PRUDENT INVESTOR RULE AND MODERN PORTFOLIO THEORY

Corina S. Weigl*

1. Introduction

The amendment to the *Trustee Act*,[1] (the "Act") in 1999 to implement the "prudent investor rule" was a welcome and promising development for trustees and their advisors. With the further amendment in 2001 to allow for the delegation by trustees of investment functions, we in the profession believed that the investment standard applicable to trustees had been truly modernized.[2] Certainly the fact that the prudent investor rule is based on modern portfolio theory gave us the impression, perhaps false, that a trustee now had the tools to invest in a manner that is consistent with modern investment practices.

Unfortunately, while the statutory standard of care applicable to a trustee's investment authority and the basis upon which it is derived are clear, an understanding of the manner in which it can be applied by a trustee are not as widely understood. As stated by one commentator:[3]

> The "prudent investor" rule enables the trustee to invest in accordance with modern portfolio theory . . . It is critical that the courts also understand that modern portfolio theory is an area of expertise. It is up to trust counsel to assist the courts in understanding that the "prudent

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1. R.S.O. 1990, c. T.23.
2. Upon assuming the administration of a trust, one of the first considerations a trustee must address is to determine what is the scope of their investment authority. In general, trustees of an express trust, are confronted either with:
   (i) an investment authority that is restricted in some manner, for example, to "socially or ethically responsible investing",
   (ii) an investment authority which is limited to those investments authorized by law for trustees, or
   (iii) the trust document fails to specify any criteria as to investment authority, resulting in the Act applying as the default authority.

   It is in the latter two categories within which the prudent investor rule will apply. Sections 26 through 27.1 codify the relevant sections for purposes of understanding the prudent investor rule. Attached as Schedule "A" is a copy of ss. 26 to 27.1 and 27.2. For completeness' sake, I have also included ss. 28 to 31.
3. Philip J. Renaud, "Alberta's 'Prudent Investor' Rule" (2003), 22 E.T.P.J. 309, at p. 316.

investor" rule incorporates modern portfolio theory, and it is beneficial to the development of trust law.

Or, as stated by another commentator, "This is an area of law where innovations may come slowly; although there are indications that the standards are beginning to change."[4]

The prudent investor rule is designed to give a trustee the tools to invest in a manner consistent with modern portfolio theory. In particular, the ability of a trustee to invest trust property in any form of property and the requirement to diversify investments, are both reflective of modern portfolio theory. While the requirement for a prudent investor to consider certain criteria when planning for the investment of trust property is not, strictly speaking part of modern portfolio theory, the obligation to plan the investment of trust property by, for example, creating an investment policy statement, is consistent with this theory. To better understand the concept of the "prudent investor" rule, therefore requires an understanding of modern portfolio theory upon which the prudent investor rule is based.

While articulating the standard of care applicable to trustees in the form of the prudent investor rule is easy, providing guidance to the trustee as to how to implement the prudent investor rule, what steps should be taken by the trustee and what options are available, is more difficult. The purpose of this paper is to provide readers with a better understanding of the theory upon which the prudent investor rule is based and how it ought to be understood. It does so by breaking down the investment of trust assets essentially into two stages, and considering the relevant aspects that should be addressed at each stage.

The first stage involves developing the plan for the investment of trust assets. As part of addressing this stage of the investment process, consideration will be given to the following matters:

(i) the role of the financial planner in developing an investment plan; and

(ii) the criteria that, as a result of s. 27(5) of the Act, a trustee must take into account when planning the investment of trust property. In addition to having to take account of certain stipulated criteria, a trustee must have regard to the terms of the trust document, as well as the duties imposed by the common law. The two relevant duties for purposes of

4. Robert A. Levy, "The Prudent Investor Rule: Theories and Evidence" (1994), 1 Geo. Mason L. Rev. 1 (Student Ed.), at p. 3.

this discussion are: the duty to act impartially towards all beneficiaries and between different classes of beneficiaries, and the obligation to minimize costs of investment decisions or strategies.

The second stage involves implementing the investment plan by actually purchasing investments to fulfill the plan. Here consideration will be given to the obligation to diversify trust investments.

In exploring the requirement of diversification, consideration is given to the importance of asset allocation, the asset classes that are available today to fulfill the duty to diversify, and the concept of indexing as a useful tool to diversify. Once a trustee has implemented the investment plan their ongoing job is to review and rebalance the trust portfolio from time to time. A discussion of the prudent investor rule would not be complete without considering the concept of delegation and sub-delegation.

Part I: Where We Were and the Move to Reform

(a) The Legal List and the Prudent Man

Prior to the enactment of the prudent investor rule in 1999 and the further amendment to the Act in 2001 to permit the delegation by trustees of investment functions, the default provisions in the Act were based upon a "legal list" of authorized investments. The concept of a "legal list" came from English legislation enacted during a period of generally stable prices and currency. The focus of the "legal list" was on limiting risk. Its purpose was to impose an overriding obligation on trustees to preserve the trust capital.

The "legal list" did this by limiting the types of property a trustee could invest in to inherently conservative investments such as securities of either the Government of Canada or the province, GICs issued by chartered banks, corporate bonds, preferred shares, provided dividends were paid regularly, and first mortgages on real estate in Canada. Common shares of corporations were permitted, provided dividends were regularly paid, however there was a cap imposed on the level of concentration of common shares within a trust portfolio. Leaving aside the various alternative and arguably more speculative asset classes available today, the following types of investments were not permitted: investments outside Canada, real estate and shares of private companies.

Many disadvantages have been identified with the "legal list" approach to a trustee's investment power. Perhaps one of the

biggest is the false sense of comfort many trustees were under if they simply relied upon the legal list. The inclusion of articulated categories of permitted investments, notwithstanding that an investment was permitted "only if the investment [was] in other respects proper and reasonable", fostered a presumption that a trustee was automatically protected from liability for negligence if the trust funds were placed in the authorized legal list of investments. This was not the case.

A second disadvantage was that by expressly articulating permitted investments, the law created inflexibility and rendered trustees incapable of responding to the need to make changes resulting from changes in the investment market. As said by one commentator, the concept of a stipulated list of investments was "both out of date and out of touch with modern portfolio theory".[5]

A further difficulty with the law governing the investment authority of trustees came from the standard of the "prudent man" imposed by the common law. The prudent man standard assesses prudence on each investment in isolation without regard to the context of the whole portfolio. As a result, a trustee is liable for losses sustained as a result of an improper investment. Further, a trustee is not entitled to set-off any gains against the losses. The result is that the trustee is liable for the losses without any corresponding benefit of taking into account the winners. This rule is known as the anti-netting rule.[6]

The "legal list", together with the standard of the prudent man, resulted in only the most conservative investments being part of trust portfolios. General inflationary trends in the latter half of the 20th century, however, resulted in securities paying fixed rates of interest; as a result, the real value of trust capital began to erode. In order to counteract the effect of inflation, trustees needed access to other forms of investment. Pressure arose for liberalization of the legal list, especially through the addition of corporate shares, which could be sold to realize gains in value.

In the late 1970s and into the 1980s it became apparent that the legal list philosophy failed to meet the requirements of a constantly changing field of possible trustee investments, in which flexibility became an essential to proper management of an investment portfolio. Because of inflation and high tax, it was felt that trustees

5. Renaud, *supra*, footnote 3, at p. 310.
6. A good examples of this, albeit American, is the case of *In re Bank of New York (Spitzer)*, 364 N.Y.S.2d 164 (1974) where despite the portfolio as a whole increasing significantly, the trustee was liable for losses in respect of one investment that was not authorized.

needed the power to adjust the balance between their fixed-interest securities and their growth stock as circumstances required, without waiting for legislative amendments or regulatory permission.

(b) Restatement (Third) of Trusts – Modernizing the Investment Standard

The path for reform came from "south of the border". In the *Restatement (Third) of Trusts* (the "Restatement"), the American Law Institute articulated a new rule that it argued would modernize the prudent man rule and take into account modern investment practices. The Restatement titled this new rule the "prudent investor rule." Ultimately, the Restatement became the standard upon which many other jurisdictions looked to when modernizing their trustee investment authority.

In the Introductory Note to the chapter that articulates the prudent investor rule, the Law Institute writes:[7]

> These criticisms of the prudent-man rule are supported by a large and growing body of literature that is in turn supported by empirical research, well documented and essentially compelling. Much but not all of this criticism is found in writings that have collectively and loosely come to be called modern portfolio theory.
>
> In addition, for some time the need for revisions had been evident from conflicts between the prudent-man rule and modern asset-management practices. Investment products and techniques have developed and changed over the years. So have information and theories concerning financial markets and prudent investing, backed not only by the extensive research mentioned above but also by the authoritative judgments and investment behavior patterns of expert fund managers.
>
> Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid repeating the mistake of freezing its rules against future learning and developments.

In establishing the prudent investor rule, the American Law Institute also articulated principles of prudence. These are intended to guide both courts and trustees as they determine whether a particular course of action is within the prudent investor rule.

The prudent investor rule, as stated in the Restatement, is as follows:

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7. *Restatement (Third) of Trust* 6, 17 IN NT (Philadelphia: American Law Institute, 2007), at p. 2.

