Enhancing Estate Planning with Investment Policy Statements

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Financial planners can enhance their clients' estate planning by using an Investment Policy Statement (IPS) to manage client assets. Most importantly, you can create an IPS to set clear expectations with clients and all parties in regard to the philosophies, policies, investment objectives, and risk parameters that will guide the investment of the client's liquid wealth.

Trustees of irrevocable trusts must follow the Uniform Prudent Investor Act (UPIA) tenets, stating trustees are required to pursue an investment strategy that accounts for factors such as risk and return. Do not just invest in "safe" investments, as the previous UPIA promulgated. By adhering to the provisions of an IPS, trustees can transparently demonstrate the manner in which they are taking prudent investment action. This IPS establishes objective guidelines for monitoring investment assets and serves as the compass for how to build a portfolio at the risk and reward level most suitable for the requirements of the trust and its beneficiaries.

These IPS considerations should be followed to better help clients make decisions for the long-term stewardship of their assets.

Prudent Investor Principles

The IPS develops a systematic investment discipline for the trustee and investment adviser to follow and can discourage the trustee or fiduciary from making emotional decisions as a result of turbulent market conditions. Trustees are bound by the "prudent investor" standards, meaning that the fiduciaries possess the duty to manage investment assets according to the trust's purpose, terms, and distribution requirements. In essence, prudent investors are required to invest with the care, skill, prudence, and diligence of an expert, under the circumstances of the trust prevailing at the time. (For more on the prudent investor rule, see page 28.)

Foremost, the current prudent investor rule recommends an investment return strategy for the total portfolio, rather than on the selection of individual assets, which by themselves may be inherently "risky," yet add to the total return of the whole portfolio. Be mindful that the trustee has the most flexibility in allocating the trust investments between growth and income for either the power to adjust or total return unitrust under the applicable UPIA. The trust's time horizon will generally dictate the appropriate investment objective for either type of structure.

It is generally advisable to diversify assets into different investment markets or asset classes unless the trustee reasonably determines that it is in the best interest of the beneficiaries not to diversify. Having a well-drafted IPS can also help trustees communicate an investment strategy to all affected parties and to account for the often-conflicting cash flow needs of the trust's current and remainder beneficiaries.

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Planning Trust Distributions

It may be challenging to adjust the timing of the planned cash inflows and outflows in the IPS to meet trust document stipulations for beneficiaries of different ages. For instance, the trust may call for distributions to beneficiaries when they reach adulthood or at preset ages, such as 30, 35, and 40. In each of these situations, you may want a different asset allocation to assure the liquidity necessary to meet distributions tied to specified ages.

Another investment need is to maintain sufficient liquid assets to pay other liabilities of the trust, such as advisory fees or taxes, when they come due. To this end, you should make projections related to the portfolio's anticipated cash inflows and outflows for the next several years.

This cash flow schedule will be invaluable in rebalancing your trust's portfolio, as deposits would or would not be added to the underweighted asset categories or over-represented asset classes will be liquidated to fund planned withdrawals. Your clients are responsible for notifying you if their cash flow needs change.

Avoiding Common Pitfalls

Note that the IPS establishes management procedures for specifically addressing prohibited investments and transactions. You need to identify these special factors in including or omitting possible investments from the portfolio. In addition, if a client brings a highly concentrated portfolio to your management, the IPS should address this consideration and communicate any diversification strategy (or not) for this concentration.

Recognize that clients may choose to impose limits on particular investments because they wish to avert concentrated exposure in a certain industry, or they desire to follow a philosophical or political orientation. For example, the use of environmental, social, or governance (ESG) factors or other criteria to screen investments should be explicitly permitted or disallowed in the IPS.

It is also important to minimize restrictive language in the IPS as much as possible, especially when delegating investment authority to professional managers. Incorporate guidelines so that each investment manager is allowed to invest in specific sectors depending on their individual investment philosophy and process.

Request your clients acknowledge, in writing, their understanding of the IPS document. Verify that your clients understand historical market performance and investment results. For instance, it would be unrealistic to expect a 25 percent annual rate of return above inflation. Regularly review the IPS to ensure the continued pertinence of its guidelines, objectives, and capital market expectations.

Coordinate IPS actions with tax and estate specialists to help them understand investment methodology and ensure successful management of your clients' trusts.

If you are working with clients who are thinking about establishing irrevocable trusts as part of their legacy planning, it is important that they understand that their trustee will frequently have difficult challenges with managing assets for both the benefit of the current and the remainder beneficiaries. A well-drafted IPS can help communicate the often-conflicting needs and how the trustee must balance these needs through the investment strategy outlined in the IPS.

Although an IPS is only required in the case of a legal fiduciary relationship, it is best practice to create an IPS for all investment relationships. With this blueprint, you can educate and guide your existing clients as to how a prudently managed portfolio works. They can then use this knowledge to help select a future trustee who will continue to proficiently manage their legacy assets by creating an IPS as part of their duties.

In *Winning the Loser's Game*, author Charles Ellis writes that "the usefulness of investment policy depends on the clarity and rigor with which investment objectives and the policy guidelines established to achieve those objectives, are stated." Legacy planning, though, can only be enhanced by increased transparency and communication with clients. The IPS is essential in the investing part of this equation to ensure success. ■