BERNSTEIN WEALTH MANAGEMENT RESEARCH

Managing Trusts: Better Decisions in An Uncertain World

Changes in the capital markets and the legislative environment have intensified the challenge of managing the interests of different trust beneficiaries.

- Commonly used distribution policies have serious shortcomings; advanced distribution methods should be considered.
- Asset-allocation and distribution policy decisions should not be made independently—linking them results in better solutions.
- With multiple variables affecting trust outcomes, an analytical model is needed to assess a trust's "fairness" and the likelihood of meeting the grantor's goals.

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Significant Research Conclusions

Despite their popularity as a core planning vehicle, trusts can be laden with tension. What's good for one beneficiary may not be good for the other: The current beneficiary often wants to receive as much as possible during the life of the trust, while the remainder beneficiary wants to preserve and grow the principal. The ensuing strife can inadvertently become a grantor's most memorable legacy, posing considerable challenges for the trustee.

What was never easy has gotten harder. Lower bond yields and lower stock prices have left less income and less principal to go around, and matters are further complicated by trust legislation that now gives trustees more discretion in making investment and distribution policy decisions.

By bringing together our sophisticated understanding of the capital markets and in-depth knowledge of how trusts work, we've developed a framework that can help trustees fulfill their fiduciary responsibilities and find solutions that best meet a trust's objectives. We measure the implications of each decision—quantifying the total wealth each beneficiary can expect to receive and, importantly, their experiences along the way. Recognizing that each situation is unique, the analysis is customized to the specific structure and goals of each trust. By establishing realistic expectations upfront, trustees can better prepare beneficiaries for the real-world experiences to come.

While this framework is best used on a case-by-case basis, our research uncovered some key insights:

- Considering the asset allocation and distribution policy *together* can mitigate the inherent tension of trusts. Asset allocation will determine the risk and return of the portfolio, while the distribution policy will determine how the risk and return are shared.
- Commonly used distribution policies have significant limitations:
  - *Income-only* trusts can lead to volatile distributions and may fall short of spending needs (as is often the case today);
  - *Fixed* distributions can provide stable income and potential growth of trust assets, but may place a disproportionate amount of the risk on the remainder beneficiary's interest;
  - An increasingly popular alternative, a *unitrust* distribution, can result in a more proportional sharing of the risk and return but can lead to large swings in distributions over market cycles—even when a smoothing rule is used.
- A blending of the attractive elements of different distribution policies—for instance, placing a carefully chosen ceiling and/or floor on the distribution amount from a unitrust—can better satisfy the needs of all beneficiaries, as long as it's combined with an appropriate asset allocation.

Market Cycles Create Uneasiness

During the roaring bull market of the 1980s and 1990s, stock and bond returns both soared: The S&P 500 advanced at an 18% annual rate while 10-year Treasury bonds compounded at an 11% total return. Both figures were about double their respective long-term averages. Amid the euphoria of rising markets, trusts were able to distribute a large and increasing income stream to the current beneficiary while *growing* the principal. Asset-allocation imperfections were of little consequence as the rising tide lifted all boats.

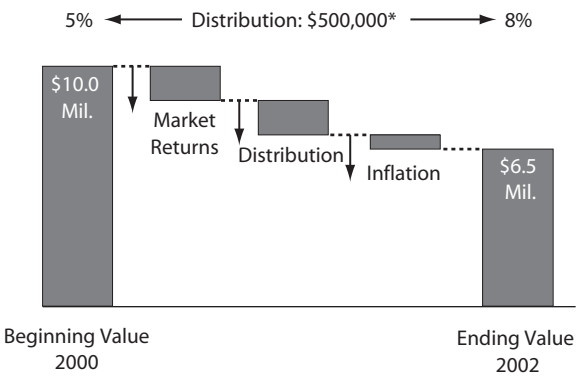
But by the end of 2002, a three-year stretch of negative stock returns had taken its toll on trust assets. Consider a $10 million trust at the start of 2000 that distributed $500,000 annually and was invested 60% in stocks and 40% in bonds (*Display 1*). The bear market alone would have eroded $1.5 million from the portfolio; further reduced by distributions and inflation, the trust assets would have declined by 35%, to $6.5 million. And a distribution that once represented 5% of the trust assets would have swelled to 8%—a level that is unsustainable over longer periods of time.

Just as striking is what has happened to yields. Ten-year Treasury rates collapsed from nearly 14% in 1982 to barely above 3½% two decades later, while the dividend yield on S&P 500 stocks dropped from 5.6% to 1.8% (*Display 2*). As a result, the pretax income generated by a $10 million portfolio invested 60% in stocks and 40% in bonds fell from $884,000 in 1982 to just $260,000 in 2002. Quite a different landscape.

Understandably, then, beneficiaries who receive only income from their trust funds have grown restless. In many cases, trustees have been pressured to make changes to the asset allocation or to make sizeable discretionary distributions of principal to the current beneficiary—without due regard to the effects on the long-term interest of the remainder beneficiary.

