

Uniform Acts, Modern Portfolio Theory, and An Unintended Consequence

by James F. McDonough, Jr. on August 8, 2013

Trustees had been governed by the Reasonable Man standard for investing trust assets that were designed to preserve principal and avoid risk. Then, Modern Portfolio Theory came into prominence and the Reasonable Man rule fell into disfavor. Modern Portfolio Theory (MPT), supported by the work of Nobel Laureates, became the prevailing theory. In the most simple of terms, MPT requires diversification by allocating capital among asset classes or sectors so as to minimize risk.

The Uniform Prudent Investor Act (UPIA) incorporates MPT that requires trustees to diversify investment portfolios. Diversification is achieved through statistical methods that are designed to minimize investment risk, through the selection of securities that respond differently to market changes. MPT notes that some stocks react, up or down, in lockstep with the market index. Defensive stocks, such as utilities, do not decline as rapidly in bad markets and do not rise as rapidly as the market in good times as the index. A diversified mix of stocks among unrelated sectors minimizes the overall risk of loss to the trust assets. MPT believes that risk can be minimized for any targeted level of returns.

The rule of UPIA can be overridden by the Trustee. A Grantor may leave a closely-held business in a trust and therefore must allow for the holding of a concentrated position by the trust. Not every successful investor uses MPT. Warren Buffet distains MPT and at one time had one-third of his portfolio in the stock of Coca Cola.

The Uniform Trust Code (UTC) is a comprehensive statute designed to improve state trust law. UTC Section 404 demands the trust “benefit the beneficiaries,” a rule that can cause conflict with a Grantor’s instructions to the Trustee. Imagine a trustee, bound by the instructions of the Grantor who waived the application of MPT as permitted by UPIA, and now faces a challenge based upon the UTC. The problem is that the UTC gives beneficiaries a reasonable basis to mount a challenge that will overturn the Grantor’s instructions to the Trustee. The beneficiaries may claim that the trust, as administered, does not meet their needs, disregarding what is written in the trust instrument. The beneficiaries may also claim the Grantor’s instructions to the Trustee represents control from the grave that prevents the trust from adapting to current circumstances and being administered for their benefit. Not every potential conflict is be resolved by uniform legislation.