

Efficient and Impartial Trust Investing

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ABSTRACT

U.S. trusts hold assets worth trillions of dollars. Historically trust assets were placed in extremely safe investments, but legal reforms have permitted more aggressive investment strategies that take advantage of the much higher returns available in financial markets. Greater investment options present new opportunities for conflict. A trustee charged with investing trust assets without favoring one beneficiary over another must choose a portfolio that balances divergent interests. Other than in the rare circumstance that beneficiary risk tolerances exactly coincide, trust portfolios cannot satisfy all beneficiaries who share the returns, instead inefficiently exposing some to what they would consider excessive risks, and others to too little risk. Trust law has recently adopted rules attempting to address conflicts between the interests of beneficiaries who are paid out of trust income and those who are paid out of principal, but the law has not fully considered the consequences of differences in beneficiary risk tolerances. A simple way to address the inefficiency introduced by common trust funds is to permit and encourage trustees to divide trust assets and invest the parts separately.

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1. *Introduction*

Common-law trusts separate legal and beneficial ownership, with trustees holding legal title to trust property, which they manage on behalf of beneficiaries who enjoy beneficial ownership.¹ This arrangement has proven sufficiently attractive to entice U.S. settlors² to establish millions of trusts with aggregate assets that comfortably exceed one trillion dollars.³ Much of the net worth of these trusts consists of financial assets that trustees are required to invest. In making these investments, trustees choose the extent to which trust returns, and therefore beneficiary payouts, are subject to market risks. Some beneficiaries are understandably quite risk averse, whereas others are much less so; and both types commonly receive payouts from the same trusts. In choosing investments trustees are required to act prudently and impartially in advancing the interests of beneficiaries,⁴ though historical practice was to invest very conservatively,⁵ effectively favoring risk-averse beneficiaries and eschewing the high expected returns associated with equities and other risky investments.⁶ Trustees in the modern era are more willing and able to embrace risks,⁷ but the investment problem remains challenging

¹ Restatement (Third) of Trusts § 2, comment (f) (2003).

² The person who establishes a trust is referred to as the trust “settlor” or “grantor” or “trustor,” all of which are synonymous; this paper uses “settlor.”

³ The exact magnitude of aggregate U.S. trust assets is unknown, though there is evidence of its considerable size. FDIC-insured U.S. banks acting as trustees report that they alone manage more than \$1 trillion of trust assets; and the IRS (<https://www.irs.gov/uac/soi-tax-stats-fiduciary-returns-sources-of-income-deductions-and-tax-liability-by-type-of-entity>) indicates that more than two million non-grantor trusts (those in which settlors are neither trustees nor beneficiaries) filed U.S. returns for tax year 2014, reporting net income exceeding \$122 billion, which at any reasonable rate of return corresponds to much more than \$1 trillion in assets. The income figure for 2014 is the most recently reported, and it is noteworthy that IRS figures indicate that aggregate trust net income has exceeded \$100 billion annually since 2005.

⁴ Restatement (Third) of Trusts §§ 79, 90 (2007). Jeffrey A. Cooper, Empty promises: Settlor’s intent, the Uniform Trust Code, and the future of trust investment law, 88 Boston University Law Review 1165, and Shades of Gray: Applying the benefit-the-beneficiaries rule to trust investment directives, 90 Boston University Law Review 2383 (2010) explores the limits of the extent to which trust investments must reflect beneficiary needs, arguing, contrary to Uniform Trust Code § 404, that there are cases in which trustees should respect settlor investment directives.

⁵ See, for example, John H. Langbein and Richard A. Posner, Market funds and trust-investment law, 1976 American Bar Foundation Research Journal 1.

⁶ On the high returns available for investments in risky assets, see Rajnish Mehra and Edward C. Prescott, The Equity Premium in Retrospect, in George M. Constantinides, Milton Harris and René M. Stulz eds., Handbook of the Economics of Finance, Volume 1B: Financial Markets and Asset Pricing (Amsterdam: North-Holland, 2003), 889-938; J. Bradford DeLong and Konstantin Magin, The U.S. equity return premium: Past, present, and future, Journal of Economic Perspectives, Winter 2009, 23 (1), 193-208.

⁷ Max M. Schanzbach and Robert H. Sitkoff, Did reform of the prudent trust investment laws change trust portfolio allocation? Journal of Law and Economics, November 2007, 50 (4), 681-711 and 35 ACTEC Journal 314 (2010) report that the fraction of bank-managed personal trust assets invested in stocks rose during 1986-1997, exceeding 60 percent by the end of this period; and that sharp rises in these fractions were associated with state adoption of modern prudent investor rule legislation.

and fraught with inefficiency, because, as this paper discusses, it is impossible to satisfy all of the investment needs of diverse beneficiaries who receive formulaic shares of the returns from a common investment fund.

The tradeoff between risk and return is seldom more vivid than in recent times, when very low interest rates mean that it is impossible to earn significant returns on investments without exposure to substantial risk.⁸ Prudent asset allocation requires assessment of the relative costs and benefits of alternative investment portfolios, with the associated potential for adverse investment outcomes when risky investments fare poorly. Those for whom poor returns would entail significant hardship are well advised to avoid excessive exposure to risky investments, even though the alternative of safe investment promises barely discernable returns. In other economic eras it has been possible to earn significant returns on portfolios invested in safe assets, but even then it was the case that riskier alternatives held the potential for better yields, and investors quite sensibly differed in the extent to which they preferred to incur risks in the hope of obtaining high returns.