DISPLAY 1

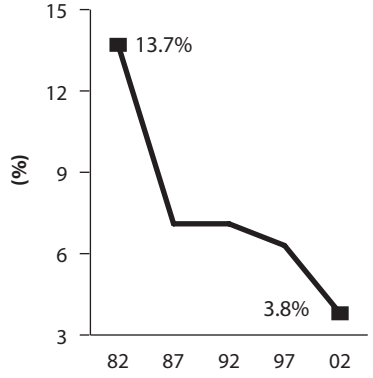
Trust Assets



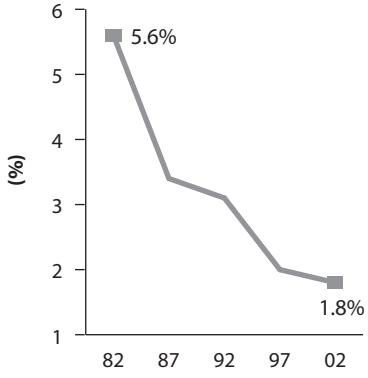
Asset allocation: 60% stock (S&P 500), 40% bonds (Lehman Brothers 5-Year Municipal Bond Index)
*Inflation-adjusted
Source: Bureau of Labor Statistics, Lehman Brothers, Standard & Poor's, and Bernstein

DISPLAY 2

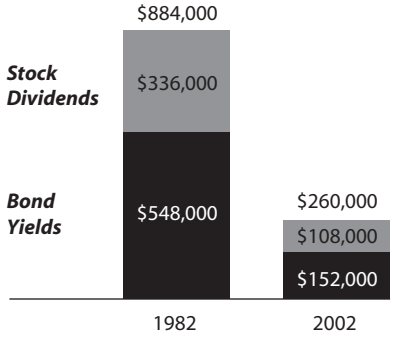
10-Year Treasury Yield



Dividend Yield



Income from $10 Million Portfolio
60% Stocks/40% Bonds



Source: Federal Reserve, Standard & Poor's, and Bernstein

Tough Environment, Tough Questions

The current environment has placed intense pressure on trustees. And perhaps even more troublesome is the uncertainty of what lies ahead: Capital-market returns are not likely to revert back to the double-digit figures that most investors had grown accustomed to in the Eighties and Nineties. It is in this context that trustees face challenging questions:

- *Is the asset allocation right for both parties?*
- *Is the current distribution sufficient and sustainable?*
- *What will be left for the remainder beneficiary?*
- *Is this "fair and reasonable"?*
- *Is the trust being managed to reflect the grantor's intentions?*

In answering these questions, trustees face the added complexity of a rapidly changing legislative environment for trusts. Over the course of the last 10 years, new legislation that gives trustees greater guidance and flexibility has been introduced in many states. In a nutshell, the three main initiatives—the Uniform Prudent Investor Act, the Uniform Principal and Income Act, and the Treasury Regulations under Section 643(b) of the Tax Code (currently in proposed form)—aim to update trust law to reflect the tenets of modern portfolio theory and total-return investing (*see A Closer Look: The Rapidly Changing Legislative Environment, page 12*). In aggregate, these changes are positive, but with greater discretion comes greater responsibility and uncertainty.

The very nature of trusts precludes any "one size fits all" answers. Each trust is designed to achieve the unique objectives of the grantor, who likely has some specific ideas in mind for how the assets should be distributed. In these litigious times, it is to the advantage of everyone involved to have a quantitative and objective perspective on how a trust will be managed. Establishing realistic expectations up front can help beneficiaries and trustees be more confident in the chosen strategies.

To help trustees find solutions that balance the needs of all beneficiaries, Bernstein has developed a proprietary trust analytical system. Our model is based on our analysis of historical capital-markets data over many decades; we have carefully examined the past returns, volatility, and valuation ratios of—and correlations among—more than 30 different asset classes. Significantly, we *learn* from history rather than rely on it, and we factor in the intricate relationships between economic events and individual asset classes.

Recognizing that the markets are inherently uncertain, we model thousands of different possible market returns, providing a wide range of possible outcomes, which allows trustees to analyze the impact of investment, distribution, and taxation policy decisions in various market environments. By combining our capital-market research with in-depth knowledge of how trusts work, we're able to develop a thorough understanding of the potential outcomes for all beneficiaries. This prospective view allows trustees to calibrate the trust policies so that the most important goals have the highest probability of occurring (*see A Closer Look: The Trust Analytical System, page 4*). While Bernstein does not offer legal advice, by working in partnership with clients and their professional advisors we can help find a solution that most closely matches the objectives of the trust.

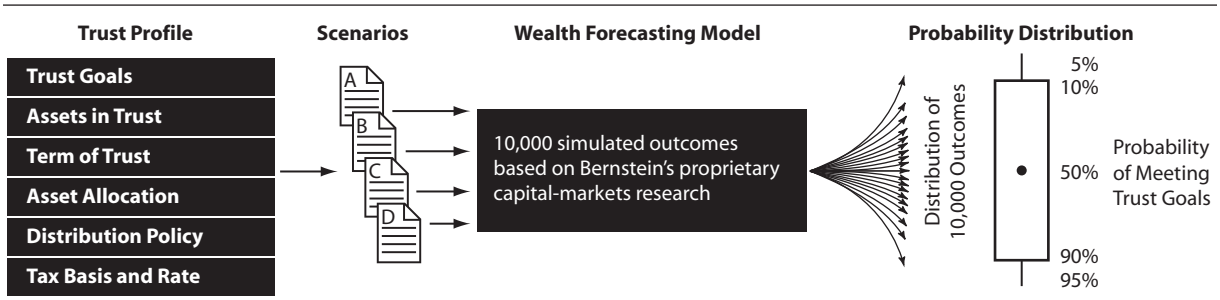
A Closer Look | The Trust Analytical System

