

# **Impartial Investing**

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It may not escape the reader's notice that the text of this very preliminary draft (sketch might be a better word) is extremely skimpy, and the draft has no footnotes. Be not dismayed: footnotes and additional clarifying if not edifying text are coming.

## *Impartial Investing*

### ABSTRACT

A trustee charged with investing trust assets without favoring one beneficiary over another must choose a portfolio that balances divergent interests. Other than in the rare circumstance that beneficiary risk tolerances exactly coincide, portfolios chosen by trustees cannot be fully satisfactory to all parties. Due to the nature of risk aversion, the preferences of the most risk-averse beneficiaries should strongly influence the resulting investment choices, in some circumstances making trust portfolios very inefficient. One way to address the inefficiency introduced by common trust funds is to permit or even encourage trustees to divide trust assets and invest the parts separately.

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## ***1. Introduction***

The tradeoff between risk and return is seldom more vivid than in recent times, when very low interest rates mean that it is impossible to earn significant returns on investments without exposure to substantial risk. Prudent asset allocation requires assessment of the relative costs and benefits of alternative investment portfolios, with the associated potential for adverse investment outcomes when risky investments fare poorly. Those for whom poor returns would entail significant hardship are well advised to avoid excessive exposure to risky investments, even though the alternative of safe investment promises barely discernable returns. In other economic eras it has been possible to earn significant returns on portfolios invested in safe assets, but even then it was the case that riskier alternatives held the potential for better yields, and investors quite sensibly differed in the extent to which they preferred to incur risks in the hope of obtaining high returns.

Fiduciaries and other agents who invest on behalf of others must likewise choose among investments that differ in their risk and return characteristics, with optimal risk choices reflecting at least in part the financial resources and life situations of the owners who receive the returns. This portfolio choice problem, which is inevitably complicated, becomes considerably more so when multiple individuals benefit from a common investment portfolio. Due regard for the situations of all who benefit from a common portfolio requires a balancing of their interests, with ultimate asset choices that may correspond only loosely to what any of the beneficiaries would have chosen individually.

Trusts commonly have multiple beneficiaries who receive distributions from the same investments. A typical example is a testamentary trust stipulating that a surviving widow receive annual distributions of income earned by trust assets, with the principle to be divided among children alive at the widow's death. The trustee, who manages the fund, selects investments, and makes distributions to beneficiaries, is charged with managing investments in a manner that does not overly favor one beneficiary at the expense of others. The requirement that trustees discharge their responsibilities with impartial regard for the interests of all trust beneficiaries is one of the fundamental requirements of trustees imposed by the common law and enshrined in

state statutes. In order to discharge this duty properly so it is necessary to anticipate the distributions that beneficiaries will receive in different states of the world.

It is by now well understood that the requirement that trustees act impartially raises complications in settings when beneficiaries benefit to differing degrees from returns in the form of income and principle, since the division between these types of return is to some degree under the control of the trustee. In the case of the testamentary trust in which the widow has a life income interest, trust investments in income-producing assets, such as corporate bonds, rental properties, or dividend-paying stocks, generate returns in the form of interest, rents, and dividends that are distributed to the surviving spouse as the trust receives them. By contrast, other types of investments, such as those in stocks of companies that do not pay dividends, may in the long run generate significant capital gains, but these returns take a form that is commonly deemed to augment principle, and therefore add to the amount ultimately received by the children rather than the widow. The trustee, in choosing among investments, therefore also necessarily chooses between favoring the widow and favoring the children.

The usual understanding is that it is the classification of some investment returns as income, and others as principal, together with trust terms that assign one or more beneficiaries income and others principal, that generates the complication for trustees. The nature of this problem is more than the mere fact that the trustee in choosing investments implicitly chooses between beneficiaries, since any allocation of the proceeds of a common fund entails tradeoffs between the interests of different beneficiaries. The investment problem is that trust investments that make the most sense from the standpoint of overall risk and return may deliver their returns in a manner that is unfair to one or more beneficiaries. In the example it is necessary to invest trust assets in income-generating investments in order to ensure that the widow receives the income that she deserves, yet not to invest too much in income-generating assets if doing so would unfairly leave the children with too little upon the widow's death. Constraining investment choices in this way can lead to situations in which trustees must eschew what would otherwise be sound investment plans in order to maintain payout streams that treat beneficiaries impartially.