Fiduciaries and other agents who invest on behalf of others must likewise choose among investments that differ in their risk and return characteristics, with optimal risk choices reflecting at least in part the financial resources and life situations of the stakeholders who receive the returns. This portfolio choice problem, which is inevitably complicated, becomes considerably more so when multiple individuals benefit from a common investment portfolio. Due regard for the situations of all who benefit from a common portfolio requires a balancing of their interests, with ultimate asset choices that may correspond only loosely to what any of the beneficiaries would have chosen individually.

Trusts commonly have multiple beneficiaries who receive distributions from the same investments.⁹ A typical example is a testamentary trust stipulating that a surviving widow

⁸ See, for example, Manthos D. Delis and Georgios P. Kouretas, Interest rates and bank risk-taking, *Journal of Banking & Finance*, April 2011, 35 (4), 840-855.

⁹ It is very difficult to obtain reliable aggregate data on numbers of trust beneficiaries, though the mere existence of multiple beneficiaries is a logical necessity if remainder beneficiaries are considered, since every trust in that sense has multiple beneficiaries, as it is always possible that a single named beneficiary may die prior to receiving all of the trust property. Split-interest charitable trusts have both charitable and non-charitable beneficiaries, and therefore multiple beneficiaries; and the U.S. IRS keeps separate statistics on split-interest charitable trusts, as they must file Form 5227 with the IRS. Lisa S. Rosenmerkel, Split-interest trusts, filing year 2012, *Statistics of Income Bulletin*,

receive annual distributions of income earned by trust assets, with the principle to be divided among children alive at the widow's death. The trustee, who manages the fund, selects investments, and makes distributions to beneficiaries, is charged with managing investments in a manner that does not overly favor one beneficiary at the expense of others. The requirement that trustees discharge their responsibilities with impartial regard for the interests of all trust beneficiaries is one of the fundamental requirements of trustees imposed by the common law and enshrined in state statutes. In order to discharge this duty properly it is necessary to anticipate the distributions that beneficiaries will receive in different states of the world.

It is by now well understood that the requirement that trustees act impartially raises complications in settings when beneficiaries benefit to differing degrees from returns in the form of income and principal, since the division between these types of return is to some degree under the control of the trustee.¹⁰ In the case of the testamentary trust in which the widow has a life income interest, trust investments in income-producing assets, such as corporate bonds, rental properties, or dividend-paying stocks, generate returns in the form of interest, rents, and dividends that are distributed to the widow as the trust receives them. By contrast, other types of investments, such as those in stocks of companies that do not pay dividends, may in the long run generate significant capital gains, but these returns may in any given year take a form that is commonly deemed to augment principal, and therefore add to the amount ultimately received by the children rather than the widow. The trustee, in choosing among investments, therefore also chooses between favoring the widow and favoring the children.

The usual understanding is that it is the classification of some investment returns as income, and others as principal, together with trust terms that assign one or more beneficiaries income and others principal, that generates the complication for trustees.¹¹ The nature of this problem is more than the mere fact that the trustee in choosing investments implicitly chooses between beneficiaries, since any allocation of the proceeds of a common fund entails tradeoffs between the interests of different beneficiaries. The investment problem is that trust investments that make the most sense from the standpoint of overall risk and return may deliver their returns

Winter 2014, 33 (3), 51-73, reports that 113,682 split-interest trusts, with aggregate gross income of \$11.7 billion, filed information returns for tax year 2012.

¹⁰ See John H. Langbein, *The Uniform Prudent Investor Act and the future of trust investing*, 81 *Iowa Law Review* 641 (1996).

in a manner that is unfair to one or more beneficiaries. In the example it is necessary to invest trust assets in income-generating investments in order to ensure that the widow receives the income that she deserves, yet not to invest too much in income-generating assets if doing so would unfairly leave the children with too little upon the widow's death. Constraining investment choices in this way can lead to situations in which trustees must forego what would otherwise be sound investment plans, as evaluated on the basis of overall risk and return, in order to maintain payout streams that treat beneficiaries impartially.

The law in recent decades has taken steps to address the problem, notably with the promulgation and widespread adoption by state governments of the Uniform Principal and Income Act and the Uniform Prudent Investor Act. These acts expand the power of trustees to invest trust assets in a manner dictated by modern capital theory that recognizes the tradeoffs between risk and return and the nature of capital market risk.¹² The Uniform Principal and Income Act permits trustees to distribute certain investment returns to income beneficiaries even when returns take forms that were not traditionally classified as income,¹³ and thereby helps to loosen the connection between the portfolio chosen by a trust investor and the division of return between different beneficiaries.

These uniform acts make considerable progress in rationalizing the investment problem facing trustees, but what appears to have been overlooked in addressing the principal and income issue is that common trust funds are problematic when beneficiaries have differing risk preferences, whether or not they differ in receiving the income and principal components of returns. As an illustration, the widow in the example might be very risk averse and the children much less so. Strong risk aversion implies that the widow would face serious hardship if income falls much below a specified level. The only way to guarantee that a portfolio generates a given stream of income is to invest a sufficient amount in safe investments. In so doing, however, the trust effectively foregoes the opportunity to earn the higher rates of return available from riskier investments, which the children would have preferred. Indeed, it is easy to envision circumstances in which the children would be willing to compensate the widow, or even

¹¹ Ibid.

¹² See the discussion in Edward C. Halbach, Jr., Trust investment law in the Third Restatement, 77 Iowa Law Review 1151 (1992).

¹³ Uniform Principal and Income Act § 104.

guarantee her an annual stream of payments, in return for the opportunity to have the trust fund invested in higher-yielding, albeit risky, assets. All parties would be made better off by such a plan, but current law does not envision trustees performing such a reform on their own.