At the core of our trust analytical system is our wealth forecasting analysis—one of the biggest R&D projects ever undertaken at the firm. It's based upon a proprietary analysis of historical capital-markets data over many decades; we model the basic drivers of asset returns (such as yields, earnings, dividends, and valuation ratios) and factor in the interrelationships among them. Then—based on realistic expectations—we can model returns, variability, and correlations between asset classes over time to address the planning questions our clients ask. The result is a vast range of possible outcomes—relating to market asset classes, not Bernstein portfolios—that serve as grist for a client's decision-making mill. Of course, there is no assurance that any specific outcome suggested by the model will actually come to pass.

But in applying our wealth forecasting analysis to trusts, we can quantify the possibilities of achieving financial goals for both the current and remainder beneficiaries under changing—and sometimes extreme—capital-market conditions. By considering different trust policies and assessing analyses such as the following, trustees can better achieve the unique goals of the trust:

- *Range of annual distributions*
- *Probability of meeting a budget each year*
- *Volatility of distributions (annual/peak-to-trough)*
- *Volatility of portfolio assets (annual/peak-to-trough)*
- *Range of accumulated distributions*
- *Range of remainder values*
- *Probability of trust depletion*

To measure real economic outcomes, our analysis takes into account the effect of taxes and inflation, and can be examined at any point over long time periods. This type of rigorous analytical framework can help trustees make better choices, working with their Bernstein Advisors.



Our trust analytical system consists of a four-step process:

1. **Client-Profile Input:** trust goals, the assets contributed, term of the trust, asset allocation, distribution policy, tax basis, tax rate, and other relevant factors;

2. **Client Scenarios:** in effect, questions the client would like our guidance on, such as what asset allocation to choose, which distribution policy to select, and what distribution amount achieves the grantor's objectives;

3. **The Wealth Forecasting Model:** our proprietary model, which—taking into account the randomness of the capital markets—uses historical data and our research to create a vast array of potential market returns; and finally

4. **A Probability Distribution of Outcomes,** encompassing, in our judgment, the range of results the client might expect to experience, from unusually good to unusually bad. ■

PUTTING OUR ANALYTICAL FRAMEWORK TO work in the context of three common client situations, we highlight here some of the significant insights derived from our research into the most pressing challenges facing trustees.

Is There an Asset Allocation That Is Right For Both Beneficiaries?

Finding an investment strategy that generates satisfactory returns without too much risk is hard enough when there's only one person to consider, but trusts have the added complexity of having multiple beneficiaries who often have disparate goals and tolerances for risk.

Consider a typical trust scenario. The current beneficiary is older and relies on the distributions from the trust as his primary source of income. For him, an asset allocation of 20% stocks/80% bonds may well be appropriate. On the other hand, the remainder beneficiary is a younger-generation wage earner with a long time horizon; an asset allocation of 80% stocks/20% bonds may be more in line with her desire to grow the trust assets. How then is the trustee to find the appropriate investment strategy for the trust?

Scenario: $10 Million Trust

	Current Beneficiary	Remainder Beneficiary
Age:	65	30
Objective:	Stable Income	Long-Term Growth
Desired Asset Allocation:	20% stocks/ 80% bonds	80% stocks/ 20% bonds

This dilemma is most apparent in the context of trusts that only distribute the income generated by the portfolio. The current beneficiary receives the bond interest and stock dividends earned by the trust's portfolio, an arrangement that reinforces his desire to skew the portfolio toward income-producing investments such as bonds. This emphasis on income is in stark contrast to the remainder beneficiary's interest in the long-term capital appreciation of stocks. In our relationships with trustees and clients, we have often found that trustees "split the difference," opting for an allocation in the range of 50% stocks/50% bonds. Such a compromise may not be in the best interest of either beneficiary, as the current beneficiary will likely receive less income and the remainder beneficiary less growth than either would like.

Fortunately, thanks in large part to new trust laws, there's a better way. Rather than solely adjusting the asset mix, the trustee can consider asset allocation and distribution policy *together* to find an optimal combination that best achieves the intentions of the grantor. No longer limited to distributing the income generated by the trust portfolio, many trustees are now permitted to make adjustments to the amount distributed to the current beneficiary irrespective of whether the distribution is composed of dividends, interest, or capital gains. This flexibility allows trustees to find the right balance between risk and return: Asset allocation will determine the risk and return of the trust portfolio, while the distribution policy will determine how the risk and return are shared by the beneficiaries. Using sophisticated analytical tools, the decisions can be fine-tuned so that both beneficiaries can be made better off.