The law in recent decades has taken steps to address the problem, notably with the promulgation and widespread adoption by state governments of the Uniform Principal and Income Act and the Uniform Prudent Investor Act. These acts expand the power of trustees to invest trust assets in a manner dictated by modern capital theory that recognizes the tradeoffs between risk and return and the nature of capital market risk. The Uniform Principal and Income Act permits trustees to distribute certain investment returns to income beneficiaries even when returns take forms that were not traditionally classified as income, and thereby helps to loosen the connection between the portfolio chosen by a trust investor and the division of return between different beneficiaries.

These uniform acts make considerable progress in rationalizing the investment problem facing trustees, but what seems to have been overlooked in addressing the principal and income issue is that common trust funds can be problematic when beneficiaries have differing risk preferences, whether or not they differ in receiving the income and principal components of returns. As an illustration, the widow in the example might be very risk averse and the children much less so. Severe risk aversion implies that the widow would face serious economic hardship if income falls much below a specified level. The only way to guarantee that a portfolio generates a given stream of income is to invest a sufficient amount in safe investments. In so doing, however, the trust effectively foregoes the opportunity to earn the higher rates of return available from riskier investments, which the children would have preferred. Indeed, it is easy to envision circumstances in which the children would be willing to compensate the widow, or even guarantee her an annual stream of payments, in return for the opportunity to have the trust fund invested in higher-yielding, albeit risky, assets. But as a realistic matter this transaction cannot take place under the terms of the trust and enforcement of the law as it is now understood.

Common investment pools are problematic when payouts are fixed by formula, as in the case of the trust that provides a life income to the spouse and the remaining principal to the children. In this example, the surviving spouse receives the payout of what is essentially a variable annuity, with annual payments equal to income generated by the trust fund, and that discontinues at the spouse's death; and the children receive the payout from what might heartlessly be called a variable life insurance contract on the surviving spouse's life. The financial inefficiency arises because the variable component of the annuity and the variable

component of the life insurance contract are required to correspond to a division of the returns of the same investment portfolio. As a result, it is not possible to invest one part of a trust fund in risky assets and another in safe assets, even if such a division would advantage beneficiaries and not harm anyone else.

This paper draws attention to the economic costs of constraining trusts to invest in common portfolios for the benefit of individuals with widely differing risk tolerances. The analysis characterizes the properties of portfolios that are invested without favoring one beneficiary at the expense of another, noting the outsized impact of risk-averse beneficiaries. And the paper considers the possibility of permitting trustees to divide trust funds, assesses the potential efficiency gains, and addresses some of the legal issues raised by such division.

## **2. *Trustee Duties and the Uniform Principal and Income Act***

Common law trusts separate legal and beneficial ownership: trustees hold legal title to trust property, while trust beneficiaries enjoy beneficial ownership. This flexible ownership arrangement has proved very popular among trust settlors, particularly in recent years. Some trusts, such as revocable inter vivos trusts, display many of the characteristics of fee simple property ownership on the part of settlors, whereas others, including irrevocable non-grantor trusts, may, and typically do, entail more arm's-length relationships among settlors, trustees and beneficiaries. In all of these cases the returns enjoyed by beneficiaries depend on asset allocation decisions made by trustees.

A considerable amount of economic value is at stake in trustee investment decisions. The aggregate value of property held by trusts in the United States is not known exactly, but for several years U.S. banks have reported that they hold and manage on behalf of clients roughly \$1 trillion of trust assets. Banks manage only a portion of total U.S. trust assets, and that the aggregate value of property held by U.S. trusts comfortably exceeds \$1 trillion is suggested by the fact that those trusts filing tax returns have reported more than \$100 billion in aggregate annual income almost every year since 2005.