Common investment pools are problematic when payouts are fixed by formula, as in the case of the trust that provides a life income to the spouse and the remaining principal to the children. In this example, the surviving spouse receives the payout of what is effectively a variable annuity, with annual payments equal to income generated by the trust fund, and that discontinues at the spouse's death; and the children receive the payout from what might heartlessly be called a variable life insurance contract on the widow's life. The financial inefficiency arises because the variable component of the annuity and the variable component of the life insurance contract are required to correspond to a division of the returns of the same investment portfolio. As a result, it is not possible to invest one beneficiary's component of a trust fund in risky assets and another beneficiary's component in safe assets, even if such a division would advantage both beneficiaries and not harm anyone else.

And the trustee's problems typically run deeper even in simple cases. Suppose that there are two children in the example, Son and Daughter, who have very different life situations and therefore different risk preferences: Son, who requires a certain trust payout to meet anticipated later in life family expenses, is risk-averse; Daughter, who does not have such needs, is risk-neutral. Each receives a distribution equal in value to half of the trust fund at the death of their mother. Son obviously prefers that the trust fund be invested safely during his mother's life, whereas Daughter prefers that the fund be invested in higher yielding, albeit risky, assets. A trustee who splits the difference exposes Son to risks and forces Daughter to miss out on high expected returns, to say nothing of the consequences for their mother. An enterprising trustee who seeks to guarantee Son the payout produced by a safely invested trust fund would inevitably need to distribute different amounts to Son and Daughter upon the death of their mother, which in the absence of other actions or new legislation would likely expose the trustee to liability for breach of trust.¹⁴

¹⁴ See the Uniform Trust Code §§ 803, 1001.

These investment problems arise due to the ability of trustees to choose among many investments, and the nature of the sharing arrangements that characterize trust fund distributions. Historically trusts were largely required to be invested in land, government bonds, and other very safe assets.¹⁵ These restrictions greatly limited the choices available to trustees, making investment decisions relatively uncomplicated. Modern trust law reforms, particularly the Uniform Prudent Investor Act, that permit and encourage trustees to take advantage of the opportunities available in financial markets, offer better risk and reward combinations but also require that trustees in making investment decisions pay careful attention to beneficiary needs. The Uniform Principal and Income Act offers methods of efficiently resolving conflicts among beneficiaries who receive distributions from different components of investment returns. What is currently missing is a uniform act, or in truth analysis and proposals, that would efficiently resolve conflicts among trust beneficiaries with differing tolerances for investment risk. This paper takes some steps in that direction.

2. Trustee Duties and the Uniform Principal and Income Act

Trustees, whether or not they are compensated for their services, are charged with managing and investing trust assets and making distributions to beneficiaries. Trustees therefore work on behalf of others, and in so doing have legal duties of loyalty to beneficiaries and prudence in the conduct of trust affairs.¹⁶ Loyalty to beneficiaries entails the avoidance of self-dealing, and includes a duty to treat beneficiaries impartially in settings where there are multiple beneficiaries. Prudence in the conduct of trust affairs includes sound management of investments, which historically entailed very conservative investment plans in which trustees were expected to avoid investment in any risky assets that might deliver significant negative returns.

This extremely conservative approach to asset selection did not produce satisfactory investment returns over the last two centuries during which risky equities have, on average, greatly outperformed other, less risky, investments. Despite the excellent average performance

¹⁵ Langbein and Posner, *op cit*.

¹⁶ For trustee duties generally see Uniform Trust Code §§ 801 – 817.

of risky equity investments, it remains the case that investors must endure the possibility of some downside risk as the price of greater expected returns. Modern (since the 1950s) capital market theory formalizes the theory of risk and return, and identifies an efficient frontier of risks and returns that can be obtained by owning combinations of assets, including assets that might be individually risky but which, in combination with other assets with offsetting risks, yield safer aggregate returns.¹⁷ The Uniform Prudent Investor Act permits, indeed encourages, trustees to invest trust property in risky assets if such investments can be combined in an efficient way with other assets to deliver a desirable combination of total risks and returns.¹⁸ Along what is known in finance as the “efficient frontier” there remains a tradeoff between risk and return: investment portfolios that are less risky have lower expected returns, whereas investment portfolios that are more risky have higher expected returns. The efficient frontier is defined by the impossibility of finding a different combination of assets that would offer greater expected returns with the same risk, or reduced risk with the same expected returns.¹⁹ But the trustee must still choose an overall risk position for the investment portfolio, mindful of the fact that even with efficient investments reducing the greater expected returns necessarily entails greater risks. Since the trustee invests on behalf of the beneficiaries, presumably beneficiary risk tolerance should guide choice along the risk and return frontier.

The trustee’s duty of impartiality is codified by Section 803 of the Uniform Trust Code, which provides that “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.” The official comment accompanying this provision explains further that, “The differing beneficial interests for which the trustee must act impartially include those of the current beneficiaries versus those of beneficiaries holding interests in the remainder; and among those currently eligible to receive distributions. In fulfilling the duty to act impartially, the trustee should be particularly sensitive to allocation of receipts and disbursements between

¹⁷ Edwin J. Elton and Martin J. Gruber, Modern portfolio theory, 1950 to date, *Journal of Banking & Finance*, 1997, 21, 1743-1759 offers an interpretive review of modern portfolio theory.

¹⁸ Uniform Prudent Investor Act § 2.

