

Fiduciary Fun

October, 2001

Information and Ideas for the Modern Beneficiary and Trust Creator

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Palm Beach Meeting

No formal meeting in early January is planned this year. Instead Standish Smith will be available to meet with individual Heirs® members who wish to discuss a particular problem. Contact Heirs® now for an appointment.

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Do You Have Your E-Mail Address?

Beneficiaries with e-mail addresses get first crack at being interviewed by the media!

Printing costs for deficient ridden non-profit Heirs® are high and unnecessary in an electronic age. By allowing us to communicate with you by e-mail, you help Heirs® conserve its limited resources. But, in addition, you will receive faster, more frequent news bulletins and more opportunities to get your story out to the media. How's that? Recently, a writer at a national magazine called on a Tuesday to request comments from people with total return trusts or who might be contemplating same. We could have got on the telephone if we knew who to call – which we didn't. We could also used snail-mail but for one problem. She needed the input by Friday! But because we had e-mail addresses on a portion of our membership, we were able to make quick contact. Result? Several members called the writer directly. SEND US YOUR E-MAIL ADDRESS TODAY! No need to write – just call (610) 525-4442 and leave a message.



Investment Performance Evaluation

By Patrick Collins, Ph.D., CLU, CFA

Preface by Standish H. Smith

Portfolio performance evaluation is easy if money is never added to or taken from principal for fees, transaction costs, cash distributions, etc. – ie there are no “capital flows” in or out of the portfolio. (A dividend/interest payment is not considered a capital flow). In this very simple case, portfolio performance expressed in percentage terms is simply the difference between the portfolio's final value plus any dividends/interest payments collected during the interim period divided by the initial value. In other words, performance is strictly a function of the total return tendered by the securities which make up the portfolio.

But in real life portfolios are rarely stable. A money manager may pour fresh capital into an account to buy more securities while deducting management fees and other costs on an ongoing basis from principal. Hence the simple calculation just described unless corrected for such capital flows could well be meaningless for purposes of judging “best” total return. That's because the results of the calcu-

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Early Termination Through Renunciation

By Lawrence S. Rosenwald, Esq.

Introduction

Many deceased settlors of trusts would be shocked to learn how their trusts were later administered. These same settlors were convinced to create trusts by financial planners who described the trust as a tax saving device by which children, grandchildren, and even spouses would be cared for financially by a benevolent and benign corporate trustee who would commit to protect the beneficiaries' interest in a manner consistent with the settlor's intent. Years ago, this description may well have been accurate. Those with the financial wherewithal to create a trust usually had a close relationship with a local bank whose officials and trust officers often knew the settlor's family and could be counted upon to carry out his/her intent. But merger mania among financial institutions has subsequently destroyed whatever intimacy ever existed. In fact, many income beneficiaries have seen the local bank gobbled up by a corporate giant which, in turn, continued to evolve through merger.

Currently trusts are frequently administered by individuals who had no relationship with the settlor. Moreover, today it is not atypical for a trust officer to be assigned 300 or more accounts! Despite assurances that there will be annual reviews, it is clear that there is often little time to assign to each trust. How can a trust officer ever hope to know his/her clients well enough to be able to treat them in the same manner as a settlor? While larger trusts command greater attention as they generate substantial fees, it is often the beneficiaries of smaller trusts who require the greatest financial assistance. Unfortunately, however, trust officers won't (or can't) spend the time on matters that produce relatively little income for the bank.

Too, trusts no longer work the same way. Historically, trust corpus was divided between income producing assets and dividend paying equities - typically those with growth potential. But growth has displaced the role of the dividend. For example, one of my clients had a trust valued at \$250,000 in 1980 which then produced more than

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Heirs NYC Picketing Trip Cancelled

Due to the recent tragedy in New York City, our picketing *Continued on page 7*



Publicity Works!

From time to time, Heirs® is fortunate enough to get media exposure for banks that mismanage estates and trusts. For example, recently *Bankers Trust* victim Suzanne McCormick and myself made a joint three minute presentation courtesy of WHYY-TV out of Wilmington, DE. (In fact, there have been over 150 print articles plus other radio/TV coverage mentioning Heirs® since its inception in 1991.) Whether you agree or not, publicity is a formidable tool for reform because it alerts state/federal legislators and regulators to the problems posed by bank administrators. And most importantly, publicity alerts beneficiaries everywhere to the fact that they are not alone – that there are thousands of others with similar complaints. That alone encourages beneficiaries to demand better administration and prospective trust creators to seek concessions before designating an individual/bank as trustee (It’s just a matter of education!).