For example, rather than paying out income only from a 50%/50% portfolio, a trustee could: 1) change the asset allocation to 80% stocks/20% bonds, which is more in line with the remainder beneficiary's tolerance for risk and; 2) change the distribution policy so that the trust pays out a fixed amount, $300,000 grown with inflation, thus providing the current beneficiary with the stable income he desires.[1]

Optimizing Trust Policies

	Asset Allocation	Distribution Policy
Current:	50% stocks/50% bonds	Income-Only
New:	80% stocks/20% bonds	Fixed at $300,000 (grown with inflation)

1 A trustee can implement the change to the distribution policy in the following ways: 1) If the UPAIA is enacted in the state in which the trust resides, the trustee can change the definition of "income" to be a fixed amount grown with inflation; 2) If the UPAIA has not been passed in the state in which the trust resides, the trustee can exercise a discretionary power to institute a distribution policy that is a fixed amount, provided the trust document authorizes the trustee to make those discretionary distributions.

In the current scenario, the income-only distribution is dependent on interest and dividend yields generated by the 50/50 asset mix. In the new scenario, however, the asset allocation has no bearing on the amount that is distributed—the trust will pay out $300,000 grown with inflation each year—which, of course, will then be subject to tax. The after-tax distribution in Year 1 for the fixed distribution will be $268,000—compared to $246,000 for the income-only distribution.

To assess the advantages and disadvantages of these two scenarios over time, we forecast a wide range of possible outcomes under changing market conditions. This approach allows us to determine the likelihood that a desired outcome will occur in the future.

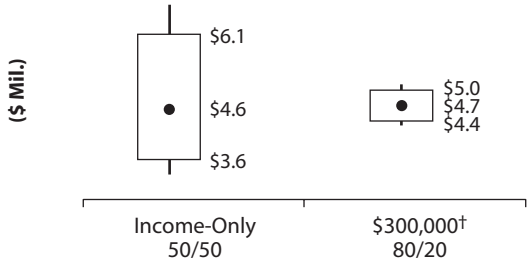
First, let's look at income stability. The income trust's link to interest and dividend income can create large year-to-year swings in the distribution, primarily due to the volatile nature of interest rates. In fact, according to our research, there's a 26% chance that the distribution will decline by 10% or more in any given year. On the other hand, in the new scenario the current beneficiary will receive a steady income stream over time—the only variation being the effect of taxes. Understandably, most current beneficiaries covet such income stability.

Next let's consider the wealth the current beneficiary could expect to accumulate over the life of the trust (in this case, 20 years). Our analysis is depicted in Display 3 as "box-and-whiskers" charts, wherein the box itself contains 80% of the potential outcomes generated by our model and each whisker encompasses another 5% of outcomes. It turns out that both scenarios result in nearly the same median inflation-adjusted value of just above $4½ million—meaning there's a 50% chance the current beneficiary will accumulate that amount or more. However, the current scenario has greater variability—including almost 20% more downside risk—compared to a tight range of potential outcomes for the fixed distribution. A beneficiary who is concerned about income stability is often willing to forgo the upside potential for the consistent income and reduced downside provided by a fixed distribution.

DISPLAY 3

Cumulative After-Tax Wealth to Current Beneficiary*

Year 20



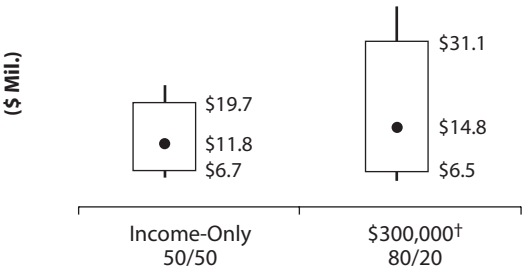
Unless otherwise noted, all equity allocations in this article are globally diversified (35% U.S. Growth, 35% U.S. Value, 25% Developed International, 5% Emerging Markets); bond allocations are 100% intermediate-term municipal bonds. Results are based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 40 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System at end of book.
*Inflation-adjusted
†Grown with inflation

As for the remainder beneficiary's desire to grow the principal, the higher stock allocation of the new scenario will result in much greater growth potential (*Display 4*). Indeed, at Year 20 the median inflation-adjusted value of the remaining assets in this scenario is $3 million higher than in the current scenario—and the upside potential is much greater. The new scenario has slightly more downside, but that's acceptable given the remainder beneficiary's tolerance for risk.

DISPLAY 4

Remainder Value*

Year 20



*,† Refer to Display 3 footnotes.

In this case, an 80/20 asset mix coupled with a fixed distribution was the best solution. However, different objectives call for different asset allocation/distribution policy combinations. For example, if the trust payout were higher—say, $500,000 per year instead of the $300,000 assumed here—the volatility inherent in an 80% weighting in stocks could prove excessive. A bear market in the early years, combined with a high fixed distribution, could put the principal value of the trust at serious risk—reinforcing the need to consider each trust's asset allocation and distribution policy together.

Is there an asset allocation that is right for both beneficiaries? By considering the asset allocation and distribution policy together, trustees can alleviate the "income-versus-growth" conflict and find a combination that is better for *both* beneficiaries. Asset allocation will determine the risk and return of the trust assets, while the distribution policy will determine how the risk and return are shared.

Will Each Beneficiary Receive a "Fair" Share from the Trust?

The Uniform Principal and Income Act (UPAIA) underscores the duty of all trustees to manage trusts in a way that is "fair and reasonable" to all beneficiaries, unless of course the terms of the trust specify otherwise.[2] In what can be an emotionally charged situation, trustees are often in the precarious position of interpreting the grantor's definition of fairness and then assuring that it is being achieved. This is particularly challenging during weak markets, when short-term needs and difficult conditions can overshadow long-term strategies. An objective perspective is imperative.