¹⁹ The efficient frontier was introduced by Harry M. Markowitz, Portfolio selection, *Journal of Finance*, March 1952, 7 (1), 77-91. The point of this analysis is that many asset combinations do not lie on the efficient frontier because they compound risks, or offer subpar expected returns, in a manner that could be avoided by investing in other, more efficient, combinations of assets.

income and principal and should consider, in an appropriate case, a reallocation of income to the principal account and vice versa, if allowable under local law.”

The duty of impartiality extends beyond an appropriate division of investment returns between income and capital, though as the comment to Section 803 of the Uniform Trust Code illustrates, considerable concern has been focused on this division. This is the focus of the Uniform Principal and Income Act, Section 104 of which provides, “A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust’s income, and the trustee determines, after applying the [allocation] rules in Section 103(a) , that the trustee is unable to comply with [the duty of impartiality as codified in] Section 103(b).” The official comment to Section 104 elaborates: “If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.”

The Uniform Principal and Income Act has been widely adopted by U.S. states. Consequently, trustees need not shy away from certain otherwise desirable investment portfolios on the ground that they would provide too little return to income beneficiaries, since trustees are permitted to make compensating distributions from capital appreciation to income recipients. These compensating distributions must, however, reflect the nature of the investment plan rather than a strategy that systematically favors one beneficiary, since neither the Uniform Trust Code nor the Uniform Principal and Income Act permits trustees to defy the terms of the trust by favoring one beneficiary over another. As the official comment to Section 104 of the Uniform Principal and Income Act notes, “Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust;

rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of the investment decisions made by the trustee under the prudent investment rule."

There is more than one way for trusts that are invested in assets delivering much of their return in non-income form to provide sufficient annual income to income beneficiaries. As noted, one method is to permit trustees to make equitable adjustments between principal and income. Another is structure the trust as a unitrust that annually pays income beneficiaries a fixed percentage of the value of trust assets, regardless of the trust's annual return. Of course settlors have the option of establishing the trust that way from its inception, but even if a settlor does not do so, many states have adopted legislation permitting trustees subsequently to convert trusts with annual income beneficiaries to trusts that pay erstwhile income beneficiaries annual amounts equal to fixed (typically between three and five percent) fractions of the average values of trust assets over the preceding three years.²⁰ The motivation for this option is to afford trustees greater latitude in selecting investment portfolios without concern for the distribution of returns between principal and income.

Statutory developments such as those reflected in the Uniform Principal and Income Act address a conflict that can arise between the trustee's duty of prudence and the trustee's duty of impartiality. Prudence dictates that trust assets be invested efficiently, which, as captured by modern capital theory, implies that portfolios consist of combinations of assets that put the trust portfolio on the efficient frontier. Impartiality requires that trustees must treat beneficiaries equitably, which implies that income beneficiaries receive appropriate payouts from annual trust income. There is a first-order inequity that can arise if prudent trust investments entail too much, or too little, return to income beneficiaries relative to those who receive principal. Legal developments of the last forty years have been directed at addressing this first-order inequity, while little if any consideration has been devoted to the potential for inequity and inefficiency when trust assets are invested on behalf of beneficiaries with differing preferences over safe and risky investments.

3. *Investment Risks with Multiple Beneficiaries*

Trust beneficiaries have a common interest in excellent investment performance of trust assets, since investment returns are ultimately distributed to beneficiaries; but beneficiaries differ in the extent to which they would be willing to trade off higher expected investment returns for lower risks. Simple measures customarily adopted to address the principal and income problem do not address these differences in risk preferences. In the example of the testamentary trust with a risk-averse surviving widow as the income beneficiary and children with differing risk tolerances as the remainder beneficiaries, even a conversion of the widow's lifetime income interest to a unitrust in which the widow receives annual disbursements of four percent of trust assets (measured over a three-year rolling average) does not address the conflicting risk preferences of the beneficiaries. There are two reasons why not, first that the widow's payout stream remains a dampened function of trust returns, and the widow's unitrust conversion does not address the differing risk preferences of Son and Daughter.

Unitrust payouts are typically functions of three year rolling averages of trust asset values, so a trust with assets that perform well over three years will make significantly higher payouts in years three and four than a trust with assets that do not perform well. Consequently, a widow who is extremely risk averse will much prefer that a unitrust from which she receives payments is invested safely. In the example Son would also prefer safe investments, but Daughter does not, so the choice of safe investments implicitly favors the widow and Son at the expense of Daughter.

Can a trustee who does not convert the trust to a unitrust nonetheless make risky investments, dipping as need be into principal to ensure that the widow receive sufficient annual disbursements, regardless of investment performance? That would depend on the terms of the trust. The official comment to Section 803 of the Uniform Trust Code notes that "The duty to act impartially does not mean that the trustee must treat the beneficiaries equally. Rather, the trustee must treat the beneficiaries equitably in light of the purposes of the trust. A settlor who prefers that the trustee, when making decisions, generally favor the interests of one beneficiary over those of others should provide appropriate guidance in the terms of the trust."

²⁰ Restatement (Third) of Trusts § 111 (2012); the associated comment (c) notes that as of 2011, "thirty states...have

Trustees violate the duty of impartiality if they provide a type of free investment insurance to one class of beneficiaries, because the distributions pursuant to that insurance come at the expense of other beneficiaries. If the widow, as a life income beneficiary, receives a distribution of the trust's annual income in years when the trust generates significant positive income, and also receives a substantial distribution in years when the trust generates negative or very modest income, then the expected economic value of her distributions exceeds a life interest in trust income. If the trust terms are that the widow should receive the life income from trust property, a trustee who distributes to the widow trust income in some states of the world and more than trust income in other states of the world is not acting impartially.

