee must obtain and study carefully ADV forms for the remaining managers.

D. Compare and evaluate responses.

E. Communicate with remaining candidates.

The finalists should be interviewed either by phone, or if the trust is large enough, by an in person visit to the offices of the advisor. Complete the evaluation process and make final selections.

IX. Exercise reasonable care, skill, and caution in delegating investment management responsibilities to outside portfolio managers or advisors.

A. Delegate only to highly ranked (within peer group) experts.

Delegating investment management functions to an outside portfolio manager is not a zero sum game. Because a portfolio manager can serve multiple masters, he or she is not obligated to resign trust A's appointment as a pre-condition of accepting the appointment of trust B. Theoretically, every trust can have the benefit of delegating its investment management function to the number one portfolio manager within a given peer group. This is the reason why it is critical to specify and adhere to the criteria for portfolio manager selection and retention in the IPS.

Case Study: A trustee outsources only the Mid Cap Growth portion of a trust's asset allocation to a perennial leader of the US Growth / Mid-Cap Equity peer group. He or she avoids low ranked (by peer group) performers, those who specialize in different investment styles, and those who allow style drift to distort the prescribed asset allocation.

X. Periodic monitoring and reporting.

Comments to the Uniform Prudent Investor Act, contain the following recitation regarding a fiduciary's duty to monitor:

"Duty to monitor. Subsections (a) through (d) apply both to investing and managing trust assets. "Managing" embraces monitoring, this is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments"

There are two parts to the trustee's monitoring responsibility. The first part is verifying whether or not the investments are being managed within the parameters established by the IPS. The second part of the monitoring responsibility involves verification of whether or not the plan envisioned by the IPS remains on target to accomplish the beneficiaries' goals viewed with the hindsight of actual events.

A. Interim investment monitoring and reporting for small trusts.

For the smaller trust, interim monitoring normally deals only with the first part of the monitoring responsibility. It is performed either quarterly or monthly as determined by the trustee, based on the size of the trust portfolio and the degree of oversight required.

1. The trustee must first determine and assign every manager to a peer group and verify portfolio performance statistics for all non-mutual fund managers only.

a. Independently determine and assign every manager to a peer group.

b. Independently compute and verify all of the investment performance statistics (rate of return, standard deviation, Sharpe ratio, beta, and alpha) for all non-mutual fund managers only.

After completing parts a) and b) above, if the trustee can answer questions 2-8 below in the negative, no further interim monitoring should be required. Where the trustee must answer "yes" to any one of the 6 questions, further monitoring is required.

2. Has the manager allowed style drift to occur with the result that at anytime during the period under review more than 20% of the portfolio's holdings resided in another asset category?

3. Have there been any material personnel changes in the manager's organization during the interim period?

4. Have there been any legal or regulatory actions commenced against the manager or his or her organization during the period under review?
5. Has the manager's portfolio rate of return; standard deviation; or Sharpe ratio declined below its peer group's median for the trailing three-year period?
6. Has the manager's portfolio rate of return; standard deviation; or Sharpe ratio declined below the 3rd quartile in its peer group for any 2 consecutive quarters in the trailing three-year period?
7. Has the manager's portfolio Alpha statistic turned negative for the trailing three-year period?

A letter documenting the answers to these questions together with a quarterly report from each portfolio manager or mutual fund mailed to the beneficiaries can satisfy interim reporting requirements.

B. Annual investment monitoring and reporting for small trusts.

The annual monitoring function involves all of the interim functions plus the additional requirement that the trustee monitor whether or not the prior year's events, have caused the trust to veer off the IPS plan to achieve its goals. Where the monitoring discloses that changes are required, it is incumbent upon the trustee to see to it that the necessary changes are made and where required, the IPS amended.

In my opinion, annual monitoring and reporting should not be attempted without the benefit of computer assistance. Monitoring and reporting software is available from various vendors and the Internet.

1. Perform interim monitoring as described above
2. Prepare or have prepared annual financial reports
3. Analyze the trust's overall investment performance by comparing the portfolio's performance statistics (beta, rate of return, standard deviation, Sharpe ratio, and alpha) with those of its composite benchmark and peer group and compare results to targeted requirements in IPS.
4. Prepare or have prepared an analysis of costs charged by each manager and compare to management agreement and IPS.
5. Rebalance portfolio to target allocation in IPS (provided straying is not appropriate).

6. Perform or have performed tax efficient investment calculations where distributions are required.

XI. Avoid Conflicts of Interest and Prohibited Transactions

A. Investments are managed in accordance with trust documents and Investment Policy Statement.

B. Fiduciaries and parties in interest are not involved in self-dealing.

C. Where consultants are utilized for searches, they are not involved in selling "research" to money managers.

D. "Finders' fees", 12-b-1 fees, or other forms of compensation for asset placement are appropriately applied, utilized and documented.