One low-key way to publicize your situation is to register your complaint on the internet. Several sites are already available for doing so. Heirs® also plans to do so in the future. If you would like to “broadcast” your complaint, let us know and we will do the rest!

The plot thickens. Individual beneficiaries tied to unresponsive bank administration are also discovering that media exposure can encourage a bank to cooperate. Here are two examples.

Donald Dickenson and the Cushing Trust

Donald Dickenson (Slippery Rock, PA), one of 17 beneficiaries of the \$17 million Cushing trust, was instrumental in moving same from *Mellon* to *Bankers Trust* with the latter’s promise that it would not liquidate a large (80%) energy sector holding. When *Bankers Trust* allegedly reneged on its offer by subsequently reducing the energy concentration to 52% at a tax cost of about \$862,000, Dickenson again moved the trust to lower cost *Harleysville Bank* (PA) who had previously agreed to act as temporary trustee. Then the trouble started. Eventually *Bankers Trust* withheld \$300K as a “legal reserve fund”, money which Dickenson (acting pro se) forced the bank to release. The bank in its effort to keep the Cushing Trust fought removal despite the fact that the trust instrument contained an unconditional trustee removal clause! It also defended its “right” to deduct its legal costs – some \$47K to date – from trust assets. Dickenson has forced the bank to refund \$7K but continues to fight for the recovery of the balance.

Did publicity help? Almost certainly. Dickenson can’t pinpoint any specific action on the bank’s behalf that would “prove” that taking his story to the media has furthered his case. (That may only be good strategy on the part of the bank in that any show of weakness would likely encourage other beneficiaries to air their grievances publicly). But as his fee case proceeds through discovery, Dickenson is convinced that a story in *Private Asset Management* that appeared on May 28, 2001 as well as his picketing activities in front of *Bankers Trust* successor *Deutsche Bank* earlier this year has had a positive effect and therefore he plans to continue broadcasting his problem to the general public. Interestingly, Dickenson remarks that the bank insisted that any material developed during discovery could not be used publicly. But he promises to tell all once his case is finished!

Postscripts:

- 1) William Wilkie, longtime head of personal trust operations at *Bankers Trust*, resigned on June 30, 2001.
- 2) Reportedly, *Bankers Trust* refused comment about the Wilkie resignation to a writer at *Private Asset Management* (Mia Laab) with words to the effect that he didn’t like her previous articles about the bank!
- 3) Pat Hanley works with Suzanne McCormick and other beneficiaries with accounts at *Bankers Trust*. Contact him at (914) 693-6998.

Charles Taylor

Charles is a real estate investor in the Charlottesville, VA area. He holds a degree in anthropology from the University of Virginia (1981). He is moving a NY sited \$1.4 million trust (originally \$1.25 million in 1955) to a small local bank (*Virginia National Bank of Virginia*) from *Bankers Trust*. His mother is the sole income beneficiary while he has a remainder interest. Early on the bank refused to let the trust fund a mortgage on his mother’s home after reviewing the matter for three months. His mother’s income fell to about \$2600 monthly but it was still not enough to sustain her. (She is currently filing for bankruptcy). An attempt was made to convert her trust into a total return trust which would have allowed his mother to receive principal distributions but NY has yet to pass the Uniform Principal and Income Act (UPIA) which would allow same. Because the trust’s legal situs (not just its administration) is moving to Virginia which has passed the UPIA, his mother will now be able to receive principal distributions as well as income. Interestingly, Charles’s great grandfather was Justin White who founded New York’s white shoe law firm of White & Case, the law firm that “founded” *Bankers Trust* in 1901 and worked with JP Morgan to finance WWI!

Charles points out that the bank doesn’t communicate with its beneficiaries, one reason he believes so many are dissatisfied. He would have moved the trust years ago but William Wilkie, long time personal trust operations chief, always refused saying ‘you’ll never move this trust’. (Ed. note: the trust, like most older trusts, omitted a trustee removal clause). While removal negotiations were in progress, several *Bankers Trust* employees’ advised him not to speak to Heirs®! Heirs® believes that the intense negative publicity currently directed at the bank may have induced the bank to release his account and contributed to Wilkie’s recent resignation.