One can imagine an arrangement in which trust assets are invested in a risky portfolio, and there is a haircut on the widow's distribution if trust assets perform particularly well, so that she receives say only 20 percent of annual returns that exceed 7 percent of assets, in return for which the widow receives a minimum distribution of a fixed dollar amount, or 2 percent of assets, each year. If the haircut and the minimum distribution are calculated to be of offsetting economic value, then the trustee has not violated the duty of impartiality. What happens in such a case is that the widow in essence receives the value of a fund invested in a variable annuity with various long and short positions in differing assets that deliver the planned stream of payments. It is clearly in the interest of the trustee, and likely all stakeholders, that that such an arrangement be made explicit and in writing, in order to avoid potential litigation, and encourage greater precision in, and use of, such arrangements. In the absence of an explicit arrangement, a trustee could face a charge of breach of duty if over time trust fund investments fare poorly and the trustee nonetheless makes regular and significant distributions to the widow.

While in the example the widow and Daughter have conflicting interests over the investment profile of trust assets, it is also the case that Daughter and Son have conflicting interests. Daughter prefers that trust assets be invested in high-return risky investments, whereas Son prefers safer investments. These two interests inevitably conflict: as long as the trust portfolio remains on the efficient frontier, then any change in the composition of the portfolio favors one child at the expense of the other. The fact that assets may have many years to accumulate prior to the widow's death does not change the underlying reality that safer

some form of unitrust-conversion statute, usually as an alternative accompanying the adjustment power.”

investments produce safer ultimate distributions to Son and Daughter, whereas riskier investments produce riskier distributions.²¹ Conversion to a unitrust in deference to the widow's risk aversion does not reduce the conflict of interest between Son and Daughter, and indeed increases it, since in reducing the riskiness of the widow's claim on the trust fund returns it increases the extent to which the children are exposed.

The trust that benefits the widow and children is of course merely an example, chosen to illustrate some of the issues that arise with multiple trust beneficiaries. Many trusts have combinations of charitable and non-charitable beneficiaries, in circumstances in which it is easy to imagine that the beneficiaries have very different preferences toward risk; and the same is true of trusts with beneficiaries of different ages, generations, and life situations. Risk preferences, it might be noted, are evaluated on the basis of how beneficiaries would value streams of trust distributions. If it were possible for beneficiaries to hedge their trust positions at zero or low cost by taking various long and short asset positions,²² then beneficiary risk preferences would be the same as those of the market as a whole, and therefore equal to each other, eliminating any potential for conflict. Hence the potential for conflict relies on the notion that costless or low-cost complete hedging is unavailable or unrealistic for many or perhaps all beneficiaries, so the riskiness of the streams of trust distributions that they receive matters to them beyond just how it affects what would be the market values of these streams.

²¹ There is a common fallacy that long investment horizons over which assets are reinvested somehow reduce the riskiness of investing in a risky portfolio. This proposition has been forcefully rejected by finance theory, notably by Paul A. Samuelson, who notes in a series of articles, including *Risk and uncertainty: A fallacy of large numbers*, *Scientia*, April – May 1963, 1-6 and *Lifetime portfolio selection by dynamic stochastic programming*, *Review of Economics and Statistics*, August 1969, 51 (3), 239-246, that the proposition is equivalent to arguing that a gambler who bets on red at the roulette wheel somehow reduces the riskiness of his position by doubling the bet every time he loses. Samuelson's final salvo is the remarkable article, *Why we should not make mean log of wealth big though years to act are long*, *Journal of Banking & Finance*, 1979, 3 (4), 305-307, in which every word has just one syllable (presumably intended to make the article intelligible to those in the finance community who were not otherwise convinced).

²² As a practical matter the way this might work is that Daughter, who feels that the trust is not invested as aggressively as she would otherwise like, would go long a number of risky investments, financing her positions by borrowing on the market and pledging future trust distributions as collateral for these loans. Analogously Son, who worries that the trust is invested in too many risky investments, would go long a number of safe investments, financing his positions by borrowing on the market and pledging future trust distributions as collateral for these loans. Obviously the ability of Daughter and Son to engage in these transactions depends on the extent to which financial markets are willing to lend, and the prices at which they would be willing to lend, on the basis of future trust distributions as collateral. If either Daughter or Son holds a large and diversified portfolio of personal assets outside the trust, then there is the possibility of changing these asset holdings to neutralize any effect of trust investments on the overall riskiness of exposure to financial risks.

4. *Portfolios of Blended Funds*

How does one invest trust assets in a manner that treats impartially beneficiaries with differing risk preferences? Modifying slightly the previous example, suppose that a trustee were charged with investing a \$2 million trust fund for 20 years, at the end of which the assets will be liquidated and distributed half to risk-averse Son and half to risk-neutral Daughter. Obviously all parties have an interest in the trust fund portfolio lying on the efficient frontier, but Son and Daughter differ in their preferred point on the frontier.

Some guidance is available from considering the differing current valuations of future trust fund distributions. If the trust fund were invested in a safe portfolio then Son's current valuation of his expected future stream would be \$1 million, in that assets so invested would be worth the same today as a \$1 million fund that Son controls, since Son if given complete discretion would choose the safe portfolio. Son's valuation of other, typically more risky, trust fund investment portfolios would differ, with his valuations generally declining in the riskiness of the portfolio, and always falling below \$1 million. Similarly, if the trust fund were invested in a sufficiently more risky portfolio Daughter would value her stake at \$1 million currently, attaching lesser valuations to less risky alternatives.