Trustees, whether or not they are compensated for their services, are charged with managing and investing trust assets and making distributions to beneficiaries. Trustees therefore work on behalf of others, and in so doing have legal duties of loyalty to beneficiaries and prudence in the conduct of trust affairs. Loyalty to beneficiaries entails the avoidance of self-dealing, and includes a duty to treat beneficiaries impartially in settings where there are multiple beneficiaries. Prudence in the conduct of trust affairs includes sound management of investments, which historically entailed very conservative investment plans in which trustees were expected to avoid investment in any risky assets that might deliver significant negative returns.

This extremely conservative approach to asset selection did not produce satisfactory investment returns over the last two centuries during which risky equities have, on average, greatly outperformed other, less risky, investments. Despite the excellent average performance of risky equity investments, it remains the case that investors must endure the possibility of some downside risk as the price of greater expected returns. Modern (since the 1950s) capital market theory formalizes the theory of risk and return, and identifies an efficient frontier of risks and returns that can be obtained by owning combinations of assets, including assets that might be individually risky but which, in combination with other assets with offsetting risks, yield safer aggregate returns. The Uniform Prudent Investor Act permits, indeed encourages, trustees to invest trust property in risky assets if such investments can be combined in an efficient way with other assets to deliver a desirable combination of total risks and returns. Along the efficient frontier there remains a tradeoff between risk and return: investment portfolios that are less risky have lower expected returns, whereas investment portfolios that are more risky have higher expected returns. The efficient frontier is defined by the impossibility of finding a different combination of assets that would offer greater expected returns with the same risk, or reduced risk with the same expected returns. But the trustee must still choose an overall risk position for the investment portfolio, mindful of the fact that even with efficient investments reducing the greater expected returns necessarily entail greater risks. Since the trustee invests on behalf of the beneficiaries, presumably their tolerance for risk should guide choice along the risk and return frontier.

The trustee's duty of impartiality is codified by Section 803 of the Uniform Trust Code, which provides that "If a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests." The official comment accompanying this provision explains further that, "The differing beneficial interests for which the trustee must act impartially include those of the current beneficiaries versus those of beneficiaries holding interests in the remainder; and among those currently eligible to receive distributions. In fulfilling the duty to act impartially, the trustee should be particularly sensitive to allocation of receipts and disbursements between income and principal and should consider, in an appropriate case, a reallocation of income to the principal account and vice versa, if allowable under local law."

The duty of impartiality extends beyond an appropriate division of investment returns between income and capital, though as the comment to Section 803 of the Uniform Trust Code illustrates, considerable concern has been focused on this division. This is the focus of the Uniform Principal and Income Act, Section 104 of which provides, "A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the [allocation] rules in Section 103(a), that the trustee is unable to comply with [the duty of impartiality as codified in] Section 103(b)." The official comment to Section 104 elaborates: "If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust."

The Uniform Principal and Income Act has been widely adopted by U.S. states. Consequently, trustees need not shy away from certain otherwise desirable investment portfolios

on the ground that they would provide too little return to income beneficiaries, since trustees are permitted to make compensating distributions from capital appreciation to income recipients. These compensating distributions must, however, reflect the nature of the investment plan rather than a strategy that systematically favors one beneficiary, since neither the Uniform Trust Code nor the Uniform Principal and Income Act permits trustees to defy the terms of the trust by favoring one beneficiary over another. As the official comment to Section 104 of the Uniform Principal and Income Act notes, “Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio’s total return is too small or too large because of the investment decisions made by the trustee under the prudent investment rule.”

There is more than one way for trusts that are invested in assets delivering much of their return in non-income form to provide sufficient annual income to income beneficiaries. As noted, one method is to permit trustees to make equitable adjustments between principal and income. Another is structure the trust as a unitrust that annually pays income beneficiaries a fixed percentage of the value of trust assets, regardless of the trust’s annual return. Of course settlors have the option of establishing the trust that way from its inception, but even if a settlor does not do so, many states have adopted legislation permitting trustees subsequently to convert trusts with annual income beneficiaries to trusts that pay erstwhile income beneficiaries annual amounts equal to fixed (typically between three and five percent) fractions of the value of trust assets. The motivation for this option is to afford trustees greater latitude in selecting investment portfolios without concern for the distribution of returns between principal and income.