Become A Volunteer

There are many projects which Heirs® presently can’t do because of a lack of man/woman power. Those with an interest in trust reform please consider becoming an Heirs® “vice president” in charge of:

- lobbying AARP to support a trust/estate reform agenda
- lobbying House and Senate Banking Committees to do the same
- helping beneficiaries write up their own stories for submission to local newspaper, national media, etc.
- petitioning certain daytime TV talk shows to do a program on beneficiaries.
- coordinating the activities of beneficiaries with accounts at bank “X”
- doing legal research on specific topics
- running the Heirs® organization!
- your idea?

Your time is more important to Heirs® than money. Getting involved with beneficiaries can be a wonderful learning exercise and will benefit you in your campaign to improve your own estate/trust situation.

Early Termination Through Renunciation

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\$20,000 in annual income. By 1999, the trust corpus had grown to \$500,000 but income decreased to approximately \$14,000 per year! In fact, accounting for inflation, income beneficiaries are sometimes much worse off now than twenty years ago unless the trust instrument provides for - and the trustee will agree to - invasions of principal. Thus, it is hardly surprising that income beneficiaries have become increasingly frustrated as they are forced to live on less and less income. In this case, we succeeded in replacing the trustee with a smaller, more creative institution despite the fact that most bank trustees won't consent to their removal.

An Alternative – Disclaimer/Renunciation

There are, fortunately, other alternatives. Premature termination of the trust is one possibility. Sometimes technical grounds are available for early termination especially if the purpose of the trust has been fulfilled – for example a trust created especially to finance a child's education. But when such grounds are not available, there is another approach. If an income beneficiary relinquishes his or her interest within nine months of the decedent's death without ever having received an income distribution and other conditions are met, the trust can be terminated by way of an “income disclaimer” without federal tax consequences. And even if an income beneficiary has collected income for years, the trust may still be terminated in a similar fashion by having the income beneficiary relinquish his or her rights to future income payments. This is called a renunciation. If renunciation is to be effective, it must accomplish three purposes: 1) terminate the trust; 2) result in the accelerated distribution of the corpus to one or more remainders who are also concerned about the welfare of the income beneficiary; and 3) avoid significant tax consequences.

Why Accelerated Distribution Is Important

Many trusts are designed to terminate with the death of the income beneficiary in which case early termination by renunciation may be viewed as the legal equivalent of his/her death. A cooperative trustee may agree to early termination without court approval. In other instances, the trustee may seek court approval of a proposed renunciation. In any event, a trust with simple, straightforward language mandating that termination will occur upon the death of the income beneficiary does not necessarily mean that the court will rule in favor of an accelerated distribution of trust corpus to the remainders. In fact, a court might simply rule that the renouncing income beneficiary loses the right to income! To avoid such a pitfall, one should agree to renounce only if renunciation will result in an accelerated distribution. Hence in order to protect oneself, an income beneficiary who wishes to renounce should do so conditionally, i.e. retain the right to withdraw his/her petition if the court fails to rule in favor of an accelerated distribution.

The issue becomes more complicated if the language of the document is complex. For example, consider a situation where the trust will continue in existence even if distributions terminate to the income beneficiary. For example, the settlor may have provided that the trust will continue for 21 years after his/her son's death or until a grandson reaches 40 years of age. Thus, renunciation by the son may only redistribute the income stream to the grandson. That's why the trust instrument must be reviewed and analyzed in light of prior court rulings and existing state statutes to determine how same might be interpreted by the court.

A court may also refuse to allow distribution of trust corpus to the remainders if renunciation is premised on a written agreement providing that the

remainders will later share corpus (read principal) with the income beneficiary. Unless the settlor provided for distributions of principal to the income beneficiary, a court might rule that such an agreement was contrary to the settlor's intent. That does not mean that following distribution of the corpus to a remainder interest that that person cannot use same as he or she believes is appropriate. The key is that the income beneficiary must understand that the remainderman is a kind of “surrogate trustee” who may not treat him/her fairly and that consequently renunciation could produce a loss of income!