If, starting from a safe portfolio, Son's valuation of his stream consistently (and continuously) declines as the riskiness of the trust fund portfolio increases, and if, starting from a risky portfolio, Daughter's valuation of her stream consistently and continuously declines as the riskiness of the trust fund portfolio declines, then there exists a point somewhere between these two extremes at which they would each value their expected distributions by the same amount. It might seem entirely reasonable to ask an impartial trustee constrained to use a single trust fund for these two beneficiaries to choose the investment portfolio that produces these equal valuations.

There are some important concerns with basing expectations of trustees on such outcomes. The first is that it may be extremely difficult to have access necessary to the preference information necessary to implement such a solution. This is a very real practical

concern, though perhaps less of one from the standpoint of understanding the concept of impartiality in this context. A second concern is that there may be more than two beneficiaries whose risk preferences all differ, in which case there is no guarantee – indeed, it is quite unlikely – that there exists a single asset allocation that generates equal valuations for all beneficiaries.

A third concern is that this trust allocation rule implicitly privileges risk-averse beneficiaries over more risk-neutral beneficiaries.²³ Risk aversion can make portfolio valuations very sensitive to the risk characteristics of investment returns. An example of risk aversion is the case of perhaps an elderly beneficiary whose only expenses are regular, recurring, and must be contracted for in advance, so this beneficiary values having the same income every year, experiences enormous hardship if income ever falls below the anticipated level, and benefits not at all from additional income above the anticipated amount. If this individual is one of two beneficiaries of a trust with assets of \$3 million and the possibility of investing in some combination of perfectly safe assets with one percent annual returns, or risky investments that deliver either zero or four percent returns with equal probability, then one plausible investment plan is for the trustee to invest two thirds of the trust assets (\$2 million) in safe investments, thereby guaranteeing a minimum of \$20,000 annual returns for the trust, of which half (\$10,000 a year) would go to the risk-averse beneficiary.

The risk-averse beneficiary would prefer that all \$3 million of the trust assets were invested in the safe investment, thereby producing a distribution of \$15,000 a year to each beneficiary, but the other beneficiary in the example is assumed to be risk neutral, and would prefer that the trust were invested in risky assets that generate average returns of two percent a year. If \$2 million of trust assets were invested safely and \$1 million in risky assets, the trust will produce annual returns of either \$60,000 or \$20,000, depending on whether the risky investments are successful or unsuccessful, and will therefore distribute either \$30,000 or \$10,000 to each beneficiary. The expected distribution is therefore \$20,000, the same expected

²³ It is possible for individuals to be risk-loving, in the sense that they prefer a risky gamble to a certain outcome, even if the certain outcome has a lower expected value than the risky gamble. But since individuals have many market opportunities to indulge their risk-loving preferences, the usual assumption in the finance literature, adopted here, is that individuals are able to find sufficient risks on their own that they are not risk-loving with respect to additional sources of income. Consequently, the most risk-loving that someone might be with respect to trust income is that he or she is risk-neutral, meaning that they value a risky stream of distributions based only on its expected value, and not on the features of its riskiness.

annual income the risk-neutral beneficiary could have obtained with a \$1 million fund invested in the risky asset with an expected two percent rate of return. Consequently, the risk neutral beneficiary would value his or her interest in the trust fund at \$1 million, and would be willing to trade his or her beneficiary rights for that amount. The guaranteed component of the risk-averse beneficiary's distribution is \$10,000 per year, which could be obtained by investing \$1 million in safe assets. Under these circumstances the risk-averse beneficiary would therefore value his or her interest in the trust at \$1 million.

In this example the trust's investment plan lies between the risk-averse beneficiary's desired investments (entirely safe) and the risk-neutral beneficiary's desired investments (entirely risky), and the resulting allocation is valued equally by both. The investment allocation that equalizes valuations is a function of the distributions of potential investment returns and beneficiary tolerance for risk. As a general matter greater beneficiary risk aversion pushes the value-equalizing investment plan in the direction of safer investments, with extreme risk aversion, such as the case of a beneficiary who simply must have a given amount of income every year in order to afford life-saving medical treatment, having a particularly potent effect on investments by a trust even with many other beneficiaries. In the example the risk-neutral beneficiary's valuation of his or her anticipated stream of distributions declines linearly with the fraction of the trust invested in safe assets. Among broad classes of risk-averse individuals, the details of which depend on the shape of utility functions, the valuation of anticipated distributions declines more than linearly with the fraction of the trust invested in risky assets. As a result, the preferences of risk averse beneficiaries can effectively limit the extent to which trusts are invested in risky assets.

A fourth concern, one that is particularly worrisome, is that the resulting allocation is inefficient. In the example the two trust beneficiaries each value their interests in the trust at \$1 million, even though trust assets sum to \$3 million. The \$1 million difference between the aggregate value of beneficiary interests (\$2 million) and total trust assets (\$3 million) constitutes the loss in value occasioned by a trust investment plan that only imperfectly meets the income needs of beneficiaries. Value loss is intrinsic to this situation, in that there is no investment plan for the trust, as long as it is constrained to distribute investment returns equally to all beneficiaries, that achieves as valuable an outcome as the beneficiaries could obtain if they each

invested their own shares of the trust independently and each received the returns to their own investments.

5. *Separating Trust Funds*

A common investment pool used to finance distributions to beneficiaries with differing risk preferences has the potential to yield inequities, and a near-certainty to yield inefficiencies. Trustees might try to address the problems by making ad hoc adjustments, such as unsanctioned distributions to risk-averse beneficiaries in states of the world in which trust investments perform poorly, but in doing so are unlikely to remedy all the inefficiencies, and risk introducing even greater inequities, quite apart from exposing themselves to potential liability for breach of trust.

