KAREN S. GERSTNER & ASSOCIATES, P.C.
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
Telephone (713) 520-5205
Fax (713) 520-5235
www.gerstnerlaw.com

BASICS[*]

Trust Investments

Synopsis

The job of trustee is an important one. When investing trust assets, a trustee must apply a special degree of prudence. In fact, beginning in 2004, the Texas legislature has imposed a new set of standards for trust investments by adopting the Uniform Prudent Investor Act. The Act does not set out a list of permissible and impermissible investments. Rather, it requires the trustee to invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. Moreover, the trustee is generally required by statute to diversify the investments of the trust. Every trustee should undertake a detailed review of the trust's assets, with the particular requirements of the Uniform Prudent Investor Act in mind.

I. Trust Management and Investment - The Prudent Investor Standard.

A. The Texas Trust Code.

Historically, Texas law consisted of a modified "prudent person" rule for trust investments. The original "prudent man" standard of trust investing dated from the 1830s, and focused on preservation of capital, coupled with deriving trust income from long term safe investing. Beginning January 1, 2004, the Texas Trust Code applies a new set of rules that shift the trustee's duty from a wealth conservator who avoids risk to that of a wealth manager who consciously assumes and manages risk. This new set of rules is known as the Uniform Prudent Investor Act (the "Act"). In summary, the Act provides that, unless application of the Act is altered by the terms of the trust instrument, a trustee "*shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.*"

The rule goes on to provide:

> "Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions or strategies; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; (5) the expected total return from income and the appreciation of capital; (6) other resources of the beneficiaries; (7) needs for liquidity, regularity of

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income, and preservation or appreciation of capital; and (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries."

Texas law once evaluated a trustee's performance on an asset-by-asset basis. More recently, however, the trust's mix of assets is determinative. The Act states, "*A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust*." This rule incorporates modern portfolio management theory into Texas trust law. Portfolio theory recognizes that it may be appropriate in some portfolios to include some higher risk investments that have greater opportunity for higher returns. Thus, a prudent investor might make an investment of a small percentage of the trust estate in an asset that might not be suitable if it comprised the entire trust estate (or a large portion of the trust estate). Likewise, an otherwise prudent investment might *not* be prudent in the context of the entire trust. For example, a prudent person might invest in real estate if the projected returns justify the investment. If the trust estate is already comprised primarily of real estate, however, this purchase may violate the prudent investor standard because of the lack of diversification. Likewise, certificates of deposit may be prudent to hold in a portfolio, but because they have no growth potential and may be eroded by inflation, it may be imprudent to hold a major portion of the trust estate in these investments.

The Act sets forth three additional guidelines for prudent trust investing. First, as a trustee, you cannot sit idly by without making a diligent inquiry into the facts regarding the assets of the trust and its beneficiaries. Rather, you must make a reasonable effort to verify facts relevant to the investment and management of trust assets. Second, no specific trust investment is expressly permitted (or prohibited) by the Prudent Investor Act. Except as otherwise provided by the Act, you may invest in any kind of property or type of investment consistent with the standards of the law. *This rule is a significant departure from prior law*, which expressly permitted a trustee to retain assets originally contributed to the trust, even if the asset was not one which the trust might otherwise prudently acquire. Finally, with specialized skill comes special responsibility. A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise in administering the trust. Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

B. The Governing Instrument.

As noted earlier, the Act's mandates apply unless the trust instrument or Will provides otherwise. The governing instrument may alter the investment duties of the trustee. Therefore, it is essential that you review the terms of the trust agreement or Will to determine whether the document provides a different standard of trust investing than that specified in the Act. For example, a trust agreement might restrict the trustee from investing in certain assets or types of investments. The agreement might direct the trustee to favor one beneficiary or class of beneficiaries over another (for example, by directing the trustee to invest for maximum income without regard to preservation of capital). Since the Act applies only in the absence of contrary language in the governing instrument, you must review the governing instrument thoroughly, and make note of any special directions or restrictions. In the event of any questions about interpreting the document, you should consult with competent legal counsel.