Tax Consequences

Once having already received trust income, the IRS views the income beneficiary as being entitled to a lifetime income stream, income that is being relinquished for life. Hence, the IRS considers renunciation as a gift of income to the remainderman. To many income beneficiaries, this will not seem to be a bad tradeoff even if it might boost taxes. Consider the former example where the income beneficiary was only receiving \$14,000 per year on a \$500,000 corpus because the trust included low yielding equities. Assuming a life expectancy of 20 years, one might assume that the amount of the gift would be based on a calculation of \$14,000 x 20 but this is not the case. Instead the IRS essentially ignores the trust's actual income yield and instead calculates its future income for gift tax purposes using its own predetermined rate. While the rate floats, in recent years it has been about 7%. In fact, in our example, said gift tax would have been based on a (grossly simplified!) calculation of 7% x \$500,000 x 20 or \$700,000. Where taxes are involved, other factors may also come into play.

The size of the gift has critical tax consequences at the death of the renouncing income beneficiary. Each person currently has a \$675,000+ exemption from federal estate taxes at death, a number that will increase shortly. Fortunately, however, there is a \$10,000 annual exclusion available for each donee. Thus, in our example, the income beneficiary can give each of her two children \$10,000 per year, tax free. If she renounces 100% of her income interest in 2001, the actual gift would be reduced for tax purposes by \$20,000. Hence if the combination of said gift and his/her assets at death will be less than \$675,000, it might be a good idea to renounce. But if the income beneficiary has other sizable assets, the loss of the exemption could be devastating.

Doing several partial renunciations over a number of years may be preferable. For example, an income beneficiary could renounce only that portion of the corpus which is covered by the annual exclusion. A person with four or five children could actually decrease the size of the trust significantly over a two or three year period by a series of partial renunciations. Caution: renunciation/disclaimer is a complex procedure and must be carefully crafted with expert advice.

Ed. Note: This article was edited for publication. Also note that the analysis presented above differs both from that presented in a prior edition of *Fiduciary Fun*. and in the August, 2001 edition of the *Heirs® Personal Trust Handbook*.

Investment Performance Evaluation

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lation depend not just on the “quality” of the selected issues but significantly on how much money was invested at any particular time. In other words, the ending value of the portfolio is a function not just what securities were held in in the portfolio but the investor’s acumen is timing the market to get the best purchase prices and how much capital (read shares of each security) was invested at any given moment. Because so many factors can affect the portfolio’s final value, this calculation, also called the Dollar Weighted Return (DWR) approach, doesn’t adequately “measure” the skill of the investor unless capital flows are absent.

Fortunately there is another method which better reflects the investor’s (or fund manager’s) ability to pick high total return securities. This approach, called the “Time Weighted Return” (TWR) method is totally independent of portfolio capital flows. To calculate TRW, one computes the net capital gains/losses plus any dividends/interest as a percentage of the portfolio’s initial value for a given period (say 3 months) during which there are no capital flows to/from the portfolio. The calculation is then repeated for the second period - necessarily of the same length as the first period (here 3 months) - based on the initial value of the portfolio following any capital flows. The TRW for the portfolio over the entire six month period is then simply the average of the portfolio’s quarterly percentage returns. Because the calculation of TRW depends only on the percentage returns of the securities held at any particular time by the portfolio and not on the portfolio’s momentary gross value, it better reflects the investors’ ability to pick quality issues although not the investor’s ability as a market timer. Hence the TRW index is the better statistic for comparing one investment manager versus another. This is particularly relevant for professional fund managers who must sell underlying stocks to meet redemption requirements and/or buy to meet customer demand for shares in said fund. That is, fund managers can control what securities are used but not always the timing of purchases/sales. Nevertheless, the DWR calculation, however crude, can also be sometimes useful because it reflects the overall performance of a fund taking into account expenses and infusions of fresh capital from as well as distributions of principal to shareholders.

But portfolio performance is not just about dividends and capital gains. The volatility (risk) of a portfolio also bears consideration as the following remarks from Patrick Collins make clear.

(Patrick Collins continues)

What’s the risk?

