The Prudent Investor Rule; Two Years of Practice

Advocis

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Outline

- History
  - Legal list approach,
  - Need for reform
  - When does the prudent investor rule apply?
- Modern Portfolio Theory
  - The Prudent Investor Rule adopts Modern Portfolio Theory
- Liability of Trustees
- Suggested Procedure for Trustees

Outline

- Investment criteria
  - Factor by factor review
  - Spouse trust example
- Delegation of Investment Authority
  - Mutual funds,
  - Segregated funds
  - Pooled funds

Outline

- Case studies
- Questions
- Canadian Bar Association
  - Wills, Estates and Trusts Section
    - Proposal for allowing RRSPs and RRIFs to be held in a spousal trust
    - Creditor proofing all RRSPs and RRIFs

Trusts

- What is a trust?
  - A trust is not a legal entity
    - Although CCRA taxes it like an entity (s.104(2))
  - A trust is a relationship
    - Between the trustees and the beneficiaries

Trusts

- Settlor:
  - Settles (establishes) the trust
    - Transfers property to the trust
      - Gold coin, money
      - Will: trust for children or spouse
    - Details the terms of the trust
      - Trust agreement
        - How the trustees manage the trust property
        - Who are the beneficiaries
        - When and under what conditions they receive the property

Trusts

- Trustee
  - Legal owner of the trust property
  - Manages the property in accordance with the terms of the trust agreement
  - Fiduciary duties owed by trustees
    - Utmost good faith
    - Cannot profit from the trust

Trusts

- Beneficiary
  - Enjoy the benefits of the trust property
    - In accordance with the terms of the trust
    - Sometimes the trustee will determine when the beneficiary is entitled to the property (discretionary trust)
    - Sometimes the beneficiary receives the property at a specified age
    - Different classes of beneficiaries
      - Life
      - remainderman

Trusts

- Who is a trustee?
  - Express trustee
  - Executor
  - Administrator of an estate
  - Trustee of an “in trust” account
  - Trustees of insurance proceeds

- All are subject to the Trustee Act and the prudent investor rule.

The Prudent Investor Rule

- The Prudent Investor Rule replaces the legal list approach
- Legal list approach:
  - Investment in authorized investments from approved list
    - Securities of the Government of Canada
    - Guaranteed investment certificates
    - Bonds or debentures of Canadian corporations that pay a regular dividend (not >35% total trust)

Legal List Approach

- Common shares:
  - that paid regular dividends during the previous 5 years
  - may not exceed 35% of the market value at that time of the whole trust estate.
- Real estate was not an authorized trustee investment
- Mutual funds, and segregated funds were not authorized investments
  - Because it was a delegation of authority

The Prudent Investor Rule

- Alberta retains the old legal list approach in limited circumstances:
  - Schedule for older trusts that defined the investment powers of the trustee by express reference to the *Trustee Act*
  - *Dependent Adults Act:*
    - Trustees appointed by the court
    - Unless the order specifies the Prudent Investor Rule
  - If the trust specifically adopts the Schedule

The Prudent Investor Rule

- The prudent investor rules applies to a trust regardless of whether the trust was created before or after the section came into force
  - Unless a contrary intention is expressed in the instrument creating the trust

The Prudent Investor Rule

- Enduring Powers of Attorney
  - Attorneys are subject to the Prudent Investor Rule
    - When “exercising a power of investment under an enduring power of attorney.”
    - Unless a contrary intention is stated in the epa
      - Attorneys are not trustees

The Prudent Investor Rule

- The death of the GIC Junky!
- Old Trustee Act
  - Legal list approach
    - "Safe investments"
    - GIC's = safe haven?

Modern Portfolio Theory

- **The Prudent Investor Rule is a legal application of Modern Portfolio Theory**

Modern Portfolio Theory

- Modern Portfolio Theory is an area of expertise
  - Trustees should seek expert advice
  - The courts may require expert witnesses to assist in assessing the loss
- History
  - Harry Markowitz, 1952

The Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel 1990

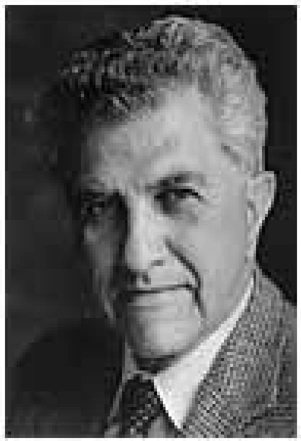
"for their pioneering work in the theory of financial economics"