C. Duties at the Inception of the Trust.

When a trustee commences his or her duties, the Prudent Investor Act requires that the assets of the trust receive special scrutiny. By law, within a reasonable time after accepting a trusteeship or receiving trust assets, you must review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of the Act. The Act does not define a "reasonable time," because the reasonableness of the time period depends upon the particular facts and circumstances of the trust in question. In fact, the Act's commentators note that in some cases, a period of one year would be reasonable, while in other cases, a more immediate review would be required. The best practice is to review the trust assets immediately upon accepting the trusteeship or receiving new assets.

D. Duty of Loyalty.

The Act requires a trustee to invest and manage the trust assets solely in the interest of the beneficiaries. You may not personally benefit from trust investments, nor may you enter into an investment that is in your best interest, to the detriment of the beneficiaries of the trust. For example, if you individually co-own an asset with the trust, and it is in the best interest of the trust beneficiaries to sell the property, you would be required to do so, even if you personally did not wish to participate in the sale. Likewise, unless expressly permitted by the trust instrument, a trustee is prohibited from loaning trust funds to or from himself; an affiliate, director, officer, or employer of himself or an affiliate; a relative; or an employer, employee, partner, or business associate. A trustee is also prohibited in most instances from selling trust property to, or buying trust property from, the persons listed above.

E. Duty of Impartiality.

If a trust has two or more beneficiaries, you must act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Thus, for example, if a trust requires all income to be distributed to A each year, with the balance of the trust to be distributed to B upon A's death, the trustee owes duties to both A and B. Investment in high yield "junk" bonds may be very advantageous to A, since those bonds pay a high rate of interest income (if they don't default). Yet the risk of a bond defaulting rests almost entirely on B, who does not benefit from the bonds' high yield. On the other hand, an aggressive growth stock portfolio may yield little or no dividend income, much to the detriment of A, while causing the corpus of the trust ultimately passing to B to increase substantially. Unless the trust agreement provides otherwise, the trustee must balance the interests of both A and B in implementing an investment strategy for the trust.

F. Duty Regarding Costs.

A trustee must be mindful of the costs of administering the trust. The Act mandates that in investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. Thus, while it may be prudent for a person with no specialized investment experience to hire an investment advisor, the cost of that advice must be weighed against the benefit to be obtained. For smaller trusts, the benefit of diversifying through the use of mutual funds may be more appropriate.

II. Issues with Specific Trust Assets.

A. Real Estate.

Generally, trustees should inspect any real property held in the trust shortly after beginning their duties. For property located far away, they may consider hiring an agent to make the inspection. However, if the property is valuable enough to justify the travel expense, the inspection probably should be made personally. Such inspections can expose the following potential problems: environmental or other hazards that may open the trust estate to liability; use of the property by unauthorized persons; lack of compliance by the tenants with lease requirements; maintenance needs; potential zoning changes; and possible changes in the area around the property which may affect the value and use of the property in the future.

As a trustee, you should confirm that there is current and appropriate casualty and liability insurance for all real estate owned by the trust. You should read each policy in its entirety and discuss it with the trust's insurance agent. Care should be taken to insure that each policy's coverage will be effective and adequate. Pay special attention to exclusions (such as vacant dwellings) that may apply.

You should read each lease on each piece of real property owned by the trust. Make note of applicable notice provisions regarding the lease termination date and any notices that may need to be given or received. The books should be reviewed to confirm that the tenant is paying the proper amount (particularly in a net lease, where taxes or other expenses that are to be borne by the tenant may change). With respect to leases that are nearing their expiration, you should evaluate whether the lease is on market terms, and should begin taking steps to re-sign the tenant or to attempt to lease the property before it becomes vacant. Any improved real estate which is not leased should be carefully reviewed. Appropriate steps should be taken to protect the property from vandalism or other damage, to lease the property, if possible, or to dispose of the property, if appropriate.

You should review property tax appraisals from each taxing authority to insure that values are not overstated. Take the necessary steps to reduce overstated values to appropriate levels. For agricultural property, overstated values may affect roll-back taxes, if and when the property is sold and its use is changed. Also verify that the property taxes on the property are current, and that any appropriate exemptions available to the trust estate are being utilized.