> The trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
>
> (a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.
>
> (b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.
>
> (c) In addition, the trustee must:
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> (1) conform to fundamental fiduciary duties of loyalty (§ 78) and impartiality (§ 79);
> (2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§ 80); and
> (3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§ 88).
>
> (d) The trustee's duties under this Section are subject to the rule of § 91, dealing primarily with contrary investment provisions of a trust or statute.[8]

(c) The "Prudent Investor" Rule – Modern Portfolio Theory

As can be seen from the comments in the Restatement referred to above, the overriding purpose of the prudent investor rule was to codify a standard of care that allows trustees to invest in a manner which coincides with modern portfolio theory. As one commentator has stated:[9]

> The "prudent investor" rule is a legal application of modern portfolio theory. Modern portfolio theory states that investment risk may be managed through the use of a properly diversified portfolio such as would be maintained by a reasonably "prudent investor". The goal of the "prudent investor" is not simply to minimize risk to the investments held on behalf of the trust, but to choose a portfolio that achieves an optimal

8. *Restatement (Third) of Trusts* § 90 (2007), at p. 1. Note: The rule in this form has not been adopted; however it does generally form the basis for all of the modern prudent investor regimes and jurisprudence. It should be noted that this was first published in 1992.
9. Renaud, *supra*, footnote 3, at p. 312.

> relationship between expected return and risk. Risk is judged on the portfolio as a whole, rather than on an asset-by-asset basis. The simplest way to understand modern portfolio theory is through the old phrase, "don't put all your eggs in one basket".

In addition to the duty to use care and skill, a trustee must exercise caution when investing. This requirement imposes on trustees a duty to invest both with a view to protecting the capital and securing a reasonable return. However, all investments have risk. Accordingly, the duty of a trustee is not necessarily to avoid risk at all costs but rather to prudently manage risk in order to achieve a certain return.

The recognition that making a trustee liable for any risk taken resulted in trust portfolios where expected returns did not maintain the real value of the trust property, was one of the compelling reasons for many jurisdictions to move towards the prudent investor rule. Modern portfolio theory and its "central consideration" of the trade-off between risk and reward[10] on a portfolio-wide basis became the guideposts for the new standard of care. Understanding modern portfolio theory is, therefore, a necessary place to start when considering the prudent investor rule.

(d) Modern Portfolio Theory

Modern Portfolio Theory ("MPT") has been developed by economists and financial experts over the course of the past 60 years. Beginning with the work of Harry Markowitz in 1952, and including the work of William Sharpe and Merton Miller, these three economists developed MPT as a portfolio management technique. In 1990 they won the Nobel Memorial Prize in Economics for this work.

As MPT has become an area of expertise unto its own, it is not the purpose of this paper to provide a detailed discussion of MPT. However, it is useful to summarize the four main components of MPT as a back-drop to any discussion of the prudent investor rule. They are as follows:[11]

1. Rationale investors are not willing to accept risk unless the level of return compensates them for it — the more risk, the

10. Prefatory Note to the Uniform Prudent Investor Act.
11. The following discussion is based upon the chapter "Investment Philosophy" by Christopher P. Van Slyke and Peter J. Merrick, in *Advisors Seeking Knowledge – A Comprehensive Guide to Succession and Estate Planning*, Peter J. Merrick, ed. (Markham, Ontario: LexisNexis, 2013), ch. 69. Additional references to reinforce a discussion point are separately sourced.

greater return. But most investors are risk averse — they seek to reduce risk to the greatest extent possible in order to achieve a certain level of return. The Alberta Law Reform Institute summarizes this aspect of MPT as follows:[12]

> The goal of the prudent investor (or the trustee employing the prudent investor rule) is not simply to minimize risk; it is to optimize the risk-expected return relationship. Having determined a target rate of return, the objective is to choose a portfolio that minimizes risk while achieving that expected return. Conversely, having determined an acceptable level of risk, the objective is to select a portfolio with the highest expected return consistent with the accepted level of risk.

2. Securities markets are efficient. This means that while the returns of different securities may vary as new information becomes available, these variations are inherently random and unpredictable. Assets are re-priced every minute of every day according to new information that is available to the market. In other words, "all public information that can be known about a stock is known . . . stocks are priced accordingly."[13] For investors this means one cannot expect to consistently "beat the market" by picking individual securities or by "timing the market".

3. Assessing risk and reward should be undertaken based on the portfolio as a whole or within market segments of the portfolio, rather than on an asset-by-asset basis within the portfolio. In terms of the impact on the performance of a portfolio, how capital is allocated to specific asset classes is far more important than selecting the individual investments and market timing.[14] The ALRI summarizes this aspect of MPT as follows:[15]

> Investing a portion of the trust funds in highly volatile assets could be part of a prudent investment strategy. Indeed, adding volatile (risky)

12. Alberta Law Reform Institute ("ALRI"), "Trustee Investment Powers: Consultation Memorandum No. 7" (Edmonton: Alberta Law Reform Institute, 1999), at p. 9.
13. Christopher P. Van Slyke, Peter J. Merrick and Charles Stanley, "Investment Policy Statements, Asset Allocation and Regular Rebalancing of Portfolios" in *Advisors Seeking Knowledge – A Comprehensive Guide to Succession and Estate Planning*, *supra*, footnote 11, ch. 70 at p. 860.
14. MPT imposes no limitations on investments that ultimately might create an efficient portfolio.
15. ALRI, *supra*, footnote 12, at p. 9.

> assets to a portfolio might actually decrease the overall volatility (riskiness) of the portfolio, depending on the degree and direction (positive or negative) of correlation between that asset and the rest of the portfolio.

4. Every risk level has a corresponding optimal combination of asset classes that maximize returns. Portfolio diversification is not so much a function of how many individual stocks or bonds are involved but the relationship of one asset to another. This relationship is referred to as "correlation". The higher a correlation between two investments, the more likely they are to move in the same direction. The ALRI states the following:[16]

> The key to effective risk management is diversification, and the key to effective diversification is selecting assets whose expected returns are negatively correlated, uncorrelated or at least only weakly correlated with each other.

Risk clearly plays a fundamental role in MPT. In particular, the following has been stated to describe the fundamental aspect of risk within MPT:[17]

> [A]ll investments, including U.S. Treasuries, may become worthless or more commonly, may not perform in the manner anticipated, a concept referred to as "risk". Every investment faces internal and external factors which give rise to risk, known as "firm risk". Every company faces the internal risk of being defrauded by an employee or a third party. In addition, factors outside the company, external factors, also impact the value of an investment . . . To reduce risk, an investor should invest in a wide range of stocks and even in different asset classes that move in different directions as various external market changes occur.

For this reason, understanding risk is an important part of being a prudent investor. The concept of risk will be further discussed below.

(e) The Codification of MPT via the Prudent Investor Rule in Sections 27 to 27.2

Several aspects of ss. 27 through 27.2 of the Act point to the conclusion that the Act was intended to codify MPT. First, s. 27(1) and (2) provide that a trustee is permitted to "invest in any form of

16. *Ibid.*, at p. 9.
17. Trent S. Kiziah, "The Trustee's Duty to Diversify: An Examination of the Developing Case Law" (2010), 36 ACTEC L.J. 357, at pp. 359-361.

property in which a prudent investor might invest." When investing trust property, a trustee "must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments."

As a result, under the prudent investor rule, there are no restrictions on the form of investments in which a trustee can invest. In other words, the trustee is unconstrained in his or her choice of investments. However, the standard of care imposed upon a trustee will require those investments to be investments in which a prudent investor would invest. Thus, while there does not appear to be an express limitation on the nature of investments, if a prudent investor would not invest in the particular investment under consideration, it follows that a trustee should also not so invest.

Second, the positive obligation to diversify imposed by s. 27(6), which is the counter balance to the lack of any limitation on the types of investments available for selection by a trustee, is a central tenet of MPT.

Lastly, s. 27(5) provides that *in planning* the investment of trust property, a trustee *must* consider the following seven criteria, *in addition to any others that are relevant to the circumstances*:[18]

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;
5. The expected total return from income and the appreciation of capital;
6. Needs for liquidity, regularity of income and preservation or appreciation of capital.
7. An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

The positive obligation *to plan* the investment of trust property and *when planning*, to consider the above listed criteria, is also consistent with MPT, which focusses on the portfolio as a whole, as opposed to individual investments. In other words, a trustee must develop an investment strategy and when doing so s/he must take into account the above criteria (referred to collectively as the "Criteria").[19] Furthermore, certain of the Criteria are consistent

18. Subsection 27(5).
19. For a useful discussion of whether a trustee can consider non-financial criteria, see Timothy Youdan's paper "Investment by Fiduciaries – Selected Topics", presented at the Law Society of Canada's 10th *Annual Estates and*

with MPT. For example, the role that each investment within the whole portfolio plays focuses on the relationship that assets have to one another. This is an important part of MPT.

While the express duty to have a written plan or strategy is only imposed when a trustee delegates to an agent the ability to exercise any of the trustee's functions relating to the investment of trust property,[20] the development of a written investment policy statement ("IPS"), even in the absence of any delegation, would not be inconsistent with the actions of a prudent investor. In fact, having a written IPS that both documents a trustee's consideration of the Criteria, as well as demonstrates that the trustee engaged in a reasonable assessment of risk and return, will go a long way to reducing the risk of liability for the trustee.

Turning first then to the first stage of the investment of trust property – planning the investment of trust property.

Part II: Stage One – Planning the Investment of Trust Property

One of the initial tasks a trustee must engage in upon taking on the administration of a trust is to understand the scope of their investment authority. For instance, are there any limitations or express directions to be followed by the Trustee.

The next task for the trustee is to plan the investment of the trust property. While the Act does not impose a mandatory obligation to plan, the fact that s. 27(5) imposes a positive obligation on a trustee to consider the Criteria when planning, indirectly means a trustee is under an obligation to plan. Furthermore, MPT, upon which the prudent investor rule is based, requires there to be planning engaged in when a trustee first determines their return objectives and risk tolerances, and then constructs the portfolio through asset class determinations and allocations of assets within those asset classes. It is important to note that while a consideration of the Criteria is relevant to planning the investment of trust property, the Criteria need not be considered every time a trustee proposes to make or change an investment.