Harry M. Markowitz

USA

City University of New York
New York, NY, USA

1927 -



Merton H. Miller

USA

University of Chicago
Chicago, IL, USA

1923 - 2000

William F. Sharpe

USA

Stanford University
Stanford, CA, USA

1934 -

www.nobel.se/economics/laureates/1990/

Modern Portfolio Theory

- Don’t put all your eggs in one basket
  - Diversification
- The **risk/return relationship** is the key
  - A trustee must invest trust funds with a view to obtaining a **reasonable return** while **avoiding undue risk**, having regard to the circumstances of the trust.

Modern Portfolio Theory

- The goal of the prudent investor is not simply to *minimize* risk; it is to *optimize* the risk-expected return relationship.
  - Having determined a **target rate of return**, the objective is to choose a portfolio that **minimizes risk while achieving that expected return**.
  - Conversely, having determined an acceptable level of risk, the objective is to select a portfolio with the highest expected return consistent with the accepted level of risk.

Modern Portfolio Theory

- Risk is judged on a portfolio-wide basis, rather than an asset-by-asset basis.
  - Investing a portion of the trust funds in highly volatile assets could be part of a prudent investment strategy.
    - adding a volatile (risky) asset to a portfolio might actually decrease the overall volatility (riskiness) of the portfolio

Modern Portfolio Theory

- The key to effective risk management is **diversification**, and the key to effective diversification is selecting assets whose expected returns are **negatively correlated**, **uncorrelated**, or at least only **weakly correlated** with each other.

Modern Portfolio Theory

- Trustees should evaluate the expected return and risk associated with investment strategies or decisions within the context of the **overall trust portfolio**, rather than by focussing on particular investments in isolation.

Modern Portfolio Theory

- A court assessing the damages payable by a trustee for a loss to the trust arising from the investment of trust funds may take into account the **overall performance of the investments**.
  - Anti-netting rule: The trustee is prohibited from netting gains against losses even though the whole of the trust investments gained in value.

Liability of Trustees

- 4(1) A trustee is not liable for a loss in connection with the investment of trust funds that arises from a decision or course of action that a trustee exercising reasonable skill and prudence and **complying with section 3** could reasonably have made or adopted.

Liability of Trustees

- If there is a loss:
  - A court assessing the damages payable by a trustee for a loss to the trust arising from the investment of trust funds may take into account the **overall performance of the investments**.
  - Abrogates the anti-netting rule

Liability of Trustees

- **3(5)** Without restricting the matters that a trustee may consider, **in planning the investment of trust funds** a trustee must consider the following matters, insofar as they are relevant to the circumstances of the trust:

Matters to Consider

- 3(5)(a) the purposes and probable duration of the trust, the total value of the trust's assets and the needs and circumstances of the beneficiaries;
- 3(5)(b) the duty to act impartially towards beneficiaries and between different classes of beneficiaries;

Matters to Consider

- 3(5)(c) the special relationship or value of an asset to the purpose of the trust or to one or more of the beneficiaries;

- 3(5)(d) the need to maintain the real value of the capital or income of the trust;

Matters to Consider

- 3(5)(e) the need to maintain a balance that is appropriate to the circumstances of the trust between
  - risk,
  - expected total return from income and the appreciation of capital,
  - liquidity, and
  - regularity of income;

Matters to Consider

- 3(5)(f) the importance of diversifying the investments to an extent that is appropriate to the circumstances of the trust;
- 3(5)(g) the role of different investments or courses of action in the trust portfolio;

Matters to Consider

- 3(5)(h) the costs, such as commissions and fees, of investment decisions or strategies;

- 3(5)(i) the expected tax consequences of investment decisions or strategies.

The Role of the Financial Planner

- Two major stages in the investment of trust assets:
  - Planning the investment of trust assets.
  - Implementing the investment plan by purchasing the investments.

The Role of the Financial Planner

- The planning stage
  - Determine the trust's objectives and develop an asset mix appropriate to the needs of the trust and its beneficiaries.
  - Examine the risk/return relationship that is most appropriate to the trust and the beneficiaries.

Suggested Procedure for Trustees

- The trustee should seek legal advice concerning the proper interpretation of the trust instrument and how the interpretation impacts on the factors in section 3(5).