Let's examine a common scenario involving marital trusts: The current beneficiary is the grantor's second spouse, and the remainder beneficiaries are the grantor's children from his first marriage. The grantor's intent was for the spouse and the children to share equally in the assets. The trustee is considering distributing annually to the spouse the greater of the income generated by the trust or $400,000, grown with inflation.[3] In order to provide a sizeable remainder for the children, the trustee feels it is prudent to invest heavily in stocks.

Scenario: $10 Million Marital Trust

Current Beneficiary:	Second spouse (50 years old)
Remainder Beneficiaries:	Children from first marriage
Asset Allocation:	80% stocks/20% bonds
Distribution Policy:	Greater of all income or $400,000 grown with inflation

But the children have a gripe: They believe that an annual distribution of $400,000 or more will unfairly favor the spouse during the expected term of the trust. One way to evaluate this concern is to refer to Section 7520 of the Tax Code, which provides a methodology for determining how the trust assets will be shared by the beneficiaries. According to this method, the children may indeed have a case: The spouse is poised to receive 72% of the trust wealth!

This straightforward calculation, however, has serious limitations. First, rather than account for how the trust assets are invested between stocks and bonds, this approach assumes a return based solely on prevailing interest rates. In addition, the analysis ignores the variability in future market returns by assuming a constant average rate of return each year. And lastly, it fails to consider the effect of taxes and inflation.

Our analytical framework incorporates all of these factors to generate a realistic expectation of how the wealth of the trust will be shared by both beneficiaries.

2 UPAIA Section 103(b)

3 For the trust assets to qualify for a marital deduction under Section 2056 of the Internal Revenue Code of 1986, as amended, the trust has been established to annually distribute the greater of fiduciary accounting income or $400,000.

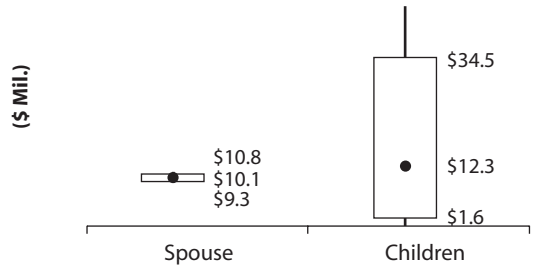
As shown in Display 5, because there's limited variability in the amount distributed to the spouse, the likely range of wealth she will receive is rather predictable—between $9.3 million at the 90th percentile (bottom of the box) and $10.8 million at the 10th percentile (top of the box). On the other hand, the potential range of the children's wealth is huge—between $1.6 million and $34.5 million. Translated into percentages, this means the children's share of the trust will likely be somewhere between 13% and 77%. The range is so wide because the combination of a sizable fixed distribution and a stock-heavy asset allocation places a disproportionate amount of risk on the remainder beneficiaries. In fact, there's a 7% chance that the trust will run out of money by year 30. And we'd note that this risk would be even more pronounced if the distribution amount was higher.

DISPLAY 5

Cumulative Inflation-Adjusted Wealth

80/20 Portfolio

Year 30

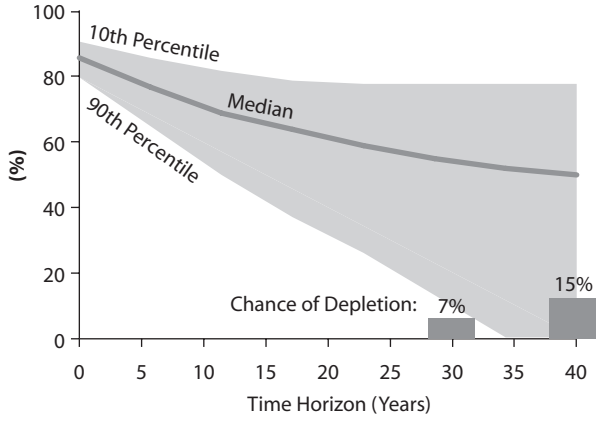


Refer to Display 3 footnote on page 6.

What's more, the children's share is contingent on the life expectancy of the spouse. Should she live longer than her 30-year life expectancy, the children's share will be at even greater risk. In this case, if the spouse were to live 40 years rather than 30, the range of potential wealth would be even wider and the chance of depletion would double (*Display 6*).[4] Armed with this information, the trustee may conclude that a fixed distribution is not suitable as it unfairly shifts all of the risk to the children.

DISPLAY 6

Children's Share of Trust Wealth



Refer to Display 3 footnote on page 6.

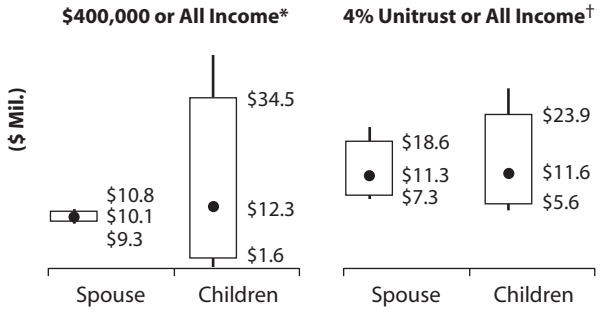
Our research suggests that in this case a unitrust could help rectify the apparent imbalance of risk and return. Because unitrusts distribute a percentage of the trust assets each year, both beneficiaries share in the upside—and downside—of the trust wealth. On the left side of Display 7, we've shown the same data as in Display 5, while the right side shows the range of total wealth to each beneficiary were the trust to distribute the greater of all income or 4% of the trust assets. In the median case, the spouse would receive $11.3 million while the children would receive $11.6 million (*see A Closer Look: Choosing a Distribution Level That Results in the Right Balance, page 10*).