Trusts Summit, November 5 and 6, 2007. In this paper, Mr. Youdan concludes that there are three circumstances when non-financial criteria can be considered. They are: (i) the trust document directs the trustee to consider particular criteria, (ii) the objects of a charitable trust justify considering non-financial criteria, for example, a cancer treatment centre avoiding investing in tobacco companies, and (iii) such criteria can be considered if doing so does not have a detrimental effect on financial performance.

20. See s. 27.1(2).

In planning the investment of trust property, one of the first tasks of a trustee should be to work with legal counsel and an investment advisor, such as a financial planner, to determine whether there are any other circumstances besides the listed Criteria that may be relevant. This will require a thorough review of the terms and circumstances of the trust, as well as the personal circumstances of the beneficiaries. The guidepost of this analysis is for the trustee to have a good understanding of the personal and financial circumstances applicable to all the beneficiaries.

Unlike other codifications of the obligation to consider stipulated criteria where there is an express consideration of relevancy applicable to each criteria,[21] the Act does not expressly state that the Criteria are only to be considered to the extent they are relevant. Notwithstanding, the obligation to consider any other considerations that are "relevant" implies that a notion of relevancy will be applicable to all the Criteria. Accordingly, if during the planning stage one of the Criteria is determined not to be relevant, for example, the term of the trust means that inflationary considerations will not be relevant, then this Criteria will not be something that the trustee will need to take into account when planning the investment of the trust property. If a Criteria is determined not to be relevant, documenting why would be a good risk management practice to adopt.

The Act does not impose a requirement on a trustee to obtain investment advice. As a result, a question that often arises is whether a trustee ought to obtain advice in fulfilling their investment obligations. Clearly there will be situations where obtaining advice may not be appropriate, for example, the size of the trust cannot justify the expense. However, in most contexts, in the author's view, the complexity of considerations that goes into planning the investment of trust property would tend to support a conclusion that a trustee who intends to satisfy the prudent investor standard will seek advice.[22] Further, as reasoned by the Alberta Law Reform Institute, common sense provides sufficient guidance on this issue:

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21. See the Alberta *Trustee Act*, R.S.A. 2000, c. T-8.
22. In Renaud's paper he makes the very persuasive argument that modern portfolio theory is an area of expertise like trust law and taxation matters. Accordingly, like seeking legal advice to understand their legal obligations, to be expected to understand and satisfy the prudent investor standard, a trustee will need advice from someone who has expertise in modern portfolio theory.

> It is only a matter of common sense that a prudent trustee who is not knowledgeable about investment matters would seek out investment advice with respect to the investment of trust property. *We have little doubt that, if confronted squarely with the issue, Canadian courts would hold that the duty of prudence includes a duty to obtain investment advice in appropriate circumstances.*[23]

The nature of the Criteria would suggest that the advice a trustee may require may not be limited to investment advice. For instance, whether an asset has a special relationship to the purposes of the trust, is more a matter for a legal advisor to assess. Similarly, the need to consider the expected total return from income and appreciation of capital will be important considerations in the context of the duty to maintain an even hand. The expected tax consequences of investment decisions may require the assistance of a tax advisor. Ultimately though, financial planning assistance will arguably be the most important form of advice at the investment planning stage. What follows is a consideration of the role of the financial planner in developing an IPS. Thereafter, a consideration of each of the Criteria will be provided.

(a) Role of the Financial Planner[24] in the Development of an IPS[25]

(i) The IPS

An IPS is a written document that essentially articulates the trustee's plan for the investment of the trust property having regard to the Criteria and other fiduciary obligations imposed on the trustee. While it should articulate the trustee's objectives for the investment of trust property, it should be more than just a general statement of those objectives. Rather, it should:

- address the trustee's desired annual return;
- identify risk tolerances;

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23. Renaud, *supra*, footnote 3, at p. 342.
24. For purposes of this paper the term "financial planner" refers to an investment advisor who has the skill set to both assess a trustee's risk tolerance when developing an appropriate asset mix, and develop an investment plan to achieve the needed return. They must also understand that as a result of obligations imposed on a trustee, such as the even hand duty, developing an IPS for a trust is a different exercise than developing an IPS for an individual.
25. The following discussion is based upon Merrick at pp. 865-866. See also Renaud, *supra*, footnote 3, at pp. 320 and 347-348.

- identify acceptable asset classes and asset allocations, together with what limits might be placed on different asset classes, for example 60:40 equities to fixed income, as well as what limitations might be placed on types of investments;
- outline tax management strategies and currency issues that need to be addressed;
- stipulate procedures for reviewing and monitoring the portfolio, and rebalancing of the portfolio.

The development of an IPS will involve the trustee determining the amount of exposure to the two main asset classes of equities and fixed income. This determination will depend upon the objectives, resources available, term of the trust, needs of the beneficiaries, and risk tolerances. In the context of a trust portfolio it is often the case that the trustee is recommended a 60:40 split between equities and fixed income.[26]

Once the balance between the two main asset classes is determined, the next step is to add sub-asset classes. An asset class is a group of securities that have similar risk and return characteristics. Therefore each asset class will have its own expected return and risk. Different sub-asset classes are added to a portfolio either because they will increase the expected return or they will decrease the volatility of the portfolio as a whole, or both.

When considering how asset classes affect return, one commentator has concluded that there are three primary factors that influence returns:

1. the amount invested in equities versus fixed income;
2. the amount invested in large company stocks versus small company stocks; and
3. the amount invested in growth companies versus value companies.

A fourth factor, known as Direct Profitability, has recently been observed.[27]

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26. This split is often referred to as the 60:40 balanced portfolio. In practice it appears that this split has become a form of safe-harbour default. If this is the case, in the author's view, this would be an unfortunate result. The prudent investor rule prescribes no limits on what constitutes a prudent portfolio. In fact, depending upon market conditions or beneficiary needs, etc., such a balance may not be prudent.
27. Brad Steiman, "The Next Dimension", *Northern Exposure* (Dimensional Fund Advisors, November, 2013).

(ii) The Financial Planner

A financial planner can play a crucial role when it comes to crafting an IPS. They can assist in determining the trustee's objectives and developing a mix of assets that will satisfy the needs of the trust and its beneficiaries. Financial planners are also able to document each of the matters that were considered and that will eventually appear in the written plan. This service may prove to be invaluable, particularly if beneficiaries are litigious, and the trustee is later required to justify investment decisions to either the beneficiaries or the court.

A financial planner can also help to ensure that any investments ultimately made by the trustee are in keeping with the initial plan. Qualified financial planners bring with them a knowledge of the marketplace, as well as investment strategies that will help to ensure that every purchase is in keeping with the goals as identified in the investment plan.

While the services of a professional financial planner can be important, it is important to remember that they are not necessarily well versed in the various legal and tax issues that may arise during the life of a trust and which may impact the investment plan. For this reason, it is important that the financial planner work closely with legal, tax, and other advisers in both the preparation and implementation of the trustee's investment plan.

(b) The Criteria

As already noted, s. 27(5) articulates the Criteria a trustee is to consider when planning the investment of trust property. What follows is a consideration of each of the Criteria.

(i) Income Tax Considerations

The tax position of both the trust and the beneficiaries, together with the tax attributes of the assets comprised in a trust portfolio and the returns provided by those assets,[28] are relevant considerations to address when planning an investment portfolio.

In the context of the duty to diversify, the relevance of the tax attributes of particular assets is perhaps most relevant on the receipt of assets, particularly where they have a low cost basis. The tax cost of, for example, recognizing any accrued gain may outweigh the

28. The tax rate applicable to the returns earned by different assets depends upon the type of return realized, *i.e.*, whether it is interest income, dividend income or capital gains.

advantages of diversifying the holding. As noted in the Commentary to the Uniform Prudent Investor Act:[29]

> Tax considerations, such as preserving the stepped up basis on death under Internal Revenue Code § 1014 for low-basis assets, have traditionally been exceptionally important in estate planning for affluent persons. Under the present recognition rules of the federal income tax, taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover.

However, as Kiziah notes, "[m]ere income tax exposure cannot justify asset retention or the exception would consume the rule."[30] You cannot simply retain a low-basis asset without considering the associated risks of doing so. Where an adjustment to the basis of an asset is anticipated in the future, retaining the asset — or avoiding diversifying the asset — may be justified.

Where a qualifying spousal trust[31] exists, a trustee ought to have regard to the advantages of the tax deferral when considering whether and when to realize assets with accrued gains. In other cases, the availability, tax utility and timing of realizing potential capital losses will also factor into the realization of investments with accrued gains. Selling assets with accrued gains so to offset losses, can reduce the taxes over the long-term. Considerations of this kind will likely require tax advice.

(ii) Asset's Special Relationship to the Purpose of the Trust or the Beneficiaries

This criteria is akin to an express waiver of the duty to diversify. In other words, if a trustee concludes that an asset has a special relationship to either the purpose of the trust or the beneficiaries, then the duty to diversify the exposure to that asset is waived. However, as noted below under the heading Waiver of Duty to Diversify, even a mandatory provision not to diversify may be overridden depending upon the circumstances. As a result, reaching the conclusion that an asset has a special relationship ought not to give a trustee comfort that the asset can be held at all costs.

However, if assets are retained as property of a trust indefinitely, a trustee cannot simply ignore the fact that they constitute

29. Uniform Prudent Investor Act, Commentary at para. 2(c)(3).
30. Kiziah, *supra*, footnote 17, at p. 368.
31. A qualifying spousal trust is a trust for the benefit of a taxpayer's spouse or common-law partner that meets the requirements of either subsec. 70(6) or subsec. 73(1.01)(c)(i) of the *Income Tax Act*, R.S.C. 1985, c. 1 as amended.

investments of the trust. The trustee must continue to monitor these assets, notwithstanding their special nature, and take action if substantial changes to these assets occur. For example, if the nature of these assets substantially changes, a trustee will need to consider whether a special relationship, that justifies their retention, still exists. A substantial change could include the ownership or nature of the assets changing; the market changing in such a manner that retaining ownership of the assets will result in a significant financial loss or any other change that could result in the ending of the special relationship of the asset to the trust.