- The trustee should choose a competent investment advisor.
  - Role of the financial planner

Suggested Procedure for Trustees

- The trustee and investment advisor/financial planner should develop an investment plan with the investment advisor having regard to the criteria
  - Review each of the criteria in detail
  - Ensure that it is consistent with the terms and relevant to the circumstances of the trust and the beneficiaries

Suggested Procedure for Trustees

- The advisor should outline the investment plan in writing.
- Take notes on the development of the investment plan and be prepared to justify decisions.
- Review the plan with legal counsel

Suggested Procedure for Trustees

- The trustee should monitor the performance of the advisor on a regular basis.
  - Volatile times require more frequent reviews.
  - The review should be documented.

Suggested Procedure for Trustees

- The administration of the trust should be reviewed with the trustee's lawyer and when in doubt, the trustee should seek legal advice.
  - In some cases, the trustee may wish to seek the advice and direction of the court.

Case Study

- Jane: age 65 (widowed)
  - Second marriage: Bill, age 58
  - Two children from her first marriage

Case Study

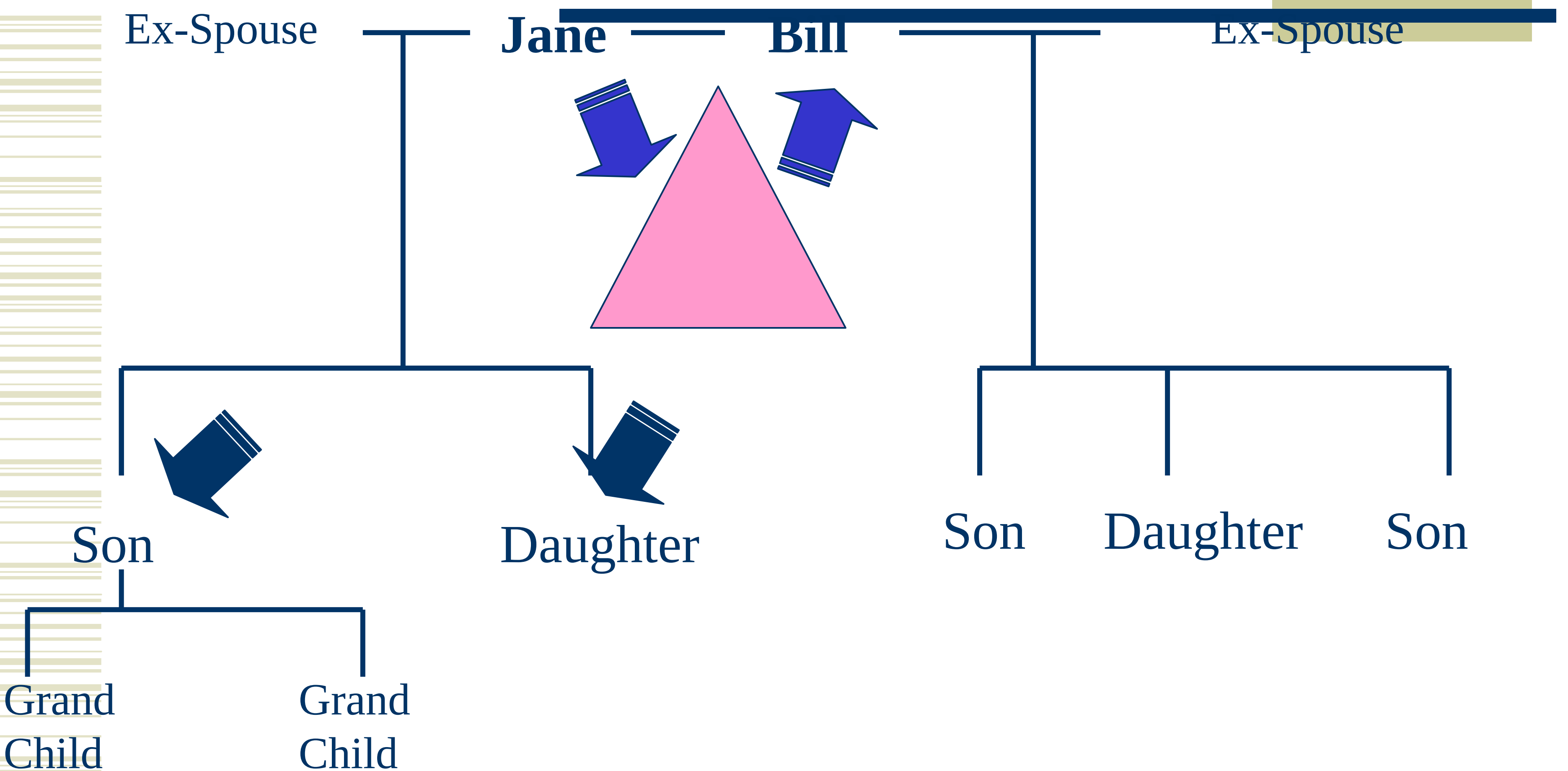
- Jane: estate value: $1,250,000
  - House: $250,000
  - Investments: $1,000,000