DISPLAY 7

Cumulative Inflation-Adjusted Wealth

80/20 Portfolio

Year 30



Refer to Display 3 footnote on page 6.
*Greater of all income or $400,000 grown with inflation
†Greater of all income or 4% unitrust with 3-year smoothing

4 Based on the actuarial tables in Section 7520 of the Tax Code, there's a 10% probability that the spouse will live 40 years or more.

However, shifting to a unitrust means that the spouse will be subject to the annual ups and downs of the trust. Her tolerance for risk must now be considered, which would not have been the case were the distributions fixed. As described earlier, selecting the distribution policy is only one variable in the equation; the other variable is asset allocation, which will directly impact distribution fluctuations.

As you'd expect, higher equity allocations will result in greater volatility in the value of the trust assets and therefore the amount distributed to the current beneficiary. To help limit future declines in the amount distributed, a smoothing technique can be used. Generally, smoothing rules are set up so that the distribution each year is based on the average market value of the trust portfolio this year and, say, the previous two years. In fact, a number of states have included three-year smoothing in the unitrust conversion provisions of their principal and income acts.

Our analysis suggests that even with this smoothing policy, given the current 80/20 stock/bond allocation the spouse in this case could experience a 10% or greater income decline in one in every 10 years. Naturally, the frequency of such a drop decreases as bonds are added to the portfolio (*Display 8*): A 50/50 mix cuts the frequency of a decline in income of 10% or greater by half. For this reason, many trustees end up investing in fewer stocks than they might have initially considered when setting up a unitrust. Of course, this decision will also hinge on the amount of the beneficiary's outside assets.

DISPLAY 8

4% Unitrust* or All Income

Asset Allocation (Stock/Bond)	Frequency of 10% or More Drop in Income
80/20	1-in-10 years
60/40	1-in-16 years
50/50	1-in-20 years

Refer to Display 3 footnote on page 6.
*Three-year smoothing

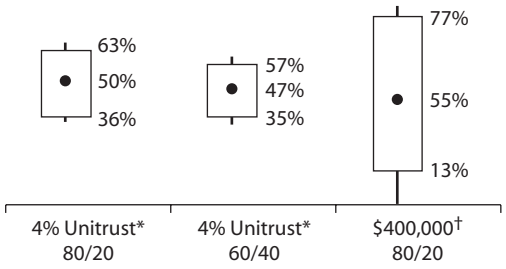
But keep in mind that increasing the bond weighting has a trade-off: Over time, total wealth will likely be lower. By changing the asset allocation to a more balanced 60/40 mix, the spouse in this case will receive about $1 million less (based on the median outcome); the children's assets will be somewhat more affected, just over $2 million lighter.

Importantly, with a unitrust, changing the asset allocation will not meaningfully change how the wealth is shared by the beneficiaries. Because unitrusts allow both parties to share in the performance of the trust assets, the trustee can have greater confidence in the degree that each beneficiary will benefit from the trust. In Display 9, the range of possible outcomes is narrower for the two unitrusts shown on the left than for the fixed distribution shown on the right.

DISPLAY 9

Range of Children's Share of Wealth

Year 30



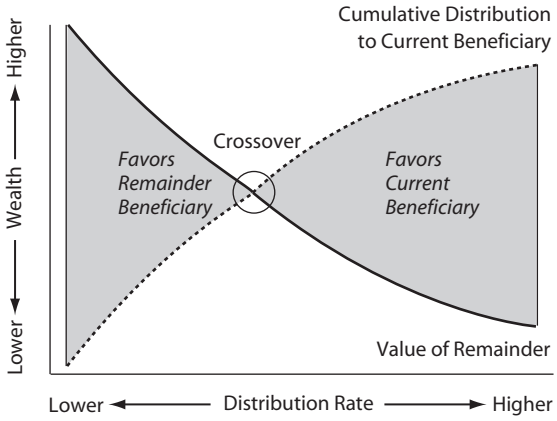
Refer to Display 3 footnote on page 6.
*Greater of all income or 4% unitrust with 3-year smoothing
†Greater of all income or $400,000 grown with inflation

Will each beneficiary receive a "fair" share from the trust? Fiduciaries can quantify how trust assets are likely to be shared over time. Trusts that distribute a fixed amount will lead to significant uncertainty for the remainder beneficiary; higher distributions and higher stock allocations escalate the risk. A unitrust allows for a more equitable distribution of the risk and return of the portfolio over time, regardless of the asset allocation, and may be appropriate when distribution fluctuations are tolerable.

