

# The Florida Prudent Investor Rule: What Every Judge Should Know and Ask

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## Executive Summary

- ✓ The vast majority of individual fiduciaries will not possess the knowledge and skill to comply with the Prudent Investor Rule (the “Rule”). Sadly, most “financial consultants” also lack such skills. This paper provides a framework for judges to evaluate investment plans submitted to them by fiduciaries.
- ✓ The Rule is embodied in state law and requires fiduciaries to undertake an ongoing investment process which is more complex and sophisticated than that required under earlier law. Applying Modern Portfolio Theory, the Rule emphasizes the portfolio as a whole and the interplay between risk and reward. We examine in this white paper the critical fiduciary duties of: (1) formulation of an investment policy; (2) diversification; and (3) cost control.
- ✓ A fiduciary may delegate investment functions to a financial consultant. However, financial consultants utilized by a fiduciary should possess the demonstrated education, skill and experience to assist the fiduciary in the design and implementation of a written Investment Policy Statement which is in accord with the Rule. Furthermore, determining the method of compensation to the financial consultant, and the total fees and costs paid relating to the investments recommended, is an appropriate inquiry given the duty of fiduciaries to keep costs and fees reasonable under the Rule.
- ✓ Given the high costs of active management, and lack of academic evidence suggesting any added value, the utilization of “passively managed” mutual funds is appropriate. Arguably, the utilization of a “passive” investment methodology may be mandated under the rule, given the high costs of active management and lack of academic evidence demonstrating its value.
- ✓ Exhibits with this white paper include:
  - Ex. 1 A questionnaire is suggested for judges to submit to fiduciaries and consultants.
  - Ex. 2 For individual fiduciaries, a series of questions regarding investments is suggested.
  - Ex. 3 A sample Investment Policy Statement (IPS) for a fiduciary is provided.
  - Ex. 4 Suggested language is set forth for a court order approving an IPS.
  - Ex. 5 The Uniform Prudent Investor Act (1994) with commentary is attached.
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- Exhibit 1: Questionnaire To Fiduciaries. A suggested questionnaire to fiduciaries and their investment advisors is provided for potential use by the Florida jurist.
- Exhibit 2: Suggested Test Questions For An Individual Fiduciary
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- Exhibit 5: Uniform Prudent Investment Act (UPIA), text and commentary.
- Exhibit 6: Suggested Reading List

**About The Author.** Ron A. Rhoades is a 1985 honors graduate of the University of Florida College of Law and currently practices law in the fields of estate planning and taxation. He was formerly a consultant to a global financial services firm, assisting in the development of programs to teach investment consultants as to tax and retirement planning issues. In 2001 he joined with several certified public accountants to form Joseph Capital Management, LLC, a registered investment advisory firm serving individual investors and fiduciaries, where he serves as its Director of Research and Chief Compliance Officer. He is the co-author of the 2003 book, *The Science of Investing: How To Use Academic Research to Reduce Risks and Increase Investment Returns*, the 1995 book *Estate Planning for the Florida Resident: Questions and Answers*, and numerous articles on estate, retirement, financial, tax and investment planning.

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**A. Introduction.** In recent years scandal after scandal has rocked the financial services industry, from stock analyst conflicts of interest to “hidden” compensation paid to stock brokerage firms and stockbrokers to mutual fund market timing and late trading scandals. Despite recent and ongoing reforms, the financial services industry remains one in which conflicts of interest and marketing hype abound. In contrast, over the last 15 years a growing body of academic research relating to investment theory has poured forth from university professors. Utilizing statistical analysis and huge databases of financial information, these academics have revealed those very few investment strategies that work to provide long-term, consistent results. This academic research is spreading (albeit slowly) through the investment advisory community.

It is in this background of both the recent scandals rocking the financial services industry and the new truths revealed by academic research that this paper seeks to provide Florida jurists with a suggested manner in which to evaluate investment proposals submitted for judicial approval. This paper focuses on the application of the Florida version of the prudent investor rule (hereafter the “Rule”), embodied in Section 518.11, *Florida Statutes* (2003), to fiduciaries and their investment advisors. However, the principles set forth in this paper could apply to any investment plan subject to the Rule in any state, and could also be followed by individual investors not subject to the Rule.

**B. Overview of Investment Strategies To Embrace; Mistakes To Avoid.** Investors of all types, whether individual investors, non-profit corporations, trustees, guardians, or other fiduciaries, can and should act with reasonable care in the management of investment portfolios. Prudent investing employs appropriate strategies and avoids costly mistakes. As discussed in our text, *The Science of Investing: How To Use Academic Research to Reduce Risks and Increase Investment Returns* (Joseph Financial Publications, 2003), there are eight strategies that can assist any investor in reaching their financial goals and eight mistakes that can detract from an investor’s achievement of long-term financial success.

<b>Eight Strategies That Will Aid You In Achieving Your Long Term Goals</b>	
Invest Part of Your Portfolio In Stocks To Counter The Risks Posed By Inflation	Pay Attention To Bond Credit Quality
Invest Part of Your Portfolio In Value Stocks To Enhance Returns	Keep Bond Maturities At Reasonable Levels
Invest Part of Your Portfolio In Small Company Stocks To Enhance Returns	Create and Adhere To An Investment Policy
Invest Part of Your Portfolio In International Stocks To Reduce Volatility	Rebalance Your Portfolio Periodically Or Upon Significant Change

### **Eight Potential Mistakes - Any One of Which Can Defeat Your Chances For Success**

Failure To Diversify Among Individual Securities	Paying Too Much In Hidden Transaction and Opportunity Costs
Failure To Diversify Among Asset Classes	Losing Too Much to Taxes
Mistaking Past Investment Management Success For Skill	Lack of Emotional Fortitude; Failure To Adhere to An Investment Discipline
Paying Too Much In Disclosed Fees and Costs	Not Planning For Inflation

Any one failure to employ the strategies set forth above, or to avoid the common mistakes set forth above, could substantially reduce the net returns of an investment portfolio. As stated in the preface to our book:

For many years we have served as counselors and advisors to a large number of clients - retirees, executives, small business owners, entrepreneurs, and working families. Far too often new clients come to see us who have endured repeated and significant losses in their overall investment portfolios based upon "professional advice" from their stockbroker or other "investment counselor." While to some degree occasional portfolio losses will occur, many investors reported portfolio declines of 40%, 50%, 60% and even more from early 2000 through early 2003. Such extreme volatility in portfolios should not be acceptable. We were driven to write this book to aid individual investors to understand how Wall Street really works, to educate investors on how to avoid the many traps which might arise in the investment process, and to demonstrate how to achieve long-term investment success while keeping risk to reasonable levels.

In our view traditional Wall Street firms have utterly failed the individual investor. "Wall Street" in its traditional form is an archaic system which includes:

- A compensation system based upon commissions, 12b-1 fees, and the sale of "proprietary" (i.e., "in-house") products, leading to inevitable conflicts of interest for the registered representative (stockbroker / salesperson);
- Completely inadequate training of the vast majority of investment advisors in strategic asset allocation concepts, taxation, and financial and estate planning;
- High fees and costs relating to the vast majority of investments and products; and
- Misleading marketing which promises that a firm out there has some "crystal ball" - some unique insight into the markets from which investors might profit - when in fact there is no credible evidence that suggests that such forecasting of the markets or individual security prices works consistently over the long term.

By contrast, thanks in part to the continued development of databases and computers, in the past twelve years dramatic progress has been made in academic circles. New research has confirmed the failures of traditional Wall Street and "active portfolio management" and at the same time has illuminated those few strategies which can succeed. As a result, investors can now:

- Access an enormous body of historical evidence on the performance of stocks, bonds, mutual funds, and other investments;
- Obtain a common sense understanding of the inevitable relationship between risk and return in our capital markets;

- Develop a deeper understanding of the absolute need to keep costs and taxes to a minimum;
- Avoid the inherent conflicts of interest and high costs posed by commissions, 12b-1 fees, contingent deferred sales charges, and proprietary mutual funds;
- Either alone or with the aid of an objective, trusted advisor, access to some of the finest, lowest-cost investment products available today.

This white paper seeks to apply a few of the concepts expressed in our longer text in the context of the application of the Rule to fiduciaries. This white paper is not intended as a legal brief on the prior application by courts to the actions of fiduciaries. Rather, we seek to provide jurists with an overview of modern financial theory as expressed in the Rule and an understanding of the different types of “financial consultants” to fiduciaries who may appear before them. We further suggest practical ways in which jurists can hold fiduciaries to the high standards of the Rule.

**C. The Application of The Prudent Investor Rule To Florida Fiduciaries.** The current version of the “prudent investor rule” was modified and set forth in the Uniform Prudent Investor Act (“UPIA”), which was approved by the National Conference of Commissions on State Laws in 1994)<sup>1</sup>. Now enacted in many states, the UPIA requires trustees, executors and many other types of fiduciaries bound by the law to act “prudently.” Florida’s current version of the Rule contains several departures from the language of the UPIA and is found in Sections 518.10 to 518.14, *Florida Statutes* (2003).<sup>2</sup>

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<sup>1</sup> A copy of the UPIA, with commentary, is attached to this white paper as Exhibit 5.

<sup>2</sup> Section 518.11, *Florida Statutes* (2003): Investments by fiduciaries; prudent investor rule.--

(1) A fiduciary has a duty to invest and manage investment assets as follows:

(a) The fiduciary has a duty to invest and manage investment assets as a prudent investor would considering the purposes, terms, distribution requirements, and other circumstances of the trust. This standard requires the exercise of reasonable care and caution and is to be applied to investments not in isolation, but in the context of the investment portfolio as a whole and as a part of an overall investment strategy that should incorporate risk and return objectives reasonably suitable to the trust, guardianship, or probate estate. If the fiduciary has special skills, or is named fiduciary on the basis of representations of special skills or expertise, the fiduciary is under a duty to use those skills.

(b) No specific investment or course of action is, taken alone, prudent or imprudent. The fiduciary may invest in every kind of property and type of investment, subject to this section. The fiduciary’s investment decisions and actions are to be judged in terms of the fiduciary’s reasonable business judgment regarding the anticipated effect on the investment portfolio as a whole under the facts and circumstances prevailing at the time of the decision or action. The prudent investor rule is a test of conduct and not of resulting performance.

(c) The fiduciary has a duty to diversify the investments unless, under the circumstances, the fiduciary believes reasonably it is in the interests of the beneficiaries and furthers the purposes of the trust, guardianship, or estate not to diversify.

(d) The fiduciary has a duty, within a reasonable time after acceptance of the trust, estate, or guardianship, to review the investment portfolio and to make and implement decisions concerning the retention and disposition of original preexisting investments in order to conform to the provisions of this section. The fiduciary’s decision to retain or dispose of an asset may be influenced properly by the asset’s special relationship or value to the purposes of the trust, estate, or guardianship, or to some or all of the beneficiaries, consistent with the trustee’s duty of impartiality, or to the ward.

(e) The fiduciary has a duty to pursue an investment strategy that considers both the reasonable production of income and safety of capital, consistent with the fiduciary’s duty of impartiality and the purposes of the trust, estate, or

A Florida guardian is held to the “prudent investor” standard by virtue of Section 744.361, *Florida Statutes* (2003).<sup>3</sup> A trustee of a trust to which Florida law applies is held to the “prudent investor” standard by virtue of Section 737.302, *Florida Statutes* (2003).<sup>4</sup> A personal representative of a Florida estate proceeding is held to the “prudent investor” standard by virtue of Section 737.302, *Florida Statutes* (2003).<sup>5</sup> A Florida conservator is held to the “prudent investor” standard by virtue of Section 747.035, *Florida Statutes* (2003).<sup>6</sup> An attorney-in-fact acting under a Florida durable power of attorney is held to

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guardianship. Whether investments are underproductive or overproductive of income shall be judged by the portfolio as a whole and not as to any particular asset.

(f) The circumstances that the fiduciary may consider in making investment decisions include, without limitation, the general economic conditions, the possible effect of inflation, the expected tax consequences of investment decisions or strategies, the role each investment or course of action plays within the overall portfolio, the expected total return, including both income yield and appreciation of capital, and the duty to incur only reasonable and appropriate costs. The fiduciary may, but need not, consider related trusts, estates, and guardianships, and the income available from other sources to, and the assets of, beneficiaries when making investment decisions.

(2) The provisions of this section may be expanded, restricted, eliminated, or otherwise altered by express provisions of the governing instrument, whether the instrument was executed before or after the effective date of this section. An express provision need not refer specifically to this statute. The fiduciary is not liable to any person for the fiduciary's reasonable reliance on those express provisions.

(3) Nothing in this section abrogates or restricts the power of an appropriate court in proper cases:

(a) To direct or permit the trustee to deviate from the terms of the governing instrument; or

(b) To direct or permit the fiduciary to take, or to restrain the fiduciary from taking, any action regarding the making or retention of investments.

(4) The following terms or comparable language in the investment powers and related provisions of a governing instrument shall be construed as authorizing any investment or strategy permitted under this section: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

(5) This section applies to all existing and future fiduciary relationships subject to this section, but only as to acts or omissions occurring after October 1, 1993.

<sup>3</sup> Section 744.361, *Florida Statutes* (2003): Powers and duties of guardian.--

(6) A guardian who is given authority over any property of the ward shall:

(a) Protect and preserve the property and invest it prudently as defined in s. 737.302, apply it as provided in s. 744.397, and account for it faithfully.

(7) The guardian shall observe the standards in dealing with the guardianship property that would be observed by a prudent person dealing with the property of another, and, if the guardian has special skills or is named guardian on the basis of representations of special skills or expertise, he or she is under a duty to use those skills.

<sup>4</sup> 737.302 Trustee's standard of care and performance.--Except as otherwise provided by the trust instrument, the trustee shall observe the standards in s. 518.11 regarding investments by fiduciaries when dealing with the trust assets. If the trustee has special skills, or is named trustee on the basis of representations of special skills or expertise, the trustee is under a duty to use those skills.

<sup>5</sup> 733.602 General duties.--

(1) A personal representative is a fiduciary who shall observe the standards of care applicable to trustees as described by s. 737.302.

<sup>6</sup> Section 747.035, *Florida Statutes* (2003): Rights, powers, and duties of conservator.--

(1) The conservator shall have all the rights, powers, and duties of a guardian of the property as established in chapter 744 ...

the “prudent investor” standard by virtue of Section 709.08(8), *Florida Statutes* (2003).<sup>7</sup> Registered investment advisors acting under a written agreement with the client which provides that the advisor will provide management of the client’s portfolio, may also constitute “fiduciaries” under Florida law by virtue of Section 518.10, *Florida Statutes* (2003).<sup>8</sup> Other organizations, institutions and public bodies are also subject to the prudent investor rule, either in its original form or as modified.<sup>9</sup>

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<sup>7</sup> Section 709.08, *Florida Statutes* (2003): Durable power of attorney.--  
(8) Standard of Care.--Except as otherwise provided in paragraph (4)(e), an attorney in fact is a fiduciary who must observe the standards of care applicable to trustees as described in s. 737.302.

<sup>8</sup> Section 518.10, *Florida Statutes* (2003): Fiduciary defined as used in ss. 518.11-518.14.--For the purpose of ss. 518.11-518.14, a "fiduciary" is defined as an executor, administrator, trustee, guardian (except any guardian holding funds received from or currently in receipt of funds from the United States Department of Veterans Affairs, to the extent of those funds alone), or other person, whether individual or corporate, who by reason of a written agreement, will, court order, or other instrument has the responsibility for the acquisition, investment, reinvestment, exchange, retention, sale, or management of money or property of another. [Emphasis added.]

<sup>9</sup> Timeshare trust funds: Section 721.13(2)(b), *Florida Statutes* (2003): “The managing entity shall invest the operating and reserve funds of the timeshare plan in accordance with s. 518.11(1); however, the managing entity shall give safety of capital greater weight than production of income.”

The “prudent investor rule” is adopted, in modified form, by other statutes, including:

- Section 1010.10, *Florida Statutes* (2003), “Florida Uniform Management of Institutional Funds Act;”
- Section 660.431, *Florida Statutes* (2003), relating to bank investment of “common trust funds;”
- Section 710.114, *Florida Statutes* (2003), relating to custodians (Uniform Transfers to Minors Act);
- Section 218.415, *Florida Statutes* (2003), “Local Government Investment Policies”;

Other state and federal statutes, such as ERISA, apply to investments in qualified retirement plans and impose similar standards for adherence to the “prudent investor rule”, including qualified pension plans, 401(k) plans, etc. For example, *see* Section 215.47(9), relating to investments by the Florida State Board of Administration (which manages as of 12/31/03 \$120 billion in 25 separate funds), and following a detailed recital of authorized investments and certain restrictions, stating: “The board in performing the above investment duties shall comply with the fiduciary standards set forth in the Employee Retirement Income Security Act of 1974 at 29 U.S.C. s. 1104(a)(1)(A) through (C). In case of conflict with other provisions of law authorizing investments, the investment and fiduciary standards set forth in this subsection shall prevail.” *Also see* Section 121.4501(15)(a), *Florida Statutes* (2003), relating to the Public Employee Optional Retirement Program,” stating in pertinent part, “Investment of optional defined contribution retirement plan assets shall be made for the sole interest and exclusive purpose of providing benefits to plan participants and beneficiaries and defraying reasonable expenses of administering the plan. The program’s assets are to be invested, on behalf of the program participants, with the care, skill, and diligence that a prudent person acting in a like manner would undertake. The performance of the investment duties set forth in this paragraph shall comply with the fiduciary standards set forth in the Employee Retirement Income Security Act of 1974 at 29 U.S.C. s. 1104(a)(1)(A)-(C).”

***D. Modification Or Non-Application of the Prudent Investor Standard.*** It is possible for the Rule to not be applicable to the situation at hand, or to be modified. Examples include:

- ▶ The terms of the governing instrument may modify or eliminate the application of the Rule. Section 518.11(2), *Florida Statutes*(2003).<sup>10</sup> See also Section 732.302, *Florida Statutes*(2003) (“Except as otherwise provided by the trust instrument ...”). See also Section 709.08(8), *Florida Statutes*(2003) (“The attorney in fact is not liable to third parties for any act pursuant to the durable power of attorney if the act was authorized at the time.”) A provision waiving the applicability of the Rule need not refer specifically to the statute. Section 518.11(2), *Florida Statutes* (2003).
- ▶ The terms of a court order may permit deviation from the Rule. See 518.11(3), *Florida Statutes* (2003).<sup>11</sup> See also Section 518.13, *Florida Statutes* (2003).<sup>12</sup>

Modification of the Rule may be strongly desired if certain assets are likely to be subjected to the control of a fiduciary, such as closely-held business interests or substantial real estate interests. In addition, the creator of a trust or a testator may not desire the diversification required by the Rule, and may prefer a “safer” mix of certificates of deposit, tax-free bonds, or other similar investments. Unfortunately, numerous situations arise in which such assets come into the hands of a fiduciary without any modification of the Rule’s standard.

For example, it may also be desirable to make the application of the Rule inapplicable to Florida personal representatives under the terms of a will, at least where the estate administration is expected to be completed within a few months or years, even where there are not unique assets. The Rule appears to

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<sup>10</sup> 518.11 Investments by fiduciaries; prudent investor rule ...

(2) The provisions of this section may be expanded, restricted, eliminated, or otherwise altered by express provisions of the governing instrument, whether the instrument was executed before or after the effective date of this section. An express provision need not refer specifically to this statute. The fiduciary is not liable to any person for the fiduciary’s reasonable reliance on those express provisions.

<sup>11</sup> Section 518.11, *Florida Statutes* (2003): Investments by fiduciaries; prudent investor rule ...

(3) Nothing in this section abrogates or restricts the power of an appropriate court in proper cases:

(a) To direct or permit the trustee to deviate from the terms of the governing instrument; or

(b) To direct or permit the fiduciary to take, or to restrain the fiduciary from taking, any action regarding the making or retention of investments.

<sup>12</sup> Section 518.13, *Florida Statutes* (2003): Authority of court to permit deviation from terms of instrument creating trust not affected.– Nothing contained in ss. 518.10-518.14 shall be construed as restricting the power of a court of proper jurisdiction to permit a fiduciary to deviate from the terms of any will, agreement, or other instrument relating to the acquisition, investment, reinvestment, exchange, retention, sale, or management of fiduciary property.

require a personal representative to adopt an investment strategy. However, as many investment advisors point out, investment strategies involving stocks and other volatile investments often take many years to see positive results, and the short-term duration of an estate proceeding may dictate a short-term investment strategy involving mostly liquid investments which are not susceptible to substantial price volatility. In the author's estate administration law practice the author frequently advises personal representatives of Florida estate to liquidate all investments which are subject to diminution in value (such as stocks, stock mutual funds, bond funds, and long-term bonds), under the observation that personal representatives will always be blamed if the "market" goes down in the short term but rarely if ever get credit if the "market" goes up.<sup>13</sup> As an alternative, personal representatives are also advised by this author to promptly consult with beneficiaries (trustees of long-term trusts, or individual beneficiaries) should a longer-term investment strategy be desired, which strategy would take into account not just the time horizon to the completion of the estate administration proceedings but also the investment time horizon of the beneficiary.<sup>14</sup> In such instances, the beneficiaries' written approval of the strategy would be appropriate. As seen later in this white paper, it is often advisable for either the beneficiaries of the estate or the personal representative to engage an investment consultant and to have a written investment policy statement prepared in order to properly formulate, adopt and document the long-term investment strategy and protect the personal representative from potential claims for non-adherence to the Rule. At a minimum the beneficiaries and the personal representative should sign the written investment plan. Also, in many instances the release of the personal representative from any liability which might arise due to short-term market fluctuations would appear to be appropriate

***E. The Rule's Application of "Modern Portfolio Theory."*** The Rule, as expressed in the Uniform Prudent Investor Act [National Conference of Commissioners on Uniform State Laws (1994)] sets forth the core duty of a fiduciary to act pursuant to Modern Portfolio Theory:

"A trustee shall invest and manage trust assets as a prudent investor would ... the trustee shall utilize reasonable care, skill and caution ... A trustee's investment and management decisions respecting individual

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<sup>13</sup> Section 733.612, *Florida Statutes* (2003): Transactions authorized for the personal representative; exceptions.-- Except as otherwise provided by the will or court order, and subject to the priorities stated in s. 733.805, without court order, a personal representative, acting reasonably for the benefit of the interested persons, may properly: (1) Retain assets owned by the decedent, pending distribution or liquidation, including those in which the personal representative is personally interested or that are otherwise improper for fiduciary investments ... (4) Invest funds as provided in ss. 518.10-518.14, considering the amount to be invested, liquidity needs of the estate, and the time until distribution will be made.

<sup>14</sup> Problems may arise, however, when there are multiple beneficiaries who are not in agreement with a long-term investment strategy.

assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably related to the trust.”

Florida’s version of the Rule closely tracks the language of the UPIA as set forth above. Note that the job of a fiduciary is not to *minimize all risk*. Rather, it is first to determine the target rate of return for the investment portfolio as a whole, and then to *optimize risk* for the entire investment portfolio given that target. Risk is not judged for each asset, but rather the entire portfolio is viewed as a whole. A “risky asset” may be a good addition to an investment portfolio if it lowers the overall risk (i.e., volatility) of the investment portfolio or if it boosts the overall returns of the investment portfolio, or both.

The Rule adopts the basic tenets of Modern Portfolio Theory first articulated by Professor Harry Markowitz nearly 50 years ago, including the proposition that individual investments should be viewed as part of a portfolio. As further developed by Nobel Prize winner William Sharpe and others, Modern Portfolio Theory holds that each asset has an expected rate of return and that actual returns can and do deviate from expected returns. This departure from expected rates of return occurs because of two types of risk - “market risk” (also called “systemic risk”) and “specific risk” (also called “unsystematic risk”). One goal of a fiduciary is to optimize “returns” while minimizing these risks.

Let’s take an example. Suppose the fiduciary determines that the trust needs to achieve a target rate of return of 6%, after fees but before taxes. Suppose further that the fiduciary determines that the time horizon for use of the majority of the trust funds is quite long - 15 years or more. The fiduciary then determines an expected rate of return for fixed income investments and an expected rate of return for stock investments as a whole. Using some assumptions, the fundamental strategic asset allocation decision is made - how much to put into equities (stocks, stock mutual funds) and how much to put into fixed income investments.