- Bill: assets: $250,000
  - Income: $45,000 per year
  - no pension, small RRSP

Case Study

- Jane’s goals:
  - Support for Bill for life
  - Preserve estate for her children
- Solution:
  - Spousal Trust for investments
  - Trust of house; power to buy replacement

Second Marriage
Spousal Trust



Matters to Consider

- (a) the purposes and probable duration of the trust, the total value of the trust’s assets and the needs and circumstances of the beneficiaries;
  - Income for life
    - Less for Bill’s working life;
    - More on retirement
    - Encroach on capital for special needs

Matters to Consider

- (b) the duty to act impartially towards beneficiaries and between different classes of beneficiaries;
  - Rule of common law: **even hand rule**
  - Spousal trust
    - Income for life of spouse
    - Preserve and grow capital for children
    - Maintain an even hand between the two classes of beneficiaries

Matters to Consider

- (c) the special relationship or value of an asset to the purpose of the trust or to one or more of the beneficiaries;
  - Jane’s house (better to have a specific trust for this)
  - The lake cottage?
  - The family business?
  - The family farm????

  - Is this sufficient to protect the trustee?

Matters to Consider

- (d) the need to maintain the real value of the capital or income of the trust;
  - Depends on the terms of the trust
  - Keep up with inflation
    - Capital growth

Matters to Consider

- (e) the need to maintain a balance that is appropriate to the circumstances of the trust between
  - risk,
  - expected total return from income and the appreciation of capital,
  - liquidity, and
  - regularity of income;

Matters to Consider

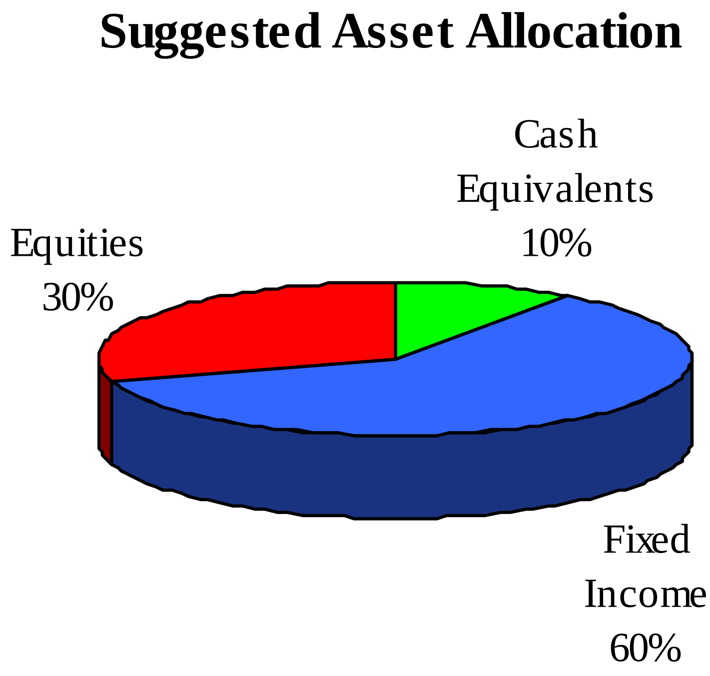
- (f) the importance of diversifying the investments to an extent that is appropriate to the circumstances of the trust;

- (g) the role of different investments or courses of action in the trust portfolio;

Matters to Consider

- (h) the costs, such as commissions and fees, of investment decisions or strategies;
  - Mutual fund MER's?
- (i) the expected tax consequences of investment decisions or strategies.