The black letter language of Restatement 3rd’s §227 (General Standard of Prudent Investment) instructs trustees to develop “an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.” It is not entirely obvious, however, why risk matters. The Wall Street aphorism: “no one ever spent a risk-adjusted dollar,” implies that a money management focus should be on return rather than risk. One conceptual trap lies in the tendency to excuse risk for winning investments and to assign all risk to unsuccessful strategies. Although capital markets pay investors only the risk-free rate for investments without risk, beneficiaries sometimes fail to realize the inconsistencies in statements like: “I want the trustee to earn high rates of return,” and, “the trustee should not have made that investment because it was too risky.” Trustees however, are seldom charged with the task of maximizing return; rather, they are charged with maximizing the probability of a successful financial outcome “in light of the purposes, terms, distribution requirements, and other circumstances of the trust.” But the mathematics of prudent investing suggests that these two objectives are incompatible. Maximizing the chance of achieving maximum return is, in economic terms, a “maximize the maximum” or Max/Max strategy.

The opposite of a Max/Max strategy is a “minimize the minimum” or, Min/Min strategy. This is a strategy designed to maximize safety. We may view the ‘safety maximization function’ as the inverse of the ‘return maximization function.’ Following such a strategy, however, entails a significant opportunity cost. For example, the worst that could happen to an automobile driver is a fatal accident. An effective strategy for minimizing the minimum is never to drive a car. The opportunity cost is that the driver remains homebound—a price that most people would deem to be too high. It is easy to see the mistake of the Min/Min strategy. However, the mistake of the Max/Max strategy may be just as onerous. The true (high leverage) Max/Max strategy is a bankruptcy strategy given a sufficiently long planning horizon. Intelligent investment planning requires quantification of both risk and reward so that investors can make a good decision regarding the portfolio best suited to their economic needs and risk tolerance. Lacking explicit risk/reward guidelines, there can be no objective, independent standard against which the success or failure of trust administration can be measured.

One reason why risk matters is that losses hurt a portfolio more than gains help. If a dollar loses 20%, the remaining \$0.80 must earn 25% in the next period in order to break even. A loss of 50% requires a 100% return to break even; and a loss of 90% requires a 1000% return to break even. The greater the magnitude of loss, the more difficult it is for the portfolio to recover. In mathematical terms, variance penalizes the wealth accumulation function. This phenomenon is known as “variance drain.” Variance is a statistical measure of the dispersion of actual returns over time from the average of the returns. The following example demonstrates the importance of knowing the variance statistic (or, the standard deviation statistic which is the square root of variance). Assume that both trustee A and trustee B produce a yearly return of 20%. Do you care which one manages trust assets? Perhaps not; but a decomposition of returns to calculate variance may supply some helpful additional information. In this case, assume that each trustee invested equal amounts in ten stocks with the following results:

Stocks	Trustee A	Trustee B
A	+5%	+25%
B	0%	-14%
C	-3%	+37%
D	4%	+22%
E	-6%	+16%
F	+2%	-3%
G	-1%	+42%
H	+3%	+31%

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Investment Performance Evaluation

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I	-2%	+15%
J	+198%	+29%

Intuitively, most investors would agree that they would not want to engage trustee A. Trustee A's track record reveals no ability to pick winning stocks. In fact, a single lucky bet is the source of the portfolio's returns. The variance statistic confirms this intuition. Trustee A's variance is 12.93 times higher than that of Trustee B. Given this amount of variance, it is difficult for Trustee A to claim that he is skilled rather than lucky.

A quantitative measure of risk is crucial for prudent asset management. Investing funds based solely on speculative opinion is highly problematic. The variance (standard deviation) statistic brings out the informational content of track record in a clear and useful form. Not only does it address the skill-versus-luck question; but, more importantly, it demonstrates likely future risk and return tradeoffs that confront the trustee. Risk matters; and, in capital markets, returns in excess of risk free securities cannot be achieved without taking risk. Thus, the second cornerstone of an effective performance evaluation is the requirement that the agent responsible for generation of investment returns also reports the standard deviation of the returns over applicable planning periods.

Horse Race Or Performance Benchmark

According to conventional wisdom it is easy to identify superior investment performance: simply line up money managers and let them run for a reasonable period of time—i.e. three or five years. The one that produces the greatest return is, by definition, the best manager. Undoubtedly, this “horse race” model is intuitively appealing and easy to understand.

Should investment performance be evaluated in a peer group context (i.e. a horse race) or should performance be compared to a pre-specified and appropriate benchmark? The answer to this question has profound implications. The peer group metric suggests that the trustee will seek hot-hand managers; the benchmark evaluation metric suggests that there is a predetermined yardstick by which to measure performance. Under the benchmark metric, the performance evaluation question reduces itself to whether the trustee added or subtracted value relative to the benchmark. Under the horse-race metric, the performance evaluation question reduces itself to whether the trustee produced better than average returns.