50% allocated to fixed income investments, 5% assumed long term rate of return =	2.5% gross contribution to investment portfolio
50% allocation to equities (i.e., stock mutual funds), 10% assumed long term rate of return =	5.0% gross contribution to investment portfolio
	—————
Subtotal:	7.5% gross rate of return
Less mutual fund management and administrative fees, mutual fund transaction and opportunity costs, and investment advisory fees:	(1.5%) deduction
Total:	6.0% net expected return

The fiduciary knows that a different allocation, say 80% to equities and 20% to fixed income, would deliver higher *expected rates of return* over the long term, but the fiduciary also knows that the risk associated with such a different asset allocation (such as the risk of a substantial and prolonged decline in the stock market) is not worth taking given the needs of the beneficiary.

Knowing that a 6% net rate of return is required, the fiduciary may then choose to invest in different asset classes. The fiduciary seeks to minimize the “market risk” of the portfolio, sometimes with the addition of a “risky” asset class. For example, take an investment portfolio consisting of 50% short-term corporate bond fund, 25% U.S. large company balanced asset class, and 25% U.S. large company value asset class. The addition of a “micro cap” asset class is seen as adding a more “risky” asset to the investment portfolio. In addition, the addition of an “international value” asset class is also seen as adding a more “risky” asset to the portfolio. But look what happens when such asset classes are added:

	Composition of Portfolio	Historical Rate of Return 1975-2002 For Portfolio	Standard Deviation (One Measure of Volatility)
Portfolio 1:	50% short-term corporate bond fund 25% S&P 500 index fund 25% U.S. large cap value fund	<b>11.79%</b>	<b>8.84</b>
Portfolio 2:	50% short-term corporate bond fund 16.67% S&P 500 index fund 16.67% U.S. large cap value fund 16.67% U.S. micro cap fund	<b>12.42%</b>	<b>9.03</b>
Portfolio 3:	50% short-term corporate bond fund 12.5% S&P 500 index fund 12.5% U.S. large cap value fund 12.5% U.S. micro cap fund 12.5 int'l large cap value fund	<b>12.63%</b>	<b>8.38</b>

© 2003 Dimensional Funds Advisors, utilizing DFA Returns software. Used with permission. Past performance is not an indication of future returns. Portfolios formed utilizing DFA 2-Year Global (Bond) Portfolio (a short-term corporate bond fund); DFA U.S. Large Company Portfolio (a large cap balanced U.S. stock fund), DFA U.S. Large Cap Value Portfolio (a large cap value U.S. stock fund), DFA U.S. Micro Cap Portfolio (a small/micro cap U.S. stock fund); and DFA International Value Portfolio (an international “developed markets” large cap value fund). Annual rebalancing of the entire investment portfolio is assumed to occur. Returns are stated gross of rebalancing costs, taxes, and investment advisory fees, but net of mutual fund management and administrative fees.

“Standard deviation” is a measure of the variance of a portfolio - the range by which actual returns differ from expected returns in a portfolio. For example, in Portfolio 1 the historical return was 11.79% while the standard deviation was 8.84. This means:

- 1/6 of the years - Returns are expected greater than  $11.79 + 8.84$  (greater than 20.63%);
- 2/3 of the years - Returns are expected with the range of 20.63% to 2.95%; and
- 1/6 of the years - Returns are expected less than  $11.79 - 8.84$  (less than 2.95%).

The goal of building portfolios under Modern Portfolio Theory with different asset classes is to *maximize* the returns while *reducing the volatility risk* - i.e., raise returns while keeping the “standard deviation number” low. In our example, when the fiduciary moved from Portfolio 1 to Portfolio 2 the “risk,” as measured by the volatility of the portfolio, increased slightly, but the fiduciary felt justified in taking this risk due to the much higher historical return such a portfolio generated. When the fiduciary then moved from Portfolio 2 to Portfolio 3, the fiduciary saw both a small increase in return while achieving a modest reduction in portfolio volatility. While U.S. micro cap stock funds and international value stock funds are more “risky” in and of themselves, their addition to a portfolio either increases the return and/or decreases the risk (“standard deviation”) of the entire investment portfolio.

**F. The Specific Duties Imposed By The Rule, Generally.** The Rule sets forth a laundry list of duties imposed upon fiduciaries. We examine three of these duties in the sections that follow.

- ▶ The duty to formulate and implement an investment policy;
- ▶ The duty to diversify; and
- ▶ The duty to control expenses.

Other duties, such as the general duty of due care and the duty of impartiality (including the weighing of interests between income beneficiaries and remaindermen, are not addressed in this white paper. Additionally, while total return trust<sup>15</sup> legislation has its roots in Modern Portfolio Theory, it is not explored in this white paper, given the substantial attention to this fairly recent development in other legal literature.<sup>16</sup>

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<sup>15</sup> See Section 738.1041, *Florida Statutes* (2003), which adopts the “total return trust” and provides a trustee to convert an “income trust” to a “total return trust” without court approval. The type of “total return trust” permitted is the one with which most practitioners are familiar - sometimes called the “noncharitable unitrust.” With this concept, the trust language directs a unitrust payment of a specified percentage of the trust value each year (ranging from 3% to 5% under Florida law for trusts converted to total return trusts) to the current (“income”) beneficiary. The advantage of the noncharitable unitrust concept is that it is easily understood. The disadvantage of the noncharitable unitrust is that the income beneficiary and the remainder beneficiary do not proportionately share in both the growth of the trust and the investment risk of the trust.

There are other forms of total return trusts, including an “annuity trust” which pays a fixed amount each year and the “allocated total return trust.” The investment theory behind the allocated total return trust is that the trustee invests for long-term, after-tax total return. The actual return, after being adjusted for inflation, is split between the current beneficiary and the remainder beneficiary. The settlor of the allocated total return trust determines the relative proportions of this allocation. Other variations of the total return unitrust are possible.

In addition, and as an alternative to the implementation of a total return unitrust, Section 738.104, *Florida Statutes* (2003), provides a trustee in certain situations with the power to adjust between principal and income. In order to make an adjustment the trustee must invest as a prudent investor. Additional restrictions on this power to adjust are set forth in the statute.

<sup>16</sup> See Edward F. Koren and Shane A. Hart, “Unitrust Provisions of the Florida Revised Principal and Income Act,” chapter contained in Florida Bar CLE Materials “The RPPTL 22<sup>nd</sup> Annual Legislative and Recent Case Law

***G. The Duty To Formulate and Implement An Investment Policy.*** Section 518.11(d), *Florida Statutes* (2003) imposes upon the fiduciary the “duty, within a reasonable time after acceptance of the trust, estate, or guardianship, to review the investment portfolio and to make and implement decisions concerning the retention and disposition of original preexisting investments in order to conform to the provisions of this section.” Furthermore, Section 518.11(1), *Florida Statutes*, provides: “A fiduciary has a duty to invest and manage investment assets as follows: (a) The fiduciary has a duty to invest and manage investment assets as a prudent investor would considering the purposes, terms, distribution requirements, and other circumstances of the trust. This standard requires the exercise of reasonable care and caution and is to be applied to investments not in isolation, but in the context of the investment portfolio as a whole and as a part of an overall investment strategy that should incorporate risk and return objectives reasonably suitable to the trust, guardianship, or probate estate. If the fiduciary has special skills, or is named fiduciary on the basis of representations of special skills or expertise, the fiduciary is under a duty to use those skills ....” By its terms, the statute contemplates that an “investment strategy” will be formulated. What should this investment strategy, or plan, look like?

For many years under ERISA and other statutes various types of institutional trustees (pension fund trustees, government trust fund trustees, etc.) have been held to the prudent investor rule standard. In complying with the standards of the Rule it has become common practice to document the investment decision-making process by means of an investment policy statement (“IPS”). Indeed, the use of the IPS “has become sufficiently common among institutional trustees so that an institution without such a statement usually suffers from severe self-inflicted exposure.”<sup>17</sup> The author submits that informed fiduciaries, as a means of demonstrating adherence to the Rule’s requirements, will likewise develop an IPS for the portfolio over which they possess responsibilities.

An IPS is a written document. It may be one page long or 30 pages long (or much longer), depending upon the nature and complexity of the assets contained in the investment portfolio and the investment objectives. While there is no particular format for an IPS, the author suggests the following key elements:

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Update,” July 26, 2002. *Also see* Edward F. Koren, “Florida’s New Principal and Income Act - Redux,” chapter contained in Florida Bar CLE Materials “The RPPTL 23<sup>rd</sup> Annual Legislative Update and Recent Case Law Update,” August 1, 2003.

<sup>17</sup> Hartog, John A., and Sanderson, Paul, *A Trustee’s Crime and Punishment: Managing Fiduciary Liability Under the California Prudent Investor Act*, available online at <http://www.calteclaw.com/files/2dquartlyart.pdf>

*Investment Policy Statement: Matters To Address*

1. Factual Background.
  - a. The identity of the beneficiaries.
  - b. The contemplated distributions to or for the benefit of the beneficiaries given their needs and/or the terms of the governing instrument.
  - c. The investment time horizon for the utilization of funds.
  - d. The application of Section 518.11, and any modification to the Rule by the terms of the governing instrument, prior judicial action, or other means.
2. Investment Objectives. The desired rate of return for the investment portfolio as a whole, given the needs of the beneficiaries.
3. Current Investment Review. An examination of the current investments (with recommendations as to retention or disposition).
4. Permitted Investments. The permitted types of investments for implementation of the investment policy, including a discussion of any restrictions imposed by the governing instrument.
5. Diversification / Strategic Asset Allocation. The level of diversification among asset classes and among individual investment assets which is to be established and maintained. If strategic asset allocation is followed, the proposed strategic asset allocation and rebalancing targets. (A discussion of the importance of “strategic asset allocation” is set forth later in this white paper.)
6. Tax Strategy. The strategy to control taxes imposed upon the trust or estate, and/or upon the beneficiaries.
7. Specific Investment Recommendations. The specific investment recommendations (to such a level of detail as appropriate), including a detailed listing of anticipated fees, costs and expenses associated with implementation of the investment strategy and the specific investments recommended.
8. Review Process; Reporting. The frequency and form of portfolio reviews, and the reporting process [by custodians of the investment funds to the fiduciary, by the investment consultant (if retained) to the fiduciary, and by the fiduciary to the court].
9. Investment Consultant Duties. If an investment consultant is retained, the duties and responsibilities of the fiduciary and the investment consultant as to each other. Any and all conflicts of interest of the fiduciary should be disclosed, either in the investment policy or in a separate written document.
10. Execution. Signatures of the fiduciary (and, if applicable, the investment consultant who prepared or assisted in the preparation of the plan), indicating whether the plan is subject to judicial approval prior to its implementation.

A sample Investment Policy Statement for a guardianship is set forth in Exhibit 3. Sample language which might be found in a court order approving an Investment Policy Statement is set forth in Exhibit 4 to this white paper.

**H. The Duty To Diversify.** Section 518.11(c), *Florida Statutes* (2003) sets forth another fundamental rule that the fiduciary must follow: “The fiduciary has a duty to diversify the investments....” Why? Because fiduciaries are investors, not speculators.

While “diversification” is frequently talked about, it is seldom understood. The author once had a new client who already owned 26 different mutual funds. Diversified? Not hardly. Nearly every mutual fund contained “large company” stocks, most of the “growth” variety. A detailed analysis of the holdings of all 26 stock mutual funds revealed that the client, through the stock funds, had 4.2% of his portfolio in one stock and 3.1% of his portfolio in another stock.

Very few investors, and investment consultants, understand the true statistical data underlying the definition of diversification. As a result, few portfolios are properly diversified and an extended risk is being taken- unquestionably unwittingly, but nonetheless evident- by most investors (whether or not aided by investment consultants). One need not possess a stellar memory to recall the verbal complaints of many investors from 2000-2002 who saw 40% or greater drops in their portfolios, all the while thinking they were diversified. To properly explain diversification, two definitions are required:

*“Market” or “Nondiversifiable” or “Systematic” Risk.* This is risk due to the movement of the market itself. The benchmark could be the S&P 500 (an index of 500 of the largest U.S. companies), the Wilshire 5000 (an index of a representative sampling of the entire U.S. stock market), etc. There also exists various indexes for international markets, real estate, and sectors. If an investor possessed one or a few investments in a given asset class (i.e., a group of investments with similar characteristics), the investor could compare the return of those investments to that of the benchmark index.

Market risk is related to overall economic factors and affects all investments (some more than others). According to Modern Portfolio Theory, the capital markets compensate the investor for “market risk” - through higher expected returns. For example, a greater allocation to stocks in an investment portfolio (as opposed to fixed income investments) results in a greater *expected* rate of return. However, increasing the allocation to stocks will often also result in greater volatility of the overall investment portfolio. A fiduciary has a duty to minimize “market risk,” but not to the point of eliminating the likelihood that the desired rate of return for the investment portfolio will be achieved.

*“Specific Company” “or Diversifiable” or “Unsystematic” Risk.* This is the risk of the rise or fall in the price of one company’s stock causing a significant move, either up or down, in an investment portfolio. This is a risk that can be substantially reduced, almost to the point of elimination. “Specific company risk” relates to the unique characteristics of a particular investment or company, and the capital markets do not normally compensate the investor for taking such risks.

The fiduciary has a duty to minimize this “specific company risk.” The only means of doing this (as to stock investments) is to hold stock in many different companies. Given the fact that holding equal weightings of 100 stocks in an investment portfolio still carries with it the risk that one company will file bankruptcy and cause a decline in the value of the portfolio by 1/100 (1%), a prudent person (and prudently acting fiduciary) could easily conclude that well over 1,000 stocks are needed to successfully minimize specific company risk. In that manner, the decline in value of a single stock investment would not unduly hurt the portfolio’s expected returns.

Mutual funds may represent the preferred tool for achieving broad diversification. As stated in the comments to the diversification rule found in the UPIA, “It is difficult for a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments. Transaction costs such as the round-lot (100 share) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts ... Broader diversification is usually preferred in trust investing ... and pooled investment vehicles [i.e., mutual funds] make thorough diversification practical for most trustees.”<sup>18</sup> In other words, the vast majority of fiduciaries should utilize mutual funds as a means of achieving diversification, in order to minimize specific company risks.

Arguably fiduciaries investing \$10 million or more could explore investing in individual stocks and still achieve diversification at low cost. Another advantage of such an individual stock portfolio would be greater flexibility in offsetting gains and losses (thereby better controlling the “tax drag” on investment returns). However, for investors with amounts to invest which are less than \$10 million, the cost of purchasing a huge number of stocks would appear to be too great, especially given the larger transaction costs (“bid-ask spreads” and commissions) associated with purchasing “mid-cap” and “small-cap” stocks. Hence, for most investors stock mutual funds become the preferred option to obtain adequate diversification and minimization of “specific company risk.”

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<sup>18</sup> Comment to Section 3, Uniform Prudent Investment Act (UPIA). See Appendix C for a copy of the UPIA.

The duty to diversify extends not just among individual securities, but also among asset classes. This is because holding 1,000 stocks that are all “small company” and “growth” oriented is not diversification. The concept of asset classes, and diversification among asset classes, is explored in a later section of this white paper.

***I. The Duty To Control Expenses.*** The Rule goes a large step further is discussing an additional duty of a fiduciary, as set forth in Section 518.11(1)(f), *Florida Statutes* (2003): “The circumstances that the fiduciary may consider in making investment decisions include, without limitation ... the general economic conditions, the possible effect of inflation, the expected tax consequences of investment decisions or strategies, the role each investment or course of action plays within the overall portfolio, the expected total return, including both income yield and appreciation of capital, and the duty to incur only reasonable and appropriate costs.” [Emphasis added.]

As stated in the commentary to the UPIA, “[I]t is important for trustees to make cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio.” In other words, to act prudently a fiduciary must act to reduce costs. Like any investor, a fiduciary should be informed of the total costs of the investment, and should consider alternatives. Higher costs should be incurred only when there is a legitimate reason to do so - such as higher expected returns or the need to engage an investment advisor to assist the fiduciary.”<sup>19</sup> Given the importance of this issue to fiduciaries and those who evaluate their actions, the next several pages of this white paper explore the issue of investment costs in some detail.

***I.(1) “Disclosed” Fees and Costs.*** What types of fees and costs are associated with the investment process. Aside from the fees of the fiduciary, the “disclosed costs” of investing might include:

- Up-front commission or sales loads: Often imposed on sales of various financial products, including mutual funds. Mutual funds which impose a “sales load” have that amount deducted from the amount invested. The more an investor invests in a particular mutual fund (or, in many instances, in several funds in a fund family), the less the sales load, as shown in this sample breakpoint schedule:

Investment Amount \_\_\_\_\_ Sales Load

***“I’ve Never Paid My Broker Any Fees.”***

It’s surprising how often we hear this from investors. Many investors are unaware of sales loads, contingent deferred sales charges, commissions, 12b-1 fees, bid-ask spreads, and other fees and costs of investing. Every investor should always know each and every fee which is paid - either to the broker, the brokerage firm, or the investment manufacturer, or others in the investment process.

<sup>19</sup> Comment to Section 7, UPIA. See Appendix C.

Less than \$25,000	5.0%
\$25,000 but less than \$50,000	4.25%
\$50,000 but less than \$100,000	3.75%
\$100,000 but less than \$250,000	3.25%
\$250,000 but less than \$500,000	2.75%
\$500,000 but less than \$1 million	2.0%
\$1 million or more	0.0%

The SEC recently launched numerous investigations on the failure of brokerage firms to ensure that customers received breakpoint discounts as they invested larger amounts with funds.<sup>20</sup>

- Deferred contingent sales charges: These apply to sales of certain life insurance policies, certain fixed and variable annuities, as well as certain mutual funds which have “Class B” shares. Class B mutual fund shares do not impose a front-end sales charge, but they may charge higher expenses that investors are assessed over the lifetime of their investment in a fund as compared to Class A shares. Class B shares also normally impose a contingent deferred sales charge (CDSC), which you pay if you sell your shares within a certain number of years. In addition, investors who purchase Class B shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares.

Sample CDSC Schedule (Class B Shares)

<u>Years Since Purchase</u>	<u>Contingent Deferred Sales Charge (CDSC)</u>
0-1	5%
1-2	4%
2-3	3%
3-4	3%
4-5	2%
5-6	1%
6+	0%

The National Association of Securities Dealers (NASD) is continuing a comprehensive review of Class B shares sales practices.<sup>21</sup> In recent years the NASD and other regulatory authorities have investigated abuses regarding the unsuitability of large sales of Class B shares to investors.

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<sup>20</sup> See “Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds,” March 2003, which can be found at <http://www.sec.gov/news/studies/breakpointrep.htm>. See also NASD “Investor Alert” titled “Mutual Fund Breakpoints: A Break Worth Taking,” January 14, 2003, which can be found at [http://www.nasd.com/Investor/Alerts/alert\\_breakpoint.htm](http://www.nasd.com/Investor/Alerts/alert_breakpoint.htm).

<sup>21</sup> See NASD Investor Alert, “Class B Mutual Fund Shares: Do They Make the Grade?”, issued June 25, 2003, and available at [http://www.nasd.com/Investor/Alerts/alert\\_classb\\_funds.htm](http://www.nasd.com/Investor/Alerts/alert_classb_funds.htm)

- Mutual fund or investment manager administrative and management fees: The money paid to the manager(s) of a mutual fund, annuity subaccount, or other type of professionally managed investment (also called an advisory fee) and the fees relating to such mutual fund expenses as accounting, legal, registration fees, etc. These fees vary tremendously, from under 10 basis points (0.10% per year) to 2% a year (or even much higher). The often-high management fees of certain mutual fund complexes have been criticized,<sup>22</sup> and some recent settlements with regulatory authorities are forcing some mutual fund complexes to lower their fees.<sup>23</sup>
- 12b-1 “marketing fees: Mutual fund promotional expenses such as advertising and public relations that are paid by shareholders. A great portion of 12b-1 fees paid to mutual fund companies are then passed on to brokers and brokerage firms as one means of compensating them for “ongoing advice” relating to investment in the fund. In the past year 12b-1 fees have received increased scrutiny and proposals have been floated to eliminate them.<sup>24</sup>
- Variable annuity “mortality and expense” fees: Variable annuities also charge a “mortality and expense” fee (typically 1.25% annually, or higher) to pay for the *guarantee* which is provided under the annuity contract. While the nature of guarantees vary, they provide that the investor in the variable annuity will receive, at a minimum, the amount initially invested in the annuity upon the death of the annuitant (usually the annuitant is the owner of the annuity contract, but not always). *In the author’s view, the high additional costs of variable annuities and their negative tax consequences make these products unsuitable for investments by fiduciaries in nearly all instances. For more about the many tax and high-cost issues involving variable*

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<sup>22</sup> See, for example: John Bogle, former Chairman of The Vanguard Group, stating: “Nowhere is the conflict between fund managers and fund shareholders more sharply and obviously manifested than in the level of management fees and operating expense ratios—from 2.21% for the high-cost quartile of equity funds to 0.65% for the low-cost quartile—a 1.56% differential that accounts for nearly 70% of the 2.38% enhancement in annual returns earned by the low-cost quartile over the past ten-years.” *Has Your Fund Manager Betrayed Your Trust? Consider the “Stewardship Quotient”* - speech before The American Institute of Certified Public Accountants, Las Vegas, Nevada, January 5, 2004.

<sup>23</sup> See Press Release by the New York State Attorney General, entitled “Spitzer, Salazar Announce Market-Timing Settlement with Janus Capital Management, LLC,” in which Janus agreed to reduce management fees fund shareholders pay over a 5-year period.

<sup>24</sup> See SEC’s “Concept Release, Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs” [Release Nos. 33-8349; 34-48952; IC-26313; File No. S7-29-03], stating: “We also request comment on whether we should propose additional changes to rule 12b 1 to address other issues that have arisen under the rule, or propose to rescind the rule.” Available at the [www.sec.gov](http://www.sec.gov) web site.

annuities, please e-mail [info@josephcapital.com](mailto:info@josephcapital.com) and request that a complimentary copy of “Chapter Thirty-One: Why You Should Avoid Variable Annuities”<sup>25</sup> be e-mailed to you.

I.(2) The Availability Of “No-Load Funds.” Not all mutual funds charge commissions related to the investment made by the customer. Called “no load funds,” these funds do not charge a front-end sale charge (“sales load”) or a contingent deferred sales charge (“CDSC”). NASD rules also require that the 12b-1 fees not exceed 0.25% of the fund's average annual net assets in order to call itself a no load fund.

“No-load, no 12b-1 fee funds” are also available. These are funds that do not charge any commissions (either “sales loads” or “CDSC”), nor 12b-1 fees. They are often available directly to individual investors who choose to invest without the aid of a broker or insurance agent. Other no-load, no 12b-1 “institutional-style” low-cost mutual funds are available through some fee-only investment advisory firms.

I.(3) “Hidden” Transaction and Opportunity Costs. In addition, there are a variety of “hidden” costs of investing which are not easily discerned by an investor. Whether investing in funds which possess sales loads or contingent deferred sales charges or 12b-1 fees, or investing in no-load, no 12b-1 fees, fiduciaries should seek to understand and minimize these “hidden” costs through careful selection of investments and minimal portfolio changes.

The “expense ratio” commonly referred to in mutual fund prospectuses and in Morningstar reports is really a “partial expense ratio.” As stated in one comment to the SEC’s concept release exploring disclosure of transaction costs, “[t]he partial expense ratio is misleading because it impliedly represents, in conjunction with other shareholder expenses listed in the fee table, the total cost of fund ownership. In fact, as the [SEC] recognizes, the partial expense ratio omits funds’ portfolio transaction costs, which alone can be 5 times the amount of a fund’s other expenses combined.”<sup>26</sup>

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<sup>25</sup> Chapter Thirty-One is a 20-page excerpt from *The Science of Investing: How To Use Academic Research to Increase Returns and Reduce Risks In Your Investment Portfolio* (Joseph Publications, LLC, 2003), and is provided by e-mail upon request as a public service by Joseph Capital Management, LLC. Despite the many negative aspects of variable annuities they continue to be widely sold. We believe this to be due to the higher commissions usually paid upon the sales of variable annuities, compared to other investment products.

<sup>26</sup> Comments of Fund Democracy, Consumer Federation of America, Consumers Union and Consumer Action dated March 16, 2004 to the SEC’s Portfolio Transaction Costs Concept Release. The comments are available at [www.funddemocracy.com](http://www.funddemocracy.com) and also at [www.sec.gov](http://www.sec.gov).