An alternative to doing nothing, or to making ad hoc adjustments, is to permit and encourage trustees to separate trust funds by beneficiary in cases in which there are significant differences in risk preferences. For example, a trust that provides income for life to a risk-averse widow, with the remainder upon her death to go to risk-neutral State College, might be separated by the trustee into two funds, most conveniently as two separate trusts, though possibly as separate funds within the same trust. Assets in each fund would correspond to actuarial values at the time of the separation, with the assets in the fund benefiting the widow invested in a variable annuity, and the assets in the fund benefiting State College invested either in a variable insurance policy on the widow's life or in assets that mature around the anticipated time of the widow's death. This division would permit each component to be invested separately, with investments corresponding to the situations of respective beneficiaries.

Trustees are currently permitted to divide trusts into two or more separate trusts, doing so under statutory authority in the Uniform Trust Code,²⁴ and under common law understanding as captured in the Restatement of Trusts (Third).²⁵ The Uniform Trust Code section 417 provides that, "After notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, if the result does not impair rights of

²⁴ Uniform Trust Code § 417.

²⁵ Restatement (Third) of Trusts § 68 (2003).

any beneficiary or adversely affect achievement of the purposes of the trust.” Section 68 of the Restatement does not require notice to beneficiaries, instead providing that “The trustee may divide a trust into two or more trusts or combine two or more trusts into a single trust, if doing so does not adversely affect the rights of any beneficiary or the accomplishment of trust purposes,” though the official commentary (§ 68(b)) offers, “The trustee’s general duty to provide information to beneficiaries on a reasonable basis (see § 82) would ordinarily mean that the trustee, before taking action under this Section, should advise appropriate beneficiaries of the contemplated action. It is not necessary that all beneficiaries be notified but, so far as practical, the information should be provided to legally competent beneficiaries who are entitled or eligible to receive distributions currently from the trust and those to whom distributions would be made if the present interest(s) of the trust were to terminate at the time of the notification. (The purpose of the notification is not to obtain consent, to suggest that beneficiaries have veto power, but to allow beneficiaries’ views to be heard, for the trustee’s information and consideration.)”

As a practical matter trusts are often divided to maximize tax advantages or to avoid the unwanted consequences of the rule against perpetuities. As noted by the official commentary to section 417 of the Uniform Trust Code, “Division of trusts is often beneficial and, in certain circumstances, almost routine. Division of trusts is frequently undertaken due to a desire to obtain maximum advantage of exemptions available under the federal generation-skipping tax. While the terms of the trusts which result from such a division are identical, the division will permit differing investment objectives to be pursued and allow for discretionary distributions to be made from one trust and not the other. Given the substantial tax benefits often involved, a failure by the trustee to pursue a division might in certain cases be a breach of fiduciary duty.” Similarly, the Reporter’s notes to § 68 of the Restatement (Third) of Trusts discuss several cases of trust division used to avoid federal taxes, and one of the use of trust division to avoid potential future liability claims against a portion of original trust assets.

The official commentary to section 417 of the Uniform Trust Code anticipates the use of trust division to facilitate efficient investing: “This section authorizes a trustee to divide a trust even if the trusts that result are dissimilar. Conflicts among beneficiaries, including differing investment objectives, often invite such a division, although as in the case with a proposed combination of trusts, the more the terms of the divided trusts diverge from the original plan, the

less likely it is that the settlor's purposes would be achieved and that the division could be approved.”

The language of section 417 of the Uniform Trust Code, this comment, and the language of section 68 of the Restatement (Third) of Trusts all reference trust purposes, noting that trusts cannot be modified in a way that undermines the accomplishment of trust purposes. This is a clear echo of the familiar *Clafin* doctrine of U.S. trust law,²⁶ which holds that trusts cannot be modified even with the consent of all beneficiaries, if the proposed modification would defeat a material trust purpose. The question on point then is whether requiring beneficiaries to receive distributions from a common set of investment returns is a material trust purpose. As the discussion in this paper illustrates, this requirement is inefficient and makes beneficiaries worse off; and doubtless many trusts are set up in boilerplate fashion without much consideration of the implications of differing risk tolerances among beneficiaries; but it could be the case that settlors deliberately intended trustees and trust beneficiaries to labor under this restriction, in which it could qualify as a material purpose.

Why might trust settlors prefer that beneficiaries share the returns to common investments? One possibility is that settlors prefer to have some classes of trust beneficiaries receive identical ex post distributions. In the example of risk-averse Son and risk-neutral Daughter sharing the trust principal on the death of their mother, their distributions when the trust terminates will be identical. If instead the trust were earlier divided, with the trust for Son's benefit invested in safe assets, and the trust for Daughter's benefit invested in risky assets, then the ultimate distributions are extremely unlikely to be identical, notwithstanding their equal value at the time of initial investment. The settlor might feel that a desired equal treatment of these two beneficiaries requires equal ex post distributions, not equal ex ante contributions to their respective investment funds. In the absence of explicit explanation it is difficult to say whether in fact a trust was created with such a keen eye to the timing of its equal treatment of beneficiaries; and there may be little presumption associated with the rather boilerplate way in which so many trusts have been established.

²⁶ *Clafin v. Clafin*, 20 N.E. 454 (Massachusetts 1889).