Take steps to evaluate and minimize any potential environmental risks associated with holding real estate. Your objective is to identify and minimize current environmental exposure, and enact procedures to prevent future problems. Identifying environmental exposure can be difficult, but at a minimum, a special inquiry should be made if you know or suspect that gas tanks are or have been located underground, dangerous material (e.g., pesticides, motor oil, defoliant, etc.) have been sprayed on the property, or an industrial use has been made of the property. Potential protective environmental actions include carefully selecting the tenants and managers responsible for maintaining property (including the financial ability of those persons to rectify any environmental problems created by them), performing environmental audits, and carefully drafting property management and lease agreements to deal with environmental issues. With regard to property that the person who created the trust (or another party) desires to add to the trust, or which may be purchased by the trustee at a later date, you should perform due diligence *before* accepting or purchasing the property, to insure that you are not taking on environmental liabilities and thus exposing the remainder of the trust estate to liability. In some cases, taking these steps creates a defense preventing the imposition of liability on the trustee or the trust estate, even if environmental contamination is later found to exist.

B. Mineral Interests.

You should carefully review all division orders to insure they properly reflect the trust's ownership, and that the trust is receiving the royalties and other payments to which it is entitled. Also be sure that the operators, lessees and other parties who may be making payments as a result of the mineral interests (as well as the appropriate taxing authorities) have the trust's proper address.

C. Business Interests.

The presence of business interests in trust estates presents significant risks and issues for trustees. If your trust holds a business interest, you must specifically identify what is held – the restrictions, voting rights, management rights and other characteristics. Further, you should determine whether it is marketable.

Immediately request and review all buy-sell agreements, voting agreements, business continuation agreements and other shareholder agreements to which the trust is a party or which impose restrictions on, or give rights to, the business interests held by the trust. Make notations of the substantive provisions of the documents. Give notice of your current address to the other parties in the manner specified in those documents to insure that you receive the notices required to be given to the trustee. In addition, it may be advisable to have these agreements reviewed by counsel to determine whether they are still appropriate to the current circumstances of the trust and if not, whether they may be renegotiated. In connection with reviewing these agreements, you should also review any insurance on owners or other key employees which is designed to fund payments under those agreements, and should verify that any required insurance is in place, is owned by the proper entity, and is payable to the proper beneficiary.

If your trust holds a controlling interest in a closely held business, you must immediately determine whether it should be continued, liquidated or sold. In making this determination, consider whether the trust instrument authorizes you to continue a business; whether holding it would allow the trust to be adequately diversified; whether sufficient funds are on hand to operate the business; whether there is a market (or if one may be created) for selling the interest; whether the expected returns of the business are sufficient to offset the risks; and whether competent people are running the business, or can be hired to do so at an acceptable cost. Remember that a business which generated a nice income for its founder may not be of sufficient size to provide a reasonable return to the trust estate if an outside person must be hired to run it.

If you decide to continue the business (either indefinitely or for winding down), its current structure should be evaluated and changed if necessary. Different business entities include sole proprietorships, general partnerships, limited partnerships, limited liability companies, and corporations (including S corporations, assuming the trust can qualify as an S corporation shareholder under the Internal Revenue Code). In deciding which entity should be used, consider the costs associated with changing the current structure, the value of limiting the exposure of other trust assets to the business risks, providing the fiduciary appropriate control of the business, minimizing negative income tax consequences, and limiting adverse effects to beneficiaries upon termination of the trust.