The “hidden costs” of investing include, but are not limited to,<sup>27</sup> the following:

- “Bid-ask spreads” - stock purchases: In our stock market system firms called "market makers" hold stocks in inventory. This is a means of providing liquidity in the markets (i.e., to provide individual investors with the ability to buy and sell stocks when the market is open). These market makers provide investors who are purchasing or selling with the immediate opportunity to effect the trade. Market makers have several costs to deal with, including: (1) order-processing costs, such as the cost of a seat on the exchange, computer equipment, and labor costs; (2) the opportunity cost of having funds tied up in the inventory of a stock; and (3) the risk that the inventory value will decline as a result of price moves in the stock in the inventory. The "bid-ask spread" is the means by which market makers cover these costs (and usually make some profit).

As an example, suppose you purchase 100 shares of stock for \$100 per share at the same time another investor sold the same amount of the same stock. What did the seller - another investor - receive? Not \$100 per share, but more likely a reduced amount - such as \$99.50. This 50 cents difference per share is called the "bid/ask spread," and it is the compensation that the market maker received for processing the trade. Does not sound like much, but for 100 shares the spread totals \$50.00. Multiply that by many trades and it quickly becomes a large expense, especially for mutual fund managers, stockbrokers, or individual investors who trade a lot.

A portion of the fees paid “market makers” in the form of the “bid-ask spread” make their way back to the brokerage firms which execute the trade. This practice is usually disclosed in the fine print of brokerage customer’s contracts. An example of this language might be: “The Broker will receive compensation for directing the order equity flow. With respect to OTC transactions, compensation may be in the form of a per share cash payment ....”

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<sup>27</sup> Other “hidden costs” of trading, such as cost changes due to delayed or canceled trades, are not discussed. A good summary of the overall “hidden costs” of trading by institutional firms (mutual funds, pension funds) can be found in Plexus Group Commentary #54, January 1998, entitled “The Hidden Iceberg of Transaction Costs”, in which it is stated: “The average cost of trading large cap stocks by our measures is just over 1% for either a buy or a sell. The average cost of swapping a stock in a portfolio for one thought to be more attractive is twice this amount. Thus the difference in performance must be at least 2% to make the trade worthwhile. 2% doesn’t seem like much when weighed against the “home runs” a portfolio manager is capable of hitting, but the cost absorption is unmerciful. Since these costs are incurred on every trade, the average return from stock picking – including winners, losers, buys and sells – must gross at least 2% to make active management worthwhile. The problem is much more severe for small cap stocks. The average cost of trading small cap stocks is 4½ times as large as trading large cap stocks. The difference between the two icebergs illustrates how the factors of the trade change not only the total cost but also the structure of the costs. In both cases, the visible costs of commission (printed on the ticket) and the impact (price movement while the order is in the broker’s hands) are much less than the invisible, insidious costs of delay and missed trades. Thus, the costs of not trading dwarf the trading costs. Yet these invisible costs are real and reduce captured performance.” [www.plexusgroup.com/fs\\_casestudies.html](http://www.plexusgroup.com/fs_casestudies.html)

- “Bid-ask spreads” and “principal mark-ups” on individual bond purchases: How much does it cost to trade an individual bond? That depends greatly upon the type and amount of the bond being issued and the shopping that the seller or buyer undertakes. If the trader is an institutional investor working with many different brokers, and seeking the very best price, and trading in quantities of \$1,000,000 or more, than the bid-ask spread will usually average about 1/20th of 1% (5 basis points). By contrast, an individual investor, purchasing in quantities of \$250,000, would typically pay from 50 basis points to 300 basis points (½% to 3%) each time an individual municipal bond is purchased or sold. Individual investors who invest in individual bonds in amounts lower than \$250,000 can pay even higher costs - with spreads rising easily to as high as 5% for each purchase. When bonds are purchased out of a broker's inventory a similar cost, called "dealer mark-up," occurs. The municipal bond market, more frequently utilized by individual investors (due to the availability of “insured” municipal bonds), is more “illiquid” than the corporate bond market, and hence bid-ask spreads tend to be higher for individual municipal bonds than for corporate or U.S. government or government agency bonds.
- Market impact costs: Imagine that you are a mutual fund manager who holds \$20 million of stock in Able Company. On average, about \$5 million of Able Company's stock trades any day. You have decided to sell all of your position in Able Company. If you try to sell all of your holding in Able Company stock in one day, the selling price dramatically fall as supply of the stock (at the current price point) outstripped demand. If you sell the stock over several weeks you may lessen any abrupt price change, but you are likely to see a modest price fall occur (on average). With delay in the selling process you also risk a price fall (due to other market forces, or news about the company) in the interim. This hidden cost of investing is called "market impact." It results from the fact that large purchases or sales of stock move the price of the stock up or down, whether such purchases occur in one day or over several weeks. While market impact is difficult to measure, most estimates put market impact costs for mutual funds in the 0% (for small mutual funds trading large company stocks infrequently) to 1% or even higher (for large mutual fund complexes trading in mid-cap, small-cap, or foreign stocks).
- Opportunity costs (of holding cash): Many mutual funds also hold a substantial amount of cash. The average stock mutual fund holds around 5% of its fund assets in cash.<sup>28</sup> Mutual funds hold cash for a variety of reasons - such as to handle mutual fund redemptions (investors pulling money out of the fund occasionally), attempts to time the market, or merely because they have not yet identified the stocks into which the cash funds should be invested. Since stocks have

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<sup>28</sup> Per analysis undertaken using Morningstar Principia Pro software, using 12/31/03 data, for 4,700 stock mutual funds with unique characteristics.

returned to the investor about 10% a year over long periods of time, and since money market funds probably average about a 4% yield, the difference - 6% a year times the average percentage cash holding of 11% - represents an "opportunity cost" to the investor. Stated differently, the average negative impact on the individual investor by the cash holdings of the average stock mutual fund is about 0.6% to 0.7% a year.

I.(4) Should "Hidden" Transaction Costs Be Disclosed? For the individual investor purchasing individual stocks or bonds, bid-ask spreads and principal mark-ups can (and should) be ascertained by asking the broker-dealer firm's registered representative. However, mutual funds, which may be the vehicle of choice to achieve diversification for most fiduciaries, are not currently required to full disclose the "hidden" costs of investing.

At hearings held before the U.S. Senate and the U.S. House of Representatives during 2003, a number of witnesses testified that inadequate information about portfolio transaction costs makes it difficult for mutual fund shareholders to know the overall costs of their investment.<sup>29</sup> The Securities and Exchange Commission ("Commission") is considering various alternatives designed to improve the information that mutual funds disclose about their portfolio transaction costs.<sup>30</sup> For many mutual funds the amount of transaction costs incurred during a typical year is substantial and can dwarf the "disclosed" expense ratio of the fund. Additionally, commissions are often paid out of fund assets to brokerage firms, which in turn sell the mutual funds, creating a conflict of interest in which brokerage firms "push" certain mutual funds, giving them preferential treatment in the sales promotion process. While the SEC is exploring this issue, difficulties arise in measurement. One comment to the SEC proposal states that the SEC "should not require funds to disclose other measures of transaction costs other than brokerage commissions. Methodologies that focus upon market impact, opportunity costs or other measurements [such as bid-ask spreads] may be useful to advisers as management tools and may also be relevant to funds' boards of directors in evaluating overall portfolio management performance of fund advisers. These methodologies, however, have distinct limitations, differ widely in their approach, and can produce significantly inconsistent results when applied to the same trading data."<sup>31</sup>

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<sup>29</sup> See Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Securities and Exchange Commission [Release Nos. 33-8349; 34-48952; IC-26313; File No. S7-29-03].

<sup>30</sup> Id. See also NASD Press Release dated May 12, 2004, "NASD'S GLAUBER ANNOUNCES MUTUAL FUND TASK FORCE: Goal Is To Bring Greater Transparency to Fund Costs, Distribution, which can be found at [http://www.nasdr.com/news/pr2004/release\\_04\\_032.html](http://www.nasdr.com/news/pr2004/release_04_032.html).

<sup>31</sup> Comments submitted by David Jones, Senior Vice President and Product Strategy & Communications, and Eric D. Roiter, Senior Vice President and General Counsel, of Fidelity Management & Research Company, Mar.2, 2004. However, other comments have suggested that some form of disclosure and estimating is possible. See "Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs," Securities and Exchange Commission [Release Nos. 33-8349; 34-48952; IC-26313; File No. S7-29-03], found at [www.sec.gov](http://www.sec.gov).

I.(5) Adding Up The Costs. It is incumbent upon the fiduciary and the investment advisor engaged by the fiduciary to identify and select investments which minimize both disclosed and hidden costs, lest a good portion of the expected returns offered by the capital markets be consumed by costs. What are the total costs of actively management stock mutual funds? John Bogle, former Chairman of The Vanguard Group, has often estimated the average total costs of stock mutual funds as ranging from 2.5% to 3% a year.<sup>32</sup>

I.(6) An Example of Mutual Fund Costs. Let's look at an example of a *relatively* low cost actively managed mutual fund. The American Funds New Perspective stock mutual fund is a very large mutual fund in terms of managed assets. (Please note: The author does not recommend that fiduciaries purchase this or any other actively managed mutual fund; the discussion of this fund is only for purposes of illustrating fees.) According to the fund's prospectus<sup>33</sup> this fund has three ways an investor can purchase its shares (through brokers): (1) Class A shares in which an up front commission is paid; (2) Class B shares in which a declining sales commission is assessed if the investor withdraws his investment from the fund within the first six years; and (3) Class C shares in which a contingent deferred sales charge is assessed only if the fund is sold within one year of purchase. Let's examine the various annual fees of these three different classes.

	<u>Class A</u>	<u>Class B</u>	<u>Class C</u>
Management Fees	0.40%	0.40%	0.40%
12b-1 Fees	0.25%	1.00%	1.00%
Other Expenses	0.17%	0.20%	0.24%
5.25% upfront commission divided by 7 years:	<u>0.82%</u>	<u>None</u>	<u>None</u>
Total annual "disclosed" fees:	1.64%	1.60%	1.64%

Note that in the case of Class A shares we divide the "up front" commission by seven years on the assumption that the average investor will own the fund for that period of time. Studies report that the average holding period of a mutual fund is much less (four years). If an investor were to hold the Class

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<sup>32</sup> "The [disclosed] cost of mutual fund ownership is vastly understated. Why? Because management fees, operating expenses and sales charges constitute only a fraction of fund costs. Portfolio transaction costs—an inseparable part of owning most funds—are ignored. Out-of-pocket costs paid by fund investors are ignored. Fees paid to financial advisers to select funds (partly replacing those front-end loads) are ignored. Put them all together and it's fair to estimate that the all-in annual costs of mutual fund ownership now runs in the range of 2½% to 3% of assets." "The Mutual Fund Industry in 2003: Back to the Future," Remarks by John C. Bogle, Founder and Former Chairman, The Vanguard Group, Before the Harvard Club of Boston, the Harvard Business School Association of Boston, and the Boston Security Analysts Society, Boston, Massachusetts, January 14, 2003.

<sup>33</sup> Prospectus, American Funds<sup>SM</sup> New Perspective Fund®, December 1, 2002.

A shares for 20 years, then the total annual "disclosed" fees would drop to about 1.08% a year on average, simply by dividing the 5.75% sales charge by 20 years (which understates the true cost, since the commission paid is not available to the investor during those 20 years, thereby affecting returns), and then adding the management and administrative fees, 12b-1 fees, and other expenses. Also note that the commissions paid under Class A shares also decline as the investor places more money into the fund within a period of time. For example, if the investor places at least \$50,000 into Class A share, then the sales charge declines to 4.5%.

However, the foregoing costs are not the only ones present in this fund. The American Funds New Perspective Fund also incurs various "hidden" costs - including transaction and opportunity costs. Based upon data derived from Morningstar Principia Pro as of 12/31/03 and the fund's Statement of Additional Information (Sept. 30, 2003), this mutual fund has these characteristics:

Total amount invested in fund	\$27.6 billion
No. of stock holdings	211
Average invested in each stock:	\$130 million
Annual turnover	28%
Cash holdings as percentage of fund:	8.6%

One estimate of bid-ask spreads is 0.36% per trade for trades in large cap funds.<sup>34</sup> With a turnover ratio of 28%, which involves both a purchase and sale of a stock, we can *estimate* bid-ask spreads for this fund at 0.20% (0.36% x 28% turnover x 2 trades for each turnover) annually.<sup>35</sup> The opportunity costs due to cash holdings we can estimate at 0.52% (6% x 8.6% cash holdings) annually. The actual commissions of the fund can be found in a recent Statement of Additional Information for the fund, and were \$25,174,000 during 2003. Based upon a total amount invested of \$27.6 billion as of Sept. 30, 2003, this translates to a commission percentage cost of 0.09%. Note that this is a relatively large mutual fund which invests in large companies. With an average holding in each stock of nearly \$130 million, substantial market impact costs are likely as the fund purchases or sells stocks (thereby driving the price of the stock temporarily up or down, respectively), and should fall within our estimated range of 0% to 1% annually. Adding up the total costs, Class C shares are therefore *estimated* to have *total costs* of at 2.45% to 3.45% annually for an investor in this fund. [We added up the foregoing costs: 1.64% + 0.20% + 0.52% + .09% (plus 0-1%).]

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<sup>34</sup> Karceski, Jason, *Mutual Fund Brokerage Commissions* (January 2004), a study commissioned by the Zero Alpha Group and available at [www.zeroalphagroup.com](http://www.zeroalphagroup.com).

<sup>35</sup> *Id.*

I.(7) The “Tax Drag” On Investment Returns. It's not what you make, it's what you keep. In addition to fees and costs, taxes play an important role in determining the net return to investors. Most financial advisors pay little attention to taxes, probably due to their limited knowledge of our complicated, interrelated system of federal, state and local income, estate and gift taxes. A little knowledge can be a dangerous thing, as well. For example, realizing too many capital gains in a tax year can lead to serious alternative minimum tax consequences. As a result, a broad knowledge of the taxation of investment returns, tax deductions, and tax credits is necessary in order to formulate a tax-efficient investment strategy over the long term. What do we mean by "tax efficient investing"? Simply put - it is keeping more of the gross investment returns the capital markets offer - either for you or your heirs, after taxes are paid.

How important is this attentiveness to taxation? According to an SEC study, investors in actively managed mutual funds lose an estimated 2.5% a year in annual returns to taxes.<sup>36</sup> Another study by accounting firm KPMG Peat Marwick for the Congressional Joint Economic Committee found that the annual impact of taxes ranged from zero for the most tax-efficient funds to 5.6 percentage points for the least.<sup>37</sup> Combined with actively managed stock mutual fund costs (both "disclosed" and "hidden") that average 2.5% to 3.0%% (or more) per year, taxes and costs can combine to eliminate 50% or more of an investor's expected annual return. On a compounded basis, that 50% loss can equate to an erosion of the vast majority of the returns the capital markets have to offer to individual investors.

Commencing in 2002 the SEC required mutual funds (except money market funds) to disclose their after-tax rates of return in their prospectuses. While this disclosure makes certain assumptions about individual income tax rates which may not be relevant to the fiduciary's (or beneficiary's) particular situation (including ignoring alternative minimum taxes, and state and local income taxes, and Florida intangible taxes), the after-tax returns serve as an informative manner of comparing the tax efficiency of various mutual funds.

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<sup>36</sup> “Final Rule: Disclosure of Mutual Fund After-Tax Returns,” 17 CFR Parts 230, 239, 270, and 274 [Release Nos. 33-7941; 34-43857; IC-24832; File No. S7-09-00].

<sup>37</sup> KPMG Peat Marwick LLP, “An Educational Analysis of Tax-Managed Mutual Funds and the Taxable Investor.”

There are many techniques than can be utilized in financial planning and investment management to reduce the tax drag on an investor's return. Strategies which can be utilized by the fiduciary include:

- The utilization of tax-managed stock mutual funds in taxable accounts;
- The allocation of fixed income investments to tax-deferred accounts (qualified retirement plan accounts and traditional IRAs), while allocating equity investments to taxable accounts, all other things being equal;
- Harvesting capital losses from some investments to offset capital gains (and, subject to applicable limits, to also offset ordinary income);
- If fixed income investments must be held in taxable accounts, and if the marginal income tax rate warrants, the possible utilization of tax-free municipal bonds and muni bond funds;
- Deferment of the realization of capital gains (but not at the expense of sound investment strategies, such as the targeted rebalancing of an investment portfolio);
- Planning to avoid the application of, or minimize the impact of, the dreaded alternative minimum tax (AMT);
- Avoiding tax-inefficient investments (such as nonqualified variable annuities) unless there exists a strong asset protection or other reason to have such investments; and
- The possible utilization of tax-managed international stock funds in taxable accounts in order to harvest foreign tax credits (not available if held in tax-deferred or tax-free investment accounts).

Incorporating a sound tax policy into the overall investment plan is one way in which a knowledgeable investment advisor can add value to the investment management process.

***J. The Authority To Delegate Investment Management.*** The UPIA and Section 518.112, *Florida Statutes* 2003)<sup>38</sup>, explicitly authorize a fiduciary to “delegate investment and management functions” provided the fiduciary uses reasonable skill and care in:

- ▶ selecting the investment advisor;
- ▶ establishing the scope of the delegation (i.e., the parameters under which investments are to occur, and whether the accounts are “discretionary” or “non-discretionary”); and
- ▶ reviewing the actions of the investment advisor periodically.<sup>39</sup>

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<sup>38</sup> Section 518.112, *Florida Statutes* (2003), provides in pertinent part: “Delegation of investment functions.--

(1) A fiduciary may delegate any part or all of the investment functions, with regard to acts constituting investment functions that a prudent investor of comparable skills might delegate under the circumstances, to an investment agent as provided in subsection (3), if the fiduciary exercises reasonable care, judgment, and caution in selecting the investment agent, in establishing the scope and specific terms of any delegation, and in reviewing periodically the agent's actions in order to monitor overall performance and compliance with the scope and specific terms of the delegation ...

(3) A fiduciary may delegate investment functions to an investment agent under subsection (1) ... if:

(a) In the case of a guardianship, the fiduciary has obtained court approval.

(b) In the case of a trust or estate, the fiduciary has given written notice, of its intention to begin delegating investment functions under this section, to all beneficiaries, or their legal representative, eligible to receive distributions from the trust or estate within 30 days of the delegation unless such notice is waived by the eligible beneficiaries entitled to receive such notice. This notice shall thereafter, until or unless the beneficiaries eligible to receive income from the trust or distributions from the estate at the time are notified to the contrary, authorize the trustee or legal representative to delegate investment functions pursuant to this subsection ...

1. Notice to beneficiaries eligible to receive distributions from the trust from the estate, or their legal representatives shall be sufficient notice to all persons who may join the eligible class of beneficiaries in the future.

2. Additionally, as used herein, legal representative includes one described in s. 731.303, without any requirement of a court order, an attorney-in-fact under a durable power of attorney sufficient to grant such authority, a legally appointed guardian, or equivalent under applicable law, any living, natural guardian of a minor child, or a guardian ad litem.

3. Written notice shall be:

- a. By any form of mail or by any commercial delivery service, approved for service of process by the chief judge of the judicial circuit in which the trust has its principal place of business at the date of notice, requiring a signed receipt;
- b. As provided by law for service of process; or
- c. By an elisor as may be provided in the Florida Rules of Civil Procedure.

Notice by mail or by approved commercial delivery service is complete on receipt of notice. Proof of notice must be by verified statement of the person mailing or sending notice, and there must be attached thereto the signed receipt or other satisfactory evidence that delivery was effected on the addressee or on the addressee's agent. Proof of notice must be maintained among the trustee's permanent records.

(4) If all requirements of subsection (3) are satisfied, the fiduciary shall not be responsible otherwise for the investment decisions nor actions or omissions of the investment agent to which the investment functions are delegated.

(5) The investment agent shall, by virtue of acceptance of its appointment, be subject to the jurisdiction of the courts of this state.

(6) In performing a delegated function, the investment agent shall be subject to the same standards as the fiduciary.

<sup>39</sup> The UPIA provides:

SECTION 9. DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS.

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

However, can a fiduciary (such as a bank or trust company, or an investment professional) who possesses special skills relating to investments or advertises as such delegate the investment function?<sup>40</sup> “Perhaps not ... the fiduciary can only delegate when a prudent investor of *comparable skills* might delegate. An expert investor probably would not delegate investment functions except in limited circumstances.”<sup>41</sup>

I.(1) The Need for Expertise. It is the author’s experience that most individual fiduciaries fail to possess the requisite knowledge of investment theory to properly structure a portfolio in order to establish the desired rate of return for the portfolio over time and reduce risk given that needed return. Simply mention the words “Modern Portfolio Theory” to most individuals and a blank stare often results. Hence, delegation of the investment function by an individual fiduciary without adequate knowledge of Modern Portfolio Theory and investment risks, the expected returns of various asset classes, and costs, would appear proper in order for the fiduciary to ensure compliance with the requirements of the Rule.

Often trustees, guardians and other fiduciaries might resist the delegation of investment duties. One reason to resist such delegation would be a probable reduction of the fiduciary’s fees, as certain investment duties the fiduciary would have otherwise possessed would be delegated.<sup>42</sup> In the face of such

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- (1) selecting an agent;
  - (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
  - (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.
- (b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.
- (c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.
- (d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.
- Comments to this section of the UPIA can be found in Exhibit 5 to this white paper.

<sup>40</sup> Section 518.11(1)(a), *Florida Statutes* (2003) provides in pertinent part: “ If the fiduciary has special skills, or is named fiduciary on the basis of representations of special skills or expertise, the fiduciary is under a duty to use those skills.”

<sup>41</sup> “Successfully Delegating Fiduciary Duties and Powers,” by Jack A. Falk, Jr., Esq., a chapter contained in Florida Bar CLE materials entitled “Your 2004 Trust & Estate Symposium,” Feb. 5, 2004.

<sup>42</sup> While neither Florida’s version of the Prudent Investor Rule nor the UPIA expressly state that the fiduciary’s fee should be reduced when investment functions are delegated, a common-sense application of the general duty to control costs and the statutes governing determination of a fiduciary’s fee may dictate such.

As to personal representatives, Section 733.617(7), *Florida Statutes* (2003) expressly provides that upon petition to a court compensation to a personal representative may be reduced by a number of factors, one of which is the compensation paid to other professionals and fiduciaries.

As to trustees, Section 737.204, *Florida Statutes* (2003) provides in pertinent part:

Proceedings for review of employment of agents and review of compensation of trustee and employees of trust.--

resistance, and where delegation appears proper, the questions set forth in Exhibit 2 might be posed by a Florida jurist to test the investment knowledge of individual fiduciaries (and, as well, investment consultants who might appear before the jurist).

Few individual, non-professional investors will be able to correctly answer the questions set forth in Exhibit 2. At the same time, it is also the author's experience that many "investment consultants" (brokers, insurance agents, and investment advisors) also will fail to pass the foregoing test of fundamental investment concepts, and that they lack the substantial training necessary to construct portfolios. In addition, few investment consultants receive any specific training as to the Rule and its application. In fact, the UPIA warns in its comments to Section 8: "If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate. But if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries."<sup>43</sup> Given the often high costs of employing

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(1) After notice to all interested persons, the court may review the propriety of the employment by a trustee of any person, including any attorney, auditor, investment adviser, or other specialized agent or assistant, and the reasonableness of any compensation paid to that person or to the trustee.

(2) If the settlor's estate is being probated, and the settlor's trust or the trustee of the settlor's trust is a beneficiary under the settlor's will, the trustee, any person employed by the trustee, or any interested person may have the propriety of employment and the reasonableness of the compensation of the trustee or any person employed by the trustee determined in the probate proceeding.

(3) The burden of proof of propriety of the employment and the reasonableness of the compensation shall be upon the trustee and the person employed by the trustee. Any person who is determined to have received excessive compensation from a trust for services rendered may be ordered to make appropriate refunds.

As to guardians, Section 744.108, *Florida Statutes* (2003), provides:  
Guardian's and attorney's fees and expenses.--

(1) A guardian, or an attorney who has rendered services to the ward or to the guardian on the ward's behalf, is entitled to a reasonable fee for services rendered and reimbursement for costs incurred on behalf of the ward.

(2) When fees for a guardian or an attorney are submitted to the court for determination, the court shall consider the following criteria:

(a) The time and labor required;

(b) The novelty and difficulty of the questions involved and the skill required to perform the services properly ...

