WHITE PAPER

OTHER PEOPLE'S MONEY

In today's world, many headlines and news articles are focusing on people in various walks of life serving in the role of "fiduciaries." From time to time, many of us may be asked to take on the responsibilities of a "fiduciary" in situations involving our families, friends, favorite non-profit organizations, foundations, or endowments in which we are involved or we choose to support. So, a very basic question that often is not completely understood is: "**what is a fiduciary?**"

BY **BILL SPITZ**, DIRECTOR

BY **JIM RAMSEY**, PRINCIPAL

continued on next page ›

Essentially, a fiduciary is a person or organization that owes to another the duties of good faith and trust. The highest legal duty of one party to another, it also involves being bound ethically to act in the other's best interests. A fiduciary might be responsible for general well-being, but often it involves finances – managing the assets of another person, or of a group of people, for example. Money managers, bankers, accountants, executors, board members, and corporate officers can all be considered fiduciaries. *Investopedia*

As a trust company, our daily lives revolve around serving as a fiduciary for our clients, so all of our associates are well versed in the duties and responsibilities described in the previous paragraph. But, as we noted above, we are aware that many of our clients also serve in fiduciary roles. Even if not serving as a fiduciary in a legal sense, it can be argued that one has a moral obligation to serve as a good steward for personal or family assets. We therefore thought it might be useful to provide a little education as well as our own perspective on assuming this important responsibility. We will go into more detail shortly, but the requirements of a fiduciary can be summarized in three bullet points:

- **A fiduciary must act in the best interests of both current and future beneficiaries**
- **A fiduciary must have the requisite level of knowledge and expertise to fulfill her obligations**
- **And, a fiduciary must behave prudently while exercising a reasonable level of care.**

First, we provide a primer on legal and moral obligations and then turn to the specifics of serving as a fiduciary for investment assets.

Overriding Obligations

While it does smack of motherhood and apple pie, the first obligation of a fiduciary is the duty of loyalty and good faith which is the requirement to act solely in the interest of the beneficiary. While this notion is largely self-explanatory, one complicating factor is that there may well be multiple beneficiaries with different needs, and there is the potential conflict between present and future beneficiaries. For example, providing more support to current beneficiaries may diminish the ability of a fund to support future beneficiaries. In those circumstances, a fiduciary must exercise balanced judgment that considers the sometimes conflicting interests of all parties. This duty to act impartially does not mean the fiduciary must treat beneficiaries equally, only that the fiduciary must treat the beneficiaries fairly in light of the different purposes and interests of each.

continued on next page ›

What does it mean to act solely in the interest of the beneficiary? Primarily, to the extent possible, the fiduciary must avoid conflicts of interest. This is particularly important for professional fiduciaries who receive compensation for serving in that role. Compensation must be reasonable under the circumstances and the fiduciary cannot otherwise profit personally from the relationship. However, in some instances, it is difficult to totally eliminate conflicts which means the conflicts must be fully disclosed and accepted by the beneficiaries.

The second requirement is the fiduciary must possess the requisite level of knowledge and expertise to fulfill their obligations, which encompasses many areas such as:

- **An in-depth understanding of the terms and provisions of any legal documents establishing the fiduciary relationship, i.e., a trust document or investment management agreement**
- **A thorough understanding of the needs and objectives of the beneficiaries**
- **Significant knowledge with respect to financial matters including investments**
- **Any special or unique knowledge necessary to manage particular types of assets, such as commercial or residential real estate, partnership interests, private businesses, farms, art, collectibles, and other unique types of property**
- **Knowledge of related areas such as taxation, trust and estate law, etc.**
- **Knowledge of applicable laws and regulation**

Historically, the standard applied to fiduciaries was the “prudent person” rule but that has now been supplanted by the “prudent expert.”