A Closer Look | Choosing a Distribution Level That Results in the Right Balance

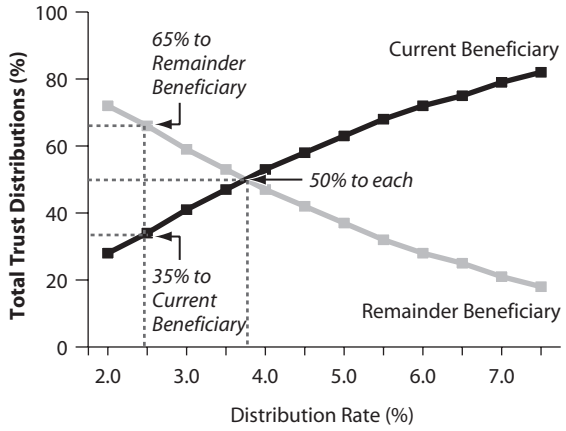
To analyze how a trust will be shared by the current and remainder beneficiaries, we've developed a methodology that measures the wealth that will accrue to each party. This approach is illustrated in the chart below, wherein the dotted line represents the current beneficiary and the solid line, the remainder beneficiary. Naturally, there is an inverse relationship between the two lines: as the wealth of one beneficiary increases, the wealth of the other declines. At the "crossover" point, the total accumulated wealth paid out to each beneficiary is equal. Distribution rates to the left of crossover favor the remainderman; distribution rates to the right of crossover favor the current beneficiary.

Finding the Right Balance: End of Trust Term



We calculate the values after taxes and inflation to get an apples-to-apples comparison of how the purchasing power of the trust assets will be distributed over the term. Using this framework, we can help trustees find the unitrust distribution level that achieves the grantor's intent. To bring this to life, consider a $10 million unitrust invested in 60% stocks/40% bonds (*Display, next column*). If the goal is to split the wealth equally over a 30 year period, a unitrust distribution level of 3.8% would be optimal in this particular trust situation. If instead the grantor wanted two-thirds of the trust's benefit to go to the remainder beneficiary, a 2.4% distribution level would be right.

Share of Wealth: Based on Median Value, Assuming 30-Year Trust Term



Refer to Display 3 footnote on page 6.

Time is a critical factor. If the term of the trust is expected to be less than 30 years, a higher distribution level would be required to achieve the same proportions, as more wealth must be transferred to the current beneficiary over a shorter time period. For example, to achieve an equal sharing of the trust wealth over a 20-year period, the distribution level would need to be 5.0% instead of 3.8%; a distribution of 3.1% (rather than 2.4%) would result in two-thirds going to the remainder beneficiary.

So far this analysis has been based on the median outcome from our probabilistic model, but if a greater level of confidence is desired, the same analysis can be done using the 90% confidence level. For instance, if the grantor wants to ensure that the current beneficiary receives at least 50% of the trust's assets, a distribution level of 4.8% would result in a 9-in-10 chance of that occurring.

Not limited to just unitrusts, this framework can be applied to all other types of distribution policies. We recommend that trustees consider how the beneficiaries will share the benefits of the trust before implementing any strategic decisions. ■

Trust Income Is Too Low; How Can I Make It Right?

With interest rates at 40-year lows, beneficiaries receiving income-only distributions have watched their cash flow wane in recent years. Starved of income, many beneficiaries have been clamoring for trustees to make changes that would bring the distribution back to its previous level.

But of course, strategies that generate additional income are generally accompanied by additional risk:

Increase Bond Allocation—Given the lower growth potential of bonds compared with that of stocks, a bond-heavy portfolio can threaten the purchasing power of the trust assets, especially in an environment of low interest rates.

Lengthen Maturities—Going out further on the yield curve by investing in longer-term bonds heightens interest-rate risk: The value of the bond investment would, of course, drop if interest rates rise.

Reduce Credit Quality—The potential for higher bond yields has to be weighed against higher default risk, which can be particularly unsettling in a long-term, fiduciary-type setting.

What then can a trustee do? Consider the following scenario:

Scenario: $10 Million Trust

Asset Allocation:	60% stocks/40% bonds
Current Distribution Policy:	Income Only
Current Distribution Amount:	$230,000
Expected Term:	30 Years

Trust Goals:

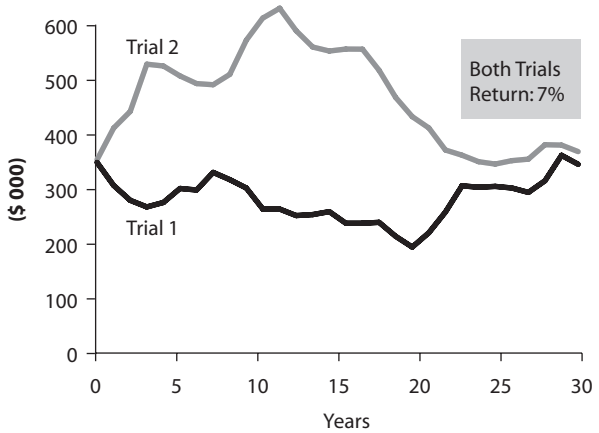
- Boost income to $350,000
- Limit sharp declines in income
- Preserve remainder

Unitrusts are increasingly being considered by trustees to solve the problem of low portfolio yields: They can provide a quick boost to income, without needing to adjust the asset allocation of the trust. To reduce the inherent volatility of a unitrust's distributions, a smoothing policy can be implemented. In this case, a 4% unitrust with three-year smoothing can provide $350,000 in after-tax income, and limit the odds of a 10% drop in income to an expected frequency of one in every 17 years.