(e) The nature and value of the incapacitated person's property, the amount of income earned by the estate, and the responsibilities and potential liabilities assumed by the person ...

(I) The experience, reputation, diligence, and ability of the person performing the service.

"The law specifically authorizes an executor or a trustee to incur expenses only to the extent they are appropriate and reasonable in relation to the purposes of the estate or trust, the assets in it, and the skill of the trustee. The overall cost of the delegation must be controlled, and, in appropriate cases, all or part of the advisor's fee may have to come out of the executor's or trustee's commission. A will or trust agreement should therefore state clearly the source from which the costs of delegation are to be paid." *Professional Notes* from The New York Community Trust, October 1996, commenting on New York's adoption of the new Prudent Investor Rule.

<sup>43</sup> A copy of the UPIA is set forth in Exhibit 5 to this white paper.

“investment consultants,” either in terms of commissions, 12b-1 fees, percentage-based asset management fees, and other forms of compensation, it is worth querying when the employment of an “investment consultant” is worthwhile. To answer this question, we must examine the types of investment consultants who may seek to advise fiduciaries, of which there are three main types.

I.(2) Insurance Agents. Section 626.112(1), Florida Statutes requires the registration of insurance agents. Generally, separate licenses are issued for property/casualty insurance agents, for health insurance agents, and for life insurance agents. Insurance agents generally receive compensation from the insurance company upon the sale of a product, usually in the form of a commission. Insurance agents are not typically compensated directly by the consumer.

Insurance agents who are also not either securities brokers or registered investment advisors usually possess the ability to sell a limited range of products made available by their employer. Often these products are life insurance, variable annuities, or high-cost “proprietary” mutual funds. Given the limited ability of insurance agents to access a broad range of (low-cost) investment products, there will be rarely any instance in which an insurance agent should be utilized to assist a fiduciary in designing and implementing an investment policy for a trust, estate or guardianship.

I.(3) Securities Brokers. Section 517.12(1), Florida Statutes requires the registration of the sellers of securities. These are often referred to as "securities brokers" or "stockbrokers," but more accurately they are termed "registered representatives" of a "securities broker-dealer" firm. In Florida and most other states sellers of securities products generally must possess either a Series 6 license (for mutual funds sales, generally) or Series 7 license (for mutual fund, individual stock and bond sales, generally). Regulation of brokerage firms and their registered representatives is also provided by the U.S. Securities and Exchange Commission pursuant to the Securities and Exchange Act of 1934 ("SEA"), as amended, and the National Association of Securities Dealers (NASD) (a “self-regulatory organization”). Under Section 3(a)(4) of the SEA "broker" is defined broadly as any person engaged in the business of effecting transactions in securities for the account of others. Brokers have statutorily or regulatory imposed duties, such as the "duty of fair dealing" and the "duty of best execution," but do not generally possess a broad fiduciary duty to the customer (i.e., a duty to act in the customer's best interests).<sup>44</sup>

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<sup>44</sup> In an attempt to not subject their registered representatives to the higher standards of the Investment Advisors Act of 1940, many brokerage firm customer agreements, even some providing for asset-based fees, contain a statement similar to the following found in one major brokerage firm’s agreement: “I agree that [this] Agreement pertains to the brokerage services you provide to me. I understand that if I elect to enroll in an investment advisory service, whether discretionary or non-discretionary, I must execute additional agreements. I agree to pay your account fees, service and other fees, and securities brokerage fees as they may apply to my account from time to time ... I understand that I may pay for each securities transaction on a per trade basis (transaction-based pricing) on which I am charged a commission or other compensation for each transaction to purchase or sell securities. I understand that, for certain accounts, you offer alternatives to transaction-based pricing, such as

Compensation to a stockbroker usually flows from commissions from the sale of investment products, including “sales loads” and “contingent deferred sales charges” and commissions on stock trades. Individual stockbroker compensation is determined by each brokerage firm, but the structure of such compensation arrangements often create additional conflicts of interest. For example, one brokerage firm’s customer agreement states:

[NAME OF MAJOR BROKERAGE FIRM] has a financial interest in the sales of proprietary products that are manufactured by its affiliates. [NAME OF MAJOR BROKERAGE FIRM] and its affiliates receive selling commissions or other compensation for investments, financial and insurance products you purchase. Field leaders receive a salary, bonus and are responsible for an operating budget for expenses. The amount of the bonus and operating budget varies depending on the products or service you purchase. Field leaders may receive higher compensation when proprietary products and mutual funds in the [NAME OF PROGRAM] are purchased ... because compensation structures vary by product type, financial advisors receive more compensation for sales of certain types of products, such as insurance rather than others.

Securities brokers may also choose to be registered investment advisors (discussed below), in which they are termed “dually registered.” In such instances the registered representative would usually enter into an investment advisory contract with the fiduciary client and would be subject to the fiduciary duties of the Investment Advisors Act of 1940, discussed below.

Since the late 1990's traditional brokerage firms have designed programs involving the payment of an annual percentage-based fee for account advice. Can securities brokers offer comprehensive planning, such as that involved in the preparation of an investment policy statement, without being a registered investment advisor? The SEC has proposed a rule<sup>45</sup> which exempts registered representatives of broker-dealer firms who provide certain fee-based planning services from the application of the Investment Advisers Act of 1940 (and its higher “fiduciary duty” standard and disclosure requirements), this proposed rule has received much criticism from consumer advocates<sup>46</sup> and registered investment advisors.<sup>47</sup>

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asset-based pricing. Under asset-based pricing ... I will pay a fee based on my relationship with you in lieu of paying traditional commissions and service fees. Annual fees are based on eligible assets in my household's enrolled accounts ... I understand that both transaction-based pricing and asset-based pricing are brokerage pricing alternatives and that neither alternative is an investment advisory service.”

<sup>45</sup> SEC Proposed Rule, Nov. 4, 1999, “Certain Broker-Dealers Deemed Not To Be Investment Advisers” [Release Nos. 34-42099; IA-1845; File No. S7-25-99], available at [www.sec.gov](http://www.sec.gov).

<sup>46</sup> In 2003 the Consumer Federation of America, Fund Democracy, the Investment Counsel Association of America, Financial Planning Association, Certified Financial Planner Board of Standards, and the National Association of Personal Financial Advisors, delivered a joint letter to SEC Chairman William Donaldson, urging the SEC to take action on the rule proposed by the SEC in 1999, stating “SEC inaction on this important regulation has allowed brokers to transform themselves into investment advisers, or at least market themselves as if they have, without triggering the regulatory protections appropriate to that role,” said Barbara Roper, Director of Investor Protection for the Consumer Federation of America, adding “[t]he SEC must act promptly to ensure that consumers are not misled or confused.” “Investment advisers have a strict fiduciary duty that requires them to eliminate or disclose all conflicts of interests,” said David Tittsworth, Executive Director of the Investment

Nevertheless, the Florida jurist will see securities brokerage firm registered representatives, who purport not to be providing “investment advisory services,” formulating comprehensive investment plans for clients.

I.(4) Registered Investment Advisors. Section 517.12(3), Florida Statutes requires the registration of investment advisors. These are more accurately referred to as "investment advisory representatives" of a "registered investment advisor" (RIA) firm. A Series 65 or 66 license is required to become an investment advisory representative (IAR). Regulation is provided to larger registered investment advisor firms (i.e, generally those with over \$30 million of managed assets) by the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940 ("IAA"), as amended. Other investment advisors are subjected only to state regulatory scrutiny. An understanding of the duties imposed upon investment advisor representatives can be gleaned from the following:

"Fundamental to the Advisers Act is an adviser's fiduciary obligation to act in the best interests of its clients and to place its clients' interests before its own. As part of its fiduciary duty to clients, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to clients. Advisers are required to disclose any facts that might cause the adviser to render advice that is not disinterested. When an adviser fails to disclose information regarding potential conflicts of interest, clients are unable to make informed decisions about entering into or continuing the advisory relationship."<sup>48</sup>

The imposition of such a broad fiduciary duty upon registered investment advisors by the Investment Advisers Act of 1940 was confirmed by the U.S. Supreme Court in *S.E.C. v. Capital Gains Bureau*, 375 U.S. 180 (1963). In discussing the formation of the Investment Advisers Act of 1940, the U.S. Supreme Court noted this testimony before the Committees of the U.S. Senate by the president of the Investment Counsel Association of America, the leading investment counsel association:

"[T]wo fundamental principles upon which the pioneers in this new profession undertook to meet the growing need for unbiased investment information and guidance were, first, that they would limit their efforts and activities to the study of investment problems from the investor's standpoint, not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their

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Counsel Association of America, adding: “[w]e think that brokers who act like an investment adviser should be held to the same laws and standards that investment advisers are held to.” A copy of this comment letter is available located at [www.sec.gov](http://www.sec.gov) under “Proposed Rules,” and listed under Comments to the proposed rule “Certain Broker-Dealers Deemed Not To Be Investment Adviser.”

<sup>47</sup> See Comments of Ron A. Rhoades, Director of Research, Joseph Capital Management, submitted to the Securities and Exchange Commission on April 5, 2004, located at [www.sec.gov](http://www.sec.gov) under “Proposed Rules,” and listed under Comments to the proposed rule “Certain Broker-Dealers Deemed Not To Be Investment Adviser.”

<sup>48</sup> "Letter From the Office of Compliance Inspections and Examinations: To Registered Investment Advisers, on Areas Reviewed and Violations Found During Inspections," dated May 1, 2000, and posted on the SEC's web site, [www.sec.gov](http://www.sec.gov).

investment judgment; and, second, that their remuneration for this work would consist solely of definite, professional fees fully disclosed in advance."<sup>49</sup>

Registered investment advisors in Florida who manage investment portfolios for their clients, are clearly subject to a fiduciary duty by the plain meaning of Section 518.10, *Florida Statutes* (2003).<sup>50</sup>

J.(5) Contrasting the Types of Advisors. Insurance agents and registered representatives of securities broker/dealer firms are generally compensated upon the sale of a product (such as a life insurance policy, an annuity, a mutual fund, or a stock). They generally receive commissions from the issuer of the product. Generally, the compensation received by an insurance agent or registered representative is not provided directly from the consumer. Additionally, while various duties are imposed upon insurance agents and securities brokers with regard to such issues as suitability or fair dealing, the very high "fiduciary" standard is not usually imposed.

By comparison, an investment advisor representative (IAR) of a registered investment adviser (RIA) firm serving individual clients is subjected to a much higher degree of regulation. Generally, investment advisory representatives and their RIA firms (if not dually registered as an RIA firm and a broker/dealer firm) receive compensation directly from the client, either in the form of an hourly fee, a fixed fee or semi-annual retainer arrangement, or a percentage of the assets managed for the client. The IAR and the RIA firm are subjected to a high fiduciary standard - to act in the best interests of the client.<sup>51</sup>

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<sup>49</sup> *S.E.C. v. Capital Gains Bureau*, 375 U.S. 180, 190 (1963).

<sup>50</sup> 518.10 Fiduciary defined as used in ss. 518.11-518.14.--For the purpose of ss. 518.11-518.14, a "fiduciary" is defined as an executor, administrator, trustee, guardian (except any guardian holding funds received from or currently in receipt of funds from the United States Department of Veterans Affairs, to the extent of those funds alone), or other person, whether individual or corporate, who by reason of a written agreement, will, court order, or other instrument has the responsibility for the acquisition, investment, reinvestment, exchange, retention, sale, or management of money or property of another.

<sup>51</sup> F.A.C. Section 3E-600.0131 Prohibited Business Practices for Investment Advisers and Their Associated Persons, provides in pertinent part:

"(1) The following are deemed demonstrations of unworthiness by an investment adviser or an associated person of an investment adviser under Section 517.161(1)(h), F.S., without limiting that term to the practices specified herein:

(a) With respect to any customer, transaction or business in, to or from this state, engaging in any conduct prohibited by, or failing to comply with the requirements of, the following: Sections 204, 204A, 205, 206, 207, 208 of the Investment Advisers Act of 1940 ...

(2) The federal statutory and regulatory provisions referenced herein shall apply to investment advisers and federal covered advisers, to the extent permitted by the National Securities Markets Improvement Act of 1996."

Accordingly, the fiduciary duties which have been held to exist under federal law for registered investment advisory firms and their representatives also apply to state-registered advisors. In addition, the definition of fiduciary found in Section 518.10, *Florida Statutes* (2003) incorporates registered investment advisors in Florida who provide management of their client's investment portfolios.

Furthermore, IARs and RIA firms must disclose conflicts of interest, as evidenced by Rule 3E-600.0131, Florida Administrative Code, which prohibits IARs and RIA firms from "[f]ailing to disclose to customers in writing before any advice is rendered any material conflict of interest relating to the adviser or any of its employees which could reasonably be expected to impair the rendering of unbiased and objective advice ...." Overall, the regulatory scheme imposed upon investment advisory firms is generally regarded to be stricter than that imposed upon registered representatives. For example, under the "brochure rule" the investment advisory representative must provide to the client either Form ADV, Part II, which contains a multitude of disclosures about the RIA firm, its fees, the background of its investment advisory representatives, and their compensation. Additionally, RIA firms are prohibited from utilizing client endorsements in advertising (unlike broker/dealer firms).

I.(6) Is One Type of Investment Consultant Always Preferable? While the different regulatory schemes impose different duties and responsibilities on each type of advisor, neither the UPIA nor Section 518.11, *Florida Statutes* (2003) require the utilization of any particular type of advisor. Hence, the author suggests that inquiry as to the suitability of the type of investment consultant chosen should be focused upon the ability of the consultant to design and implement an appropriate Investment Policy Statement for the trust, estate or guardianship, the costs incurred in connection with the engagement of the consultant and the implementation of the consultant's recommendations, and the acceptance by the investment consultant of responsibility for the development and implementation of the investment plan.

I.(6)(a) The Ability To Develop An Investment Policy: Investment consultants who are chosen to design and/or implement an Investment Policy Statement should demonstrate the ability to develop this written document. Comprehensive knowledge of investment theory (including Modern Portfolio Theory and its subset, Efficient Markets Theory), individual income taxation, and (where appropriate) fiduciary income taxation should be demonstrated. Unfortunately, a good portion of the training given to brokers, insurance agents, and investment advisors is in the skill of "gathering assets under management," (i.e., selling). As a result, a significant number of investment consultants design portfolios which exhibit substantially greater risk than fiduciaries should accept.

How can an investment consultant's knowledge and objectively be tested? We suggest that individual fiduciaries can ask "financial advisors" or "investment consultants" these key questions:

- ▶ Will you present to me a written investment plan, customized to meet the needs of the beneficiary?
  
- ▶ Will you put in writing to me that you are a fiduciary?

- ▶ Will you promise that every recommendation you make to me will be in the best interests of the ward or trust beneficiary?
- ▶ Do you also provide me tax advice regarding the investment planning?
- ▶ Will you fully disclose to me any and all potential conflicts of interest you or your firm may possess with regard to any recommendations made?
- ▶ Will you discuss with me all of the fees associated with my investments, including commissions, 12b-1 fees, sales loads, contingent deferred sales charges, bid-ask spreads, principal mark-ups, mutual fund transaction and opportunity costs, and other "hidden" costs of investing?
- ▶ Do you have access to low-cost mutual funds?
- ▶ Do you also have access to any low-cost, institutional-style mutual funds not directly available to individual investors?
- ▶ Will you promise to not attempt to place into the investment portfolio any variable annuities, proprietary products of your own firm, or high-cost investment products?

If the answer to any of these questions is “no,” then perhaps it’s time for the fiduciary to keep looking for another investment consultant.

I.(6)(b) Appropriateness of Fees Paid To An Investment Consultant. What is an appropriate fee to be paid to an investment advisor? Disclosure of fees and costs should be a paramount focus of any inquiry into a proposed investment plan. The focus should be not just on the fee paid to the individual investment consultant, but rather the total costs of implementation of the recommended investment strategy. Jonathan Clements, a respected columnist of the Wall Street Journal, writes that a goal is to have total fees and costs relating to investing at not greater than 1% annually.<sup>52</sup> However, Mr. Clements

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<sup>52</sup> Clements, Jonathan, *Getting Going* column in Wall Street Journal, August 13, 2003, in which he states: “I would not use an adviser unless the total annual cost, including the adviser's fee, is less than 1.2% of your portfolio's value, and preferably below 1%. Few advisers will meet that hurdle. But if the total cost is much higher, it will be difficult to earn decent returns.” In a more recent column, on April 11, 2004, Mr. Clements adds: “Settle on the three advisers you are most comfortable with, and arrange to meet them in person. What should you look for? Good advisers won't be narrowly focused on your investment portfolio. Instead, they will take a broad view of your finances, asking about your goals and trying to figure out how best to achieve them. If the conversation ranges over estate planning, trimming taxes, refinancing your mortgage, adjusting your insurance coverage and paying for your kids' college education, that's an excellent sign. Also look for advisers who are forthright about costs, including not only their fees, but also the fees charged by the investments they will recommend. I would

did not appear to include in his estimate all of the “hidden costs” of investing, previously discussed in this white paper. When all “hidden” costs are estimated and taken into account, this author suggests that the acceptable threshold for total fees and costs is 1.5% annually or less for investment portfolios of \$250,000 or greater. Larger investment portfolios should possess somewhat lower annual total fees and costs. By contrast, portfolios of less than \$250,000 may require additional fees relating to design and implementation in the first year, with lower fees (closer to the 1.5% threshold) appropriate in subsequent years.

The appropriate *type* of fee paid to the investment advisor may also vary. For example, a fee-only investment advisor receiving fees based upon a percentage of assets under management (or a negotiated annual flat fee) may be in a better position to provide objective analysis and access lower-cost investment products, if that advisor refuses all other forms of compensation (direct or indirect). However, a fee based upon a percentage of assets under management, such as 1% a year, may be inappropriate if the investment portfolio involves only the laddering of a government or municipal bond portfolio or the laddering of C.D.’s. For example, the laddering of a municipal bond-only portfolio, and its ongoing monitoring, may be better undertaken by a knowledgeable registered representative of a securities brokerage firm. Alternatively, a registered investment advisor charging a much lower annual percentage fee and shopping fixed income investments through multiple brokerage firms (to get better pricing) could be considered.

I.(6)(c). Acceptance of Legal Responsibility By The Investment Consultant. Section 518.112, *Florida Statutes* (2003), provides an incentive for a fiduciary to engage an investment consultant, as proper delegation of investment duties can limit the fiduciary’s liability as to certain investment decisions.<sup>53</sup> In contrast to the UPIA,<sup>54</sup> the Florida Prudent Investor Rule does not expressly provide that the investment consultant engaged by the fiduciary has a duty to exercise care. However, other provisions of Federal or Florida law or regulations may impose a fiduciary duty or duty of due care upon the investment consultant.<sup>55</sup>

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lean toward advisers who levy an annual retainer, an hourly fee or a percentage of assets, and I would be leery of those who charge commissions. As I mentioned above, advisers typically cost around 1% a year. I certainly wouldn’t pay more than that, and if you hunt around, you can find competent advisers who charge less.”

<sup>53</sup> Section 518.112(4), *Florida Statutes* (2003), provides: “If all requirements of subsection (3) are satisfied, the fiduciary shall not be responsible otherwise for the investment decisions nor actions or omissions of the investment agent to which the investment functions are delegated.”

<sup>54</sup> Section 9(b) of the UPIA provides: “In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.” See the UPIA and its comments in Exhibit 5 to this white paper.

<sup>55</sup> As discussed previously, a registered investment advisory firm and its investment advisor representatives possess

The fiduciary should not delegate to an investment consultant if the consultant seeks to avoid the fiduciary duties imposed by Federal or Florida law, or seeks relief from the standards of care otherwise applicable to the investment consultant. As set forth in the comments to Section 9 of the UPIA:

The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation. This sense that it is imprudent to expose beneficiaries to broad exculpation clauses underlies both federal and state legislation restricting exculpation clauses, e.g., ERISA §§ 404(a)(1)(D), 410(a), 29 U.S.C. §§ 1104(a)(1)(D), 1110(a); New York Est. Powers Trusts Law § 11-1.7 (McKinney 1967).<sup>56</sup>

For example, the following clause, found in the client agreement of a registered investment advisor, would be improper for a fiduciary to approve: "Advisor shall not be responsible for losses in connection with Advisor's errors in judgment ... except for losses resulting from gross negligence, bad faith, or wilful malfeasance."

Fiduciaries should seek to clarify whether the investment consultant has accepted a fiduciary duty in connection with the investment management services provided. A paragraph could be inserted into the investment advisory contract which clearly delineates the fiduciary responsibility of the investment consultant and the associated duty to disclose conflicts of interest. An example follows:

By signing this Investment Advisory Agreement we acknowledge our fiduciary responsibility to you. Joseph Capital Management, LLC shall exercise its best efforts to act in good faith and in the best interests of the client. Joseph Capital Management, LLC shall provide written disclosure to the client prior to the engagement of the adviser, and thereafter throughout the term of the engagement, of any conflicts of interest which will or reasonably may compromise the impartiality or independence of the adviser. Joseph Capital Management, LLC shall not receive any commissions or other remuneration that is contingent on any client's purchase or sale of a financial product. Joseph Capital Management, LLC shall not receive any

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a fiduciary duty to their clients. This duty would extend to a trustee and the trust's beneficiaries. Also as discussed previously, the duties of registered representatives (i.e., stockbrokers) of broker-dealer firms (i.e., stock brokerage firms) are less clear, even when providing fees based upon a percentage of assets under management and even when providing comprehensive investment advice (such as that which would be undertaken in the formulation of a proper investment policy statement). Fiduciaries who seek to delegate the investment function and who seek to employ broker-dealer firms should therefore request that an investment advisory contract be entered into, not a standard brokerage agreement. See section J.(3) of this white paper, above, for a further discussion of the duties (or lack of fiduciary duties) of certain registered representatives.

<sup>56</sup> A copy of the UPIA and its comments are included as Exhibit 5 to this white paper.

commissions, 12b-1 fees, or any fee or other compensation from another party based on the referral of a client or the client's business.<sup>57</sup>

J.(7) Monitoring the Investment Consultant's Actions. Section 518.12(1), *Florida Statutes* (2003) provides that the fiduciary should exercise reasonable care "in reviewing periodically the agent's actions in order to monitor overall performance and compliance with the scope and specific terms of the delegation." The Investment Policy Statement should ordinarily document what reports will be furnished to the fiduciary, and by whom. The diligent fiduciary will review reports concerning the investment portfolio at least quarterly. The fiduciary should also consider an annual comparison of the investment consultant's performance, which should include comparisons to appropriate indices. Should the fiduciary discern any unauthorized material departure from the terms of the Investment Policy Statement the fiduciary should address the matter with the investment consultant immediately and, if appropriate, bring the situation to the attention of the Court with recommendations for action.

***K. What Works and Does Not Work In Investing: An Overview.*** Related to the issue of investment fees and costs are the benefits which may be obtained from various investment strategies. The Florida jurist will often be confronted with claims as to the superiority of a particular investment product or strategy. Will the investment product or strategy proposed actually increase the portfolio's expected returns, relative to a "market neutral" portfolio (consisting of, perhaps, a low cost "total stock market" index fund and a broadly diversified low cost bond fund), especially after costs are taken into account? Given all the "hype" of the "Wall Street marketing machine," what strategies really work?

Fortunately for the fiduciary and the individual investor, academic research has been able to discern those very few strategies which may work to enhance long-term returns and/or reduce the risks present in a portfolio. Additionally, academic research has also cast substantial doubt on the ability of active management to add value to the individual investor. While space constraints does not permit a full examination of various investment strategies,<sup>58</sup> the following key observations are offered.

K.1. The Critical Role of Strategic Asset Allocation. The key determinant of investment portfolio performance (i.e., gross returns) is determined by the allocation of the investments among various asset classes. What's an asset class? We might think of each of these three types of investments - stocks, bonds

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<sup>57</sup> Excerpt from Joseph Capital Management, LLC's investment advisory agreement for its continuous investment management programs, as of April, 2004.

<sup>58</sup> See the suggested reading list, attached as Exhibit 6, for materials which more fully explore the academic research which reveals those few strategies that enhance return in portfolios, and the means of reducing portfolio volatility given the desired level of return through diversification among different asset classes.

and cash - as having different characteristics. Each type of investment has exposure to different types and amounts of risks. We would anticipate that bonds generally earn more than cash (which, lying around the house, earns nothing). Based upon a general knowledge of stocks and bonds, and what we hear in the media, we would further expect that stocks, as a group, generally earn for the investor a "return" (the sum of all the investor receives) more than bonds - over long periods of time. We also "know" that stock prices go up and down quite a bit, while the price of fixed income investments (such as bonds) does not fluctuate as much. Consequently, we can conclude that cash, bonds and stocks have different "returns" characteristics as well as different "risks" associated with them.