Several types of assets would qualify as having a special relationship and therefore justifying their retention despite the fact that they constitute a concentration of resources within the trust portfolio and should, as a result, be diversified. They are as follows:[32]

1. Family cottage or a home that is occupied by a beneficiary – a direction to allow a beneficiary to continue to occupy a residence is akin to an express waiver of the duty to diversify — the purpose of the trust will only be served if the home is retained. In the Restatement, the family ranch is identified as an asset that may have a special purpose to a trust.
2. Family business – where one of the purposes of a trust is to preserve a family's interest in and/or control of a family business, retention will be justified.[33] However, continued retention may not be justified where there is a substantial change in the nature of the company as, for example, may occur if it goes public.[34]
3. Family heirlooms.
4. Publically held companies – one might not normally expect a concentration in the shares of a publically held company to constitute an asset with a special relationship. If, however, it can be shown that the testator or settlor had an affinity to the company for some reason, then a direction to retain (or a

32. Kiziah provides a thorough review of the situations where an asset may represent a special relationship. The following is based on his article.
33. Kiziah, *supra*, footnote 17 (at pp. 372-374) refers to the following American decisions where retention of shares of a family business was justified despite a decline in the price ultimately realized by the trustee on a sale; see *United States Trust Company v. Bohart*, 495 A.2d 1034 (Conn. 1985) and *Lichtenfels v. North Carolina National Bank*, 151 S.E.2d 78 (N.C. 1966).
34. In support of this statement, Kiziah, *supra* (at p. 374) cites the decision in *Mueller v. Mueller*, 135 N.W.2d 854 (Wis. 1965).

waiver of the duty to diversify) might justify continued retention. However, caution should be exercised,[35] courts generally place great weight on the requirement to diversify.

5. Commercial real estate – Kiziah cautions relying upon the special relationship exception when justifying retention of commercial real estate.

(iii) Expected Total Return from Income and Appreciation of Capital

This Criteria focuses on both income needs and capital growth. Whether this Criteria is relevant will depend upon the terms of the trust and the circumstances of the beneficiaries. A trust where there is a life interest to one beneficiary, while capital is to be distributed to another beneficiary, will require both to be balanced. If, however, the terms of the trust favour the income interests over the interests of the remainder beneficiary, for example by ousting the even hand duty, then the investment plan may be more weighted towards income production. Where, however, the life tenant is well able to provide for him/herself but the purpose of the trust is to preserve and enhance the capital, then the plan may be focussed on capital appreciation.

This factor should be thoroughly reviewed with the financial planner when developing the plan for the investment of trust property. This is because it will impact the weighting of the portfolio between equities and fixed income securities.

(iv) Needs for Liquidity, Regularity of Income and Preservation of Capital

Like other Criteria, this factor should be reviewed with the financial planner when developing the plan for the investment of trust property. For example, an assessment of the ongoing liquidity needs of the trust, for example to satisfy expenses, will need to be undertaken as this may require cash reserves to be maintained.

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35. Kiziah refers to the decisions of *Wood v. U.S. Bank, N.A.*, 828 N.e.2d 1072 (Ohio App. 2005) and *In re Will of Dumont* 2004 WL 1468746 (N.Y.Sur. 2004) where the Dumont family's wealth was due to Mr. Dumont's long history with the Kodak company. Notwithstanding that the court accepted that Mr. Dumont's affinity to Kodak was relevant to the issue of diversification, it was not sufficient enough to avoid the Court awarding damages of $21 million against the trustee. Prudence dictated diversification over the trustor's desire to retain Kodak.

The trustee should consider whether large lump sum amounts will be needed, for example, to satisfy a tax liability, and if so, when will those sums be needed.

In the context of a trust that is to provide income to a life tenant, the trustee will need to give consideration to when income payments will be made, for example, monthly, quarterly or annually.

(v) The Role Each Investment or Course of Action Plays Within the Portfolio

This Criteria is also a factor to be reviewed with the financial planner. Aside from drawing attention to the need for diversification, the purpose of this Criteria is to focus the trustee on considering how the investments within a portfolio are related. As discussed above, one of the central aspects of MPT is to minimize risk in order to earn a certain level of return — minimizing risk requires a consideration of how assets are correlated with each other in order to select assets with a low or negative correlation.

(vi) The Possible Effect of Inflation or Deflation

This factor requires a consideration of the term of the trust. A trust with a short duration will likely have no need to address the impact of inflation because it is unlikely to have any impact. Whereas a long term trust, where capital is to be distributed to beneficiaries at some point in the distant future, will require a strategy that addresses the time value of money. Ultimately the goal of this exercise is to ensure that the real value of what the remainder beneficiaries receive has not been eroded by inflation – in other words, where appropriate, the trustee has a duty to maintain the buying power of the trust property.

(vii) General Economic Conditions

The purpose of this Criteria is to remind a trustee that investing trust property cannot be done in isolation of what is occurring within the economy as a whole. Market conditions as a whole may warrant a rebalancing of a trust portfolio to be more heavily weighted in either equities or fixed income depending upon the circumstances. A prudent trustee will not ignore general market conditions.

(c) Review of the Investment Plan

Once the investment plan has been developed, the trustee and their advisor will move to implementing the plan by purchasing investments to fulfill the plan. Once the plan is established it too ought to be reviewed by the trustee, however, a review of the plan need not occur as regularly as of the portfolio itself. It has been suggested that a review of the plan may not be required for five years, unless a change in circumstances for one or more of the beneficiaries occurs or in the economy occurs.[36]

Part III: Stage Two – Implementing the Investment Plan

Once a trustee has developed a plan for the investment of trust property, the next stage is the implementation of that plan by way of selecting the investments. Here the focus is on asset allocations within the chosen asset classes. The advisor will need to have appropriate expertise in how to structure the portfolio in order to achieve portfolio optimization.[37] However, the investment advisor who implements the plan will need to have a solid understanding of the investment plan, as (hopefully) documented in an IPS.

The focus of the discussion here will be on:

1. the duty to diversify;
2. asset classes and asset allocations;
3. the obligation to review and rebalance the portfolio; and
4. the authority to delegate to a third party aspects of implementing the investment plan.

(a) Duty to Diversify

As already noted, diversification is a foundational principle to MPT. By imposing a mandatory obligation on trustees to diversify the investment of trust property to an extent that is appropriate to:

(i) the requirements of the trust, and

(ii) general economic and investment market conditions,[38]

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36. Renaud, *supra*, footnote 3, at p. 348.
37. As explained by Levy, *supra*, footnote 4 (at p. 12):

    Optimization is the process of selecting assets systematically so that the combined portfolio represents the most efficient tradeoff between the rate of return and risk. Optimization depends on three key factors: (i) the expected rate of return for each asset, (ii) the predicted risk of each asset, and (iii) the anticipated relationship between each asset's return and the returns of every other asset.
38. See s. 27(6).

the Act codifies MPT.

The duty to diversify may also be limited or waived by the terms of the governing document.[39]

The two conditions imposed by s. 27(6) reflect the fact that under some circumstances it may be prudent not to diversify the trust portfolio. An example often used to support a lack of diversification is that of a general economic decline, accompanied by a flat stock market and widespread business failures, where the best course may be to concentrate the trust property in the least volatile securities, despite a low rate of return. Full diversification could also be impractical for small trusts because of brokerage commissions, investment counselling fees, and other incidental costs.

Ultimately, diversification is the norm, so long as it is appropriate for the trust and market conditions and is otherwise not augmented by the terms of the governing trust document.

(b) Waiver of the Duty to Diversity

It is important to note that the duty to diversify is tied to a consideration of the power to retain and the duty to convert. It is beyond the scope of this paper to consider the impact upon the duty to diversify where the governing document expands, restricts, eliminates or otherwise alters the duty. The American commentator, Trent Kiziah provides a thorough examination of the impact the governing document may have on the duty to diversify. Suffice it to say that a trustee must carefully examine a trust document to determine whether any of the following exists:[40]

(i) an implied waiver, arising for example, because the testator/testarix held a concentrated position in an asset during his/her lifetime such as in a private family run business;

(ii) a general power to retain, which is generally insufficient to waive the duty. Jurisprudence generally favours specific language authorizing or directing a trustee to retain a specific investment;

(iii) specific language waiving the duty, even if found in "boilerplate" power provisions, which may be sufficient to waive the duty;

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39. Subsection 27(9) provides that s. 27 does not authorize or require a trustee to act in a manner that is inconsistent with the terms of the trust.

40. Kiziah, *supra*, footnote 17, at p. 390-391.

(iv) specific reference to a particular asset concentration which will generally be sufficient to waive the duty; or

(v) a mandatory retention provision which will operate to waive the duty. However, as Kiziah explains, the distinction between permissive and mandatory provisions ignores the fact that a court may still invalidate a mandatory provision because (a) it is capricious, (b) it may inappropriately remove from the trustee the duty of prudency, or (c) circumstances may be changed since the original direction which justify ignoring the direction.

(c) What is Diversification?

Kiziah defines diversification by quoting from *In re Will of Dumont*:[41]

> Diversification is the receipt of a concentrated portfolio, and selling off the majority of the concentration before any hint of problems with the company or stock is received. Diversification is a sale which is done even when the subject company is climbing. Conversely a sale to preserve the value of a trust corpus and ideally to remedy a suffered loss is not the same. Although such a sale could result in a diversified portfolio, diversification would not be the reason for the sale. . . .