Statutory developments such as those reflected in the Uniform Principal and Income Act address a conflict that can arise between the trustee’s duty of prudence and the trustee’s duty of impartiality. Prudence dictates that trust assets be invested efficiently, which, as captured by modern capital theory, implies that portfolios consist of combinations of assets that put the trust portfolio on the efficient frontier. Impartiality requires that trustees must treat beneficiaries equitably, which implies that income beneficiaries receive appropriate payouts from annual trust income. There is a first-order inequity that can arise if prudent trust investments entail too much, or too little, return to income beneficiaries relative to those who receive principal. Legal

developments of the last forty years have been directed at addressing this first-order inequity, while little if any consideration has been devoted to the potential for second-order inequity that can arise if trust assets are invested in a way that favors beneficiaries with specific preferences over safe and risky investments.

### **3. *Investment Risks with Multiple Beneficiaries***

Trust beneficiaries have a common interest in excellent investment performance of trust assets, since trust assets are a public good from their standpoint. As is the case in other contexts, those who benefit from this public good may have differing preferences over its deployment. National defense is a public good from the standpoint of the citizenry, but some citizens prefer that military assets be devoted to the Asia/Pacific region, others that they focus on Europe; some prefer that the military take aggressive stances, others that the military be more reactive; and there are many other differences. In the trust context beneficiaries may have legitimate differences of opinion about the most suitable trust investments, motivated at times by differences of opinion and often by differences in risk preference.

The example of the trust in which the widow has a life income interest and the children a remainder interest actually embodies several competing interests. The widow might be more risk-averse than the children, and the risk aversion of the children might also differ, with Son more risk averse than Daughter. In this case even a conversion of the widow's lifetime income interest to a unitrust in which the widow receives annual disbursements of four percent of trust assets does not address the conflicting risk profiles of the beneficiaries, first because the widow's payout stream remains a dampened function of trust returns, and second because the value of the ultimate distribution to Son and Daughter is a function of trust returns that Son and Daughter will value differently.

Unitrust payouts are functions of contemporaneous, or possibly one-year lagged, asset values, so a trust with assets that perform well over three years will make significantly higher payouts in years three and four than a trust with assets that do not perform well. Consequently, a widow who is extremely risk averse will much prefer that a unitrust from which she receives

payments is invested safely. In the example Son would also prefer safe investments, but Daughter does not, so the choice of safe investments implicitly favors the widow and Son at the expense of Daughter.

Can a trustee who does not convert the trust to a unitrust nonetheless make risky investments, dipping as need be into principal to ensure that the widow receive sufficient annual disbursements, regardless of investment performance? That would depend on the terms of the trust. The official comment to Section 803 of the Uniform Trust Code notes that “The duty to act impartially does not mean that the trustee must treat the beneficiaries equally. Rather, the trustee must treat the beneficiaries equitably in light of the purposes of the trust. A settlor who prefers that the trustee, when making decisions, generally favor the interests of one beneficiary over those of others should provide appropriate guidance in the terms of the trust.”

Trustees violate the duty of impartiality if they provide a type of free investment insurance to one class of beneficiaries. If the widow, as a life income beneficiary, receives a distribution of the trust’s annual income in years when the trust generates significant positive income, and also receives a substantial distribution in years when the trust generates negative or very modest income, then economic value of her interest exceeds a life interest in trust income. If the trust terms are that the widow should receive the life income from trust property, a trustee who distributes to the widow trust income in some states of the world and more than trust income in other states of the world is not acting impartially.

One can imagine an arrangement in which trust assets are invested in a risky portfolio, and there is a haircut on the widow’s distribution if trust assets perform particularly well, so that she receives say only 20 percent of annual returns that exceed 7 percent of assets, in return for which the widow receives a minimum distribution of a fixed dollar amount, or 2 percent of assets, each year. If the haircut and the minimum distribution are calculated properly, they might be of offsetting economic value, in which case the trustee has not violated the duty of impartiality. What happens in such a case is that the widow in essence receives the value of a fund invested in a variable annuity with various long and short positions in differing assets that deliver the planned stream of payments. This paper proposes that such an arrangement be made explicit, in order to protect beneficiaries and trustees, and encourage greater use of such

arrangements. In the absence of an explicit arrangement, a trustee could be liable for a charge of breach of duty if over time trust fund investments fare poorly and the trustee nonetheless makes regular and significant distributions to the widow.