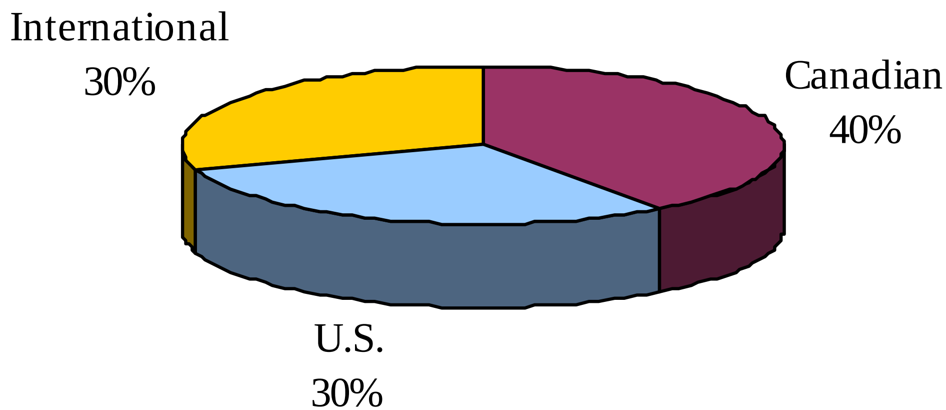
Asset Allocation



- Assume spouse’s $250,000 will be invested in the same manner

Asset Allocation: Equities

Suggested Equity Allocation for Capital



Delegation

- At common law, a trustee could not delegate investment decisions
  - Therefore can’t invest in mutual funds
- Prudent Investor Rule:
  - A trustee may delegate to an agent the degree of authority with respect to the investment of trust funds that a prudent investor might delegate in accordance with ordinary investment practice.

Delegation

- Must exercise prudence in
  - selecting the agent,
  - establishing the terms of the delegated authority, and
  - **monitoring** the performance of the agent to ensure compliance with the terms of the delegation.
- How do you monitor the performance of a mutual fund manager?

Delegation

- Therefore:
  - Investment in a **mutual fund** or **segregated fund** or in a similar investment set out in the regulations **is not a delegation** of investment authority with respect to the investment of trust funds.

Estate Planning

- Review old wills and powers of attorney
- Use of the Traditional Investment Power
  - To invest, and from time to time reinvest assets of my estate in securities and investments inside or outside Canada, **without being limited to those investments to which trustees are otherwise restricted by law.**

Estate Planning

- Adopt the Prudent Investor Rule but Make Exceptions for Specific Assets
- i.e. Allow retention or investments in assets that may not meet the criteria of the rule
  - Farm estates
  - Family owned businesses
  - Unusual assets
    - Real estate developments
    - Recreational properties

Case Study: Trust for Minor Child

- Mary: age 2
  - Parents tragically killed in a car accident and left an estate of $50,000 in trust for Mary to age 25
    - Will: Trustees have discretion to pay income or capital as they consider advisable for her maintenance, education, benefit or advancement
    - Pay the remaining capital, when she attains age 25

Investment Objectives: $50,000 Trust for Minor Child

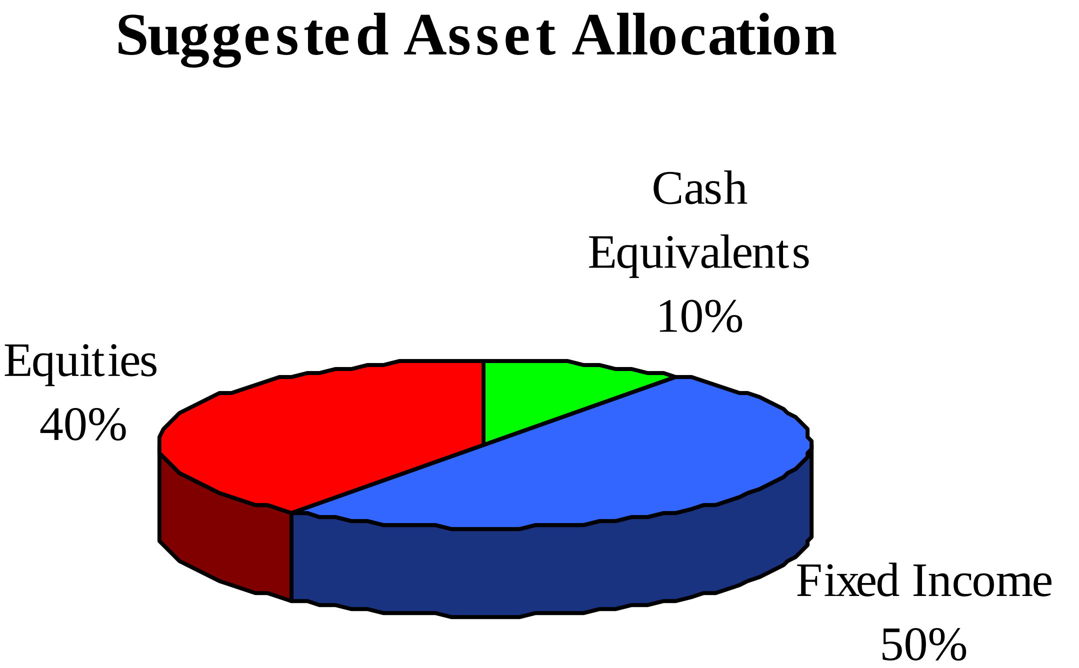
- Generate income for maintenance, education, and benefit or advancement of child
- Growth of capital to ensure capital provides for Mary over the long term

