

Investment Policy Statements for Trusts

Foundations, trusts and retirement plans are required to have an investment policy statement. Wealthy individuals, as well as anyone with money earmarked for goals such as retirement or college education, should have an investment policy statement. Often referred to as an IPS, the investment policy statement is the basic building block in an intentional investment process, according to *Creating an Investment Policy Statement* by Norman M. Boone, M.B.A., CFP®, and Linda S. Lubitz, CFP®.

With an IPS, an adviser and a client agree upon all the essential issues surrounding how and why the money is to be managed. This step usually is handled after the adviser has assessed the current situation of the trust by reviewing the applicable trust documents, tax returns, and other financial documents. The adviser must manage the trust portfolio such that it complies with the purposes, terms, distribution requirements and other circumstances of the trust, according to *The New Fiduciary Standard*, by Tim Hatton, CFP®, CIMA, AIF, written in conjunction with the Foundation for Fiduciary Studies.

In addition, *The New Fiduciary Standard* says it's important that advisers determine whether the trust documents identify trustees and named fiduciaries in writing; if there is sufficient detail identifying selection criteria, duties, and responsibilities of investment committee members; if the trust documents allow for fiduciaries to delegate prudently investment decisions to others.

In many cases, the process for creating an IPS for a trust is the same as it is for a retirement plan or a foundation. An adviser must:

- identify a client's goals
- identify a target rate of return
- understand the time horizon
- understand the client's risk tolerance
- identify acceptable investment categories and vehicles
- establish an acceptable allocation of asset categories
- write an IPS
- select the specific investments that fit the allocation model
- monitor and adjust the portfolio as appropriate.

On the surface, this process seems simple enough. The tricky part, however, comes when you have to adjust the IPS to meet the requirements of the trust document. For example, the beneficiaries might be minors (typically 18, but 21 in some states), or the beneficiaries may be adult children receiving regular distributions for college funding, or the trust may call for distributions to beneficiaries at preset ages, such as 25, 30, and 35. Each of these scenarios might call for a different asset allocation to assure the appropriate liquidity at the appropriate time.

When advisers create an IPS for a trust, special attention must be paid to the timing of planned cash inflows and outflows, and that an investment time horizon has been identified. Knowing the investment time horizon determines which asset classes will be considered, what the mix among asset classes will be, what sub-asset classes will be considered, and which managers or funds will be selected.

With respect to timing, an adviser must make sure there are enough liquid assets to meet distributions when due. The trust may call for distributions to pay specific expenses of the beneficiary, like college tuition. Likewise, there must be enough liquid assets to meet distributions tied to specified ages such as when a trust beneficiary turns age 25 or 30. These distributions are known well in advance and cash can be set aside for them. The adviser must also make sure there are enough liquid assets to pay other liabilities of the trust such as advisory fees or taxes when they come due.

To do this, the adviser should prepare a schedule of the portfolio's anticipated cash inflows and outflows for at least the coming five-year period. A time horizon in which a distribution must be made within five years would be considered short-term and a time horizon in which a distribution must be made after five years would be considered long-term. If short-term distributions exceed the inflow of cash over a given period, assets will have to be earmarked to cover the shortfall. Generally, though not always, assets earmarked for short-term time horizons would be invested in cash and short-term fixed-income securities with liquidity and preservation of capital often being the primary investment objective. And assets earmarked for long-term time horizons could be placed in a wider variety of asset classes, including stocks, bonds and cash or even real estate and alternative investments. The cash flow schedule also helps the adviser rebalance a portfolio, by using deposits to add to under-represented asset categories and by liquidating holdings that have grown too large in order to fund planned withdrawals.

Advisers often will take one of two approaches to allocating assets within a trust. In one case, the adviser might separate the money that must be distributed within five years from the money that must be distributed after five years, maybe even using separate accounts for each time horizon. The shorter-term money would likely be allocated to investments that provide safety of principal – cash and short-term fixed-income securities, for instance. The adviser would then invest the remaining portion of funds in assets typical of a portfolio with a long-term time horizon, stocks and bonds, for instance.

Alternatively, the adviser might invest all of the assets together, allocating assets among stocks, bonds and cash in one account, and use strategic or annual rebalancing of the portfolio to produce the funds for required distributions.

Along with preparing for partial distributions of the trust corpus, the IPS and the investments must also align with the eventual liquidation of the trust. Trusts have a finite life and must be liquidated at some point. Depending on the terms of the trust, this liquidation may be a short-term distribution (within five years) or a long-term distribution (five years or longer). The IPS and the investments must reflect that time period in the asset allocation.

The Investment Policy Statement is a lot like a blueprint for the management of a portfolio. It should spell out all the roles of the various parties related to the trust, including the adviser, client, and other parties, and especially the process by which the account is to be managed and monitored. A good IPS helps foster communication between adviser and client, and helps everyone to understand their responsibilities and duties as they work together to administer and manage the trust to carry out its purposes in the lives of the trust's beneficiaries.

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