Conclusion

No small trust exemptions Under MPIR. It appears that all Michigan trusts, both large and small, must comply with MPIR. In the comments to section 2 of the Uniform Prudent Investor Act, the following recitation regarding exceptions in the case of smaller trusts is instructive:

"The Drafting Committee declined the suggestion that the Act should create an exception to the prudent investor rule (or to the diversification requirement of Section 3) in the case of smaller trusts. The Committee believes that subsections (b) and (c) of the Act emphasize factors that are sensitive to the traits of small trusts; and that subsection (f) adjusts helpfully for the distinction between professional and amateur trusteeship. Furthermore, it is always open to the settlor of a trust under Section 1(b) of the Act to reduce the trustee's standard of care if the settlor deems such a step appropriate. . . ."

Internet compliance help is available at frankcpa.com. As part of implementing the 11 steps I have suggested that fiduciaries turn to the Internet for help in performing many of the MPT calculations, without providing a list of these web sights. The reason for this apparent omission is that the very financial / investment web sights most needed by fiduciaries for MPIR compliance change very rapidly. Instead I invite you to visit my web sight at frankcpa.com where direct links to the best and most current of those other web sights are provided.

Glossary

Alpha

A statistic used to measure a portfolio manager's contribution to the portfolio's performance. It measures the incremental rate of return per period in excess of the portfolio's return attributable to the risk the portfolio has assumed, as measured by beta. It measures the portfolio's non-systematic risk. A positive alpha indicates the portfolio has performed better than its beta would predict. A negative alpha indicates a portfolio has under performed, given the expectations established by the fund's beta.

Benchmark

An investment strategy-driven financial index. Used as a benchmark to measure comparative portfolio performance.

Beta

Beta is a statistical measure of the volatility over time of a portfolio's total value compared to the price volatility of its targeted market index (such as the S&P500). Beta measures a portfolio's non-diversifiable otherwise known as market or systematic risk. Portfolios are thought of as more risky than the market if their beta is larger than 1 or less risky if their beta is smaller than 1. A beta of "0" indicates a portfolio with no market risk (e.g. cash or short term Treasury Bills). A Beta of "1.0" indicates a portfolio with risk equal to its targeted market index. A beta of "2.0" indicates a portfolio with double the risk.

Capital Markets Line (CapM)

A straight line representing the risk / return opportunity available in a given market via a linear combination of two assets: Risk Free T-Bills and the "market" portfolio represented by an equity market index (i.e. the S&P 500 index).

Correlation

Correlation measures a portfolio's movement as compared to the movement of an index or benchmark during the same time period. A maximum value of "1.00" indicates that the portfolio and index move exactly together. A value of "-1.00" indicates they move exactly opposite of one another. All other patterns of movement fall in between. Efficient diversification is achieved when asset classes with poor correlation are utilized.

Decile Rank

The decile in which a portfolio's performance factor or risk factor falls. Deciles are calculated by ranking in descending order the factor being measured for all products in a peer group and dividing all products into 10 equal-sized groups, or deciles. A decile ranking of 1 indicates that the factor being measured is in the top 10% of all portfolios in the specific peer group

Peer Group

A peer group is a collection of real investment portfolios with similar investment characteristics.

Index

An index is a statistical composite that measures changes in financial markets. Indices measure the ups and downs of stock, bond, and other financial markets, reflecting market prices and weighting of the individual components within the index.

R-Squared

The percentage of a portfolio's performance explained by the behavior of the appropriate market benchmark. The higher the R², the closer the correlation of the portfolio's performance patterns to that of the appropriate market benchmark.

Rate-of-Return

The aggregate increase in the value of a portfolio resulting from the net appreciation (or depreciation) of the principal, plus (or minus) the net income (or loss) experienced during a period of time. When reporting for time periods of one year and more, annualized rates of return are used. When reporting for periods of less than one year, the percentage rates are not annualized.

Sharpe Ratio

A risk-adjusted measure calculated by using standard deviation and excess return (portfolio return minus the T-Bill return) to determine reward per unit of risk. The higher the Sharpe ratio the better the portfolio's historical risk-adjusted performance.

Standard Deviation

A statistical measure of the range of a portfolio's performance, the variability of a return around its average return over a specified time period. Approximately 68% of the time, returns of a portfolio are expected to differ from its mean return by no more than plus or minus the standard deviation figure.

Exhibits

Exhibit A Sample Client Trust

(Download PDF version of this exhibit at
<http://www.icle.org/partners/materials/2000CR6513/20002C6513-exA.pdf>)

Exhibit B Investment Policy Statement for Family Wealth (Client)

(Download PDF version of this exhibit at
<http://www.icle.org/partners/materials/2000CR6513/20002C6513-exB.pdf>)

Exhibit C Example Illustration of Trust's Risk Tolerance

(Download PDF version of this exhibit at
<http://www.icle.org/partners/materials/2000CR6513/20002C6513-exC>)