"Stocks" as an asset class can further be broken down into investment "styles":

"Large cap stocks" vs. "mid-cap stocks" vs. "small-cap stocks"

"Growth stocks" vs. "balanced" (or core) stocks" vs. "value stocks"

"Domestic" (U.S.) vs. "international developed markets stocks" vs. "emerging markets stocks"

Fixed income investments are often broken down by maturity or duration: long-term, intermediate-term, or short-term. Fixed income investments are also broken down by credit quality: "high," "intermediate," and "low" (i.e., "junk-bond").

The allocation of an investment portfolio among asset classes is key to not only long-term performance, but also to the volatility of the portfolio. Through diversification among asset classes with different characteristics the overall volatility (one measure of risk) of an investment portfolio can be reduced. In other words, "don't put all of your eggs in one basket."

K.2. Market Timing and Security Selection: Failure To Add Value. If you follow Wall Street's advertising it seems that every firm has some analyst, mutual fund manager, or technique that enables them to select stocks or time the market's ups and downs in a way that will "beat the market." What do the academics say? "It is safe to say, on average, the pension funds and balanced mutual funds are not adding value above their asset allocation policy due to their combination of timing, security selection management fees, and expenses. Thus, about 100 percent of the total return is explained by asset allocation policy."<sup>59</sup>

Please note that just because an investment manager did well in the past does not mean the same manager will continue to "outperform" in the future, as evidenced by this study:

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<sup>59</sup> Ibbotson and Sinquefeld, *Stocks, Bonds, Bills, and Inflation 2004 Yearbook* (Chicago: Ibbotson Associates, 2004). This annual yearbook is on our recommended reading list and provides a wealth of data concerning the historical returns of various asset classes.

## Don't Chase Hot Funds: The Subsequent Performance of Top 30 Mutual Funds

5 Year Period During Which Top 30 Funds Were Identified	Overperformance Of 30 Funds Relative To S&P 500 During 5 Years The Funds Were "On Top"	Underperformance Of Same 30 Funds Relative To S&P 500 During Subsequent Period (Thru 2001)
1970-1974	+ 3.13%	- 1.04%
1975-1979	+ 15.16%	- 1.31%
1980-1984	+ 7.46%	- 1.84%
1985-1989	+ 1.67%	- 0.53%
1990-1994	+ 10.08%	- 3.41%

Source: Dimensional Funds Advisors; Micropal®

While a full discussion of the many aspects of the "active management" vs. "passive management" issue is beyond the scope of this paper, the author notes that the issue of "active vs. passive" investment management should not still be seriously debated. In this regard, the author has always enjoyed this quote from Rex Sinquefeld:

Passive management ... stands on solid theoretical grounds, has enormous empirical support, and works very well for investors ... So who still believes markets don't work? Apparently it is only the North Koreans, the Cubans and the active managers ... These [academic] studies, along with earlier studies, provide a fifty-year history of professional investment management. The message is clear: the beat-the-market efforts of professionals are impressively and overwhelmingly negative. In any asset class, the only consistently superior performer is the market itself.<sup>60</sup>

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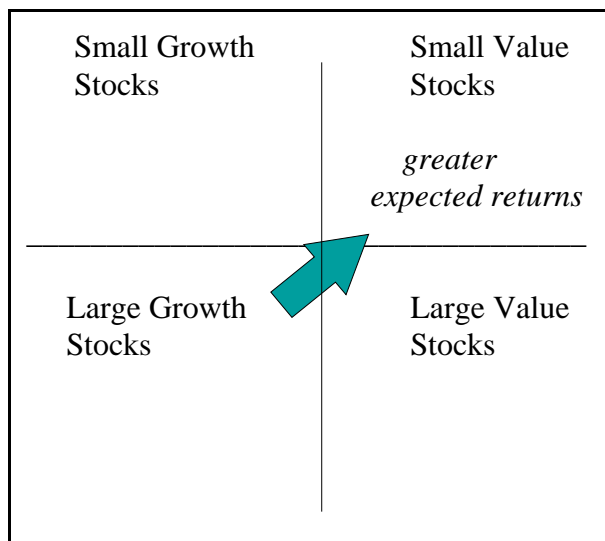
<sup>60</sup> Asset Management: Active vs. Passive Management, Rex Sinquefeld (Oct. 1995), white paper, available at [www.dfaus.com](http://www.dfaus.com) (click "Library" link at top of web page, then "articles").

K.3. What Does Work? The “Small Cap” and “Value” Effects. “Efficiency” does not eliminate the fundamental relationship between risk and reward in our capital markets. Academic research has revealed that, over long periods of time (often 10 years or longer), “small cap stocks” have historically outperformed “large cap stocks”, and that “value stocks” have historically outperformed “growth stocks.”

Research has revealed that stock mutual funds with higher BtM (book-to-market ratio) (i.e., lower price-to-book ratios) generally perform better over long periods of time. Professor Jeremy Siegel summarized data for stock asset classes when ranked by both Book-To-Market (i.e., value vs. growth) quintiles and market cap (size) quintiles, formulating the following table.<sup>61</sup>

Entire Period		Book-To-Market Quintiles				
		Growth	4	3	2	Value
Size Quintiles	Small	6.41%	12.87%	18.03%	20.40%	23.26%
	2	5.15%	11.99%	13.96%	15.23%	15.94%
	3	5.93%	11.83%	14.75%	14.60%	17.44%
	4	10.71%	10.37%	11.39%	15.18%	16.18%
	Large	10.28%	12.13%	11.02%	11.27%	13.59%

(Data for period from July 1963 through December 2000. Used with permission.)



As shown in the table above, regardless of the size quintile viewed a basket of value stocks beat a basket of growth stocks handily during the 37-year period surveyed. Additionally, in most of the value/growth quintile looked at a basket of small company stocks beat a basket of large company stocks.

As shown in the graphic at left, tilting an investment portfolio to “value” and “small cap” stocks can lead to expected higher returns over the long term.

<sup>61</sup> Jeremy Siegel, *Stocks For The Long Run* (3rd edition, McGraw-Hill, 2002), at page 138.

The “value effect” and “small cap effect” were discovered nearly two decades ago, and are often referred to as the “Fama-French 3-Factor Model.”<sup>62</sup> Many different research papers have examined the “value effect” and “small cap effect”, finding it to exist in overseas markets as well as U.S. markets.<sup>63</sup>

In the tables on the following pages is a comparison of a portfolio dominated by large company stocks only, versus a portfolio which has a substantial “small cap” and “value” tilt. Note that over the longest time horizon surveyed, 1970-2003, the portfolio with a “small cap” and “value” tilt had 1.30% greater average annualized returns. Using data from July 1926 through April 2004 the better diversified portfolio had a long-term performance advantage of 1.57% on an average annualized basis.

Also, as seen in the tables, for the period from April 2000 through March 2003 the more diversified portfolio had a positive total return of 8.60%, compared to the large cap-concentrated portfolio’s total return of -7.36%. Despite the academic research which reveals the “small cap effect” and the “value effect” and their persistency, the author continues to observe many corporate and other fiduciaries construct the equity portion of their portfolios entirely of large company stocks, often with a “growth tilt.” The negative effects of this approach were severe during the 2000-2002 large cap “meltdown.” Despite the negative results of this approach, many investors and investment professionals appear poised to repeat the same mistakes in the years ahead.

The conclusion is clear. Incorporating diversified “small cap stock” and “value stock” mutual funds into an investment portfolio increases investment returns over the very long term, with little additional risk (volatility) added to the portfolio. While not illustrated here, substantial reductions in portfolio volatility (with no statistically significant long-term effect on returns) can result when “international value” and “international small cap value” stock asset classes form a portion of the equity side of the investment portfolio.

In summary, diversification not just among individual stocks but among asset classes, utilizing academic research to identify asset classes that outperform over long periods of time in comparison the broad overall U.S. market, is one component of an investment strategy that can aid the fiduciary in achieving the desired level of return while reducing overall risk.

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<sup>62</sup> See Professor Eugene Fama and Professor Kenneth French’s seminal article on this aspect of asset class research, “*The Cross-Section of Expected Stock Returns.*” *Journal of Finance.* 47:2, pp. 427-465 (1992). A relatively recent update of this research is available online at [www.dfaus.com](http://www.dfaus.com) (click “Library” link at top of page, then “articles”), in Truman Clark’s article, *The Dimensions of Stock Returns, 2002 Update*, recommended for investment advisors. A more consumer-friendly explanation of the “value” and “small cap” effects can be found in texts by Larry Swedroe and Rhoades/Tringali/Ceparano; see Exhibit 6.

<sup>63</sup> For a summary of research on the Fama/French 3-factor model, see Professor Jim Davis’ article, *Explaining Stock Returns: A Literature Study* (December 2001), available at the [www.dfaus.com](http://www.dfaus.com) web site (click “Library” link at top of page, then “articles”). For an overview of the value effect found in international markets, see Dimson, Nagel and Quigley, *Capturing the Value Premium In The United Kingdom* (*Financial Analysts Journal*, Nov/Dec 2003).

**Annual Returns: Nondiversified Large Cap Balanced Portfolio vs. Diversified Portfolio**

Year	Non-Diversified Portfolio consisting of the following, rebalanced annually: 50% 5-Year U.S. Treasury Notes 50% U.S. large cap "balanced" stock mutual fund (i.e., S&P 500 index fund)	Better Diversified Portfolio consisting of the following, rebalanced annually: 50% 5-Year U.S. Treasury Notes 15% U.S. Large Cap balanced fund 15% U.S. Large Cap Value fund 10% U.S. Micro Cap fund 10% U.S. Small Cap Value fund
1970	10.44%	8.77%
1971	11.53%	12.83%
1972	12.07%	8.74%
1973	-5.03%	-7.77%
1974	-10.39%	-8.64%
1975	22.52%	30.32%
1976	18.36%	28.83%
1977	-2.89%	3.14%
1978	5.03%	7.66%
1979	11.26%	16.12%
1970-1979 average annualized returns	6.81%	9.30%
1980	18.15%	15.00%
1981	2.26%	8.90%
1982	25.26%	27.51%
1983	14.96%	21.23%
1984	10.15%	9.07%
1985	26.25%	24.90%
1986	16.80%	14.57%
1987	4.07%	1.40%
1988	11.45%	14.54%
1989	22.38%	17.65%
1980-1989 average annualized returns	14.90%	15.23%

<b>Annual Returns: Nondiversified Large Cap Balanced Portfolio vs. Diversified Portfolio</b>		
<b>Year</b>	<b>Non-Diversified Portfolio consisting of the following, rebalanced annually: 50% 5-Year U.S. Treasury Notes 50% U.S. large cap "balanced" stock mutual fund (i.e., S&amp;P 500 index fund)</b>	<b>Better Diversified Portfolio consisting of the following, rebalanced annually: 50% 5-Year U.S. Treasury Notes 15% U.S. Large Cap balanced fund 15% U.S. Large Cap Value fund 10% U.S. Micro Cap fund 10% U.S. Small Cap Value fund</b>
1990	3.29%	-3.75%
1991	22.71%	26.15%
1992	7.26%	12.94%
1993	10.43%	14.63%
1994	-1.92%	-2.62%
1995	26.59%	25.75%
1996	12.36%	11.47%
1997	20.73%	18.72%
1998	19.45%	9.75%
1999	9.51%	7.24%
1990-1999 average annualized returns	12.71%	11.60%
2000	1.67%	6.99%
2001	-2.23%	7.12%
2002	-4.64%	-1.35%
Total return for "market downturn" period from April 2000 to March 2003	-7.36%	8.60%
2003	15.44%	22.65%
2000-2003 average annualized returns	2.28%	8.51%
Average annual returns for 1970-2003	10.30%	11.60%
Standard deviation for the portfolio, 1970-2003	9.91%	10.33%

Source of data: DFA Returns software, © 2004 by Dimensional Funds Advisors, all rights reserved. Used with permission. Utilizing the "passive" mutual funds of DFA U.S. Large Company Portfolio, DFA U.S. Large Cap Value Portfolio, DFA U.S. Micro Cap Portfolio, and DFA U.S. Small Cap Value Portfolio, for the various asset classes illustrated, including both actual and simulated data (courtesy of Professors Fama and French). Past performance is not a guarantee of future returns. Returns include mutual fund management and administrative fees and actual or estimated transaction costs, but do not reflect fees which might be charged by a registered investment advisor to the fiduciary.

***L. Passive Management and The Prudent Investment Rule.*** While the Rule embraces Modern Portfolio Theory it does not specify the application of any particular investment strategy or the utilization of any particular form or type of investment. Nevertheless, some commentators have suggested that the Rule mandates the duty to utilize passive investment strategies (and not utilize active management techniques - such as market timing, stock picking, etc.).<sup>64</sup> Perhaps more accurately stated, especially in light of the restriction that additional costs may be incurred only “if they are appropriate and reasonable,” the Rule appears to require evidence that the higher costs of active management bring value to the investment process.<sup>65</sup>

The 1980's saw the development of super-fast computers and huge databases of information regarding stocks, bonds, and other securities, and the performance of pension fund and mutual fund managers (both “active” and “passive”). Financial economists - professors at universities all over the world - are granted access to this data and can discern what “works” and what does not “work.” In the past few decades, and especially over the last twelve years, a deeper understanding has been achieved of the factors that determine investment performance. While further insights are always yet to come, the data on active management is both compelling and consistent.<sup>66</sup> Active managers, whether they utilize security selection, market timing, or some combination of these techniques - consistently underperform passive managers over long periods of time. While statistics tell us that a few active managers will succeed over time (as a result of random chance), their success is predicted, not an indication of great investment skill,

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<sup>64</sup> The author acknowledges that there will be situations, such as the presence in the investment portfolio of a large, low-cost basis stock or mutual fund holding, that cannot be addressed adequately through strictly passive investment management. In such instances, “portfolio insurance” in the form of a collar strategy or a put-hedge strategy may be necessary in order to guard against an unreasonable time in the value of the portfolio until such time as diversification can be adequately achieved.

<sup>65</sup> The author is not aware of any such credible evidence, only anecdotes. In the words of one experienced securities litigator and author: “Once you let a broker try to ‘outperform’ the market, you are doing two things. First, you are accepting added volatility. Second, you are accepting increased costs, which practically assures that your strategy is doomed to failure. Every study by academics in economics and finance confirms that the only way to increase return significantly above the return generated by the market is by taking on additional risk. And allowing the broker to try to pick stocks, time the market, and constantly trade increases the transaction-cost burden on the portfolio to such an extent that it must outperform the market by a lot just to cover those have seen client portfolios where the cost of transactions is such that portfolio must earn in excess of 25 percent a year just to break even.” Daniel R. Solin, Esq., *Does Your Broker Owe You Money?* (Silvercloud, 2<sup>nd</sup> edition, 2004).

<sup>66</sup> For readings on the issue of passive versus active investment management, please refer to the reading list which is included as Exhibit 6 to this white paper. Also see David G. Booth, “Index and Enhanced Index Funds” (April 2001), a Dimensional Fund Advisors white paper, found in the “library” section of [www.dfaus.com](http://www.dfaus.com).

and (moreover) is not likely to be repeated. Furthermore, the academic evidence cannot uncover any way of predicting, in advance, which managers are likely to be successful in the future.<sup>67</sup>

Put more bluntly, Professors Wolfgang Drobetz and Friederike Kohler in 2002, noting the many academic researchers which had gone before them, succinctly stated their conclusion, “on average, active management (i.e., stock picking and/or timing) has not even been neutral to fund performance, but rather destroyed a significant portion of investors’ value.”<sup>68</sup>

Given all of the academic evidence available, the vast majority of objective researchers have concluded that active management has not (and cannot) demonstrate that its higher management and administrative fees (and often transaction costs and opportunity costs, as well as commissions) add any value that can be compensated under the Rule by a fiduciary. By contrast, investment advisors who apply (holistically and comprehensively) their skills in the design and implementation of an investment strategy, who adhere to Modern Portfolio Theory and who utilize passive investment methodologies, who possess the knowledge to keep the tax drag on investment returns to a minimum, and who objectively evaluate the available investment products for use in the investment portfolio, can receive compensation by the non-expert fiduciary for their value-added professional services.

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<sup>67</sup> The superiority of passive investment management over active investment management has been acknowledged by Florida’s State Board of Administration (SBA): “Based on our experience and data, the SBA’s investment program for the Florida Retirement System Pension Plan maintains a substantial reliance on passive index funds, with less emphasis on active management strategies, which have generally historically underperformed passive index funds. Although passive index funds have some operational risk, the SBA believes that they are the most effective and lowest cost method of attaining market returns over the long term.” 2002-3 Investment Report of the SBA. Despite this self-acknowledgment, only 50% of the funds of the Florida Retirement System are passively managed (per [www.sbafla.com](http://www.sbafla.com) web site, as of 2/04). 70% of the funds of the Florida Retirement System are invested in equities (i.e., stocks, stock mutual funds) (per [www.sbafla.com](http://www.sbafla.com) web site, as of 2/04). The “Florida Retirement System Total Fund Investment Plan” provides targets for allocations to “U.S.,” “global” and “foreign” equities, but does not (to this author’s surprise) establish targets within this broad asset classes for “large” vs. “small” capitalization stocks, nor for “value” vs. “growth” investments. Domestic equities are benchmarked against the Russell 3000, a broad-market U.S. stock index, which is surprising since this index is, over the long term, easy to beat by a simple shift of the U.S. equity portfolio toward “value” stocks (*see* Section K.3 of this white paper). The author submits that the plan’s trustees could do better by applying the Fama-French 3-Factor model in the development of a sounder investment policy, and by confining their equity investments to passively managed low-expense mutual funds. Florida’s employees, and taxpayers, should demand more.

<sup>68</sup> Drobetz and Kohler, *The Contribution of Asset Allocation Policy to Mutual Fund Performance*, March 2002 white paper, available at <http://www.wzw.unibas.ch/cofi/publications/papers/2002/01-02.pdf>.

**M. Conclusion: Expecting More From Fiduciaries and Their Advisors.** Managing wealth for another person is a solemn duty. It is a stewardship and a fiduciary role that should not be taken on lightly, nor without adequate research and knowledge. The Prudent Investor Rule as set forth in Section 518.11, *Florida Statutes* (2003) recognizes this fiduciary duty and subjects fiduciaries (and their investment advisors) to the highest levels of conduct. Arguably the Rule suggests (and perhaps mandates) the use of passive investing for many investment portfolios. In all events the Rule requires that costs be considered and kept low. The Rule also adopts Modern Portfolio Theory, which is best followed through a process known as strategic asset allocation.

The author suggests that the time has come to better hold fiduciaries and their investment advisors to the high standards of the prudent investor rule. Florida jurists, with their ability to review investment plans submitted by many fiduciaries, possess the unique ability to raise the expected level of adherence to the prudent investor rule and its requirement that fiduciaries, or their advisors, be exceptional stewards of wealth. The Florida jurist should send “back to the drawing board” any fiduciary who submits an investment policy which:

- fails to adopt the tenets of Modern Portfolio Theory;
- involves high costs or fees;
- does not require tax-efficient investing;
- fails to properly diversify among various asset classes and individual securities; or
- does not require adequate monitoring of the investment consultant by the fiduciary.

While not discussed previously, please be aware that the hardest part of a fiduciary’s job (and/or that of the investment consultant) may not be the formulation of the investment policy. Rather, it is sticking to the plan through inevitable market swings. This is why a sound investment policy statement will specify, in advance, the response to future market events (through rebalancing targets), in order to avoid the emotional reactions to market events which lead to incorrect decisions.

Whether or not investment decisions are to be delegated, fiduciaries should be encouraged to review texts on investment policy formulation and investment theory. Since many individual fiduciaries will not possess adequate education and skill to meet the high standards imposed by the prudent investor rule, in many instances the fiduciary should be encouraged to engage a professional investment advisor. Not every “investment consultant” will do, however. Fiduciaries should seek out those few investment consultants who possesses the skill, knowledge and expertise to assist the fiduciary in the proper discharge of the fiduciary’s duties.

In the final analysis, the Prudent Investor Rule is not a test of investment performance; rather, it sets forth standards of conduct.<sup>69</sup> No longer are certain investments defined to be “prudent” under all circumstances. Instead, the manner of formulation of a sound investment policy in adherence to Modern Portfolio Theory, and its manner of implementation, define correct practices for the fiduciary to observe. In the event of claims of breach by the fiduciary of the fiduciary’s investment management duties, it is the manner of action of the fiduciary which will be the focus of the inquiry. As reviewers of investment policies under several circumstances and as, perhaps, the ultimate protectors of the wealth for various wards and some trust and pension fund beneficiaries, the Florida jurist should be proactive in requiring fiduciaries to adhere to a sound process so as to adhere to the substantial requirements of the Prudent Investor Rule.

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<sup>69</sup> Section 518.11(1)(b), *Florida Statutes* (2003).

**Exhibit 1: Suggested Questionnaire To Fiduciaries, Their Investment and Legal Counsel In Connection With Review of Investment Proposals or Decisions**

In connection with the upcoming judicial review of either a proposed or prior action of a fiduciary (the “Inquiry”) by this Court, please answer the following questions in your petition or motion or in a supporting or opposing memorandum. If you are submitting a written investment plan, it is preferable that these questions be addressed in a formal written Investment Policy Statement, which should be attached to the petition, motion or memorandum.

1. General Applicability of Prudent Investor Rule. Is the “prudent investor rule” as set forth in Section 518.11, *Florida Statutes*, applicable to the decisions of the fiduciary which are the subject of this Inquiry? If not, please state the reason for non-applicability to this Inquiry.
2. Modification of Prudent Investor Rule. As to the Inquiry, has the prudent investor rule been modified by any language of the governing instrument (if any), any prior decision of this or any other Court, or by any other means? If yes, please summarize the modifications made to the general prudent investor rule which are pertinent to this Inquiry.
3. Investment Time Horizon; Timing For Utilization of Funds. What is the total amount of the funds available for investment? What are the anticipated distributions from the investment funds either to, or applications for the benefit of, the beneficiary(ies), and when are such distributions anticipated?
4. Target Rate of Return. Given the needs of the beneficiary and the current investment climate, what is the target rate of return for the investment portfolio as a whole (before taxes, any adjustment for inflation, investment costs, and distributions to beneficiaries)?
5. Asset Allocation. What is the suggested allocation of the portfolio between equities (stocks, stock mutual funds), fixed income investments (bonds, CDs), real estate, cash, and other asset classes? What is the expected return of this mix over the investment time horizon? What are the permitted types of investments for implementation of the overall investment policy? Does the investment plan set forth any targets for rebalancing the investments should a substantial rise or fall in values of a particular asset or asset class occur? If so, what are the rebalancing targets?
6. Current Investments. What are the current investments of the portfolio? What investments are to be retained or sold (or redeemed), and why?

7. Specific Investment Recommendations with Complete Cost Disclosure. List all specific investment recommendations recommended by the investment policy. In connection with the overall investment portfolio and each specific investment, summarize the investment costs, addressing: (1) commissions or sales loads; (2) contingent deferred sales charges; (3) 12b-1 fees; (4) investment management and administrative fees, and/or investment advisory fees; (5) bid-ask spreads likely to be incurred; (6) market impact costs likely to be incurred; and (7) opportunity costs due to cash holdings by investment managers.
8. Tax Strategy. What strategies are employed to minimize taxes, given the marginal tax rates applicable to the trust, estate or guardianship, or to the beneficiary(ies)?
9. Review Process. What is the frequency and form of portfolio reviews? What is the reporting process [by custodians of the investment funds to the fiduciary, by the investment consultant (if retained) to the fiduciary, and by the fiduciary to the court].
10. If Delegation Occurs To An Investment Consultant. If the fiduciary delegates duties to the investment consultant:
  - (a) How many investment consultants were interviewed by the fiduciary?
  - (b) Does the fiduciary possess any personal investment relationship or other business transactions with the investment consultant?
  - (c) List all of the investment consultant's actual and potential conflicts of interest which might arise from the furnishing of the advice, such as incentive compensation arrangements, sales bonuses or sales awards, non-access to lower-cost investment products due to non-availability on the brokerage platform, etc.
  - (d) What is the investment consultant firm's compensation, and that paid to the investment consultant, arising from the advice given or the implementation of the investment plan?
  - (e) What experience does the investment consultant possess in investing fiduciary funds?
  - (f) Summarize the duties and responsibilities of the fiduciary and the investment consultant as to each other.
  - (g) Provide a copy of the contract with the investment consultant. Be aware that any exculpatory clauses will be closely scrutinized and may not be acceptable if they violate of Sections 518.10-518.14, *Florida Statutes*.