If the trust acquires stock in a corporation that will be treated as an S corporation for federal tax purposes, you must determine whether the trust is an eligible shareholder. The Internal Revenue Code restricts ownership of stock in S corporations to certain qualifying trusts. Even these trusts must have the trustees or their beneficiaries make special elections to remain eligible. This election must be filed within 75 days of the date the trust acquires the stock. If the trust does not qualify as an S corporation shareholder, you must promptly decide whether to dispose of the stock (by sale or distribution), allowing the corporation to continue as an S corporation, or to hold the stock, thereby terminating the S status. Determine whether the shareholders signed an agreement which may impose liability on a shareholder for terminating the corporation's S election. You must be careful to act from proper motives if you are selling or distributing stock to preserve the S election, especially, if you are also a shareholder in the business. Any benefits to you personally from retaining S corporation treatment, if not in the best interest of the trust, may subject your action to second-guessing by the beneficiaries and the courts.

D. Review Cash Accounts.

Upon becoming trustee, determine whether all cash in bank accounts is within the insured limits in an FDIC- or FSLIC-insured institution. If not, evaluate the strength of the financial institution and take appropriate steps to protect the cash by moving it if necessary. Trustees who fail to maintain all cash funds in interest-bearing accounts may later be questioned by the beneficiaries. If you ever hold any operating funds in non-interest bearing accounts, keep records explaining this action (i.e., monthly fees or other charges would exceed any possible interest earned). Daily "sweeping" of cash in brokerage accounts may be arranged, so that as cash is earned or deposited, it is swept into an interest-bearing account. To the extent cash is not needed for the regular trust operations, carefully evaluate alternatives to cash, such as short-term debt instruments, certificates of deposit, T-bills, and other investment alternatives with high liquidity, minimal volatility, and rates superior to those obtained in bank accounts or money markets.

E. Stocks and Bonds.

Evaluate individual issues of stocks, bonds and mutual funds held by the trust estate to determine whether they should be retained as investments. Give immediate attention to issues known to be "troubled" to determine whether it is prudent to retain them while implementing the investment policy, or whether prompt sale is required. Remember that you are allowed to obtain cost-effective investment advice. Further, you open yourself up to criticism from trust beneficiaries for failing to consult with an investment professional if the trust's investment performance is poor.

F. Life Insurance Policies.

You should confirm that any company providing life insurance benefits is sound financially. There are four major rating agencies for life insurance companies: A.M. Best Co.; Standard & Poors; Moody's; and Weiss Research. You are advised to maintain policies with reasonably high ratings by at least three of the rating firms. Before purchasing new policies, consider the cost of the insurance as compared to the cost of similar policies from similarly rated carriers. Ask the agent to help you evaluate issues such as mortality assumptions, company costs, dividend paying history, investment portfolio mix, and the impact of the "load" (the commissions payable) on the expected performance of the policy. Determine whether there are comparable policies available with lower charges.

Consider whether life insurance is an appropriate asset to hold in the trust. If insurance comprises the entire trust estate (such as with a traditional irrevocable life insurance trust), you could conceivably be questioned about your failure to diversify the trust estate, unless the trust instrument expressly authorizes this form of investment. Life insurance policies, over time, may or may not perform as strongly as a more traditional well-diversified portfolio, especially if the insured substantially outlives expected mortality. Nonetheless, life insurance may be an entirely appropriate investment to own, given the purposes of the trust.

In fact, the grantor of a trust frequently intends the trust be solely for the purpose of owning such policies, and does not intend, at least until the death benefit proceeds are paid, for the trustee to create a diversified trust estate. If an existing policy is transferred to the trust as its only asset, retention of the original policy in the trust estate may be protected by express language in the trust instrument, because it was an original trust investment. Even if the policy *is* an original trust investment, however, you are making an investment decision separate and apart from the original contribution to the trust estate when you use future contributions to the trust estate to pay additional premiums on that policy.

G. Promissory Notes.

Review all promissory notes due and owing to the trust estate. Determine the balance due and whether payments are current or in default. Also, review all security agreements or deeds of trust securing the payments under the note. If the note is in default, take steps to get the maker to bring it current. The trust should take action on a note in default before its collection is barred by the applicable statute of limitations. If the note is secured by real estate, environmental risks should be evaluated before you foreclose on the property.

III. Developing an Investment Policy.

You should evaluate the entire trust corpus to determine how its investments are allocated. As discussed in more detail below, you should develop an investment policy for the trust. Then, you should map out a plan to shift current trust assets so your investment strategy may be ultimately fully implemented.