While in the example the widow and Daughter have conflicting interests over the investment profile of trust assets, it is also the case that Daughter and Son have conflicting interests. Daughter prefers that trust assets be invested in high-return risky investments, whereas Son prefers safer investments. The children's interests inevitably conflict: as long as the trust portfolio remains on the efficient frontier, then any change in the composition of the portfolio favors one child at the expense of the other. The fact that assets may have many years to accumulate prior to the widow's death does not change the underlying reality that safer investments produce safer ultimate distributions to Son and Daughter, whereas riskier investments produce riskier distributions. Conversion to a unitrust in deference to the widow's risk aversion does not reduce the conflict of interest between Son and Daughter, and indeed increases it, since in reducing the riskiness of the widow's claim on the trust fund returns it increases the extent to which the children are exposed.

The example of the trust for the benefit of the widow and children is of course merely an example, chosen to illustrate some of the issues that arise with multiple trust beneficiaries. Many trusts have combinations of charitable and non-charitable beneficiaries, in circumstances in which it is easy to imagine that the beneficiaries have very different preferences toward risk; and the same is true of trusts with beneficiaries of different ages, generations, and life situations. Risk preferences, it might be noted, are evaluated on the basis of how beneficiaries would value streams of trust distributions. If it were possible for beneficiaries to hedge their trust positions at zero or low cost by taking various long and short asset positions, then beneficiary risk preferences would be the same as the market as a whole, and therefore equal to each other, eliminating any potential for conflict. Hence the potential for conflict relies on the notion that costless or low-cost complete hedging is unavailable or unrealistic for many or perhaps all beneficiaries, so the riskiness of the streams of trust distributions that they receive matters to them beyond just how it affects what would be the market values of these streams.

#### 4. *Portfolios of Blended Funds*

How does one invest trust assets in a manner that treats impartially beneficiaries with differing risk preferences? Modifying slightly the previous example, suppose that a trustee were charged with investing a \$2 million trust fund for 20 years, at the end of which the assets will be liquidated and distributed half to risk-averse Son and half to risk-neutral Daughter. Obviously all parties have an interest in the trust fund portfolio lying on the efficient frontier, but Son and Daughter differ in their preferred point on the frontier.

Some guidance is available from considering the differing current valuations of future trust fund distributions. If the trust fund were invested in a safe portfolio then Son's current valuation of his expected future stream would be \$1 million, in that assets so invested would be worth the same today as a \$1 million fund that Son controls, since Son if given complete discretion would choose the safe portfolio. Son's valuation of other, typically more risky, trust fund investment portfolios would differ, with his valuations generally declining in the riskiness of the portfolio, and always falling below \$1 million. Similarly, if the trust fund were invested in a sufficiently more risky portfolio Daughter would value her stake at \$1 million currently, attaching lesser valuations to less risky alternatives.

If, starting from a safe portfolio, Son's valuation of his stream consistently (and continuously) declines as the riskiness of the trust fund portfolio increases, and if, starting from a risky portfolio, Daughter's valuation of her stream consistently and continuously declines as the riskiness of the trust fund portfolio declines, then there exists a point somewhere between these two extremes at which they would each value their expected distributions by the same amount. It would seem entirely reasonable to ask an impartial trustee constrained to use a single trust fund for these two beneficiaries to choose the investment portfolio that produces these equal valuations.

There are some important difficulties with basing expectations of trustees on such outcomes. The first is that it may be extremely difficult to have access necessary to the preference information necessary to implement such a solution. This is a very real practical concern, though perhaps less of one from the standpoint of understanding the concept of impartiality in this context. A second concern is that there may be more than two beneficiaries

whose risk preferences all differ, in which case there is no guarantee – indeed, it is quite unlikely – that there exists a single asset allocation that generates equal valuations for all beneficiaries.