He goes on to state:

> The duty to diversify requires a concentration be sold even if analysts are predicting that the concentration will outperform similar assets. Diversification does not focus on future anticipated performance; rather, diversification focusses on the fact that the trustee has too many eggs in one basket.[42]

(d) Risk

A discussion of diversification would not be complete without a consideration, albeit limited in scope, of the concept of risk within MPT. Risk, in terms of MPT, is largely the volatility of returns. MPT recognizes that there is no investment that is entirely risk free.[43] However, understanding the differing kinds of risk and

41. *Ibid.* at p. 362.
42. *Ibid.* at p. 362.
43. This concept is also a departure from the former legal list and prudent man rule, both of which relied upon the anti-netting rule to, in effect, make a trustee a virtual guarantor of investment returns.

appreciating the risks which can be addressed through diversification is the goal of prudent investing.

Risk is divided into two kinds — compensated or systemic risk and uncompensated or non-systemic risk.

Compensated or systemic risk is the risk of the market itself. It is a risk that cannot be reduced or eliminated with diversification. However, the pricing in the marketplace "compensates" the investor for this risk. Non-systematic risk is the volatility risk that is different than the market risk, the risk that an asset will have more or less volatility than the market.

As stated by one advisor, "the *Trustee Act* calls for an investment portfolio that is risk efficient, that is, the portfolio only takes risk for which it will be compensated and where the risk is appropriate for the trust."[44]

(e) Purpose of Diversification – Two-Fold

Charles Stanley aptly explains that the purpose of diversification is two-fold. First, it is to eliminate or substantially reduce, uncompensated or non-systemic risk. As noted, this is a key principle of MPT.[45] As stated in the Restatement:[46]

> In understanding a trustee's duties with respect to the management of risk, it is useful to distinguish between diversifiable (or "uncompensated") risk and market (or non-diversifiable) risk that is, in effect, compensated through pricing in the marketplace. *The distinction is useful in considering fiduciary responsibilities both in setting risk-level objectives and in diversification of the trust portfolio.*
>
> In the absence of contrary statue or trust provision, the requirement of caution ordinarily imposes a duty to use reasonable care and skill in an effort to minimize or at least reduce diversifiable risks... these are risks that can reduced through proper diversification of a portfolio. *Because market pricing cannot be expected to recognize and reward a particular investor's failure to diversify, a trustee's acceptance of this type of risk cannot, without more [i.e.,* a rational examination of the portfolio's risk], *be justified on grounds of enhancing expected return*. What has come to be called "modern portfolio theory" offers an instructive conceptual framework for understanding and attempting to cope with non-market risk. The trustee's normal duty to diversify in a reasonable

44. See "The "Safe Harbour" for Prudent Fiduciary Investing" by Charles Stanley, in *Advisors Seeking Knowledge – A Comprehensive Guide to Succession and Estate Planning*, *supra*, footnote 11, (ch. 71).
45. *Ibid.* at pp. 882-883.
46. Restatement section 227.

> manner, however, is not derived from or legally defined by the principles of any particular theory. See Reporter's General Note on Comments e through h for discussions of asset pricing, types of risk, and the advantage of diversification.
>
> Another aspect of risk management deals with market risk, often called "systemic" or "systematic" risk, or more descriptively for present purposes, simply non-diversifiable or compensated risk. The trustee's duties and objectives with respect to this second category of risk are not as distinct as those with respect to diversifiable risk. They involve quite subjective judgments that are essentially unavoidable in the process of asset management, addressing the appropriate degree of risk to be undertaken in pursuit of a higher or lower level of expected return from the trust portfolio. In this respect the trustee must take account of the element of conservatism that is ordinarily implicit in the prudent investor rule's duty of caution. *Opportunities for gain however, normally bear a direct relationship to the degree of compensated risk*. Thus, although an inferred, general duty to invest conservatively is a traditional and accepted feature of trust law, the duty is necessarily imprecise in its requirements and is applied with considerable flexibility.

The second purpose of diversification is to create an "efficient" or "optimal" portfolio. An efficient portfolio is described as one designed to provide the greatest return for a given amount of risk. Many financial advisors and economists, including the authors of MPT, have concluded that asset allocation is the key to creating an efficient portfolio. In fact, many studies conclude that greater than 90% of a portfolio's variability of returns is determined by asset allocation.[47] Asset allocation is further discussed below.

(f) What is a Concentration?

Understanding whether any particular investment needs to be diversified requires an understanding of when a particular investment has reached a "concentrated" amount. Unfortunately there is no precise formula to assist a trustee to know when "enough is enough". As Kiziah explains:[48]

> The UPIA does not define what constitutes an investment concentration nor does it address how many investments are needed in order achieve diversification. There is no automatic rule for identifying how much diversification is enough. According to the comments Restatement (Third) of Trusts (2003) (hereinafter "Restatement"), "significant diversification advantages can be achieved with a modest number of well-selected securities representing different industries and having other

47. Stanley, footnote 44, at p. 884.
48. Kiziah, *supra*, footnote 17, at p. 362.

> differences in their qualities. Broader diversification, however, is usually to be preferred in trust investing.

Kiziah goes on to consider the concept of diversification within the equity markets, non-equity markets and into several asset classes. In the case of the equity markets, he refers to several studies which considered the number of stocks needed to diversify non-compensable risk. Some studies suggest that 10 to 15 securities can reduce non-compensated risk, while others suggest that 120 stocks are needed to do so. Within the non-equity markets, referring to a few American cases wherein a significant concentration (*e.g.*, 60 to 66%) was in mortgages, he concludes that the duty to diversify is not limited to the equity markets but applies equally to other asset classes.

With respect to diversification into several asset classes, it is well accepted that non-compensated risk can be reduced by diversifying among asset classes. In fact the Restatement acknowledges this. (See discussion below under Asset Allocation.)

(g) Asset Allocation and Asset Classes

As noted above, an asset class is a group of securities that have similar risk and return characteristics. Each asset class will have its own expected return and risk. The concept of asset allocation refers to the manner in which the proportions of the liquid funds available in a trust portfolio are allocated into different asset classes. Therefore, different asset classes are added to a portfolio because they will increase the expected return or they decrease the volatility of the portfolio as a whole, or even better, do both.

There are three main asset classes:

(i) equities;[49]

(ii) fixed income, such as money invested in GICs, bonds and mortgages; or

(iii) cash and cash equivalents, such as money invested in Money Market funds, T-bills and savings accounts.

There are two points a prudent investor ought to be aware of. First, studies have shown that approximately 91% of the variability of the return of an investment portfolio is attributable to asset allocation.[50] Second, the performance of an asset class is cyclical,

49. This is then broken down into large-cap stocks, small-cap stocks, emerging market stock, etc.

50. Van Slyke, Merrick and Stanley, *supra*, footnote 13, at p. 861.

with each class having its own unique cycle. Generally, if some are doing well, others are not.

> A fully diversified portfolio will have some amount of all of these "asset classes" in a proper recipe that maximizes return for a given level of risk.[51]

Therefore, it is important to understand the asset classes that are available and what role they may play in a portfolio. For example, do they provide income, growth or both, and what is the inherent risk associated with the asset class. Once this is understood, a prudent trustee will be able to work with their investment advisor to determine their asset allocation strategy.

While equities and fixed income are the two main asset classes that are generally considered when trustees are engaging in the diversification of their investment portfolios, cash, as an asset class, should not be forgotten. In fact, cash is expressly contemplated within the criteria stipulated by the Act. In particular, the need for liquidity, for example, to satisfy regular expenses is an appropriate consideration when developing an asset allocation strategy.

Aside from the foregoing more traditional asset classes, there are a number of other potential asset classes in which trustees can invest, including:

(i) commercial or residential real estate,
(ii) commodities such as natural resources and precious metals,
(iii) collectibles such as art and wine,
(iv) insurance products,
(v) private equity, and
(vi) other alternative or non-traditional investments, such as hedge funds and structured notes.

Regarding these non-traditional asset classes, a trustee or advisor must be able to provide a reasonable justification for implementing one of these assets since academic research is sparse at best that will indicate the expected return, volatility and correlation with other asset classes for each of these non-traditional assets.

In addition, particular asset classes can be broken down into further sub-classes. Consider equities, for example, which can be further sub-classified as private or public, foreign or domestic, "large cap", "medium cap" or "small cap."

51. Van Slyke, Merrick and Stanley, *supra*, footnote 13, at p. 863.

Understanding what role each of these available asset classes may serve in the development of an investment portfolio is important to a trustee being able to develop a prudent strategy.

As noted above, under the prudent investor rule, there are no restrictions on the form of investments in which a trustee can invest, subject to the requirement that if a prudent investor would not invest in the particular investment under consideration, it follows that a trustee should also not so invest. As a result, subject to this caveat, there are no particular asset classes that a trustee should be either obliged to acquire or to avoid when investing the property of a trust.

Further to this point, the Restatement provides the following commentary regarding the diversification of trust property into different asset classes:[52]

> There is no defined set of asset categories to be considered by fiduciary investors. Nor does a trustee's general duty to diversify investments assume that all basic categories are to be represented in a trust's portfolio. In fact, given the variety of defensible investment strategies and the wide variations in trust purposes, terms, obligations, and other circumstances, diversification concerns do not necessarily preclude an asset-allocation plan that emphasizes a single category of investments as long as the requirements of both caution and impartiality are accommodated in a manner suitable to the objectives of the particular trust.

Although this commentary suggests that a single asset class could potentially be a prudent investment strategy in particular circumstances, in general this would not be an appropriate approach for a trustee to take with respect to the investment of the assets of a trust for three reasons. First, despite the language of the Restatement, Kiziah has noted that while American courts have not required diversification into several asset classes, "empirical studies have demonstrated that risk can be reduced by investing into several asset classes. When appropriate, the wise trustee will consider broadly diversifying inside asset classes and across asset classes."[53] Second, Canadian jurisprudence is limited such that it is not known whether our courts will be more conservative than that of the United States with respect to this issue. Third, the objectives and circumstances of most trusts are unlikely to support such a limited investment strategy.