A. Setting the Investment Policy.

Investment policies are like blueprints that orchestrate all investment decisions. They are invaluable tools for implementing, monitoring and evaluating trust investments. Deviation from such a plan may expose a trustee to liability, if he *also* fails to document his rationale for deviation. Charges of negligence are more likely to arise where no clearly articulated investment policy exists at all. Absent the existence of a policy, investment decisions are frequently made on an *ad hoc* basis, without adequate thought given to the investment in the context of the trust's overall financial plan. Since poor investment policies, and the failure to comply with good ones, may be held against trustees, your policy must be prudently developed and meticulously followed. Be certain to consult with investment advisors or study investment philosophies and trends before developing this policy.

When developing the investment policy, communicate with the beneficiaries regarding their current and future distribution needs. Such projections will necessarily impact your decisions as to the appropriate types and amounts of assets you will need to meet your obligations. Current income verses future growth must be adjusted appropriately. Also consider the beneficiaries' (including remainder beneficiaries) risk tolerance. You should consult with investment advisors and/or study investment philosophies and trends before developing this policy.

A key component of investment philosophy is the target long-term rate of return. This rate is usually defined as a percentage above the rate of inflation, as determined by the Consumer Price Index. This target should be achievable and reasonable considering historical returns of well-diversified portfolios. Many trustees use 3% to 5% above inflation as their target for long-term investment return. The rate you select, however, should not be so high as to encourage speculative investment. In short-term trusts, the target rate is frequently adjusted somewhat downward. In setting a performance goal, look at historical long-term performance of various classes of assets. Most investors are cautious about setting goals that reflect the

1980's or late 1990's rates of return, which probably will not be realistic in the future. Your investment policy should also expressly note when certain goals may not be achievable. For example, most plans indicate that the goal may not be met during extended periods of high inflation.

Although investment philosophies differ, recent research suggests that long-term performance of a portfolio may be more dependent upon the asset allocation (i.e., how the portfolio is invested in different classes of assets), than upon the performance of the individual assets within the portfolio. In other words, long-term performance is influenced more by the fund's equities to fixed-income investments ratio, than by the specific issues of stock purchased. Asset classes might include cash, fixed-income (including taxable and non-taxable bonds), securities, domestic equities (including large-cap companies and small- or mid-cap companies), foreign equities, real estate, oil and gas interests, and business or venture capital investments. All asset classes should be evaluated to determine if they are appropriate and prudent for the trust estate to hold. Among the asset classes selected, determine the percentage of the estate to devote to each, based on the trust's investment time-frame, the beneficiaries' risk tolerance, and the trust's overall purposes and performance goals. Permissible variations between percentages to be devoted to each asset class may be specified (i.e., domestic large company equities shall comprise 15% of the trust estate, plus or minus 5%). This allows you the flexibility to adjust percentages when market conditions dictate it, without changing the basic investment policy.

Your investment policy should also establish guidelines for investing within the various asset classes. For example, you may require that all bonds meet the minimum quality requirements set by the ratings agencies, or you may set a maximum maturity period for their purchase. Similar criteria should be developed for other asset classes. Further, it is advisable to specifically limit the percentage of the trust estate which may be invested in any one security or industry. Although you may deviate from this guideline in extraordinary circumstances, you should carefully document your reasons for doing so. If the beneficiaries insist on such a variation, get their signatures on a document stating they are aware of the risks, and nonetheless wish that the investment be made.

You should compare the performance of the trust estate with your goals on a regular basis. Benchmarks should be used to determine whether investments are performing well within their class. For example, if the equity portion of the portfolio is performing substantially below the S&P 500, the trust portfolio (and the equity manager, if any) should be reviewed, but not necessarily changed (a value-oriented equity manager may under-perform the market in some time frames and outperform it in others). If funds are invested with a money manager or a fund that is performing at levels significantly below other funds or money managers with similar philosophies and goals, the fund or money manager should be reevaluated.