Finally, the actual decisions of a fiduciary must be “prudent” and characterized by reasonable care and diligence. Of course, prudent behavior is very much in the eyes of the beholder so there are no hard and fast rules as to what is appropriate. And yes, fiduciaries can be subjected to criticism or legal claims in making their decisions so one should never take these responsibilities lightly. But, it is important to realize that everyone in the financial world makes mistakes, so financial decisions are not judged solely as to their outcome but from the standpoint of the knowledge and care on which the decision was based. And, the law provides protection to knowledgeable fiduciaries who exercised the appropriate level of diligence and who avoid conflicts of interests.

continued on next page ›

Investment Fiduciaries

For several reasons, we are particularly interested in one category of fiduciaries, namely those involved in managing funds for others. Of course, Diversified Trust serves as Trustee for a variety of clients and we also interact on a daily basis with investment and finance committees of non-profit organizations such as endowments and foundations. Additionally, many of us serve on these committees as do a number of our individual clients. The previously discussed requirement of an appropriate level of knowledge is particularly relevant here because successful investing requires specialized expertise, organization, discipline, and ongoing diligence. Let's consider the four key steps in managing an investment program as well as the knowledge required to execute each step successfully. These steps are:

- **Organization**
- **Formalization**
- **Implementation**
- **Ongoing monitoring**

A detailed discussion of each of these steps is way beyond the scope of a single paper, so our objective is to simply provide a basic outline of the responsibilities of investment fiduciaries.

Organization

Market commentators like to wax eloquent about the "art of investing" and there is indeed art involved. But managing money, particularly other peoples' money, is a process that requires organization and discipline. The first step is to determine the context that will govern every aspect of the investment program and it includes:

- **Mastering the documents (for example, trust documents) that govern the management of the fund**
- **Gaining a deep understanding of the needs, objectives, time horizons, and constraints of the beneficiaries**
- **Determining the appropriate level of risk for the fund**
- **Gaining an understanding of any relevant laws and regulations that apply to managing investment portfolios**

continued on next page ›

- **Establishing overall investment objectives for the fund with requirements for diversifying portfolios and avoiding concentrated positions or limited investment classes**
- **Selecting an appropriate spending rate**
- **Determining a target asset allocation as well as acceptable ranges**
- **Determining the appropriate organizational structure. Will assets be managed internally or will outside advisors be hired? Should an Outsourced Chief Investment Officer (“OCIO”) firm be retained?**

Formalization

Having created a broad construct for management of the assets, the next step is to codify every aspect of the investment process. This critical step involves:

- **Creating a formal, written Investment Policy Statement that covers at least the following:**
    1. **Specific return and risk parameters**
    2. **Stated time horizon**
    3. **Any constraints including liquidity, investment restrictions, etc.**
    4. **Target asset allocation as well as permissible ranges**
    5. **Performance measurement parameters including appropriate benchmarks**
    6. **Spending rate**
    7. **Conflicts of interest**
    8. **Appropriate levels of reporting and communication**
    9. **Diversification**
- **Either in this or a separate document, delineating the roles and responsibilities of all involved parties**
- **Similarly, formalizing and documenting relationships with outside providers such as custodians, consultants, legal advisers, and so on.**

continued on next page ›

Implementation

Once the overall structure of the investment program is in place, the next step is to actually invest the portfolio, which generally involves selecting investment managers. Manager selection is very much of an art form which requires both specialized expertise and considerable care and due-diligence. Many people make manager decisions solely on the basis of historical track records. But, past performance is not very powerful as a predictor of future results which suggests that fiduciaries must consider a variety of other criteria such as the firm's people, investment philosophy, ownership, team dynamics, risk management capability, and operational strength. Given this complexity, fiduciaries should think carefully about whether they have the requisite time and expertise, and if there is any doubt, consider employing outside resources such as consultants or OCIOs.

