FEATURE:
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A Fiduciary Perspective On Sustainable Investing

New opportunities for trustees for personal trusts

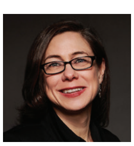
Sustainable investing is on the rise, yet one large group of investors remains on the sidelines: trustees of personal trusts.

Fiduciary duties have long precluded trustees of personal trusts from using this increasingly popular style of investing unless specifically authorized by the grantor. At the same time, modern trust statutes in states such as Delaware, Illinois and Oregon have led the way in permitting trustees to consider sustainable investing factors in their investment analysis. Many trusts in existence today, however, predate the concept of sustainable investing or are governed by laws of other states.

Two Industry Trends

Beneficiary demand is becoming increasingly common—and urgent—causing trustees to grapple with their interrelated duties. The question explored here is: Can a documented statement of beneficiary consensus values provide the required motive and sufficient beneficiary benefit to satisfy the trustee's fiduciary duties in dated trusts while adhering to the prudent investor rule? To answer this question, I'll examine the intersection of two related industry trends: sustainable investing and family values statements.

These trends share a common theme: Families are seeking more purpose and meaning from their wealth. By helping beneficiaries express their values through sustainable investing and family values statements, advisors can enable them to build an enduring family culture that may prove to be the ultimate benefit to both current and future beneficiaries.[1]



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Sustainable investing: Inflows to sustainable investments have recently skyrocketed. (See "A Growing Preference for Socially Responsible Investing.") U.S. sustainable funds received $21.4 billion net inflows in 2019, quadrupling the prior record. Global initiatives continue to gain traction,[2] and President Biden's proposed policies align with sustainable objectives, which could spark more interest from U.S. investors.[3] In fact, research by PwC indicates ESG investing could surpass traditional investments in Europe by 2025.[4] Despite its current popularity, sustainable investing's long history is marred by an alphabet soup of acronyms and inconsistent reporting requirements.[5] ESG, socially responsible investing (SRI), corporate social responsibility (CSR) and impact investing are all common descriptors defined differently by seasoned experts. In this article, the term "sustainable investments" describes an investment with a dual purpose: to produce both a competitive market return and a desired positive outcome as it relates to various societal goals.

Family values trend: A less obvious trend is the growing popularity of family values statements. These statements capture a consensus regarding a family's values and shared vision for their collective future. Years of research show that family vision statements are a best practice among multigenerational families with substantial wealth.[6] Like sustainable investments, such statements fall under a variety of naming conventions—values, vision, purpose and mission statements. These statements intend to articulate consensus among family members on shared values today and how to project those values into the family's shared future, fostering long-term family unity along the way. While lasting harmony among trust beneficiaries is a worthy goal, it's infinitely more challenging to measure than its investment counterpart. Unlike investment performance, measurement isn't quarter

by quarter or decade to decade but instead a cumulative effect measured generation by generation.

The Fiduciary Dilemma

Core fiduciary duties require a trustee to invest funds prudently and for the sole benefit of the trust beneficiaries. Common interpretation of these duties precludes using sustainable investments because its dual purpose includes a positive outcome to non-beneficiaries. This is challenging for two reasons: (1) there's an assumption of underperformance due to restricting the investible universe, which could render them imprudent; and (2) introducing the interests of a third party could run contrary to a fiduciary's duty of loyalty and impartiality.

Testing assumptions of underperformance. Trustees are required to invest trust assets prudently. Trust assets must be both individually suitable and collectively appropriate. The statutory guidance, however, isn't overly prescriptive and is intended to be flexible and adaptive. It requires carefully documented due diligence in the investment selection process and ongoing monitoring taking into account performance, risk-return characteristics and fees. Applying to the portfolio as a whole, no single factor, ESG or non-ESG, will ensure or deny a prudent determination on a specific asset.[7] All trust assets, sustainable or traditional, must meet the prudent standard.

While prudent principles remain steadfast, the sustainable investing universe has changed immensely in recent years. Global demand has created an expanded opportunity set, improved data and intensified the performance debate. Some data-driven studies suggest sustainable investments may perform as well as, or even outpace, their traditional coun-