IV. Implementing the Investment Policy.

A. Investment Consultants, Advisors and Managers.

The cost of hiring investment consultants, advisors, or money managers may be an unnecessary expense for a trustee of a small trust with limited assets to invest, or for a trustee with significant investment expertise. Remember, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. For trusts with substantial assets, however, unless you are willing to spend significant amounts of time overseeing the investments and gaining the expertise necessary to analyze them, the requirement of prudence may necessitate hiring someone to assist with devising and implementing the investment policy.

Should you choose to hire an advisor, pay careful attention to costs. So-called "wrap" accounts and similar arrangements that layer several types of investment fees may generate fees of 3% or higher on the investment assets. Carefully consider whether the anticipated return from using such an arrangement would be great enough to offset the expense when compared to the alternatives.

Above and beyond the cost considerations, if you seek professional advice, take steps to insure you make a prudent selection. Obtain several referrals. Interview multiple candidates to insure selection of an advisor who understands the parameters of the trust and shares your investment philosophy. Review his or her performance data with an eye not only on returns, but also on volatility. High overall returns coupled with frequent short periods of poor performance will be particularly unattractive to you since the final trust distributions or tax bill may come due during a low cycle. Look at how the advisor is compensated. Some advisors make commissions for products sold, while others have fees based on hourly rates or on a percentage of assets under management. Although either type *may* provide quality investment advice, beware of individuals and entities offering "financial and investment services" who in fact are merely selling a particular product.

The Texas Trust Code expressly allows trustees to "employ attorneys, accountants, agents, and brokers reasonably necessary in the administration of the trust estate." Further, the Prudent Investor Act now permits you to *delegate* your investment authority under limited circumstances. Do not assume, however, that because you have hired a professional you may blindly follow his or her advice.

In circumstances where the exercise of discretion is not an issue, it may be proper for a trustee to delegate. Some authorities suggest that trustees have a duty to personally perform all trust responsibilities except for those a prudent person would delegate to others. Keep in mind, however, that no Texas court has ever found a trustee so unqualified as to expressly *require* the delegation of investment responsibilities.

The Act provides that a trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee must exercise reasonable care, skill, and caution in selecting an agent, establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust, and periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. If a trustee properly delegates his or her authority, the trustee is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated, unless (1) the agent is an affiliate of the trustee; or (2) under the terms of the delegation, the trustee or a beneficiary of the trust is required to arbitrate disputes with the agent, or the period for bringing an action by the trustee or a beneficiary of the trust with respect to an agent's actions is shortened from that which is applicable to trustees under Texas law.

Unless a trustee formally delegates investment authority as spelled out in the Act, the trustee should not give brokers or investment advisors power over the trust account authorizing them to unilaterally purchase investments. If the agent handles a mutual fund or investment partnership which is a prudent investment and in which the trust may purchase shares, it is probably permissible to purchase those shares, even though the money manager may purchase other investments within the fund or partnership. Although no case law supports this proposition, if you exercised discretion in selecting the fund or partnership, a strong argument supporting such an action may be made.

B. Mutual Fund Investments.

One method of obtaining professional investment management at a reasonable cost is through purchasing shares of mutual funds. It may not be cost-effective for trusts with investment portfolios less than $250,000 (or $500,000, for some money managers) to utilize an individual money manager. Because mutual funds are managed by professional money managers, purchasers of their shares gain the benefit of that expertise. Additionally, utilizing mutual funds fulfills one of the primary components of prudent investing – diversification. Trust estates which are too small to cost effectively diversify on their own (i.e., those with insufficient funds to buy the number of stocks and other investments necessary to comprise a well-diversified portfolio) can nonetheless acquire a well-diversified portfolio by holding shares in a mutual fund or funds.

Mutual funds with costs and 12b-1 expenses in excess of similar mutual funds must out-perform those funds in an amount sufficient to overcome those higher costs and expenses. Prior to purchase, carefully compare high-expense funds with similar low cost ones. Funds with front-end loads (a sales charge) or back-end redemption costs must significantly out-perform other funds to be considered. Carefully review the impact those costs will have on long-term performance before purchasing a "load" fund versus a "no-load" fund. In general, brokers (at least those at full service firms) can only purchase funds with loads. Therefore, you may need to do independent research if you use a full service broker for the other investment purchases of the trust. You may decide to invest directly with the fund to provide the trust estate access to no-load funds.