A formal investment policy statement is strongly recommended for adoption by all fiduciaries. While no specific form of investment policy statement is required by this Court, fiduciaries and their advisors are directed to the following as resources for compliance with the duties imposed by Sections 518.10 to 518.14, *Florida Statutes* (2003), with respect to investment decisions by fiduciaries:

*Prudent Investment Practices -A Handbook for Investment Fiduciaries*, published by the Foundation for Fiduciary Studies and the AICPA. Available for \$30.00 at [www.fiduciarystore.com](http://www.fiduciarystore.com).

*How to Write an Investment Policy Statement*. This compact guide will give a fiduciary a clearer understanding of three key points: the definition of a fiduciary; the responsibilities and liabilities that are associated with being a fiduciary and the need for developing an investment policy statement. Available for \$19.00 at [www.fiduciarystore.com](http://www.fiduciarystore.com).

*Investment Policy Statement Guide*, by Norman M. Boone, MBA, CFP and Linda S. Lubitz, CFP. This software, available from Ibbotson Associates, is a tool which can save hours of time when preparing investment policy statements, and contains language specific to investments by fiduciaries. It is recommended for those investment consultants who frequently prepare such statements. Available for \$165.00 at [www.ibbotson.com](http://www.ibbotson.com).

## **Exhibit 2: Suggested Test Questions For An Individual Fiduciary**

*Frequently a fiduciary will appear before a Florida jurist without an Investment Policy Statement and profess to know a lot about investments. We suggest the following basic questions to test the fiduciary's knowledge.*

Q. In relation to its role under the “Prudent Investor Rule,” describe “Modern Portfolio Theory.”

A. “Modern Portfolio Theory” is utilized by risk-averse investors to construct portfolios in order to optimize market risk for expected returns, emphasizing that risk is an inherent part of higher reward. It is also called portfolio theory or portfolio management theory. According to the theory, it's possible to construct an 'efficient frontier' of optimal portfolios offering the maximum possible expected return for a given level of risk. This theory was pioneered by Harry Markowitz in his paper "Portfolio Selection," published in 1952 by the Journal of Finance. The Prudent Investor Rule, as expressed in Section 518.11, *Florida Statutes* (2003), and the UPIA, incorporates the tenets of Modern Portfolio Theory.

Q. In relation to the Prudent Investor Rule, what is the “Efficient Markets Theory” (also known as the “Efficient Markets Hypothesis”) and why is it important?

A. A theory stating that stock prices perfectly reflect all market information that is known by all investors. The theory also states that no investor can beat the market's returns through skill because it is impossible to determine future stock prices, and that luck explains why some investors beat the market. The market is "efficient" in the sense that stock prices reflect the information about a company, which is instantaneously made available to investors and investment managers. Even if there do exist some pricing efficiencies in the market, active mutual fund management has extremely high hurdles to cross in the form of higher management fees, opportunity costs, and transaction costs. Academic researchers working with survivorship bias-free databases on mutual fund performance have concluded that active mutual fund managers can be expected to underperform passive "index" strategies. Additionally, academic studies have concluded that past "winners" in the active management lottery do not usually repeat. Relating to the Prudent Investor Rule, fiduciaries have a duty to control costs, and the higher fees of active management without an academic basis for utilization of active management strategies might compel the fiduciary to adopt passive management strategies.

Q. Describe “Strategic Asset Allocation” and how it differs from “Tactical Asset Allocation.” Do you subscribe to either of these investment philosophies, and if so, why?

A. Under strategic asset allocation (SAA), long-term capital market assumptions are utilized to develop an optimal asset mix for each risk/return profile, which is rebalanced back to the desired target each month/quarter/year. SAA makes no attempt to forecast performance. Often called a "fixed-mix" approach, SAA allocates a fixed percentage of assets among each of two or more asset classes. If you've met with a professional financial advisor to develop an asset allocation strategy, and maintain your

target asset allocation mix by periodically rebalancing your portfolio, you are practicing SAA. The primary investment objective of the typical SAA fund is to provide solid rates of return at moderate risk levels by diversifying across asset classes. Secondary goals include minimal turnover and modest transaction costs. Strategic asset allocation is viewed by many academics as a sound approach to investing. By contrast, under tactical asset allocation (TAA) proprietary market research augments long-term capital assumptions to determine where most attractive current opportunities exist. TAA portfolios may be rebalanced quarterly or more often. TAA attempts to do more by introducing an element of market timing into the equation. TAA seeks to increase returns by forecasting the performance of various asset classes and then adjusting the percentage allocated to each asset class accordingly. Here's a hypothetical example. Suppose that a fund is currently allocated 65 percent to stocks, 30 percent to bonds and 5 percent to cash equivalents. If the fund managers believe that stocks are going to drop in value relative to bonds and cash equivalents, they might adjust the portfolio to 40 percent stocks, 50 percent bonds and 10 percent cash equivalents. The performance record of TAA has been somewhat mixed due to the sheer difficulty of forecasting which asset classes are expected to outperform or under perform. Few TAA funds have beaten their SAA counterparts. TAA funds face two additional hurdles. First, because they are more actively managed, these funds tend to have higher expense ratios than SAA funds. Second, because TAA funds engage in more trading than their strategic counterparts, they also tend to generate higher taxable distributions and have higher "hidden" transaction costs. As a result, TAA funds generally need to earn higher returns than SAA funds to deliver the same after tax returns.

Q. Relating to investment in various stock asset classes, what is the Fama-French three-factor model? Describe the "market effect," the "small cap effect," and the "value effect," and how these effects are determinative of the long-term investment performance of an investment portfolio.

A. In 1992 Professors Eugene Fama, Sr. and Kenneth French developed a three-factor model of determining investment portfolio returns. In their ground-breaking paper Professors Fama and French asserted that the price effect (the distinction between "growth" and "value" stocks, as measured by price-to-book ratios) and the size effect (the distinction between large and small capitalization stocks) are the variables that have the strongest relation to returns in stocks. Together with the market effect (the exposure of a portfolio to stocks, as opposed to fixed income investments), these three factors explain the vast majority of the expected returns of a investment portfolio. [A description of the "small cap effect" and the "value effect" is set forth in the white paper.]

Q. What are the two greatest risks present in the fixed income portion of an investment portfolio?

A. "Interest rate risk" and "default risk" are the two greatest risks associated with the fixed income portion of an investment portfolio. (A third major risk, "inflation risk," is arguably present for investment portfolios which are dominated by fixed income investments, if the time horizon for utilization of the investments is long.) This risk of a falling price in the value of a fixed income investment, due to higher interest rates, is known as "interest rate risk." It exists because new bonds issued after interest rates rise are likely to be issued with higher yields as interest rates increase, making the old or outstanding bonds less attractive. Historic returns of different fixed income indexes over the last thirty years or longer suggest that the average maturity of the bond portion of your

portfolio should be kept relatively low, especially when viewed in the overall context of minimizing portfolio volatility (a goal of Modern Portfolio Theory). “Credit quality risk” is another key concern in fixed income investing. This is the risk that a bond or other fixed income investment would default (i.e., not pay its interest obligations or return all or part of its principal to the investor). This risk can be minimized through government-insured investments (Treasury bonds, Treasury notes), insured investments (FDIC-insured certificates of deposit, insured municipal bonds), other high-quality obligations (government agency certificates) and/or through broad diversification (through bond mutual funds).

- Q. Relating to the duty of a fiduciary to minimize costs, describe each of the following “disclosed costs” of investing: commissions, front-end loads (of mutual funds), contingent deferred sales charges, mortality and expense charges in variable annuities, and mutual fund management and administrative expense charges.
- A. (For a description of each of these costs, please refer to foregoing sections of this white paper.)
- Q. What “hidden costs” are not disclosed in a mutual fund’s “expense ratio”? Describe each of these.
- A. Commissions paid relating to purchases of individual securities in the fund, bid-ask spreads, market impact costs, and opportunity costs relating to cash holdings. (For a description of each of these costs, please refer to foregoing sections of this white paper.)
- Q. What is an Investment Policy Statement, and why is it so valuable?
- A. While investment policy statements have for years been a required part of ERISA (Employee Retirement Income Security Act) plans and many trusts, foundations and endowments, they have recently become an accepted “best practice” in working with individual investors as well. The investment policy statement (IPS) should be the basic building block in an intentional investment process. In creating an IPS, the investment consultant and the client agree upon all of the essential issues surrounding how and why the money is to be managed. The IPS development process provides crucial education for the client and is a key communication step, helping each party to understand the other’s perspective and goals. The IPS is the document that guides the advisor as future decisions are made; it serves as a guidepost against which the reality of what has happened can be measured against the rules and procedures and benchmarks that were agreed to. While the IPS has many functions, perhaps its most important value is in its ability to counter the emotions encountered in market upswings and downswings, as a proper IPS details in advance how the fiduciary will react to future market movements (i.e., through the adoption of "rebalancing triggers" in the context of strategic asset allocation).

Mary Doe, as guardian of the property  
for  
Jane Smith, a minor

## Investment Policy Statement

April 30, 2004

by

Joseph Capital Management, LLC  
A Fee-Only Registered Investment Advisory Firm

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*Discover The Joseph Difference<sup>SM</sup>*

Objectivity • Integrity • Caring • Stewardship • A Team Approach

## Executive Summary

Factual Background; Investment Time Horizon. Mary Doe is legal guardian for her niece, Jane Smith, date of birth December 15, 2000, age 3. There is approximately \$175,000 to invest in guardianship funds. In addition to social security benefits of \$1,270 a month, there is an estimated monthly need of \$500 per month for support of Jane Smith at this time. Increases in the amount of support required are likely as Jane Smith enters her teenage years and due to general increases in prices due to inflation. Accordingly, it is anticipated that the guardianship funds will be utilized over a period of 15 or more years, commencing immediately.

Suggested "Strategic Asset Allocation." A "strategic asset allocation" of the trust funds is recommended for the next 15 years as follows:

- 50% to low-cost (no-load, no 12b-1 fee, and low management fees and transaction costs) well-diversified tax-managed stock mutual funds among several asset classes (including U.S. large cap balanced, U.S. large cap value, U.S. small cap, U.S. small cap value, and International Developed Markets Large Cap Value); and
- 50% to fixed income investments with a relatively short average duration.

Fees and Expenses. The guardian will not be charging any fees against the guardianship account. It is proposed that the investment advisor to the guardianship, with court approval, be paid a fee of 1% annually of the funds invested. The fees paid to the registered investment advisor firm would be deductible for income tax purposes, subject to the 2% adjusted gross income (AGI) limitation. As low-cost mutual funds (including low transaction and opportunity costs) are being utilized, the total fees and costs associated with the investments and the investment advisory services are estimated to be less than 1.5% per year of the account value.

Court Approval of Investment Plan Required. Court approval of entry into the investment advisory contract, and court approval of this investment policy, is required prior to its effective adoption and implementation.

## Introduction

"Guardian" and "Advisor". Hereinafter Mary Doe, as Guardian for Jane Smith will be referred to as Guardian, and hereinafter Joseph Capital Management, LLC will be referred to as Advisor.

Purpose of This Investment Policy Statement. The purpose of this Investment Policy Statement (IPS) is to establish a clear understanding between Guardian and Joseph Capital Management, LLC (Advisor) as to the investment goals and objectives and management policies applicable to the Guardian's investment Portfolio. This Investment Policy Statement will:

- Establish reasonable expectations, objectives and guidelines in the investment of the Portfolio's assets;
- Create the framework for a well-diversified asset mix that can be expected to generate acceptable long-term returns at a level of risk suitable to the Guardian, including:
  - Describing an appropriate risk posture for the investment of the Guardian's Portfolio;
  - Specifying the target asset allocation policy and targets for rebalancing;
  - Establishing investment guidelines regarding the selection of investments and diversification of assets;
- Define the responsibilities of the Guardian and the Advisor; and
- Encourage effective communication between the Advisor and the Guardian.

*The principal reason for developing a long-term investment policy and for putting it in writing is to enable the Guardian and Advisor to protect the Portfolio from ad hoc revisions of sound long-term policy. The written investment policy will help you maintain a long-term perspective when short-term market movements may be distressing and your investment strategy might otherwise be questioned.*

This IPS Is A Summary Of An Investment Philosophy. This Investment Policy Statement is not a contract. Rather, this Investment Policy Statement (IPS) is intended to be a summary of an investment philosophy and the procedures that provide guidance for the Guardian and the Advisor.

This IPS May Change As The Situation of the Ward Changes. The investment policies described in this IPS should be dynamic. These policies should reflect the ward's current status and the Guardian's philosophy regarding the investment of the Portfolio. These policies will be reviewed annually, and revised if necessary, to ensure they adequately reflect any changes related to the Portfolio, to the Guardian or ward, or to the capital markets. Should any change in this Investment Policy Statement be warranted prior to termination of the guardianship, the change would be submitted to the Court for the Court's approval.

No Investment Advisor Has A Crystal Ball. It is understood that there can be no guarantee about the attainment of the goals or investment objectives outlined herein. No investment advisor has a crystal ball. Guardian understands that the past performance of investments recommended by Advisor should not be construed as an indication of future results, which may prove to be better or worse than the past. Investment advice and the investment decisions made are subject to various market, currency, economic, political and business risks, and that investment decisions will not always be profitable.

## Client Profile

Background Information. Mary Doe is legal guardian for her niece, Jane Smith, date of birth December 15, 2000, age 3. There is approximately \$175,000 to invest in guardianship funds. In addition to social security benefits of \$1,270 a month, there is an estimated monthly need of \$500 per month for support of Jane Smith at this time. Increases in the amount of support required are likely as Jane Smith enters her teenage years. Accordingly, it is anticipated that the guardianship funds will be utilized over a period of 15 or more years, commencing immediately.

The Prudent Investor Rule Applies To These Investments. As set forth by Florida law:

744.361 Powers and duties of guardian.-- [in pertinent part]

(7) The guardian shall observe the standards in dealing with the guardianship property that would be observed by a prudent person dealing with the property of another, and, if the guardian has special skills or is named guardian on the basis of representations of special skills or expertise, he or she is under a duty to use those skills.

518.11 Investments by fiduciaries; prudent investor rule.--

(1) A fiduciary has a duty to invest and manage investment assets as follows:

(a) The fiduciary has a duty to invest and manage investment assets as a prudent investor would considering the purposes, terms, distribution requirements, and other circumstances of the trust. This standard requires the exercise of reasonable care and caution and is to be applied to investments not in isolation, but in the context of the investment portfolio as a whole and as a part of an overall investment strategy that should incorporate risk and return objectives reasonably suitable to the trust, guardianship, or probate estate. If the fiduciary has special skills, or is named fiduciary on the basis of representations of special skills or expertise, the fiduciary is under a duty to use those skills.

(b) No specific investment or course of action is, taken alone, prudent or imprudent. The fiduciary may invest in every kind of property and type of investment, subject to this section. The fiduciary's investment decisions and actions are to be judged in terms of the fiduciary's reasonable business judgment regarding the anticipated effect on the investment portfolio as a whole under the facts and circumstances prevailing at the time of the decision or action. The prudent investor rule is a test of conduct and not of resulting performance.

(c) The fiduciary has a duty to diversify the investments unless, under the circumstances, the fiduciary believes reasonably it is in the interests of the beneficiaries and furthers the purposes of the trust, guardianship, or estate not to diversify.

(d) The fiduciary has a duty, within a reasonable time after acceptance of the trust, estate, or guardianship, to review the investment portfolio and to make and implement decisions concerning the retention and disposition of original preexisting investments in order to conform to the provisions of this section. The fiduciary's decision to retain or dispose of an asset may be influenced properly by the asset's special relationship or value to the purposes of the trust, estate, or guardianship, or to some or all of the beneficiaries, consistent with the trustee's duty of impartiality, or to the ward.

(e) The fiduciary has a duty to pursue an investment strategy that considers both the reasonable production of income and safety of capital, consistent with the fiduciary's duty of impartiality and the purposes of the trust, estate, or guardianship. Whether investments are underproductive or overproductive of income shall be judged by the portfolio as a whole and not as to any particular asset.

(f) The circumstances that the fiduciary may consider in making investment decisions include, without limitation, the general economic conditions, the possible effect of inflation, the expected tax consequences of investment decisions or strategies, the role each investment or course of action plays within the overall portfolio, the expected total return, including both income yield and appreciation of capital, and the duty to incur only reasonable and appropriate costs. The fiduciary may, but need not, consider related trusts, estates, and guardianships, and the income available from other sources to, and the assets of, beneficiaries when making investment decisions.

(2) The provisions of this section may be expanded, restricted, eliminated, or otherwise altered by express provisions of the governing instrument, whether the instrument was executed before or after the effective date of this section. An express provision need not refer specifically to this statute. The fiduciary is not liable to any person for the fiduciary's reasonable reliance on those express provisions.

- (3) Nothing in this section abrogates or restricts the power of an appropriate court in proper cases:
- (a) To direct or permit the trustee to deviate from the terms of the governing instrument; or
  - (b) To direct or permit the fiduciary to take, or to restrain the fiduciary from taking, any action regarding the making or retention of investments.

## Capital Market Assumptions

Joseph Capital Management, LLC undertakes research relating to future expected rates of return by asset classes. In doing this research, we are not attempting to “time the market” nor are we attempting to engage in a practice known as “tactical asset allocation.” Instead, we undertake this research in order to provide Guardian with the most likely rate of return of the portfolio over the next 8-10 years.

Historical Returns of Various Asset Classes: A Perspective. The historical gross rate of return afforded by the universe of all U.S. stocks is set forth in a capitalization-weighted index known as the “Center For Research In Security Prices (CRSP) Universe.” Rates of return for all U.S. stocks since 1927 have averaged about 10.1% a year. Additionally, Professors Eugene Fama, Kenneth French, and Jim Davis have constructed portfolios of various asset classes and have computed returns for these asset classes which go back to 1927, as shown in the chart which follows.

Annualized Returns for Asset Classes By Decade											
Asset Class Description	1927-1929	1930-1939	1940-1949	1950-1959	1960-1969	1970-1979	1980-1989	1990-1999	2000-2003	1950-2003	1927-2003
CRSP Universe (all U.S. stocks)	16.4%	-0.3%	9.6%	18.2%	8.3%	6.1%	16.7%	18.0%	-4.9%	11.8%	10.1%
U.S. Large Company Balanced Stocks (S&P 500 Index)	21.8%	-0.1%	9.2%	19.3%	7.8%	5.9%	17.6%	18.2%	-5.3%	12.1%	10.4%
U.S. Large Company Value Stocks (Fama/French Index)	15.7%	-7.6%	15.7%	21.0%	10.1%	12.8%	20.1%	15.0%	-3.5%	14.2%	11.4%
U.S. Small Company Balanced Stocks (Fama/French Index)	6.5%	5.4%	14.6%	18.7%	13.3%	10.2%	19.5%	14.3%	14.7%	15.1%	13.4%
U.S. Small Company Value Stocks (Fama/French Index)	3.2%	-0.1%	21.2%	19.9%	16.0%	13.1%	19.0%	14.2%	20.4%	16.7%	14.4%
Inflation (CPI)	-0.9%	-2.0%	5.4%	2.2%	2.5%	7.0%	5.1%	3.0%	2.3%	6.3%	3.1%
5-Year Treasury Notes	3.8%	4.6%	1.8%	1.3%	3.5%	7.4%	11.9%	7.1%	8.8%	3.9%	5.4%

(Source of data: DFA Returns software. © 2004 by Dimensional Funds Advisors. Used with permission.  
Past performance is not an guarantee of future results.)

As seen in the above chart, small company and value stocks generally outperform large company and growth stocks over long periods of time. Additionally, after subtracting inflation, 5-year Treasury notes

do not generate large returns in excess of inflation. In all cases there is a great deal of variation in the returns of various asset classes, even over 10-year and 20-year periods of time.

Examining 10-Year (Approx.) And Current Valuation Levels. Our analysis to determine expected returns over the next 10 years only commences with historical data. We also need to examine the current valuation levels of various asset classes. To do this we utilize data from the Russell Indices, provided to us courtesy of Dimensional Funds Advisors, and S&P 500 data, provided to us courtesy of Professor Robert Shiller. Please note that in undertaking this analysis we undertake several assumptions, which may or may not occur:

- ▶ We assume that the “mean” of price-to-earnings data and price-to-book data is from 1977 through 2000 for the Russell indices. This is the longest period of time for which we currently have price-to-book data for the asset classes we desire to survey. While price-to-book ratios do not fluctuate as broadly as price-earnings ratios, all valuation ratios fluctuate in reaction to price swings in the market.
- ▶ We assume that prices of stocks will revert back, as to valuation levels, to the median values which existed over the 1977-2000 time period. We estimate that the reversion will occur to a level equal to the mean, although a reversion to a level greater than the mean could be made on the assumption that higher valuation levels may be structural in the market, and reflective of the fact that price-book ratios have expanded as intellectual capital has increased (with plant and equipment needs decreasing) over the long term. Academics have differing opinions as to whether valuation ratios are now permanently higher or whether they will revert back to the long-term means. Given the relatively high valuations of the last 25 years, we assume full mean reversion.

In our experience academic estimates of future returns of the stock market as a whole are usually off significantly. We anticipate our estimates to be way off, when we retrospectively examine them 10 years hence. However, there is substantial evidence that the overall U.S. stock market is substantially overvalued at present.

We are seeking the most probable returns for each asset class. We believe we should factor this evidence into the underlying projections undertaken in this investment policy statement, for purposes of determining a reasonable rate of withdrawal from the investment portfolio. Actual returns over the next 10 years may be much higher or lower than the “most probable” estimates we compute below.

Joseph Capital Management's Determination of Projected Rate of Returns Of Various Asset Classes, Applying Expected Return Premiums for Various Asset Classes and Assuming Reversion To The Mean Valuation of the Asset Class In 10 Years Based Upon Price/Book Ratios and Price/Earnings Utilizing Russell Index Data for December 1979-December 2000 (annual data points) and utilizing P/E Ratios of S&P 500 for 1/1977-8/2003 (monthly data points), and utilizing recent monthly data for current ratios provided by Russell and Barra/S&P.

Asset Class	"Low" Valuation Point (date)	"High" Valuation Point (date)	Median for 1979-2000	Current Ratio as of 3/31/04	% Current Ratio is Over 100% of The Median	Historical Long-Term Asset Class Return	Expected Asset Class Return Given Assumptions	Mean of Projections for The Asset Class Surveyed
U.S. Large Company Balanced Stocks, Russell 1000 P/B Data	1.23 (12/1978)	5.21 (12/1999)	1.87	3.01	61%	10.5% (Fama/ French Large Neutral Index)	4.4%	6.1%
U.S. Large Company Balanced Stocks, Russell 1000 P/E Data	7.7 (12/1979)	31.2 (12/1999)	14.6	19.79	36%		6.9%	
U.S. Large Company Balanced Stocks, S&P 500 P/E Data (excluding negative)	6.75 (3/1980)	31.5 (12/1999)	15.0	20.49	37%		6.8%	
U.S. Large Company Value Stocks, Russell 1000 P/B Data	0.87 (12/1978)	3.31 (12/2000)	1.29	2.28	77%	11.4% (Fama/ French Large Value x Util. Index)	3.7%	5.7%
U.S. Large Company Value Stocks, Russell 1000 P/E Data	6.0 (12/1979)	22.3 (12/1998)	11.93	16.30	37%		7.7%	

Joseph Capital Management's Determination of Projected Rate of Returns Of Various Asset Classes, Applying Expected Return Premiums for Various Asset Classes and Assuming Reversion To The Mean Valuation of the Asset Class In 10 Years Based Upon Price/Book Ratios and Price/Earnings Utilizing Russell Index Data for December 1979-December 2000 (annual data points) and utilizing P/E Ratios of S&P 500 for 1/1977-8/2003 (monthly data points), and utilizing recent monthly data for current ratios provided by Russell and Barra/S&P.