As a result, it would be more appropriate for a trustee to engage in an investment strategy that specifically provides for the

52. Restatement, *supra*, footnote 7.
53. Kiziah, *supra*, footnote 17, at p. 366.

diversification of investments among different asset classes and within certain asset classes, *i.e.*, to specifically provide for diversity among fixed income investments, equities and other asset classes and to specifically provide for diversification within such classes (such as the sub-classes of public and private and foreign and domestic equities) and to avoid a concentration of assets in any one industry sector. In this manner, the assets of a trust would be diversified in order to try to avoid undue exposure to any single economic sector, industry group or individual security. This more prudent approach to diversification would appear to be more in keeping with the duty to diversify trust property.

Turning then to briefly describe the two main asset classes, together with certain of the others noted above.

(i) Equities as an Asset Class

When thinking about the available asset classes, it is important to understand the relevant influence the asset class has on a portfolio. According to Van Slyke, there are three primary factors that influence equity portfolio returns. They are:

1. Exposure to the whole market, in particular, assessing an investment's volatility relative to the overall market or an appropriate asset class.
2. The percentage invested in large company stocks versus small company stocks. Over time, small company stocks have higher expected returns than large company stocks. This is because stocks of small companies are riskier than those of large companies, and investors will seek a premium for the added risk.
3. The percentage invested in growth stocks versus value stocks. Over time value stocks have higher expected returns than growth stocks. Value stocks are those that sell at lower prices relative to their earnings and book values. They are perceived by investors to be riskier than growth stocks, and investors will seek a premium for this risk.

Recent research has determined a fourth factor that will influence equity portfolio returns termed by Dimensional Fund Advisors as Direct Profitability. More highly profitable companies in an asset class will significantly outperform less profitable companies in that same asset class.[54]

54. Steiman, *supra*, footnote 27.

(ii) Fixed Income as an Asset Class

This asset class serves two functions — to produce income and to reduce volatility. Van Slyke has stated that the best way to ensure fixed income fulfills both functions is to:

1. use shorter maturities, *i.e.*, under five years;
2. use high quality issues;
3. use a variable maturity approach; and
4. use a diversified global approach while hedging all currencies.

(iii) Private Equity as an Asset Class

Private equity is an asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange. This asset class is generally illiquid so it is often thought of as long-term investment with the goal of providing growth. The prudent trustee ought to pay attention to the illiquidity of the investment and how that will factor into the needs of the trust and its beneficiaries. This asset class has very little academic research, and no consensus, regarding the key factors of expected return, volatility of returns or correlation to other asset classes.

(iv) Hedge Funds as an Asset Class

Hedge funds are a pooled investment vehicle that is operated by a privately owned company. The company in question will pool investors' money and then invest in a diverse range of markets and investment instruments. These characteristics make them appear very similar to mutual funds. One notable difference however, is that hedge fund managers tend to be compensated based on a base fee plus a percentage of profits, often referred to as the 2 and 20 — 2% of assets and 20% of profits. Since this is a very expensive investment strategy, trustee should be quite cautions about its inclusion in a fiduciary account.

(v) Structured Products as an Asset Class

There is no single, uniform definition of a structured product. Broadly speaking they are a market linked investment, meaning that the payout that will eventually be made depends on the performance of something else in the market, whether that be a basket of securities, indices, commodities, currencies, or swaps.

Structured products are not really an asset class *per se*. By their very nature, it is difficult for a fiduciary/trustee to be sure how to incorporate them properly into a trust portfolio. They also lack the known quantities of expected return, volatility and correlation to other asset classes.

Typical examples of structured products include the following:

1. investment funds;
2. capital trusts;
3. principal protected notes; and
4. split share corporations.

This asset class is generally perceived to be high risk and complex.

(vi) Real Estate Investment Trusts (REITs) as an Asset Class

REITs are a either a publicly listed, or non-traded trust whereby investors purchase a unit in a trust that invests in real estate, whether it be through properties (equity) or mortgages. The popularity of REITs largely stems from their higher yield and favourable tax treatment along with a relatively low correlation to the stock market.

(h) Indexing[55]

One type of investment that is arguably an investment that ought to satisfy the duty to diversify is an index fund of some sort. An index is a list of securities selected and weighted to measure the performance of an established segment of the market, for example, the TSX 60 or Standard & Poor's 500 Stock Index. Generally, the index portfolio includes all of the securities covered by the index, in the same relative weight as in the index — including any "losers". Companies who create indices will monitor a number of securities across countries, regions and sectors. The ultimate goal of an index fund is to realize the risk and return of the index.

Index investing can be implemented through the use of index mutual funds or index exchange traded funds (ETFs). The key characteristics of indexing can be equally applied to mutual funds

55. The following discussion is taken from "Indexing 101" by J. Alan Grissom, in *Advisors Seeking Knowledge – A Comprehensive Guide to Succession and Estate Planning*, *supra*, footnote 11, ch. 71.

and ETFs. Both mutual funds and ETFs come in the index variety and as actively managed funds.

Investing in an index fund, as opposed to investing in individual stocks or actively managed mutual funds, may have a number of advantages. The advantages can best be described by considering the differences between passive asset class investing versus active investment strategies. The former has been described as the "safe harbour" for prudent fiduciary investing. In particular, Charles Stanley has written a very persuasive argument in support of the following statement:[56]

> . . . low cost passive asset class "index" investing is the safe harbor or default standard for fiduciary trust investing, and any departure to active investment strategies that increase risk and costs, while allowable, should be demonstrably justified.

There are a number of additional benefits to using index or passive asset class funds, particularly when compared to actively managed mutual funds. Several of these benefits make index funds particularly attractive to a trustee. First, it is often less expensive to own and trade passively managed asset class funds or index funds (passive funds) when compared to actively managed mutual funds. Passive funds have a low cost to own because there are no costs associated with researching the investment; the investment simply follows the index. In addition, the assets in a passive fund are less frequently bought and sold, which means that the fees charged to investors are lower, and results in fewer taxable events. Further, the fees or management expenses are much lower than those associated with actively managed mutual funds. In fact, the average ETF fee is usually around 0.5% while the average management expense ratio ("MER") in Canada can approach 2.5 - 3%. The upshot is that passive funds have a lower cost to manage when compared to actively managed mutual funds, and more of the portfolio's returns stay with the investor.

Index ETFs are often seen as being more transparent than actively managed mutual funds. Most index providers update the performance of their indices on a daily basis, while mutual funds typically publish their holdings on a far less frequent basis. Presumably the ability to track indices on a daily basis will

56. "The 'Safe Harbour' for Prudent Fiduciary Investing – How You Can Protect the Trustees You Advise From Unnecessary Risks, Costs and Taxes While Earning Capital Market Returns" by Charles Stanley, in *Advisors Seeking Knowledge – A Comprehensive Guide to Succession and Estate Planning*, *ibid.*, ch. 72.

provide a trustee with a better means to monitor the status of their investments, in an effort to ensure that the prudent investor rule is being complied with.

Lastly, as mentioned above, due to their inherent diversification, passive funds should be considered as a useful tool for satisfying the diversification that is explicitly required as a duty for prudent fiduciary investing.

Despite the numerous benefits of utilizing passive funds, trustees should not be so quick to assume that they are the right investment product for any given portfolio. Prudence may require that a trustee at least screen the list of securities to determine if any included companies are experiencing adverse financial developments which warrant their elimination. Ultimately, however, even a passive fund will have flaws. Despite having flaws, for the trustee of a smaller trust, a passive fund will still be superior to an actively managed fund.

(i) What is Active Versus Passive Investment Management?[57]

As noted above, the commentator, Charles Stanley, makes a strong argument to support that a passive investment policy is more in keeping with the prudent investor rule. In his view, low cost, low turnover, passively managed investments are more appropriate to a trust portfolio than the more actively managed mutual fund.

Active investment management is a dynamic and some would say traditional way of building a stock portfolio. It involves the selection of individual financial securities and the buying or selling of these securities as market opportunities arise. The overall goal of active investment management is to create an investment return that outperforms the benchmark index.

Passive investment management is a much more static approach to building a stock portfolio. The investor makes infrequent changes to the asset allocations and holdings and makes no effort to "play the market". Instead, passive investors seek to minimize fees, and hold virtually all of an asset class or dimension of the market. This is often, though not always, accomplished by constructing a portfolio that approximates the performance of a well-recognized index. For example, a passive investor will seek to hold all 500 stocks in the Standard & Poor's 500 in the same proportion as in the stock market index.

57. The following discussion is taken from Stanley, *ibid.*, in *Advisors Seeking Knowledge – A Comprehensive Guide to Succession and Estate Planning*, *supra*, footnote 11, ch. 72.

(j) Duty to Review or Rebalance the Portfolio

Once the investments for each asset class are selected, the focus of the trustee should shift to reviewing, monitoring and adjusting the portfolio. A prudent trustee will engage in rebalancing of the portfolio systematically.

Rebalancing is the process by which a trustee periodically resets a mix of asset classes by taking profits from outperforming investments and buying cheaper, underperforming ones. Trustees often create a portfolio with a target allocation of asset classes in mind; say for example, 60% stocks and 40% bonds. Trustees are well advised to check the value of the portfolio at regular intervals and make adjustments as necessary. It is entirely possible that after a year, the bonds in the portfolio will have increased in value, while the stock funds have decreased in value. This fluctuation in value will mean that the stocks and bonds represent a different allocation of the portfolio than the trustee initially planned for thus changing the risk profile of the portfolio. By selling some of the bonds, and using the money to buy stocks, the portfolio can be rebalanced.

Regularly rebalancing of an investment portfolio, as outlined in the original IPS, can maintain the risk/return profile and potentially increase returns. Accordingly a trustee ought to regularly review the trust investments to determine whether a rebalancing is required.