Another alternative (with the benefit of providing a consolidated statement reflecting all the mutual funds held by the trust) is purchasing no-load funds through a discount broker who will purchase such shares for a set dollar fee (and will purchase shares in certain families of funds for no fee). Since discount brokers do not provide investment advice, fund selection would require additional independent research on your part. Some advisors who regularly research mutual funds will make recommendations of suitable funds, monitor those selected and recommend changes as appropriate, for a fee based upon a percentage of invested funds.

In selecting mutual funds, evaluate their long-term performance and volatility. Aggressive funds which stay fully invested at all times may perform very well over the long-term, but have greater fluctuations and correspondingly greater downside risk over the short-term. These funds may be appropriate for trusts with a twenty-year time horizon, but not for those only expected to last for a short period of time, since you might be required to sell during a down period in the market. Several publications provide "report cards" or evaluations of mutual funds at least once yearly, including *Forbes Magazine* (which gives each fund a grade in both bull markets and bear markets), *The Individual Investor's Guide to No-Load Mutual Funds* by The American Association of Individual Investors, *Money Magazine*, and other investment and business journals. Many investment newsletters likewise monitor and evaluate mutual funds (and stocks and bonds) on a frequent basis.

Although mutual funds are diversified in terms of holding numerous individual securities, they typically are not invested in all asset classes. Accordingly, you may invest in multiple mutual funds in order to participate in all classes you desire. For example, the trust could be diversified among the following types of funds: (1) small cap; (2) funds specializing in mature, but growth oriented, companies; (3) funds specializing in foreign equities; (4) funds specializing in income-oriented equities, such as utilities, oil and gas companies and other high yield companies; and (5) funds specializing in fixed-income investments (or possibly several funds that specialize in fixed-income securities, with different maturity ranges). Likewise, you may decide to utilize funds managed by individuals holding different philosophies.

Even if you plan to purchase individual securities for the trust, you may consider using mutual funds for some of the asset classes. For example, even if you are comfortable with your ability to invest in domestic securities prudently, you may want to use mutual funds if investment in foreign equities is desired.

C. Index Funds.

You may consider purchasing so-called "index" funds. These funds track major stock exchanges or public listings of publicly traded stock such as the S&P 500, the Wilshire 4500 (or Wilshire 5000), the Value Line Composite, the Shearson/Lehman Broad Bond Index, etc. This approach insures that you will not "under perform" those indexes by more than the expenses of the fund in question. Several families of mutual funds (including no-load families of funds with low expense ratios) offer index funds. Again, you must be sure to allocate the trust estate appropriately between the various fund types.

D. Regular Review of Portfolio and Performance.

Periodically, you should review the trust's portfolio and its performance. National bank trust departments are required by federal regulation to review all investments at least once a year. You would be wise to follow the same guidelines, and at a minimum, document periodic reviews during the trust administration process. These reviews help trustees spot small problems before they develop into major ones and provide opportunities to readjust the portfolio to keep it in line with the investment policy. If a particular asset class has experienced significant appreciation relative to the other classes, you can use the periodic review as an opportunity to sell some of the investments within that asset class, bringing the portfolio's percentages in the various asset classes back within the investment policy parameters. Your investment policy itself should articulate how frequently the portfolio review and reallocation among assets will occur. Under-performing investments or money managers should also be reviewed and changed, if appropriate.

V. Summary.

In managing trust assets and making investments for the trust, the Trustee must follow the terms of the trust. Where the trust instrument is silent or ambiguous, the Texas Trust Code rules apply. The new standard for trust management and investment in Texas is the "Prudent Investor" standard, which provides new guidelines (as well as new opportunities and risks) for Trustees. Whenever a Trustee has questions or concerns regarding these issues, it would be wise to consult with competent counsel.