In an actual horse race, laying a bet might warrant examining the weather and track conditions under which the horse competed in past races; the horse's running times; the horse's jockey; the horse's trainer and training regimen, and so forth. This research is, of course, comparable to much investment research that explores past track records in order to forecast future outcomes. One problem is that, in the investment race, there is no racing commission that tests for steroids; and, a horse running on steroids might be only a race away from total collapse. Investment managers do not reveal portfolio strategies, investment valuation models, trading tactics, etc. This is proprietary information—the investor does not see how the game is played, he only sees the race results. But are the results a product of skill or luck? In the short term, a run of luck may produce a very attractive investment management record. Over a longer term, the top performing managers will likely be the ones that took the most risk. Seeking managers with top performance rankings is equivalent to selecting for portfolio strategies that carry significant probability of future underperformance. This is why the great majority of independent, academic studies of the money management industry fail to find performance persistence even among the group of top-quartile managers. The alternative to the horse race or peer group performance evaluation metric is a benchmark performance metric. A valid benchmark is:

- Unambiguous: the composition of the benchmark must be verifiable;
- Investable: the investor has the option to invest in the benchmark as an alternative to hiring the manager;
- Measurable: benchmark returns are readily available;
- Appropriate: the benchmark matches the investment universe of the manager;
- Designated: the manager must be aware of the composition of the comparative benchmark; and,
- Defined: the comparative benchmark must be specified in advance.

Once the benchmark is defined, investment returns are compared in order to determine whether the investor is adequately compensated for portfolio risk. Underperformance of a benchmark at a low level of risk is no more a sign of poor investment skill than out performance of the benchmark at a high level of risk is a sign of superior skill. Actual trust returns can easily be levered up or down to match the risk level of the designated benchmark. The beneficiary simply has to look at the risk-adjusted return of the trust portfolio in order to determine whether the trustee's strategies add or subtract value relative to a passively managed, low cost investment alternative.

Opting to use the horse race metric, however, forever condemns the evaluation process to an “apples and oranges” comparison. A closer examination of the characteristics of a valid benchmark suggests that the horse race metric fails most standards. The median manager's portfolio is ambiguous and not available for inspection; it cannot be pre-specified (indeed, you don't know who the median manager will be until after the end of the period); and, the probability of the median manager's portfolio aligning with your trust's portfolio is extremely remote. To borrow a concept from Archimedes, without a fixed reference point, evaluation of investment skill becomes impossible. The horse race metric tells you who, in the long run, took the most risk; not who is the best investment manager.

Beneficiaries, if they are to judge historical performance of the trustee, must have accurately calculated return statistics, variance (or standard deviation) statistics and a side-by-side comparison of results with a pre-specified benchmark.

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Investment Performance Evaluation

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A sample performance evaluation report

The following is a sample of information that trustees or independent investment advisors can prepare for trust beneficiaries. The sample assumes a portfolio with a fixed asset allocation (i.e. no market timing activities). The asset management strategies of trusts differ markedly and the actual monitoring information may be very different depending on the degree of active vs. passive investment management, the degree of tactical vs. strategic asset allocation, and so forth. This example illustrates a simple five asset class portfolio where the actual investments may be individual stocks and bonds, mutual funds, unit trusts, or other investment vehicles. We also assume that the trustee elects to invest in actively managed funds under the expectation that he will be able to outperform comparable indices. Passively managed investments represent a reasonable and low cost alternative asset management strategy but they require different reporting formats.

Asset Class	Asset Allocation %	Proxy Index
US Large Co. Stocks	25	S&P 500 Index
US Small Co. Stocks	15	Russell 2000 Index
Foreign Large Co. Stocks	15	MSCI EAFE Index
Foreign Small Co. Stocks	5	DFI Small Cap Foreign Index
US Bonds	40	Lehman US Corp/Gov't Index

Portfolio benchmark return is simply the weighted sum of the proxy index returns with the weights determined by the target asset allocation percentages. Portfolio benchmark risk involves cross-product terms that depend on correlation statistics. The risk of portfolios with a few investment positions can be calculated by simple algebraic formulae found in any introductory investment text. For larger portfolios, commercial software packages are readily available. As time unfolds, beneficiaries will have an unambiguous record of how well or poorly the trustee performs relative to a pre-specified and unambiguous benchmark. Access to some basic information allows trust beneficiaries to evaluate results both cross-sectionally (relative performance within a period) and serially (relative performance across multiple time periods).