However, it is also incumbent on a trustee to regularly review the original IPS to determine whether a change in asset allocation is needed. A weighting of 60:40 between equities and fixed income securities might have been appropriate at the time the investment plan was put into place but changing economic circumstances of a beneficiary, world events like the crash in 2008 or a bull market, may require a trustee to revisit this weighting. Perhaps circumstances dictate that a weighting of 100% equities is prudent. For example, looking at today's conditions where the real rate of return on bonds may be negative, having any investments in bonds may, in fact, not be prudent.[58]

(k) Jurisprudential Consideration of the Duty to Diversify – *Critchley v. Critchley*

The statutory duty to diversify investments is only applicable in four provinces, and it is a relatively recent innovation. As such,

58. Anecdotally the 60:40 split appears to be the weighting that is considered "prudent" regardless of what economic factors might dictate.

there is not a significant amount of Canadian jurisprudence interpreting this duty. The Nova Scotia Supreme Court decision in *Critchley v. Critchley* provides the most detailed insight into a trustee's obligation to diversify investments.[59]

Under the Nova Scotia *Trustee Act* trustees are held to a prudent investor standard; the legislation also contains an investment diversification requirement similar to that of the Act.[60]

In *Critchley v. Critchley*, it was alleged that the trustee, John Critchley, had not diversified the trust investments as required under the governing legislation. In the trust documents, Critchley had been given a direction to "invest in Canadian common and preferred shares and any other investments which my trustees deem appropriate."[61] However, during his management of the trust investments, he liquidated most of the Canadian preferred and common stocks forming part of the trust portfolio and reinvested generally in the stock market, with a heavy weighting on growth stocks, some in the high risk category, and in the technology sector.

Mr. Critchley's investment strategy was criticized for sacrificing income and capital preservation for capital appreciation and for not sufficiently diversifying by type of asset or industry. The judgement summarizes the testimony of a Mr. Horgan, an investment expert who testified at the trial, with respect to certain investment strategies that he considered to be less than prudent having regard to all of the relevant factors:[62]

> [B]y December, 2000, the Trust's two investment accounts showed a significant change. Eighty-seven percent were in growth securities (stocks and mutual funds), and concentrated in the technology industry (45.3%), in high risk investments (32.5%). In his [Mr. Horgan's] opinion this investment strategy did not meet the appropriate investment objectives of the Trust. The strategy sacrificed income and capital preservation for capital appreciation and was not appropriate for a prudent investor or for this Trust.
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> . . . [B]y December, 2004, the portfolio was still primarily focussed on growth securities (80%), with about 17% in the high risk category. The portfolio was not sufficiently diversified by type of asset or industry.

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59. *Critchley v. Critchley*, 2006 NSSC 219 (N.S. S.C.).
60. *Trustee Act*, R.S.N.S. 1989, c. 479, s. 3, which reads in part:
    A trustee must diversify the investment of trust property to an extent that is appropriate having regard to
    (a) the requirements of the trust; and
    (b) general economic and investment market conditions.
61. *Critchley v. Critchley*, *supra*, footnote 59, at para. 8.
62. *Critchley v. Critchley*, *supra*, at para. 95.

> . . . [I]nvesting in the TSX index is not necessarily a prudent investment strategy, and does not constitute proper diversification, because the high flying sectors of the economy distort the index.

The judgement also highlights Mr. Horgan's conclusion that Mr. Critchley did not diversify the trust assets in the manner required of a prudent investor.[63]

> [Horgan] stuck to his opinion that "chasing performance", by maximizing exposure to the hot sector of the market, was not an appropriate strategy. Diversification was a necessity, and not, as Counsel for the Respondents' suggested, just one model strategy to choose from.
>
> . . . In [Horgan's] view, the extent of the portfolio's investments in technology stocks, in or about the year 2000, was not appropriate for a prudent investor. When pressed, despite indicating he did not structure model portfolios, he gave the opinion that a prudent investor or conservative approach would have resulted in 60 to 65% of the Trust in equities, 25-30% in fixed income securities, and the remainder in cash equivalents. No more than ten to fifteen percent should have been in the high risk investments.

The judgment concludes by endorsing Mr. Horgan's analysis of the deficiencies in Mr. Critchley's investment strategies, noting that his analysis "points out the need for an overall investment strategy, based on predetermined investment objectives and risk tolerances. These objectives and tolerances must recognize that the Trust is a trust with a short term horizon."[64]

Critchley v. Critchley is a particularly interesting decision because there was no evidence adduced that the investments Mr. Critchley had pursued were outrageously speculative, lost the trust any money or would have performed better if they had been appropriately diversified. Regardless, Mr. Critchley's investment strategy was criticized by the court as not properly adhering to the prudent investor rule and the duty to diversify trust property.

As a result, this decision provides some guidance on how to view the duty to diversify trust assets and engage in a prudent investment strategy. Factors that can be gleaned from the judgement include:

(a) trustees must have an overall investment strategy, based on predetermined investment objectives and risk tolerances. These objectives and tolerances must recognize whether the trust is a trust with a short term or long term horizon;

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63. *Critchley v. Critchley*, *supra*, at paras. 97-98.
64. *Critchley v. Critchley*, *supra*, at para. 105.

(b) income and capital preservation should not be completely sacrificed for capital appreciation;
(c) investing in the TSX index is not necessarily a prudent investment strategy nor constitutes proper diversification;
(d) diversification must address both the types of assets forming part of the portfolio and the types of industries in which the assets are found;
(e) maximizing exposure to the "hot sector" of the market is not appropriate; and
(f) no more than 10% to 15% of a portfolio should be invested in high risk investments.

These factors provide useful guidelines for trustees to follow. However, they are not necessarily determinative of appropriate investment conduct in all circumstances, as there are additional considerations that a trustee should have regard to, which may supersede the foregoing diversification requirements in certain circumstances.[65]

First, when determining their investment strategies, a trustee ought to take into account the objectives of the trust. This includes any needs for liquidity, income and preservation of capital, and the respective importance of each of these factors. If there is a high degree of liquidity or income required this will determine not the only the types of investments that are appropriate, and it may also affect what is an appropriate level of diversification. A trustee must consider each of these factors separately when determining the structure of the investment portfolio.

Second, there may be occasions where certain tax circumstances could overcome the need to diversify. For example, if the tax costs of recognizing a gain outweigh the advantages of diversifying the holding, a trustee may be justified in retaining the undiversified portfolio.

Third, there may be situations where an asset cannot be sold or can only be sold at a substantial discount. This situation is most likely to occur when there are co-owners of an asset, or where there is a non-controlling interest and a market only for the controlling or entire interest in an asset. In these situations a trustee may be

65. See Kiziah, *supra*, footnote 17, where he comments on three special circumstances where American courts have found that the trust is better served without diversifying. The three circumstances that Kiziah finds are: tax considerations; a special relationship with the trust property and where it is impossible of the trustee to sell an item in order to appropriately diversify the trust.

justified, after exploring all sale options, not to diversify the non-saleable asset.

Fourth, as noted above, certain economic conditions may indicate that the best course of action is not to diversify the assets of the trust but to concentrate the trust property in the least volatile securities, despite a low rate of return.

Fifth, certain assets may have a special relationship or value to the trust or one or more of the beneficiaries of the trusts. In such cases, the retention of such assets is likely warranted notwithstanding that it effects the proper diversification of the trust assets. The topic of the impact of certain of the Criteria stipulated in s. 27(5) on the duty to diversify was discussed in detail above.

(l) Engaging an Agent to Implement the Plan – How to Delegate and is Sub-Delegation Possible?

Subsections 27(7) and (8) of the Act provide that a trustee is entitled to obtain advice in relation to the investment of trust property. The operative trust document may also allow for the trustee to obtain advice.

Subsection 27.1(1) of the Act further provides that a trustee may authorize an agent to exercise any of the trustees' functions relating to the investment of trust property to the same extent that a prudent investor would authorize an agent to exercise any investment function. However, the Act goes on to provide that before authorizing the agent to act, trustees must prepare a written plan or strategy that (i) is comprised of reasonable assessments of risk and return that a prudent investor could adopt under comparable circumstances; and (ii) is intended to ensure that the agent's functions will be exercised in the best interests of the beneficiaries of the trust.[66] In addition, the Act provides that trustees cannot authorize agents to act unless they enter into a written agreement with the agent that requires the agent to comply with the plan or strategy that is in place and to report to the trustee at regularly stated intervals.[67]

The Act requires trustees to exercise prudence in selecting an agent and in establishing the terms of the agent's authority and monitoring the agent's performance to ensure compliance with the terms of the agent's authority. For the purposes of the Act, "prudent" monitoring of an agent's performance includes:

66. Subsection 27.1(2) and s. 28.
67. Subsection 27.1(3).

(i) reviewing the agent's reports;

(ii) regularly reviewing the agreement between the trustee and the agent and how it is being put into effect, which includes considering whether the plan or strategy of investment should be revised or replaced;

(iii) replacing the plan or strategy if the trustee considers it appropriate to do so;

(iv) assessing whether the plan or strategy is complied with;

(v) considering whether directions should be provided to the agent or whether the agent's appointment should be revoked; and

(vi) providing directions to the agent or revoking the appointment if the trustee considers it appropriate to do so.

A trustee should adhere to these additional requirements when engaging agents to exercise investment functions with respect to the trust. As a result, a trustee's written investment plan or strategy must contemplate the retention of agents and the trustee must enter into a written agreement with the agents that requires them to comply with the written investment plan or strategy and report to the trustee at regular intervals.

In many circumstances, the agreements and policy statements provided to the trustee by their investment advisors may be sufficient for these purposes. However, specific documentation provided by such advisors should be carefully reviewed to ensure compliance with these agency delegation requirements and additional documentation should be prepared if necessary for these purposes. See discussion above on creating an IPS.