A third concern is that the resulting allocation is likely to be inefficient. In the case in which there are just two trust beneficiaries whose risk preferences are common knowledge, deviations from the asset allocation that generates equal valuations have the potential to benefit both parties. Suppose, for example, that Son's and Daughter's valuations are equal when 70 percent of trust assets are invested in safe assets, and 30 percent in risky assets. Daughter might offer to take a less than 50 percent distribution of the trust property at the end of 20 years in return for having trust assets invested in more risky securities during that time, and this alternative might also be desirable from Son's standpoint. Much as in a Lindahl equilibrium in the context of public goods, if beneficiaries were able to trade their shares in trust distributions in return for adjustments to the trust portfolio, such trades could continue until a constrained efficient point is reached.

It is important to clarify what efficiency means in this context. Since Son's and Daughter's preferences differ, it will never be the case that a common trust fund portfolio is fully efficient. One would obtain efficiency by permitting either Son or Daughter to buy out the other, after which each child would be free to invest his and her portfolio in a way that maximizes their valuations. If Son and Daughter are permitted to buy each other out with distribution shares there is the potential for efficiency gains, save in the unlikely scenario that at the point of common mutual valuation each would attach the same value (one positive, one negative) to a small change in the trust fund portfolio.

Efficient trust fund portfolios inevitably reflect strongly the preferences of risk-averse beneficiaries. The reason why is that risk aversion implies that an investor's valuation of a portfolio declines at an increasing rate as the portfolio accumulates risky assets. By contrast, portfolio valuations of largely risk neutral investors decline at roughly a constant rate as their portfolios accumulate safe assets. As a result, starting from a point of equal valuation it is always possible to increase the welfare of all beneficiaries by reducing the riskiness of investments while providing smaller shares to risk averse beneficiaries.

## **5. *Separating Trust Funds***

A common investment pool used to finance distributions to beneficiaries with differing risk preferences yields inequities and inefficiencies that cannot be remedied. Trustees might try to address the problems by making ad hoc adjustments, such as unsanctioned distributions to risk averse beneficiaries in states of the world in which trust investments perform poorly, but in so doing risk introducing even greater inequities, quite apart from exposing themselves to potential liability.

An alternative is to permit trustees to separate trust funds by beneficiary in cases in which there are significant differences in risk preferences. For example, a trust that provides income for life to a risk-averse widow, with the remainder upon her death to go to a risk-neutral State College, might be separated by the trustee into two funds. Assets in each fund might correspond to actuarial values at the time of the separation. This division would permit each component to be invested separately, with investments corresponding to the situations of respective beneficiaries.

Such a division of the trust fund represents a trust modification that would need consent of all beneficiaries, and would also need to satisfy the Claflin doctrine that it does not violate a material purpose of the trust. Presumably beneficiaries would consent to a modification that makes all of them better off. The Claflin doctrine issue turns on whether providing for both the widow and State College from the same fund constitutes a material purpose of the trust. Certainly the common, almost boilerplate, practice of structuring trusts in this way reflects in large part industry practice rather than deep choice on the part of settlors. It is difficult to see what that material purpose is possibly achieved by insisting that benefits be paid from a common fund. A settlor may have a material purpose in providing equally for Son and Daughter, but a subsequent and equitable modification of the trust that, initially at least, is equally valuable to both would not seem to defeat this purpose.

## **6. *Conclusion***

Trust assets are public goods from the standpoint of trust beneficiaries, with all the potential conflicts that can arise in settings with public goods. Trusts are not the only setting in which these conflicts might arise. Private market mutual funds also have multiple stakeholders with potentially differing interests, but the reality of easy entry and exit by interested parties means that there may be little conflict among owners at any one time. Trusts are distinguished from publicly traded corporations, mutual funds, and some other business ventures by the relative difficulty of entry and exit. The same may be true of workplace pension funds and other investments with fixed sharing rules and from which stakeholders cannot easily exit. The same can even be true of individuals who save and invest in order to leave significant bequests to children and feel compelled to provide all children equal shares at the time of death

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