Another possibility is that settlors establish trusts in the way that they do in order to facilitate beneficial financial arrangements among beneficiaries. As noted earlier, the testamentary trust providing a life income estate to the surviving widow and distribution of trust assets to Son and Daughter at the death of the widow in effect provides a variable annuity to the widow and variable life insurance policies on the widow's life to Son and Daughter. Variable annuities and variable life insurance policies are of course available in private markets, but there are frequently voiced concerns that these markets may be imperfect on one or more dimensions, reflecting the impact of hidden information among buyers of these products or the absence of perfect competition among sellers. In particular, adverse selection among buyers – the greater willingness of those who know privately that they have serious health problems to buy insurance, and their unwillingness to buy annuities – is thought to make annuities and life insurance more expensive than it would be for most people in perfectly well-functioning markets. One way to view the trust for the widow, Son and Daughter is to say that all three received encumbered shares in the trust, and that the settlor required Son and Daughter to write an annuity policy for the widow, thereby avoiding any problems associated with adverse selection and imperfect competition in private markets for annuities.

A third possibility is that settlors anticipate that larger investment funds incur smaller costs of administration, tax compliance, investment advice, and other aspects of their affairs, than do smaller investment funds with the same aggregate assets. As an average statement this may be true, though its significance is surely situation-specific. But if the material purpose in question is the cost of administration, then it would be relevant to compare that cost to the cost of constraining investments benefitting diverse beneficiaries to be the same. In many realistic situations the cost of investment constraints will greatly exceed any administrative-type costs associated with dividing trust assets into smaller funds.

In this context it is worth stressing that trusts need not be divided into separate trusts in order to achieve the objectives of separating the investments that support different beneficiaries. In the case of a trust providing distributions to risk-averse Son and risk-neutral Daughter, the trust might remain intact, and the assets therefore pooled, but the trustee could maintain accounts that separated returns earned by investments intended to support Son from returns earned by investments intended to support Daughter. The consequence, as noted, will be unequal

distributions; but there are unlikely to be any additional investment fees or other external costs associated with such a division. Similarly, the trust providing income for life to the widow with the remainder at her death to Son and Daughter might base its distributions to the widow during her lifetime on the returns earned by a selected safe subset of trust investments, notwithstanding that the trust holds other risky assets. Doing so avoids any problems associated with adverse selection and imperfect competition in the market for private annuities while preserving the ability of beneficiaries to benefit from differing investment profiles.

In the absence of explicit trust language to the contrary, it is difficult to see why division of trust assets into separate funds, either formally or informally, would defeat a material trust purpose. Certainly most settlors would be delighted to improve the performance of trust investments at no cost to anyone; and many existing trusts were created during a less sophisticated financial era in which honing investment plans to maximize risk-return combinations was much more difficult and expensive. There can be considerable lags in industry practice, so even trusts created today retain features of much older trusts, including the common investment fund aspect, even as individuals are increasingly able to find financial products that are tailored to their own needs. And one of the consequences of greater financial sophistication may be that an older stark distinction between ex ante and ex post equality in financial affairs is gradually disappearing. If a parent gives \$10,000 to each of Son and Daughter, and they invest it separately, they will have different amounts in ten years – yet the modern understanding is that they have received equal treatment from the parent.

Financial markets reward taking risks by offering higher expected returns, and the difference between the expected returns to risky and safe investments can be quite significant. As a result, forcing beneficiaries to receive distributions from common investment funds that split differences between desired investment profiles can impose large costs on beneficiaries. There is an open question whether these costs are sufficiently large that it should be considered a breach of fiduciary duty for a trustee not to divide trust funds in one of the ways discussed in this paper. Certainly that is not how trust law is understood today. But one can easily imagine the introduction of facilitating language in the Uniform Trust Code that makes it easier for trustees to create separate accounts within existing trusts, and to divide trusts into new trusts for investment purposes. As awareness of the importance of these issues grows, and as industry

practice changes, at some point it becomes reasonable to expect trustees to focus on differences in beneficiary risk tolerances and take simple steps to improve the efficiency of trust investments.

6. Conclusion

Modern trust law has taken great steps to rationalize trust investment strategies while resolving conflicts between beneficiaries who receive distributions from different types of trust investments, but there is work to be done in addressing risk-related issues. It is simply inefficient to require trust beneficiaries with differing risk tolerances to share returns from a common investment fund. Fortunately, there are simple methods that can be used to address this problem, some not requiring any legislative changes, but instead just greater attention to beneficiary risk tolerances. What is perhaps most needed is a modification to standard trustee practice, abetted by understanding court interpretations, and nudged by new language and provisions in the Uniform Trust Code.

Trust assets are public goods from the standpoint of trust beneficiaries, with all the potential conflicts that can arise in settings with public goods. Trusts are not the only context in which these conflicts might arise. Private market mutual funds also have multiple stakeholders with potentially differing interests, but the reality of easy entry and exit by interested parties means that there may be little conflict among owners at any one time, since investors who are unhappy with a mutual fund's investments are free to cash out and invest in another fund. Trusts are distinguished from publicly traded corporations, mutual funds, and some other business ventures by the relative difficulty of entry and exit: trust beneficiaries cannot simply cash out. Similar inflexibility may characterize workplace pension funds and other investments with fixed sharing rules and from which stakeholders cannot easily exit. The same can even be true of individuals who save and invest in order to leave significant bequests to children and feel compelled to provide all children equal shares at the time of death. Nothing prevents an individual from establishing separate accounts for different children, investing equal initial funds in assets with differing risk characteristics, and distributing the (ex post unequal) amounts in these funds as bequests to the children at the time of death. That this is apparently not currently

a common practice does not mean that it is undesirable, or that it would not remedy inefficiencies (because it would); it mostly means that people have not been encouraged to think this way about their bequests. Settlers and trustees have also not been encouraged to take steps to avoid some of the problems that can arise when individuals with differing risk tolerances benefit from common trust funds; but fortunately there are straightforward ways in which this issue can be addressed.