While the Act does permit a trustee to delegate, it is less clear on the issue of whether sub-delegation is permitted. Subsection 27.2(2) of the Act provides that an agent who is authorized to exercise a trustee's functions relating to investment of trust property shall not delegate that authority to another person. However if a trustee is intent on permitting the sub-delegation of their investment authority, there are likely two manners in which this can be achieved.

First, there is nothing in the Act that actually restricts a trustee from granting an authority to the agent to sub-delegate investments to a third party. Subsection 27.2 (2) could be read as only limiting the agent's authority to sub-delegate the authorities granted by the trustee. Therefore, if the trustee granted the authority to the agent to sub-delegate investments; the agent could sub-delegate

investments but could not sub-delegate those authorities (in this case, the authority to sub-delegate). Under this scenario, the trustee would need to ensure that they are meeting all of the necessary requirements regarding the monitoring of the primary agent, as outlined above. It should be noted that although this method appears to be technically in compliance with the Act, there is risk that a court could view this as operating against the overall statutory purpose and intent of the Act.

Second, and alternatively, a trustee could authorize each sub-delegation. Under this scenario, an agent could sub-delegate his or her authority, however prior to finalising the terms of such sub-delegation, the agent would request the trustee to approve and authorize the authority of the sub-delegate. For all legal purposes, this would turn the sub-delegation (from agent to sub-delegate) into a delegation (from trustee to sub-delegate). In this situation, the trustee would be responsible for monitoring each individual sub-delegate in the same manner as if he or she were an agent.

The lack of express sub-delegation may be a short coming with the Act. It is not uncommon for large trusts to engage an advisor to help select and manage other discretionary managers with expertise in specific asset classes or investment strategies. The process described above ought to offer a means to address the practical need with the limitations ostensibly imposed by the Act.

Part IV: Other Considerations

(a) When Trustees use a holding company to hold and manage investments does the Prudent Investor Rule Change?

Often it is the case that the investment portfolio managed by a trustee is held through a holding company. This structure should not impact the obligations of a trustee to comply with the prudent investor rule described above.

From a strictly technical point of view, a trustee could be seen as simply investing in the holding company as opposed to in the investments held by the holding company. Since the obligations of directors of corporations when engaging in the investment of corporate assets are different from those of trustees when investing trust assets, it could reasonably be argued that the prudent investor rule could be avoided by the directors of the holding company altogether. However, it would be imprudent for a trustee, who controls the holding company and act as its directors, to take this position. Notwithstanding the indirect nature of the trustee's

ownership of the investment portfolio, a court would be likely to impose the same obligations on the trustee in their capacities as directors of the holding company as it would if the trustee held the investment portfolio directly.

As a result, both when a trustee is indirectly monitoring the investments held by an investment holding company and when a trustee is monitoring the investment of property held directly by the trustee, the trustee will be obliged to comply with the prudent investor rule described above.

(b) Are Trustees Obliged to Follow the Act or Can a Trust Oust the Prudent Investor Rule?

The Act provides that a trustee is not authorized or required to invest in a manner that is inconsistent with the terms of the trust. In other words, the terms of a trust can override any statutory requirements set out in the Act. However, caution should be exercised in this regard. While theoretically the Act could be ousted by the provisions of a trust instrument, the fiduciary obligations imposed by law on trustees cannot be completely ousted by a trust instrument. It is likely that the fiduciary obligations that a court will impose on trustees with respect to the investment of trust property will mirror those set out in the Act. As a result, the most prudent course of action for trustees is to ensure compliance with the provisions of the Act unless such compliance would require the trustees to act in a manner that is inconsistent with the trust instrument. In any event, this point may be moot as it is often the case today that the investment provisions of a trust mirror the provisions of the Act and therefore the trustee will be bound by the prudent investor rule in any event.

2. Conclusion

The purpose of the foregoing was to provide information to assist in better understanding the parameters of the prudent investor rule, in particular, the fact that it is based upon modern portfolio theory. It is hoped that those who advise both trustees and beneficiaries, together with the courts who are left to retrospectively assess a trustee's actions, leave aside the perception that the only prudent portfolio is one that is based upon the "60:40 balanced portfolio" but truly have regard to the scope modern portfolio

theory has bestowed upon a trustee's investment authority. Hopefully innovations in this regard are not as slow to develop as was the case with the implementation of the prudent investor rule.

SCHEDULE "A"

TRUSTEE ACT

26. Other Acts – If a provision of another Act or the regulations under another Act authorizes money or other property to be invested in property in which a trustee is authorized to invest and the provision came into force before section 16 of Schedule B of the *Red Tape Reduction Act, 1998*, the provision shall be deemed to authorize investment in the property in which a trustee could invest immediately before the coming into force of section 16 of Schedule B of the *Red Tape Reduction Act, 1998*.

27. (1) Standard of care – In investing trust property, a trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments.

(2) Authorized investments – A trustee may invest trust property in any form of property in which a prudent investor might invest.

(3) Mutual, pooled and segregated funds – Any rule of law that prohibits a trustee from delegating powers or duties does not prevent the trustee from investing in mutual funds, pooled funds or segregated funds under variable insurance contracts, and sections 27.1 and 27.2 do not apply to the purchase of such funds.

(4) Common trust funds – If trust property is held by co-trustees and one of the co-trustees is a trust corporation as defined in the *Loan and Trust Corporations Act*, any rule of law that prohibits a trustee from delegating powers or duties does not prevent the co-trustees from investing in a common trust fund, as defined in that Act, that is maintained by the trust corporation and sections 27.1 and 27.2 do not apply.

(5) Criteria – A trustee must consider the following criteria in planning the investment of trust property, in addition to any others that are relevant to the circumstances:

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.
5. The expected total return from income and the appreciation of capital.
6. Needs for liquidity, regularity of income and preservation or appreciation of capital.
7. An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(6) Diversification – A trustee must diversify the investment of trust property to an extent that is appropriate to,

(a) the requirements of the trust; and
(b) general economic and investment market conditions.

(7) Investment advice – A trustee may obtain advice in relation to the investment of trust property.

(8) Reliance on advice – It is not a breach of trust for a trustee to rely on advice obtained under subsection (7) if a prudent investor would rely on the advice under comparable circumstances.

(9) Terms of trust – This section and section 27.1 do not authorize or require a trustee to act in a manner that is inconsistent with the terms of the trust.

(10) Same – For the purposes of subsection (9), the constating document of a corporation that is deemed to be a trustee under subsection 1(2) of the *Charities Accounting Act* form part of the terms of the trust.

27.1 (1) Trustee may delegate functions to agent – Subject to subsections (2) to (5), a trustee may authorize an agent to exercise any of the trustee's functions relating to investment of trust property to the same extent that a prudent investor,

acting in accordance with ordinary investment practice, would authorize an agent to exercise any investment function.

(2) Investment plan or strategy – A trustee may not authorize an agent to exercise functions on the trustee's behalf unless the trustee has prepared a written plan or strategy that,

(a) complies with section 28; and

(b) is intended to ensure that the functions will be exercised in the best interests of the beneficiaries of the trust.

(3) Agreement – A trustee may not authorize an agent to exercise function on the trustee's behalf unless a written agreement between the trustee and the agent is in effect and includes,

(a) a requirement that the agent comply with the plan or strategy in place from time to time; and

(b) a requirement that the agent report to the trustee at regular stated intervals.

(4) Trustee's duty – A trustee is required to exercise prudence in selecting an agent, in establishing the terms of the agent's authority and in monitoring the agent's performance to ensure compliance with those terms.

(5) Same – For the purpose of subsection (4),

(a) prudence in selecting an agent includes compliance with any regulation made under section 30; and

(b) prudence in monitoring an agent's performance includes,

(i) reviewing the agent's reports,

(ii) regularly reviewing the agreement between the trustee and the agent and how it is being put into effect, including considering whether the plan or strategy of investment should be revised or replaced, replacing the plan or strategy if the trustee considers it appropriate to do so, and assessing whether the plan or strategy is being complied with,

(iii) considering whether directions should be provided to the agent or whether the agent's appointment should be revoked, and

(iv) providing directions to the agent or revoking the appointment if the trustee considers it appropriate to do so.

27.2 (1) Duty of the agent – An agent who is authorized to exercise the trustee's functions relating to investment of trust property has a duty to do so,

(a) with the standard of care expected of a person carrying on the business of investing the money of others;

(b) in accordance with the agreement between the trustee and the agent; and

(c) in accordance with the plan or strategy of investment.

(2) No further delegation – An agent who is authorized to exercise a trustee's functions relating to investment of trust property shall not delegate that authority to another person.

(3) Proceeding against agent – If an agent is authorized to exercise a trustee's functions relating to investment of trust property and the trust suffers a loss because of the agent's breach of duty owed under subsection (1) or (2), a proceeding against the agent may be commenced by,

(a) the trustee; or

(b) a beneficiary, if the trustee does not commence a proceeding within a reasonable time after acquiring knowledge of the breach.

28. Protection from liability – A trustee is not liable for a loss to the trust arising from the investment of trust property if the conduct of the trustee that led to the loss conformed to a plan or strategy for the investment of the trust property, comprising reasonable assessments of risk and return, that a prudent investor could adopt under comparable circumstances.

29. Assessment of damages – If a trustee is liable for a loss to the trust arising from the investment of trust property, a court assessing the damages payable by the trustee may take into account the overall performance of the investments.

30. Regulations – The Attorney General may make regulations governing or restricting the classes of persons or the

qualifications of persons who are eligible to be agents under section 27.1 and establishing conditions for eligibility.

31. Application – Sections 27 to 30 apply to a trust whether it is created before or after the date section 13 of Schedule B to the *Government Efficiency Act, 2001* comes into force.