Asset Class	"Low" Valuation Point (date)	"High" Valuation Point (date)	Median for 1979-2000	Current Ratio as of 3/31/04	% Current Ratio is Over 100% of The Median	Historical Long-Term Asset Class Return	Expected Asset Class Return Given Assumptions	Mean of Projections for The Asset Class Surveyed
U.S. Small Company Balanced Stocks, Russell 2000 P/B Data	0.99 (12/1978)	2.72 (12/1999)	1.77	2.35	33%	13.41% per Fama/ French Small Neutral Index	10.1%	10.9%
U.S. Small Company Balanced Stocks, Russell 2000 P/B Data	7.2 (12/1978)	30.8 (12/1999)	18.82	21.89	16%		11.8%	
U.S. Small Company Value Stocks, Russell 2000 Value P/B Data	0.69 (12/1978)	2.11 (12/1997)	1.19	1.81	52%	14.46% per Fama/ French Small Value x Utl Index	9.3%	10.7%
U.S. Small Company Value Stocks, Russell 2000 Value P/E Data	6.0 (12/1979)	21.3 (12/1986)	15.93	19.64	23%		12.1%	

Additional Assumptions - Asset Class Returns. In constructing your portfolio we take the following additional assumptions into account:

- The rate of return for the recommended fixed income portion of the account is estimated at 5% a year over the next 10 years.
- The rate of return for international (developed markets) asset classes is anticipated to be at least equal to that of the U.S. stock asset classes.

By emphasizing the "value effect" and "small cap effect" which historical analysis of the markets has revealed, we believe that an additional 2.0% or greater can be added to the annualized return of a stock portfolio over long periods of time (10 years or greater), relative to an investment in the "entire U.S. stock market." Please note that this is a projected average additional return over a long period of time, and there may be several years or longer of either underperformance or overperformance.

Costs and Fees Estimate. Advisor estimates total investment fees and costs as follows:

Advisor's annual fee		1.00% per year
Mutual fund management and administrative fees:		
8% DFA Tax-Managed U.S. Equity Portfolio	x 0.25%	0.020% per year
8% DFA Tax-Managed U.S. Marketwide Portfolio	x 0.43%	0.044% per year
12% DFA Tax-Managed U.S. Small Cap Portfolio	x 0.57%	0.068% per year
12% DFA Tax-Managed U.S. Small Cap Value Portfolio	x 0.56%	0.068% per year
10% DFA Tax-Managed U.S. International Value Portfolio	x 0.66%	0.066% per year
Tax-managed funds, while possessing slightly higher expenses, will keep down the "tax drag" on the portfolio.		
Custodian transaction fees (minimal per year)		0.10%
Mutual fund transaction costs from trading (est. at 0.2% x 50%)		0.10%
All mutual funds have very low turnover, and hence these "hidden" costs are minimized.		_____
Estimated total annual expenses, entire portfolio:		1.47%

The combined fees of Advisor and the recommended investment (mutual fund costs) are significantly lower than the fees of the vast majority of actively managed stock mutual funds. Additionally, Guardian receives access to institutional-style mutual funds from Dimensional Funds Advisors, which not only provide low disclosed and extremely low transaction costs but also provide (in Advisor's view) the best way to capture returns various asset classes have to offer.

Computing The Projected Long-Term Annualized Rate of Return For Your Portfolio, Derived From The Proposed Strategic Asset Allocation. Taking all of the foregoing into account, the computation of the after-inflation, after-costs estimated long-term expected and average annualized return of the Guardian's portfolio over the next 10 years can be stated as follows:

Asset Class	Target Percentage Allocation of Guardian's Portfolio	Projected Average Annualized Rate of Return, Over The Next 10 Years	Total Contribution To Guardian's Portfolio of This Asset Class
U.S. Large Cap Balanced	8.0%	6.1%	0.49%
U.S. Large Cap Value	8.0%	5.7%	0.46%
U.S. Small Cap	12.0%	10.9%	1.31%
U.S. Small Cap Value	12.0%	10.7%	1.28%
International Developed Markets Marketwide Value	10.0%	5.7%	0.57%
Subtotal - Equity Portion of Portfolio	50.0%	n/a	4.11%
Fixed Income Portion of the Portfolio	50.0%	5.0%	2.50%
Less Investment Costs	100.0%	n/a	-1.47%
After-Cost Net Projected Annualized Rate of Return of Investment Portfolio			5.14%

Over the longer term (15 years or longer) Advisor anticipates greater returns from the stock mutual funds, as Advisor projects the stock asset classes to return to their normal average annual returns. While Advisor believes the returns set forth above to be a conservative estimate, there are inherent risks in any investment strategy. Accordingly, there can be no guarantee of any particular return over either the short term or the long term.

Please note that while Advisor projects the rate of return for the U.S. Large Company Balanced and U.S. Large Cap Value asset classes to be relatively low, prudent investing will not attempt to “time the market,” but rather will emphasize a strategy in which an allocation of funds is made to all asset classes. Simply put, just because the market is “irrational” as to current levels of valuation of a particular rate of return does not mean that those irrational levels will not continue into the future, or become more “irrational.” Additionally, continued allocation of a portion of the investment portfolio to large company U.S. stocks should serve, over the long term, to temper overall portfolio volatility. Nevertheless, we suggest a strong tilt toward “small cap” stocks in the portfolio, given the substantial “overvaluation” of the large cap asset classes as of March 31, 2004.

## Tax Policy

In order to minimize taxes on interest and dividend income and capital gains generated by the portfolio, the following policies will be adopted:

- Stock mutual fund investments will be structured using tax-managed mutual funds wherever possible. Tax-managed funds seek to minimize both capital gains and interest/dividend income distributions.
- Capital losses may be realized from time to time to offset either capital gains or ordinary income. Tax planning in this regard is normally taken near calendar-year end.
- Fixed income investments will be taxable, to secure greater after-tax returns for the beneficiary.

(Guardianship estates are not subject to the rules of Subchapter J, notwithstanding the fact that the guardian is defined as a fiduciary. Instead, the guardian is responsible for filing an individual federal income tax return on behalf of the ward. This applies to the guardian of a minor as well as the guardian of an adult declared incompetent. Section 6012(b)(2) of the I.R.C. provides: “ If an individual is unable to make a return required under subsection (a), the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual. The preceding sentence shall not apply in the case of a receiver appointed by authority of law in possession of only a part of the property of an individual.”

## Marketability of Assets

It is not Advisor's standard practice to recommend illiquid, long-term investments. All of the mutual funds and fixed income investments recommended will be marketable (i.e., can easily be redeemed or sold) as of the time of purchase. A minimum cash reserve of \$2,000 will be kept at all times in a money market account and/or checking account. Cash holdings will be increased from time to time to provide up to six months of planned distributions, in order to minimize transaction costs which may be incurred in connection with sales of investments.

## Specific Investments Recommended

Stock Mutual Fund Investments. For the 50% of the portfolio allocated to fixed-income investments, the following investments are recommended:

- 4% DFA Tax-Managed U.S. Equity Portfolio
- 4% DFA Tax-Managed U.S. Marketwide Portfolio
- 16% DFA Tax-Managed U.S. Small Cap Portfolio
- 16% DFA Tax-Managed U.S. Small Cap Value Portfolio
- 10% DFA Tax-Managed U.S. International Value Portfolio

A fact sheet relating to each of these funds, and a prospectus for these funds, is attached hereto. The accounts will be held at Charles Schwab, a large discount brokerage firm, and the account is insured by the SIPC. Joseph Capital Management, LLC does not possess any ability to access the funds in the account - only the Guardian will have that authority. Trades will be contacted via telephone with both the Guardian and the Advisor present. Joseph Capital Management, LLC will not undertake any trades without the Guardian's personal involvement.

Fixed Income Investments: CD Ladder. For the fixed income portion of the portfolio it is recommended that CD's or U.S. government agency certificates be laddered for the portion allocated to fixed income investments. As of April 29, 2004, the interest rates for CD's is approximately as follows:

Maturity	Yield	APY
1 year	1.73%	1.75%
(or, in lieu of 1-year CD, until interest rates rise further, investment could occur in the 2% "Orange Savings Account", available through ING insurance, which account is FDIC insured)		
2 years	2.57%	2.60%
3 years	2.91%	2.95%
4 years	3.20%	3.25%
5 years	3.73%	3.80%

The foregoing is only an estimate of the yields, based upon a brief survey. The actual CDs or U.S. government agency certificates would be purchased after shopping rates nationally and locally, and would be FDIC-insured. All U.S. government agency certificates would possess a Standard & Poor's rating of AAA or AA.

Additionally, fixed income investments can be invested in U.S. government agency certificates and U.S. Treasury bonds, notes and bills having a maturity of not greater than 6 years, in no-load high-quality corporate and government bond funds having an average duration of not greater than 4 years, and money market accounts

## Rebalancing

Periodic rebalancing of a portfolio forces one to “take gains off the table” when markets are up, and to add to asset classes when values in that asset class decline. Academic research suggests that rebalancing may add 0.2% to as much as 0.6% to the returns in a portfolio, on average, per year, depending upon taxes and costs associated with rebalancing the extent of overall market volatility. The most important benefit of rebalancing is to maintain the desired level of risk in the portfolio.

Subject to delay in a rebalancing decision in order to secure long-term capital gain treatment, it is recommended that the portfolio be rebalanced as needed. Monitoring of the investment accounts will occur quarterly by the Advisor, Joseph Capital Management, LLC, and rebalancing shall be undertaken utilizing the following targets:

### TARGETED STRATEGIC ASSET ALLOCATION and REBALANCING TARGETS:

Asset Class: Specific Investment Name	Initial Allocation	Lower Limit For Rebalancing	Upper Limit for Rebalancing
U.S. Large Company Balanced (“Core”) Stocks: DFA Tax-Managed U.S. Equity Portfolio	8%	6%	10%
U.S. Large Company Value Stocks: DFA Tax-Managed U.S. Marketwide Value Portfolio (a broad market value stock fund)	8%	6%	10%
U.S. Small Company Balanced (“Core”) Stocks: DFA Tax-Managed U.S. Small Cap Portfolio	12%	9%	15%
U.S. Small Company Value Stocks: DFA Tax-Managed U.S. Small Cap Value Portfolio	12%	9%	15%
International Developed Markets Broad Market Value Stocks: DFA Tax-Managed International Value Portfolio	10%	7%	13%
<b>FIXED INCOME INVESTMENTS:</b> U.S. government agency certificates U.S. Treasury bonds, notes and bills FDIC-insured certificates of deposit No-load bond index funds possessing a duration of not greater than 4 years and possessing annual management fees of not greater than 0.4%. Taxable money market funds	50%	43%	57%

## Reports and Conferences

Monthly Reports Directly From Custodian. Schwab Institutional will be utilized to hold Guardian's assets. Schwab Institutional will directly provide Guardian, by U.S. mail, with a monthly report that lists all assets held by Guardian values for each asset and all transactions affecting assets within the Portfolio, including additions and withdrawals.

Periodic Reports Directly From Joseph Capital Management. Guardian shall receive not less frequently than on a quarterly basis reports from Joseph Capital Management, LLC, which reviews the portfolio. The report shall contain an analysis of the strategic asset allocation of the portfolio (current versus policy), a summary of unrealized gains and losses for the portfolio, and any recommendations for changes of the above or rebalancing. On an annual basis the investment report will provide comparisons of the portfolio to indices. The following indices shall be utilized to provide the comparisons for the stock portion of the portfolio, as a means of evaluating the performance during the past 12 month period of each specific stock mutual fund:

- Russell 1000
- Russell 1000 Value
- Russell 2000
- Russell 2000 Value
- EAFE

Meetings and Communication between Guardian and Advisor. As a matter of course, Advisor shall keep Guardian apprised of any material changes in the Advisor's outlook or recommended changes to investment policy and specific investments. In addition, Advisor shall meet with Guardian not less than semi-annually to review and explain the Portfolio's investment results and any related issues. Advisor shall also be available upon reasonable notice to provide a report to the Court, as may be required from time to time. Advisor shall also be available on a reasonable basis for telephone communication when needed. Additionally, any material event that affects the ownership of the firm of Joseph Capital Management, LLC or the management of the Portfolio must be reported promptly to the Guardian.

## Duties and Responsibilities of the Advisor and The Guardian

The Advisor. Advisor is expected to manage the Portfolio in a manner consistent with this Investment Policy Statement and in accordance with State and Federal law, including but not limited to the Florida Prudent Investor Rule set forth in Sections 518.10 to 518.14, *Florida Statutes* (2003), as revised from time to time. Advisor is a Registered Investment Advisor firm and shall act as the investment advisor and fiduciary to the Guardian until the Guardian decides otherwise. The Advisor shall be responsible for:

1. Designing, recommending and implementing an appropriate asset allocation consistent with the investment objectives, time horizon, risk profile, guidelines and constraints outlined in this statement.
2. Recommending an appropriate custodian to safeguard the assets of the guardianship estate.
3. Advising the Guardian about the selection of and the allocation of asset categories.
4. Identifying specific assets and investment managers within each asset category.
5. Ensuring that the custodian provides Guardian with a current prospectus, where applicable, for each investment proposed for the Portfolio.
6. Monitoring the performance of all selected assets on an annual basis.
7. Recommending changes to any of the above.
8. Periodically reviewing the suitability of the investments for the Guardian, being available to meet with the Guardian at least once each year, and being available at such other times within reason at the Guardian's request, including but not limited to attending and testifying at court hearings as requested.
9. Preparing and presenting appropriate reports relating to the investments on a quarterly basis which evaluate the investment portfolio in light of the strategic asset allocation adopted and suggest changes.

10. In addition, Advisor agrees to abide by its fiduciary oath, which is as follows:

Joseph Capital Management, LLC shall exercise its best efforts to act in good faith and in the best interests of the client. Joseph Capital Management, LLC shall provide written disclosure to the client prior to the engagement of the adviser, and thereafter throughout the term of the engagement, of any conflicts of interest which will or reasonably may compromise the impartiality or independence of the adviser.

Joseph Capital Management, LLC shall not receive any commissions or other remuneration that is contingent on any client's purchase or sale of a financial product. Joseph Capital Management, LLC shall not receive any commissions, 12b-1 fees, or any fee or other compensation from another party based on the referral of a client or the client's business.

11. In addition, Advisor agrees to abide by its Code of Ethics, which is as follows:

Joseph Capital Management, LLC and its investment advisor representatives and employees shall always:

- (1) Act in the best interests of each and every client;
- (2) Act with integrity and dignity when dealing with clients, prospects, team members, and others;
- (3) Strive to maintain and continually enhance our high degree of professional education regarding Modern Portfolio Theory, strategic asset allocation, and financial, tax, estate and asset protection planning; and
- (4) Preserve our firm's independence and maintain our complete objectivity with respect to our advisory services and each recommendation made to every client.

The Guardian. The Guardian shall be responsible for:

1. Assist Advisor to define the investment objectives and policies of the Portfolio.
2. With Court approval, directing Advisor to make changes in investment policy;
3. Monitor, oversee and approve or disapprove of Advisor recommendations on a timely basis with regard to specific investments to be undertaken in adherence to the Court-approved investment policy;
4. Guardian shall provide Advisor with all relevant information on the ward's financial condition and shall notify Advisor promptly of any changes to this information.
5. Guardian shall read and understand the information contained in the prospectus and each investment in the Portfolio. Guardian shall review on a monthly basis reports received from the account custodian. Guardian shall review on a quarterly basis the reports received from the Advisor. Guardian shall meet with Advisor at least semi-annually to review the foregoing reports and consult regarding possible changes to the investment policy.
6. Guardian is responsible for and empowered to exercise all rights, including voting rights, as are acquired through the purchase of securities, where practical. Guardian will use Guardian's best judgement in the voting of proxies.

This Investment Policy Statement is adopted by the below signed, subject to the review and approval of the Court possessing jurisdiction over the guardianship proceedings.

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Mary Doe, Guardian of the Property

\_\_\_\_\_, 2004

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Ron A. Rhoades, Investment Advisor Representative  
on behalf of Joseph Capital Management, LLC

\_\_\_\_\_, 2004

**THIS INVESTMENT POLICY STATEMENT IS NOT  
EFFECTIVE UNTIL APPROVED BY THE  
GUARDIANSHIP COURT.**

**Exhibit 4: Suggestions For Inclusion In Court Order Approving Investment Policy Statement**

1. The Investment Policy Statement submitted by the Petitioner and attached as Exhibit \_\_\_ to the Motion for \_\_\_\_\_ is approved as submitted. The Petitioner is directed to implement the investment recommendations made in Investment Policy Statement within a reasonable period of time.
2. The Investment Policy Statement requires monitoring of the investment portfolio on an \_\_\_\_\_ (annual, semi-annual, quarterly, monthly, continuous) basis. Rebalancing of the portfolio under the criteria set forth in the Investment Policy Statement may be undertaken without the need for further approval by this Court.
3. Should any material change be desired to the investment policy set forth in the Investment Policy Statement, including but not limited to the permitted types of investments, the target rate of return, the strategic asset allocation, and/or the total estimated fees and costs incurred in connection with the investment design and implementation process, whether by reason of changing circumstances of the ward or due to market conditions, or a change in recommendations made by Petitioner's investment advisor, the Petitioner shall promptly file a motion with this Court and seek an amendment to the Investment Policy Statement.
4. The Investment Policy Statement requires (annual, semi-annual, quarterly, monthly) reporting by the investment advisor to the Petitioner. The Petitioner shall submit a copy of the annual report of the Petitioner's investment advisor, which shall include a review of the actual versus targeted strategic asset allocation, and a comparison to the benchmark indices for each of the specific stock mutual fund investments chosen, as an attachment to the annual accounting filed with this Court.

**Exhibit 5: Uniform Prudent Investor Act (with comments)**

Drafted by the  
NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS  
and by it  
APPROVED AND RECOMMENDED FOR ENACTMENT IN ALL THE STATES  
at its  
ANNUAL CONFERENCE MEETING IN ITS ONE-HUNDRED-AND-THIRD YEAR  
IN CHICAGO, ILLINOIS JULY 29 - AUGUST 5, 1994

WITH PREFATORY NOTE AND COMMENTS

Approved by the American Bar Association  
Miami, Florida, February 14, 1995

UNIFORM PRUDENT INVESTOR ACT

PREFATORY NOTE

Over the quarter century from the late 1960's the investment practices of fiduciaries experienced significant change. The Uniform Prudent Investor Act (UPIA) undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as "modern portfolio theory."

This Act draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992) [hereinafter Restatement of Trusts 3d: Prudent Investor Rule; also referred to as 1992 Restatement].

Objectives of the Act. UPIA makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.

- (1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term "portfolio" embraces all the trust's assets. UPIA § 2(b).
- (2) The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration. UPIA § 2(b).
- (3) All categorical restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. UPIA § 2(e).
- (4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3.
- (5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. UPIA § 9.

Literature. These changes in trust investment law have been presaged in an extensive body of practical and scholarly writing. See especially the discussion and reporter's notes by Edward C. Halbach, Jr., in Restatement of Trusts 3d: Prudent Investor Rule (1992); see also Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Property, Probate & Trust J. 407 (1992); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. Rev. 52 (1987); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); Note, The Regulation of Risky Investments, 83 Harvard L. Rev. 603 (1970). A succinct account of the main findings of modern portfolio theory, written for lawyers, is Jonathan R. Macey, An Introduction to Modern Financial Theory (1991) (American College of Trust & Estate Counsel Foundation). A leading introductory text on modern portfolio theory is R.A. Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983).

Legislation. Most states have legislation governing trust-investment law. This Act promotes uniformity of state law on the basis of the new consensus reflected in the Restatement of Trusts 3d: Prudent Investor Rule. Some states have already acted. California, Delaware, Georgia, Minnesota, Tennessee, and Washington revised their prudent investor legislation to emphasize the total-portfolio standard of care in advance of the 1992 Restatement. These statutes are extracted and discussed in Restatement of Trusts 3d: Prudent Investor Rule § 227, reporter's note, at 60-66 (1992).

Drafters in Illinois in 1991 worked from the April 1990 "Proposed Final Draft" of the Restatement of Trusts 3d: Prudent Investor Rule and enacted legislation that is closely modeled on the new Restatement. 760 ILCS § 5/5 (prudent investing); and § 5/5.1 (delegation) (1992). As the Comments to this Uniform Prudent Investor Act reflect, the Act draws upon the Illinois statute in several sections. Virginia revised its prudent investor act in a similar vein in 1992. Virginia Code § 26-45.1 (prudent investing) (1992). Florida revised its statute in 1993. Florida Laws, ch. 93-257, amending Florida Statutes § 518.11 (prudent investing) and creating § 518.112 (delegation). New York legislation drawing on the new Restatement and on a preliminary version of this Uniform Prudent Investor Act was enacted in 1994. N.Y. Assembly Bill 11683-B, Ch. 609 (1994), adding Estates, Powers and Trusts Law § 11-2.3 (Prudent Investor Act).

Remedies. This Act does not undertake to address issues of remedy law or the computation of damages in trust matters. Remedies are the subject of a reasonably distinct body of doctrine. See generally Restatement (Second) of Trusts §§ 197-226A (1959) [hereinafter cited as Restatement of Trusts 2d; also referred to as 1959 Restatement].

Implications for charitable and pension trusts. This Act is centrally concerned with the investment responsibilities arising under the private gratuitous trust, which is the common vehicle for conditioned wealth transfer within the family. Nevertheless, the prudent investor rule also bears on charitable and pension trusts, among others. "In making investments of trust funds the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust." Restatement of Trusts 2d § 389 (1959). The Employee Retirement Income Security Act (ERISA), the federal regulatory scheme for pension trusts enacted in 1974, absorbs trust-investment law through the prudence standard of ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a). The Supreme Court has said: "ERISA's legislative history confirms that the Act's fiduciary responsibility provisions 'codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.'" *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110-11 (1989) (footnote omitted).

Other fiduciary relationships. The Uniform Prudent Investor Act regulates the investment responsibilities of trustees. Other fiduciaries - such as executors, conservators, and guardians of the property - sometimes have responsibilities over assets that are governed by the standards of prudent investment. It will often be appropriate for states to adapt the law governing investment by trustees under this Act to these other fiduciary regimes, taking account of such changed circumstances as the relatively short duration of most executorships and the intensity of court supervision of conservators and guardians in some jurisdictions. The present Act does not undertake to adjust

trust-investment law to the special circumstances of the state schemes for administering decedents' estates or conducting the affairs of protected persons.

Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations. As the 1992 Restatement observes, "the duties of the members of the governing board of a charitable corporation are generally similar to the duties of the trustee of a charitable trust." Restatement of Trusts 3d: Prudent Investor Rule § 379, Comment b, at 190 (1992). See also *id.* § 389, Comment b, at 190-91 (absent contrary statute or other provision, prudent investor rule applies to investment of funds held for charitable corporations).

## UNIFORM PRUDENT INVESTOR ACT

### SECTION 1. PRUDENT INVESTOR RULE.

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act].

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

#### Comment

This section imposes the obligation of prudence in the conduct of investment functions and identifies further sections of the Act that specify the attributes of prudent conduct.

**Origins.** The prudence standard for trust investing traces back to *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830). Trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." *Id.* at 461.

**Prior legislation.** The Model Prudent Man Rule Statute (1942), sponsored by the American Bankers Association, undertook to codify the language of the *Amory* case. See Mayo A. Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 *Ohio State L.J.* 491, at 501 (1951); for the text of the model act, which inspired many state statutes, see *id.* at 508-09. Another prominent codification of the *Amory* standard is Uniform Probate Code § 7-302 (1969), which provides that "the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another . . . ."

Congress has imposed a comparable prudence standard for the administration of pension and employee benefit trusts in the Employee Retirement Income Security Act (ERISA), enacted in 1974. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a), provides that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims . . . ."

**Prior Restatement.** The Restatement of Trusts 2d (1959) also tracked the language of the *Amory* case: "In making investments of trust funds the trustee is under a duty to the beneficiary . . . to make such investments and only such

investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived . . . ." Restatement of Trusts 2d § 227 (1959).

Objective standard. The concept of prudence in the judicial opinions and legislation is essentially relational or comparative. It resembles in this respect the "reasonable person" rule of tort law. A prudent trustee behaves as other trustees similarly situated would behave. The standard is, therefore, objective rather than subjective. Sections 2 through 9 of this Act identify the main factors that bear on prudent investment behavior.

Variation. Almost all of the rules of trust law are default rules, that is, rules that the settlor may alter or abrogate. Subsection (b) carries forward this traditional attribute of trust law. Traditional trust law also allows the beneficiaries of the trust to excuse its performance, when they are all capable and not misinformed. Restatement of Trusts 2d § 216 (1959).

## SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

- (1) general economic conditions;
- (2) the possible effect of inflation or deflation;
- (3) the expected tax consequences of investment decisions or strategies;
- (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
- (5) the expected total return from income and the appreciation of capital;
- (6) other resources of the beneficiaries;
- (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

### Comment

Section 2 is the heart of the Act. Subsections (a), (b), and (c) are patterned loosely on the language of the Restatement of Trusts 3d: Prudent Investor Rule § 227 (1992), and on the 1991 Illinois statute, 760 § ILCS 5/5a (1992). Subsection (f) is derived from Uniform Probate Code § 7-302 (1969).

Objective standard. Subsection (a) of this Act carries forward the relational and objective standard made familiar in the Amory case, in earlier prudent investor legislation, and in the Restatements. Early formulations of the prudent person rule were sometimes troubled by the effort to distinguish between the standard of a prudent person investing for another and investing on his or her own account. The language of subsection (a), by relating the

trustee's duty to "the purposes, terms, distribution requirements, and other circumstances of the trust," should put such questions to rest. The standard is the standard of the prudent investor similarly situated.

Portfolio standard. Subsection (b) emphasizes the consolidated portfolio standard for evaluating investment decisions. An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets. In the trust setting the term "portfolio" embraces the entire trust estate.

Risk and return. Subsection (b) also sounds the main theme of modern investment practice, sensitivity to the risk/return curve. See generally the works cited in the Prefatory Note to this Act, under "Literature." Returns correlate strongly with risk, but tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries. A trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.

Subsection (b) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule § 227(a), which provides that the standard of prudent investing "requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."

Factors affecting investment. Subsection (c) points to certain of the factors that commonly bear on risk/return preferences in fiduciary investing. This listing is nonexclusive. Tax considerations, such as preserving the stepped up basis on death under Internal Revenue Code § 1014 for low-basis assets, have traditionally been exceptionally important in estate planning for affluent persons. Under the present recognition rules of the federal income tax, taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover. See generally Robert H. Jeffrey & Robert D. Arnott, *Is Your Alpha Big Enough to Cover Its Taxes?*, *Journal of Portfolio Management* 15 (Spring 1993).

Another familiar example of how tax considerations bear upon trust investing: In a regime of pass-through taxation, it may be prudent for the trust to buy lower yielding tax-exempt securities for high-bracket taxpayers, whereas it would ordinarily be imprudent for the trustees of a charitable trust, whose income is tax exempt, to accept the lowered yields associated with tax-exempt securities.

When tax considerations affect beneficiaries differently, the trustee's duty of impartiality requires attention to the competing interests of each of them.

Subsection (c)(8), allowing the trustee to take into account any preferences of the beneficiaries respecting heirlooms or other prized assets, derives from the Illinois act, 760 ILCS § 5/5(a)(4) (1992).

Duty to monitor. Subsections (a) through (d) apply both to investing and managing trust assets. "Managing" embraces monitoring, that 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.

Duty to investigate. Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment - for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating categoric restrictions. Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent. Traditional trust law was encumbered with a variety of categoric exclusions, such as prohibitions on junior mortgages or new ventures. In some states legislation created so-called "legal lists" of approved trust investments. The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility - in this case, inflation risk - that had not been anticipated. Accordingly, section 2(e) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule in abrogating categoric restrictions. The Restatement says: "Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment f, at 24 (1992). The premise of subsection 2(e) is that trust beneficiaries are better protected by the Act's emphasis on close attention to risk/return objectives as prescribed in subsection 2(b) than in attempts to identify categories of investment that are per se prudent or imprudent.

The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments. Low levels of risk may be appropriate in some trust settings but inappropriate in others. It is the trustee's task to invest at a risk level that is suitable to the purposes of the trust.

The abolition of categoric restrictions against types of investment in no way alters the trustee's conventional duty of loyalty, which is reiterated for the purposes of this Act in Section 5. For example, were the trustee to invest in a second mortgage on a piece of real property owned by the trustee, the investment would be wrongful on account of the trustee's breach of the duty to abstain from self-dealing, even though the investment would no longer automatically offend the former categoric restriction against fiduciary investments in junior mortgages.

Professional fiduciaries. The distinction taken in subsection (f) between amateur and professional trustees is familiar law. The prudent investor standard applies to a range of fiduciaries, from the most sophisticated professional investment management firms and corporate fiduciaries, to family members of minimal experience. Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs. Restatement of Trusts 2d § 174 (1959) provides: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing itself to be expert or professional. See Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d 904 (1979) & 1992 Supp. at 48-49.

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. The official comments to the 1992 Restatement observe that pooled investments, such as mutual funds and bank common trust funds, are especially suitable for small trusts. Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments h, m, at 28, 51; reporter's note to Comment g, id. at 83.

Matters of proof. Although virtually all express trusts are created by written instrument, oral trusts are known, and accordingly, this Act presupposes no formal requirement that trust terms be in writing. When there is a written trust instrument, modern authority strongly favors allowing evidence extrinsic to the instrument to be consulted

for the purpose of ascertaining the settlor's intent. See Uniform Probate Code § 2-601 (1990), Comment; Restatement (Third) of Property: Donative Transfers (Preliminary Draft No. 2, ch. 11, Sept. 11, 1992).

SECTION 3. DIVERSIFICATION. A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

#### Comment

The language of this section derives from Restatement of Trusts 2d § 228 (1959). ERISA insists upon a comparable rule for pension trusts. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). Case law overwhelmingly supports the duty to diversify. See Annot., Duty of Trustee to Diversify Investments, and Liability for Failure to Do So, 24 A.L.R. 3d 730 (1969) & 1992 Supp. at 78-79.

The 1992 Restatement of Trusts takes the significant step of integrating the diversification requirement into the concept of prudent investing. Section 227(b) of the 1992 Restatement treats diversification as one of the fundamental elements of prudent investing, replacing the separate section 228 of the Restatement of Trusts 2d. The message of the 1992 Restatement, carried forward in Section 3 of this Act, is that prudent investing ordinarily requires diversification.

Circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an underdiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.

Rationale for diversification. "Diversification reduces risk . . . [because] stock price movements are not uniform. They are imperfectly correlated. This means that if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another." Jonathan R. Macey, *An Introduction to Modern Financial Theory* 20 (American College of Trust and Estate Counsel Foundation, 1991). For example, during the Arab oil embargo of 1973, international oil stocks suffered declines, but the shares of domestic oil producers and coal companies benefitted. Holding a broad enough portfolio allowed the investor to set off, to some extent, the losses associated with the embargo.

Modern portfolio theory divides risk into the categories of "compensated" and "uncompensated" risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk - the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks. The investor who owned only international oils in 1973 was running a risk that could have been reduced by having configured the portfolio differently - to include investments in different industries. This is uncompensated risk - nobody pays the investor for owning shares in too few industries and too few companies. Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk of having too few investments. "As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings." R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* 103 (2d ed. 1983).

There is no automatic rule for identifying how much diversification is enough. The 1992 Restatement says: "Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries . . . . Broader diversification is usually to be preferred in trust investing," and pooled investment

vehicles "make thorough diversification practical for most trustees." Restatement of Trusts 3d: Prudent Investor Rule § 227, General Note on Comments e-h, at 77 (1992). See also Macey, *supra*, at 23-24; Brealey, *supra*, at 111-13.

Diversifying by pooling. It is difficult for a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments. Transaction costs such as the round-lot (100 share) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts.

Most states have legislation authorizing common trust funds; see 3 Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 227.9, at 463-65 n.26 (4th ed. 1988) (collecting citations to state statutes). As of 1992, 35 states and the District of Columbia had enacted the Uniform Common Trust Fund Act (UCTFA) (1938), overcoming the rule against commingling trust assets and expressly enabling banks and trust companies to establish common trust funds. 7 Uniform Laws Ann. 1992 Supp. at 130 (schedule of adopting states). The Prefatory Note to the UCTFA explains: "The purposes of such a common or joint investment fund are to diversify the investment of the several trusts and thus spread the risk of loss, and to make it easy to invest any amount of trust funds quickly and with a small amount of trouble." 7 Uniform Laws Ann. 402 (1985).

Fiduciary investing in mutual funds. Trusts can also achieve diversification by investing in mutual funds. See Restatement of Trusts 3d: Prudent Investor Rule, § 227, Comment m, at 99-100 (1992) (endorsing trust investment in mutual funds). ERISA § 401(b)(1), 29 U.S.C. § 1101(b)(1), expressly authorizes pension trusts to invest in mutual funds, identified as securities "issued by an investment company registered under the Investment Company Act of 1940 . . . ."

**SECTION 4. DUTIES AT INCEPTION OF TRUSTEESHIP.** Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].

#### Comment

Section 4, requiring the trustee to dispose of unsuitable assets within a reasonable time, is old law, codified in Restatement of Trusts 3d: Prudent Investor Rule § 229 (1992), lightly revising Restatement of Trusts 2d § 230 (1959). The duty extends as well to investments that were proper when purchased but subsequently become improper. Restatement of Trusts 2d § 231 (1959). The same standards apply to successor trustees, see Restatement of Trusts 2d § 196 (1959).

The question of what period of time is reasonable turns on the totality of factors affecting the asset and the trust. The 1959 Restatement took the view that "[o]rdinarily any time within a year is reasonable, but under some circumstances a year may be too long a time and under other circumstances a trustee is not liable although he fails to effect the conversion for more than a year." Restatement of Trusts 2d § 230, comment b (1959). The 1992 Restatement retreated from this rule of thumb, saying, "No positive rule can be stated with respect to what constitutes a reasonable time for the sale or exchange of securities." Restatement of Trusts 3d: Prudent Investor Rule § 229, comment b (1992).

The criteria and circumstances identified in Section 2 of this Act as bearing upon the prudence of decisions to invest and manage trust assets also pertain to the prudence of decisions to retain or dispose of inception assets under this section.

SECTION 5. LOYALTY. A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Comment

The duty of loyalty is perhaps the most characteristic rule of trust law, requiring the trustee to act exclusively for the beneficiaries, as opposed to acting for the trustee's own interest or that of third parties. The language of Section 4 of this Act derives from Restatement of Trusts 3d: Prudent Investor Rule § 170 (1992), which makes minute changes in Restatement of Trusts 2d § 170 (1959).

The concept that the duty of prudence in trust administration, especially in investing and managing trust assets, entails adherence to the duty of loyalty is familiar. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B), extracted in the Comment to Section 1 of this Act, effectively merges the requirements of prudence and loyalty. A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.

The duty of loyalty is not limited to settings entailing self-dealing or conflict of interest in which the trustee would benefit personally from the trust. "The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person. Thus, it is improper for the trustee to sell trust property to a third person for the purpose of benefitting the third person rather than the trust." Restatement of Trusts 2d § 170, comment q, at 371 (1959).

No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries - for example, by accepting below-market returns - in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause. See, e.g., John H. Langbein & Richard Posner, *Social Investing and the Law of Trusts*, 79 *Michigan L. Rev.* 72, 96-97 (1980) (collecting authority). For pension trust assets, see generally Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May it Be Done Lawfully under ERISA?*, 31 *Labor L.J.* 387 (1980). Commentators supporting social investing tend to concede the overriding force of the duty of loyalty. They argue instead that particular schemes of social investing may not result in below-market returns. See, e.g., Marcia O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 *American U.L. Rev.* 1 (1992). In 1994 the Department of Labor issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and loyalty standards of ERISA §§ 403-404. Interpretive Bulletin 94-1, 59 *Fed. Regis.* 32606 (Jun. 22, 1994), to be codified as 29 *CFR* § 2509.94-1. The Bulletin reminds fiduciary investors that they are prohibited from "subordinat[ing] the interests of participants and beneficiaries in their retirement income to unrelated objectives."

SECTION 6. IMPARTIALITY. If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

Comment

The duty of impartiality derives from the duty of loyalty. When the trustee owes duties to more than one beneficiary, loyalty requires the trustee to respect the interests of all the beneficiaries. Prudence in investing and administration requires the trustee to take account of the interests of all the beneficiaries for whom the trustee is acting, especially the conflicts between the interests of beneficiaries interested in income and those interested in principal.

The language of Section 6 derives from Restatement of Trusts 2d § 183 (1959); see also id., § 232. Multiple beneficiaries may be beneficiaries in succession (such as life and remainder interests) or beneficiaries with simultaneous interests (as when the income interest in a trust is being divided among several beneficiaries).

The trustee's duty of impartiality commonly affects the conduct of investment and management functions in the sphere of principal and income allocations. This Act prescribes no regime for allocating receipts and expenses. The details of such allocations are commonly handled under specialized legislation, such as the Revised Uniform Principal and Income Act (1962) (which is presently under study by the Uniform Law Commission with a view toward further revision).

**SECTION 7. INVESTMENT COSTS.** In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

**Comment**

Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.

The language of Section 7 derives from Restatement of Trusts 2d § 188 (1959). The Restatement of Trusts 3d says: "Concerns over compensation and other charges are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require special attention by a trustee. . . . [I]t is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, comment m, at 58 (1992).

**SECTION 8. REVIEWING COMPLIANCE.** Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

**Comment**

This section derives from the 1991 Illinois act, 760 ILCS 5/5(a)(2) (1992), which draws upon Restatement of Trusts 3d: Prudent Investor Rule § 227, comment b, at 11 (1992). Trustees are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard. In the language of law and economics, the standard is ex ante, not ex post.

**SECTION 9. DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS.**

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

- (1) selecting an agent;
- (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
- (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

#### Comment

This section of the Act reverses the much-criticized rule that forbade trustees to delegate investment and management functions. The language of this section is derived from Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992), discussed *infra*, and from the 1991 Illinois act, 760 ILCS § 5/5.1(b), (c) (1992).

Former law. The former nondelegation rule survived into the 1959 Restatement: "The trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform." The rule put a premium on the frequently arbitrary task of distinguishing discretionary functions that were thought to be nondelegable from supposedly ministerial functions that the trustee was allowed to delegate. Restatement of Trusts 2d § 171 (1959).

The Restatement of Trusts 2d admitted in a comment that "There is not a clear-cut line dividing the acts which a trustee can properly delegate from those which he cannot properly delegate." Instead, the comment directed attention to a list of factors that "may be of importance: (1) the amount of discretion involved; (2) the value and character of the property involved; (3) whether the property is principal or income; (4) the proximity or remoteness of the subject matter of the trust; (5) the character of the act as one involving professional skill or facilities possessed or not possessed by the trustee himself." Restatement of Trusts 2d § 171, comment d (1959). The 1959 Restatement further said: "A trustee cannot properly delegate to another power to select investments." Restatement of Trusts 2d § 171, comment h (1959).

For discussion and criticism of the former rule see William L. Cary & Craig B. Bright, *The Delegation of Investment Responsibility for Endowment Funds*, 74 *Columbia L. Rev.* 207 (1974); John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 *American Bar Foundation Research J.* 1, 18-24.

The modern trend to favor delegation. The trend of subsequent legislation, culminating in the Restatement of Trusts 3d: Prudent Investor Rule, has been strongly hostile to the nondelegation rule. See John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 *Missouri L. Rev.* 105 (1994).

The delegation rule of the Uniform Trustee Powers Act. The Uniform Trustee Powers Act (1964) effectively abrogates the nondelegation rule. It authorizes trustees "to employ persons, including attorneys, auditors, investment advisors, or agents, even if they are associated with the trustee, to advise or assist the trustee in the performance of his administrative duties; to act without independent investigation upon their recommendations; and instead of acting personally, to employ one or more agents to perform any act of administration, whether or not discretionary . . ." Uniform Trustee Powers Act § 3(24), 7B *Uniform Laws Ann.* 743 (1985). The Act has been enacted in 16 states, see "Record of Passage of Uniform and Model Acts as of September 30, 1993," 1993-94 *Reference Book of Uniform Law Commissioners* (unpaginated, following page 111) (1993).

UMIFA's delegation rule. The Uniform Management of Institutional Funds Act (1972) (UMIFA), authorizes the governing boards of eleemosynary institutions, who are trustee-like fiduciaries, to delegate investment matters either to a committee of the board or to outside investment advisors, investment counsel, managers, banks, or trust companies. UMIFA § 5, 7A *Uniform Laws Ann.* 705 (1985). UMIFA has been enacted in 38 states, see "Record of Passage of Uniform and Model Acts as of September 30, 1993," 1993-94 *Reference Book of Uniform Law Commissioners* (unpaginated, following page 111) (1993).

ERISA's delegation rule. The Employee Retirement Income Security Act of 1974, the federal statute that prescribes fiduciary standards for investing the assets of pension and employee benefit plans, allows a pension or employee benefit plan to provide that "authority to manage, acquire or dispose of assets of the plan is delegated to one or more investment managers . . ." ERISA § 403(a)(2), 29 U.S.C. § 1103(a)(2). Commentators have explained the rationale for ERISA's encouragement of delegation:

ERISA . . . invites the dissolution of unitary trusteeship. . . . ERISA's fractionation of traditional trusteeship reflects the complexity of the modern pension trust. Because millions, even billions of dollars can be involved, great care is required in investing and safekeeping plan assets. Administering such plans—computing and honoring benefit entitlements across decades of employment and retirement—is also a complex business. . . . Since, however, neither the sponsor nor any other single entity has a comparative advantage in performing all these functions, the tendency has been for pension plans to use a variety of specialized providers. A consulting actuary, a plan administration firm, or an insurance company may oversee the design of a plan and arrange for processing benefit claims. Investment industry professionals manage the portfolio (the largest plans spread their pension investments among dozens of money management firms).

John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* 496 (1990).

The delegation rule of the 1992 Restatement. The Restatement of Trusts 3d: Prudent Investor Rule (1992) repeals the nondelegation rule of Restatement of Trusts 2d § 171 (1959), extracted supra, and replaces it with substitute text that reads: § 171. Duty with Respect to Delegation. A trustee has a duty personally to perform the responsibilities of trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992). The 1992 Restatement integrates this delegation standard into the prudent investor rule of section 227, providing that "the trustee must . . . act with prudence in deciding whether and how to delegate to others . . ." Restatement of Trusts 3d: Prudent Investor Rule § 227(c) (1992).

Protecting the beneficiary against unreasonable delegation. There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, on the one hand, and protecting trust beneficiaries from the misuse of such powers on the other hand. A broad set of trustees' powers, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees' Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interests of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of these powers. Delegation, which is a species of trustee power, raises the same tension. If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate. But if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries.

Section 9 of the Uniform Prudent Investor Act is designed to strike the appropriate balance between the advantages and the hazards of delegation. Section 9 authorizes delegation under the limitations of subsections (a) and (b). Section 9(a) imposes duties of care, skill, and caution on the trustee in selecting the agent, in establishing the terms of the delegation, and in reviewing the agent's compliance.

The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation. This sense that it is imprudent to expose beneficiaries to broad exculpation clauses underlies both federal and state legislation restricting exculpation clauses, e.g., ERISA §§ 404(a)(1)(D), 410(a), 29 U.S.C. §§ 1104(a)(1)(D), 1110(a); New York Est. Powers Trusts Law § 11-1.7 (McKinney 1967).

Although subsection (c) of the Act exonerates the trustee from personal responsibility for the agent's conduct when the delegation satisfies the standards of subsection 9(a), subsection 9(b) makes the agent responsible to the trust. The beneficiaries of the trust can, therefore, rely upon the trustee to enforce the terms of the delegation.

Costs. The duty to minimize costs that is articulated in Section 7 of this Act applies to delegation as well as to other aspects of fiduciary investing. In deciding whether to delegate, the trustee must balance the projected benefits against the likely costs. Similarly, in deciding how to delegate, the trustee must take costs into account. The trustee must be alert to protect the beneficiary from "double dipping." If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager.

SECTION 10. LANGUAGE INVOKING STANDARD OF [ACT]. The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this [Act]: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

Comment. This provision is taken from the Illinois act, 760 ILCS § 5/5(d) (1992), and is meant to facilitate incorporation of the Act by means of the formulaic language commonly used in trust instruments.

SECTION 11. APPLICATION TO EXISTING TRUSTS. This [Act] applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this [Act] governs only decisions or actions occurring after that date.

SECTION 12. UNIFORMITY OF APPLICATION AND CONSTRUCTION. This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among the States enacting it.

SECTION 13. SHORT TITLE. This [Act] may be cited as the "[Name of Enacting State] Uniform Prudent Investor Act."

SECTION 14. SEVERABILITY. If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

SECTION 15. EFFECTIVE DATE. This [Act] takes effect . . . . .

## **Exhibit 6: Suggested Reading List**

### ***Don't Know Whether You Can Save More? Need An "Attitude Adjustment"?***

George S. Clayson, *The Richest Man In Babylon* (New York: New American Library, a division of Putnam Penguin Inc., 1988).

Thomas J. Stanley, *The Millionaire Next Door* (New York: Pocket Books, 1996, 1998).

### ***Need A Basic Overview of Investing?***

John C. Bogle, *Common Sense on Mutual Funds: New Imperatives For the Intelligent Investor* (New York, John Wiley & Sons, Inc., 1999).

### ***Desire A Fundamental Knowledge of Modern Portfolio Theory and Efficient Markets Theory?***

Burton G. Malkiel, *A Random Walk Down Wall Street: The Time-Tested Strategy For Successful Investing* (New York: W.W. Norton & Company, Inc., 8<sup>th</sup> edition 2003).

### ***Want To Learn More About How To Apply These Investment Concepts, While Avoiding Mistakes?***

Ron A. Rhoades, Michael J. Tringali, and John J. Ceparano, *The Science of Investing: How To Use Academic Research to Increase Returns and Reduce Risks In Your Investment Portfolio* (Joseph Financial Publications, LLC, 2003). Available via inquiry to Joseph Capital Management, LLC, through either [info@josephcapital.com](mailto:info@josephcapital.com) or 352-746.4460. A 330-page "textbook" on the application of the Fama-French 3-Factor Model to portfolio design and investment selection, this text provides specific recommendations of mutual funds and exchange-traded funds in various asset classes.

Larry E. Swedroe, *The Only Guide To A Winning Investment Strategy You'll Ever Need: Index Funds and Beyond - The Way Smart Money Invests Today* (New York: Truman Talley Books, 1998).

Larry E. Swedroe, *Rational Investing In Irrational Times: How to Avoid the Costly Mistakes Even Smart People Make Today* (New York: St. Martin's Press, 2002).

### ***Think You Know It All?***

Bruce J. Temkin, *The Terrible Truth About Investing: How To Be A Savvy Investor* (St. Petersburg, Florida: Fairfield Press, 1999).

### ***Training For Fiduciaries and Their Investment Advisors.***

Donald Trone, *Prudent Investment Practices - A Handbook for Investment Fiduciaries*, published by the Foundation for Fiduciary Studies and the AICPA and available at [www.fiduciarystore.com](http://www.fiduciarystore.com). This text advances a conceptual framework for following a disciplined investment process. The handbook identifies 27 practices that detail a prudent investment process from beginning to end. Each practice is accompanied by a brief explanation of its intent and practical application. Among the subjects addressed are: procedures for developing an asset allocation strategy; preparation and maintenance of investment policy statements; implementing an investment strategy with appropriate money managers; and monitoring and supervising an investment strategy and procedures for controlling and accounting for investment expenses.

Donald Trone et. al., *The Management of Investment Decisions* (McGraw-Hill, 1995). This is an earlier work by Mr. Trone on the process of investments by fiduciaries. It is available through online bookstores.

### ***More Readings for Professional Advisors and The More Serious Investor.***

Peter L. Bernstein, *Against The Odds: The Remarkable Story of Risk* (New York: John Wiley & Sons, Inc., 1996).

Peter L. Bernstein, *Capital Ideas: The Improbable Origins of Modern Wall Street* (New York: Simon & Schuster, Inc., 1992).

Charles D. Ellis, *Winning the Loser's Game* (New York: McGraw-Hill, 4<sup>th</sup> edition, 2002).

Roger C. Gibson, *Asset Allocation: Balancing Financial Risk*, (New York: McGraw-Hill, 2000).

Ibbotson Associates, Inc., *Stocks, Bonds, Bills, and Inflation* (Annual Yearbook) (Chicago: Ibbotson Associates, published annually).

Jeremy J. Siegel, *Stocks for the Long Run* (New York: McGraw-Hill, 2002).

## **The Florida Prudent Investor Rule: What Every Judge Should Know and Ask**

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