Cross sectional information for above portfolio might list the following results:

Actual Investment	Actual Return	Proxy Index	Index Return	Value Added/Subtracted
US Large Stocks	8%	S&P 500 Index	12%	-4%
US Small Stocks	5%	Russell 2000 Index	7%	-2%
Int'l Large. Stocks	-2%	MSCI EAFE Index	-6%	+4%
Int'l Small. Stocks	4%	DFI Small Co. Foreign Index	3%	+1%
US Bonds	7%	Lehman US Corp/Gov't Index	8%	-1%

Return of the Actual Portfolio for the Period: 5.45%

Return of the Benchmark Portfolio for the Period: 6.50%

Annual Risk Free Rate (30 Day US T-Bills): 6%

Comparable reporting might convey the following annual risk results based on the standard deviation of monthly returns:

Actual Investment	Actual Investment risk	Proxy Index	Proxy Index risk
US Large. Stocks	13%	S&P 500 Index	15%
US Small. Stocks	23%	Russell 2000 Index	26%
Int'l Large Co. Stocks	18%	MSCI EAFE Index	19%
Int'l Small Co. Stocks	26%	DFI Small Cap Foreign Index	28%
US Bonds	12%	Lehman US Corp/Gov't Index	11%

Risk (Standard Deviation) of the Actual Portfolio: 16.3%

Risk (Standard Deviation) of the Benchmark Portfolio: 17.4%

Finally, risk-adjusted performance information might convey the following results (note: the more positive / less negative the reward to risk ratio, the better):

Actual Investment	Reward to Risk Ratio*	Proxy Index	Reward to Risk Ratio
US Large Stocks	.154	S&P 500 Index	.40
US Small. Stocks	-.043	Russell 2000 Index	.038
Int'l Large Stocks	-.444	MSCI EAFE Index	-.631
Int'l Small. Stocks	-.076	DFI Small Cap Foreign Index	-.107

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Investment Performance Evaluation

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US Bonds	.083
Lehman US Corp/Gov't Index	181
Actual Portfolio Reward to Risk Ratio:	-.0337
Benchmark Portfolio Reward to Risk Ratio:	.0287

Risk-Adjusted Return Shortfall: 4 basis points per year.

$$\text{* Reward to Risk Ratio} = \frac{(\text{Actual Return} - \text{Risk Free Return})}{\div \text{Standard Deviation}}$$

Based on the above data the beneficiary can readily determine if the trustee is performing satisfactorily and can identify areas for critical inquiry. Specifically:

- 1) The fact that the actual portfolio has a slightly negative reward to risk ratio while the benchmark portfolio has a slightly positive ratio suggests that the investment program is not adequately compensating the beneficiary for the amount of risk exposure to which trust assets are subject;
- 2) The largest negative difference in ratio values occurs in the US large company stock asset class, which was the top earner in the actual portfolio. The largest positive difference in ratio values occurs in the foreign large company stock asset class, which was the poorest earner in the actual portfolio. This suggests that critical inquiries regarding investment strategies would most profitably be directed towards the apparent "winner" rather than the apparent "loser"—a counterintuitive finding.

Should the trustee be criticized for underperformance? One obvious answer is that, based on only one year's results, it is not possible to make such a determination. More to the point, however, is the fact that the actual portfolio's return (5.45%) was achieved at a significantly lower level of risk (16.3%). We know that the benchmark portfolio earned 6.50% by taking a risk level of 17.4%. One critical question is: given the benchmark's performance, how much should the actual portfolio have earned at a 16.3% risk level. The answer to this question provides a true "apples to apples" comparison. A standard formula [known as the Modigliani Adjustment or M² statistic] calibrates return to risk. It indicates that the annual return shortfall of the actual portfolio amounts to only 4 basis points (or, 0.004%). Thus, the value subtracted on a portfolio with an initial starting value of \$1 million, amounts to only \$400 rather than the \$10,500 differential that appears prior to any performance evaluation. The extra \$10,100, however, was not a "free lunch" in that the extra risk (as measured by the higher standard deviation) means that losses would have been more virulent in the benchmark portfolio had the capital markets performed differently. The more salient issue is whether the investment positions of actively managed investment program deviate so far from the pre-designated proxy benchmarks that the reduction in risk leads to an expectation of systematic future underperformance relative to the benchmark. This topic, however, is beyond the scope of the current discussion.