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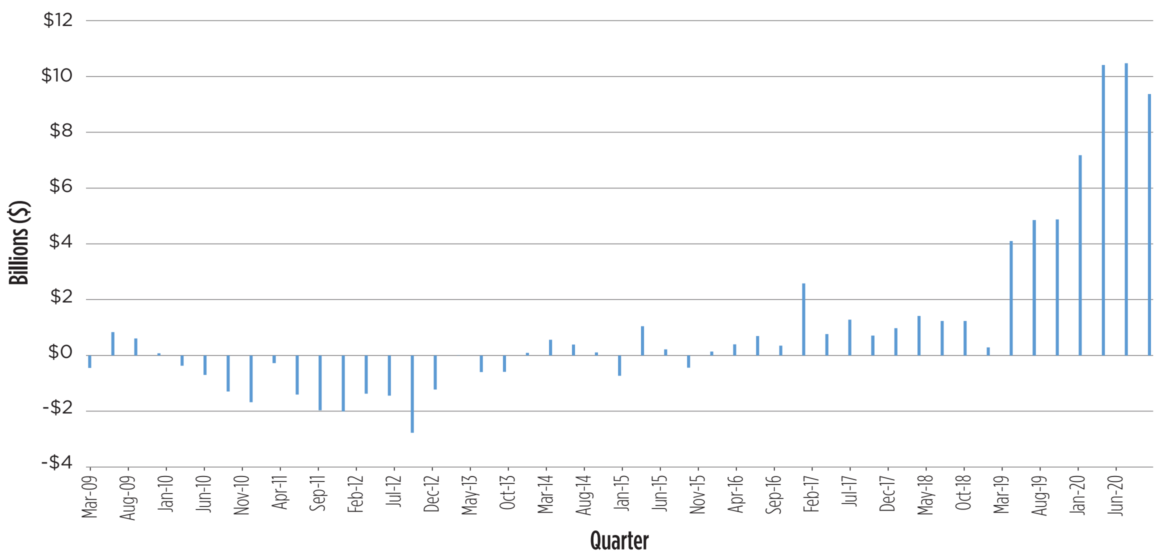
A Growing Preference for Socially Responsible Investing

*Inflows to sustainable funds have skyrocketed**



*Includes funds from Morningstar Direct's Sustainable Landscape U.S. Funds Q2 2020. Doesn't include funds that have been liquidated; doesn't include funds of funds.

— Morningstar Direct Data as of Sept. 30, 2020

terparts—yet other studies and investment experts claim the reverse.[8] Today's sustainable active management has eclipsed its exclusionary ancestor and is focused on proactively selecting companies expected to produce increased long-term marketable advantages through reputational goodwill, corporate tax benefits or reduced regulatory burdens. For passive investments, there are low-cost strategies that can be tracked against both sustainable and traditional benchmarks. With talented investment professionals on both sides of the performance debate, sustainable investments may be worthy of a prudent analysis when there's a beneficiary-driven demand. Sustainable investments can no longer be easily dismissed as conclusively underperforming.

Duty of loyalty. When managing trust assets, a trustee must put the beneficiary's interest before its own and act in the sole interest of the beneficiary.

Relying on beneficiary consensus values to implement a sustainable objective may be consistent with the duty of loyalty.

A sustainable investment, as defined here, produces both a competitive return and a positive outcome. Sustainable initiatives are, by definition, broad sweeping, and their impact can't be limited to the specific trust beneficiaries. This presents two interrelated challenges to fulfilling the trustee's duty of loyalty: (1) the sustainable objective must stem from the beneficiaries to ensure the trustee isn't putting its own interests before those of their trust beneficiaries; and (2) investment objectives must be based on the needs of the specific trust beneficiaries.

Inconsistent Positions

The above issues have been hotly debated by trusts and estates attorneys and have played out on the global stage. The United Nations, Principles for Responsible Investing[9] and the U.S. Department of Labor[10] take inconsistent positions on whether pension trustees may consider sustainable factors when investing for their beneficiaries. The source of the motive for sustainable investing is at the heart of the pension debate and provides a useful framework for a personal trust analysis. Because pension plans have a multitude of disparate beneficiaries, finding consensus on a sustainable investing goal would be untenable. Lacking beneficiary consensus, the sustainable motive is assumed to be derived from the trustee, thereby representing the trustee's values and creating an impermissible conflict.[11]

Conversely, personal trust beneficiaries have the potential for consensus values, as they often share a common ancestor. In fact, research shows that well-articulated consensus values are a hallmark of successful multigenerational wealth families, promoting long-term unity. Relying on beneficiary consensus values to implement a sustainable objective may be consistent with the duty of loyalty because it isn't expressing the trustee's interest but that of the beneficiaries.