Investment Plan Risk Assessment

Income and Growth Profile

- Income generation is primary objective, growth is the secondary focus
  - Not a large enough trust

Asset Allocation



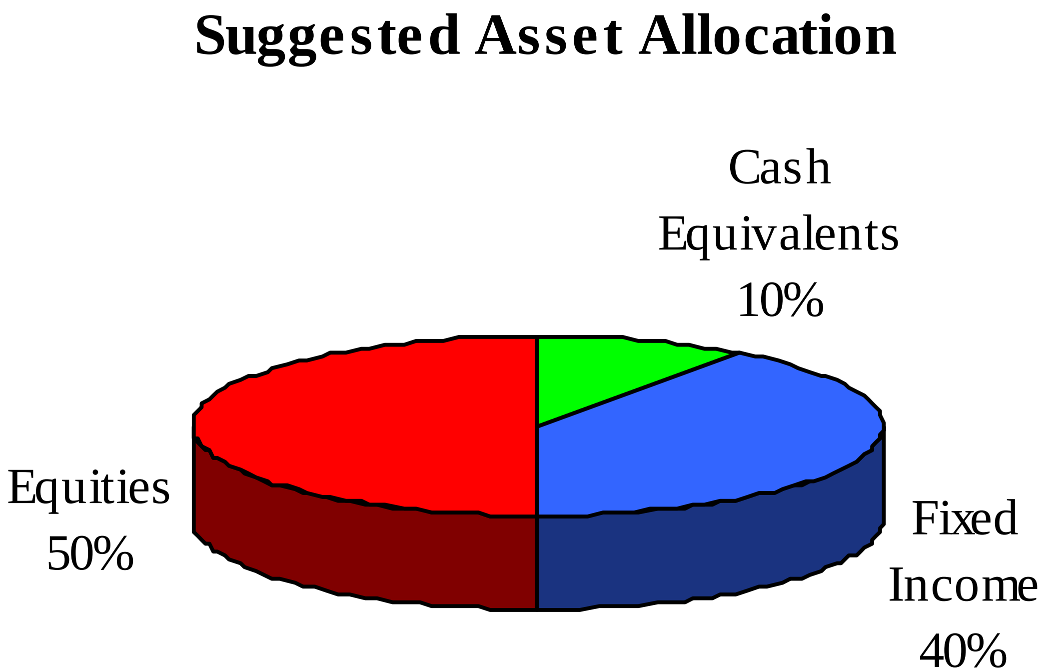
Case Study 2: Trust for Minor Child

- Mary: age 2
- Same scenario but the trust has a value of **$500,000**

Investment Objectives: $500,000 Trust for Minor Child

- Generate income for maintenance, education, and benefit or advancement of child
- Growth of capital to provide for Mary’s benefit over the long term

Asset Allocation



Conclusion

- The prudent investor rule is a good thing
  - But planning is required to exclude the rule when appropriate
  - Cooperation amongst all professionals