Investment performance evaluation is critical for determining the success or failure of a trustee's administration of assets. Unfortunately, however, some trustees do not provide beneficiaries with the information necessary to make valid determinations regarding trustee performance. Beneficiaries

may receive detailed accounting and transaction ledgers as opposed to even the most basic risk and return information. Without such information, however, it is difficult to assess the value added or subtracted by the trustee.

About the Author

Patrick J. Collins is a financial advisor with over 25 years' experience. Mr. Collins holds a Ph.D. from the University of California at Berkeley and a Chartered Financial Analyst designation from the Association for Investment Management and Research. He also holds a Professional Designation in Financial Planning from U.C. Berkeley and a Chartered Life Underwriter degree from the American College in Bryn Mawr, PA.

Heirs NYC Picketing Trip Cancelled

Continued from page 1

demonstration originally planned for Sept 20th and 21st will be rescheduled most likely in October. Sorry!

Those of you blessed with a PC and able to find the Heirs[®] website (www.heirs.net) already know that our July 13th campout at the bank was successful beyond imagination. While HBO failed to materialize as promised, the Wall Street Journal, Bloomberg Radio, and Private Asset Management (a private newsletter for mainly NY based financial institutions) did show up with pencils at the ready.

Bye the bye, we had about 16 participants, not all of whom donned sandwich boards but all of which could be visibly identified as picketers by a special cap with lettering appropriate to the occasion (see below). Afterwards, we met for serious conversation directly adjacent to the bank at a plaza thoughtfully provided by the bank.

Heirs[®] Inc.
Demonstration
Deutsche Bank
July 13, 2001

So if you are planning on hitting the Big Apple anytime this fall, connect with Heirs[®] on the dates. Picketing is lots of fun even if it rains (I'm not serious!). But you will discover that getting confrontational with your bank isn't such a big deal. OK?



Become A Point Person!

Those of you with accounts at *Bankers Trust* (now *Deutsche Bank*) know how helpful it has been to work with Pat Hanley (of Dobbs Ferry, NY). For several years Pat, a non-lawyer, has supported efforts of Suzanne McCormick to remove and surcharge *Bankers Trust* for alleged mismanagement of her estate/trust. Pat not only coordinates the sharing of ideas and resources among dissatisfied beneficiaries with *Bankers Trust* accounts but provides the "in the trenches" emotional support without which many beneficiaries would do nothing to improve their personal situation. So why don't you become the "point person" for beneficiaries with accounts at your bank. Organize a meeting – Heirs[®] can help with names/addresses/phone numbers. If you'd like to find out how Hanley does it, call *Bankers Trust* client Johnathan Place at (508) 477-5141. Or Don Dickenson at (724) 530-7405. Or Charles Taylor at (804) 975-5191.

HEIRS®, Inc.
Box 292
Vilanova, Pa
19085

Address Correction Requested

about communications

- Change of address

If you have moved or anticipate doing so, please let us know now. At least give us an alternative phone # (friend, etc) who knows your new residence.

- Want future mailings?

If not, please drop us a note so that we can keep our losses down. In 2000, Heirs® Inc. incurred a deficit of over \$15,000 and has sustained equivalent losses since 1991.

- Snail Mail

Fiduciary Fun will be bypassing snail-mail and going electronic. To ensure your future copy, we need your email address now!

- Do you (or did you have) a closely held family business in trust? Or are you a beneficiary with a trust (allegedly!) mismanaged by the Mellon bank?

If either shoe fits, Tracy and Bob King of Waynesboro, PA want to share information with others in similar circumstances. To quote from their letter to Heirs®, "we intend to correct the wrongs...that exist today in Mellon's policies.. in (this) pursuit, is there room to help each other?".

Contact them today by phone at (717)-762-4127/(717)-782-6764, by email at ath17268@yahoo.com or visit their website (currently in development) at Mellontrust.org.

- Have a trust/estate website? Want to cross-link to Heirs®?

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