The next issue is whether the sustainable investment is in the sole interest of the beneficiary. As a starting point, it may be helpful to acknowledge that every trust investment inevitably affects non-beneficiaries. Choosing one investment over another has ramifications for the selected company's shareholders, employees and society at-large through their environmental and social policies. In the case of a sustainable investment, however, the goal is to focus on investments whose non-beneficiary effect aligns with the beneficiaries' values. Importantly, the motive is derived from the beneficiary's desire to receive a personal benefit from the allocation, knowing that their investments are in line with their values. Luckily, this isn't a zero-sum game in which one needs to choose between benefiting the beneficiary over the amorphous benefactor of the positive outcome. A well-designed sustainable portfolio, consistent with the beneficiary's value system and prudent investor rule, may benefit the trust beneficiary both financially and non-financially by providing direct health benefits such as reduced stress and increased problem solving abilities.[12]

A sustainable motive derived from the consensus of trust beneficiaries rather than the trustee distinguishes personal trusts from pension funds and may open the door for sustainable investing that's

consistent with the duty of loyalty by representing the beneficiaries' values and providing a benefit to trust beneficiaries.

Iterating Impartiality

An extension of the duty of loyalty, the duty of impartiality requires the trustee to be concurrently loyal to all trust beneficiaries. Impartiality applies to both current and future beneficiaries, even those yet unborn. Given the longevity of dynastic trusts, trustees may encounter situations unanticipated by the trust terms, like a desire for sustainable investing. In these cases, there are few tools at a trustee's disposal to provide clarity. Both consents and court orders are valid options but are cumbersome in practice, often presuppose a breach of trust and capture a static perspective from a specific point in time. In contrast, maintaining a family values statement is a dynastic process, reassessed with each generation's coming of age to ensure continual relevance. Unlike a consent or court order, a vision statement evolves over time, allowing for incremental course corrections and making it uniquely aligned with a dynastic trust's investment horizon.

Trustees of long-term trusts must be adept at balancing the often competing priorities of multiple beneficiaries while simultaneously representing all of their interests when managing trust assets. Beneficiary consensus on a sustainable investment goal may prove a useful and dynamic tool to guide trustees on investible strategies. Perhaps there will be a day when balancing multigenerational beneficiaries' sustainable investing goals will be as common place as striking the right balance between growth versus value, reinvesting versus income distribution or allocating an expense between principal and income.

Clearly articulated shared values may bridge the gap between current and future generations of trust beneficiaries consistent with the trustee's duty of impartiality. Integrating the family's values through a productive sustainable investment allocation may reinforce the beneficiary's values and benefit the trust beneficiaries through intergenerational family harmony.

Case Study: Prudence in Practice

In one case, there was close alignment on core values among the trust beneficiaries that permeated their vocations, social engagements and personal spending habits. They were living a life in sync with their values with one glaring exception. Drafted long ago, their irrevocable trusts didn't contain modern trust language permitting sustainable investing. They asked their trustee to consider if there were prudent sustainable investments that would align with their consensus family values as articulated in their vision statement. Doing so would require the trustee to meet the criteria of the prudent investor rule and duties of loyalty and impartiality. Using the vision statement as the motive and consensus for the investment, the trustee was left with the task of determining if the investible options would qualify as prudent. Rather than relying on common assumptions of inferior performance, they sharpened their pencils and did the math. Using a consistent due diligence process, they selected a passive sustainable asset that was a good fit with the beneficiaries' values. Working with an external investment consultant, they stress-tested both the current portfolio and the proposed portfolio containing the sustainable investment.

The results were surprising. Try as they might, no amount of sophisticated analysis resulted in a statistically significant discrepancy between the two portfolios. In the end, they determined that both portfolios would satisfy the prudent investor standard. Through this process, the trustee was able to find an investible solution that fulfilled their fiduciary duties, enhanced diversification and represented the family's consensus values. Monitoring the sustainable investments against both a traditional and sustainable index ensures that the portfolio continues to perform as expected.

> Beneficiaries are challenging performance assumptions and asking for a modernized approach.

Pivotal Moments

Trustees are governed by a long history of fiduciary guidance, making shifts slow and purposeful. Trustees, however, aren't immune to change. Some trustees may remember when alternative assets were new on the investment scene. Once met with resistance, an alternative allocation is now common place in substantial long-term trusts. Trustees are again at an inflection point. Beneficiaries are challenging performance assumptions and asking for a modernized approach. They're asking their advisors to find ways to integrate meaning and purpose into their wealth, promoting enduring family cultures.

Assisting beneficiaries in fulfilling such lofty goals puts trustees in an awkward spot as they seek to uphold their duties and the law. Perhaps trustees will find a solution at the intersection of sustainable investing and family values. Conceivably, a beneficiary's sustainable investment objectives may someday take their place alongside the other beneficiary-specific factors that are routinely considered in designing a trust portfolio. This may pave the way to a more contemporary approach of trust investing that meets both the beneficiary's financial needs and supports longstanding family harmony.

Perhaps trustees will find a solution at the intersection of sustainable investing and family values.

Endnotes

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