Ongoing Monitoring

The fiduciary's job does not end with the investment of the portfolio because there is a significant ongoing responsibility to monitor and evaluate the success of the investment program. Specific tasks include:

- **Monitoring of adherence to portfolio guideline and restrictions**
- **Rebalancing**
- **Performance reporting**
- **Evaluation of performance and risk-adjusted returns versus stated objectives**
- **Evaluation of investment managers and other service providers versus market benchmarks and peer group universes**
- **Evaluation of portfolio fees and expenses**
- **Qualitative evaluation of service providers. For example, consideration of "people" and organizational issues**

And of course, any of these analyses may result in required action such as changing managers or service providers.

continued on next page ›

Additionally, many of the steps described in the Organizational and Formalization sections need to be repeated periodically. For example, since the needs of beneficiaries as well as the economic and market environment do change, it is important to re-evaluate the investment objectives of the fund including the prudent spending rate. Given changes in capital markets, the asset allocation targets and ranges need to be revised regularly to reflect changing return forecasts, the creation of new asset classes or investment vehicles, and so on.

Permanently Restricted Endowment Funds

Fiduciaries for some types of investment portfolios held by nonprofit organizations, endowments or private foundations are faced with even more obligations to consider.

Many states have passed laws[1] that govern the investment of endowment funds or other institutional funds held exclusively for charitable purposes, i.e., permanently restricted donations. Fiduciaries for these types of funds are required to consider the following factors in making investment decisions:

- **General economic conditions**
- **Effects of inflation or deflation**
- **Tax consequences of decisions**
- **Role that each investment plays within the overall investment portfolio**
- **Expected total return from income and appreciation of investments**
- **Other resources of the institution**
- **The needs of the institution and the fund to make distributions and to preserve capital, and**
- **An asset's special relationship or special value to the charitable purposes of the institution.**

Fiduciaries are required by law to diversify the investments of these institutional funds and also must use reasonable care in selecting and monitoring investment managers for the funds.

FOOTNOTE:

1. *Uniform Prudent Management of Institutional Funds Act*

In making decisions on whether to spend or accumulate funds of these permanently restricted portfolios, fiduciaries are required to consider:

- **The duration and preservation of the endowment fund**
- **The purposes of the institution and the endowment fund**
- **General economic conditions**
- **The possible effect of inflation or deflation**
- **The expected total return from income and appreciation of investments**
- **Other resources of the institution, and**
- **The investment policy of the institution.**

Rather than just following best practices as discussed above, fiduciaries must adopt and update written investment policy statements that should outline the goals, objectives, risk-return characteristics, diversification requirements and asset allocations for covered endowment funds.

In many states, fiduciaries are presumed to have acted imprudently and violated their fiduciary duties if they authorize spending of more than 7% of the fair market value of permanently restricted endowment funds so establishing and following spending policies is extremely important for these types of funds.

Important Notes And Disclosures

This White Paper is being made available for educational purposes only and should not be used for any other purpose. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Diversified Trust Company, Inc. believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based. Opinions expressed in these materials are current only as of the date appearing herein and are subject to change without notice. The information herein is presented for illustration and discussion purposes only and is not intended to be, nor should it be construed as, investment advice or an offer to sell, or a solicitation of an offer to buy securities or any type of description. Nothing in these materials is intended to be tax or legal advice, and clients are urged to consult with their own legal advisors in this regard.

Don't Panic!

We suspect that some people will find our description of the responsibilities and required tasks of a fiduciary rather daunting but our goal was not to frighten away those considering serving in this role. Rather, we want to inject the appropriate level of seriousness and gravity into what is clearly a position of trust and responsibility. Thankfully, there are many external resources that can lend a hand including attorneys, investment consultants, OCIO firms, trust companies, financial advisors, and so on. Our experience has been that people serving in these roles are generally well intentioned so any shortfall is usually the result of a lack of specific training and expertise. Once again, in addition to the external resources mentioned above, the financial world also provides many educational opportunities such as seminars, publications, and so on. Serving in a position of trust is psychically very rewarding whether it involves serving as a trusted advisor to an individual or family or aiding a non-profit through board service. So, we encourage our friends to contact us for assistance and support in these worthy endeavours.

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

GREENSBORO

300 N Greene Street, Suite 2150
Greensboro, NC 27401
Phone: 336.217.0151

MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979

NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302