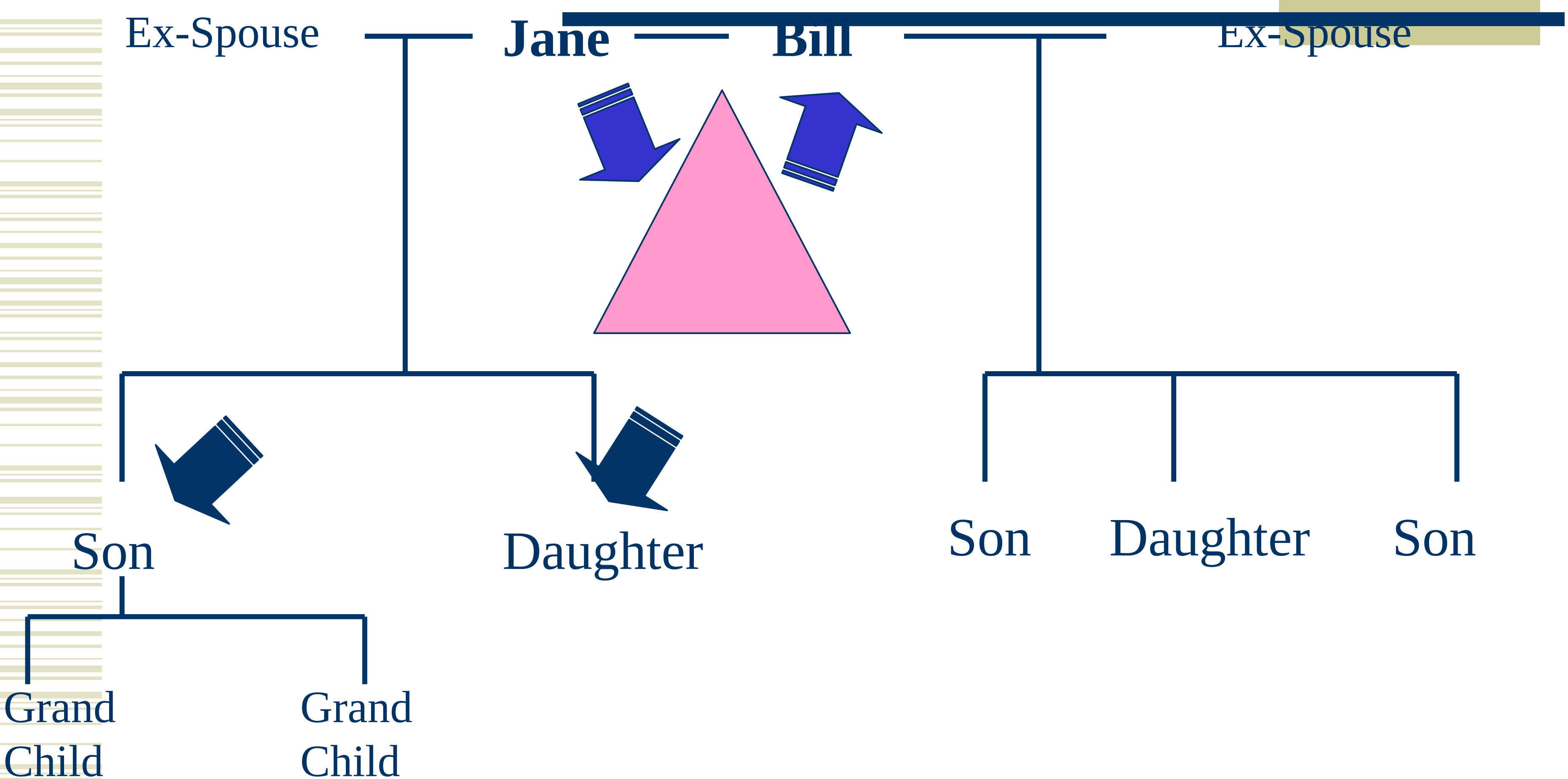
Questions

- ???????

Canadian Bar Association

- Proposal to allow RRSPs and RRIFs to form part of a spousal trust
- Currently, an RRSP must be vested absolutely in the name of the spouse to obtain a rollover
- Problems in second marriages
  - The surviving spouse keeps the entire RRSP

Second Marriage
Spousal Trust



Canadian Bar Association

- Creditor Proofing all RRSPs and RRIFs
- Study by the Alberta Law Reform Institute
  - RRSPs, RRIFs, LIRAs, LIFs and LRIFs should be exempt from claims of creditors
  - On death the plans should remain exempt where the spouse, common-law partner, financially dependent child or grandchild is designated beneficiary
    - Does not form part of the estate

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