But we caution that returns are not just experienced in one-year increments; bear markets, we all know, rarely conform to a calendar-based timetable. It is for this reason that we believe the more relevant question is how the current beneficiary will fare over extended market cycles and the length of the trust term. To illustrate this point, we looked at two divergent cases from the 10,000 trials that we ran: Both had a compound return of 7% and both experienced strong bull and bear markets, but they did so in the reverse order. Charted below is the after-tax distribution from a 4% unitrust with three-year smoothing for each case (*Display 10*).

DISPLAY 10

After-Tax Distribution
4% Unitrust with 3-Year Smoothing
60/40 Portfolio



Refer to Display 3 footnote on page 6. This analysis assumes a constant tax rate.

In Trial 1, weak returns in the early years resulted in a 45% real decline by year 20 from the initial distribution. Though this occurred gradually over an extended period, purchasing power erosion of this magnitude will likely be unsatisfactory. Strong returns in the remaining 10 years drove the distribution back up to its initial level.

Trial 2 was the exact opposite: Strong returns in the early years drove the distribution as high as $614,000, only to have poor returns sharply reduce the distribution in the later years. Of course, this scenario resulted in more total wealth for the current beneficiary, but the volatility along the way was quite extreme.

The analysis shown in Display 10 not only demonstrates that smoothing does little to mitigate the effect of market cycles on unitrust distributions, but it also reinforces a fundamental premise of probabilistic modeling: *The path of your return matters*. Both cases had the same compound return of 7%—enough to keep up with the 4% distribution and inflation, thus appearing sustainable. Yet it's clear that the path that the returns took in getting to that average dramatically affected the experience of the current beneficiary—not to mention the stress level of the trustee. While we can't show all the trials here, our research showed that nearly 60% of the 10,000 trials we ran experienced a 30% decline from the initial distribution at some point during the 30-year period.

A Closer Look | The Rapidly Changing Legislative Environment

Three notable pieces of legislation have been drafted in recent years to update trust law to reflect the tenets of modern portfolio theory and total-return investing. The legislation provides trustees with a helpful framework for managing trusts by addressing the critical variables that trustees must consider: the investment, distribution, and taxation policy.

Uniform Prudent Investor Act: Investment Policy

The standards for prudent investing are set forth in the Uniform Prudent Investor Act (UPIA). Rooted in the principles of modern portfolio theory, the UPIA recognizes that investment decisions involve the assessment of potential return and risk. The act advocates that trustees invest for maximum return within an acceptable level of risk, regardless of whether the return stems from interest, dividends, or capital growth. In what is commonly referred to as total-return investing, the primary consideration of trustees is to find an appropriate balance between risk and return for the trust and, in doing so, trustees are obligated to diversify the investments to mitigate risk.

Uniform Principal and Income Act: Distribution Policy

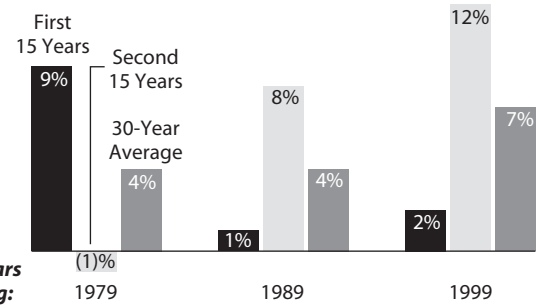
Building on this modernized approach to investing, the Revised Uniform Principal and Income Act (UPAIA) was drafted to integrate the governing rules of principal and income with the practice of investing for total return. The act encourages trustees to administer the trust impartially, based on what is fair and reasonable to all beneficiaries, unless the trust provides otherwise. To do so, the act allows trustees to make adjustments between income and principal (often referred to as the "power to adjust"). In simplest terms, a trustee can now allocate trust principal as well as dividend and interest income to the current beneficiary—or income to principal—in an effort to achieve fairness. While not all states have adopted the UPAIA, most trustees have the power to make discretionary distributions of income and principal for the health, support, maintenance, and reasonable comfort of the beneficiaries—which essentially boils down to the same decision-making process as making adjustments between principal and income. In other words, in both cases,

If the divergent paths we've described above seem to exaggerate real-life volatility, consider Display 11. For a portfolio invested 60% in the S&P 500 and 40% in Treasury bonds, we show 30-year inflation-adjusted returns broken down into 15-year periods. For the 30 years ending in 1979, for example, strong returns in the first 15 years were followed by negative returns for the next 15 years—resulting in an average of 4% for the entire period. Similar disparities occurred in the 30 years ending 1989 and 1999, providing further evidence that a long-term average speaks little of the experience along the way—moreover, these figures are before taxes and without distributing 4% each year.

DISPLAY 11

Annualized Returns

60% Stocks/40% Bonds



Bonds are represented by U.S. Long-Term Government Bonds prior to 1974 and U.S. Intermediate Government Bonds thereafter; stocks by the S&P 500.
Source: Compustat; Roger G. Ibbotson and Rex A. Sinquefield, "Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns," University of Chicago Press *Journal of Business* (January 1976) ; Lehman Brothers; Standard & Poor's; and Bernstein

the trustee has the duty to determine an appropriate distribution policy given the objectives of the trust.

As not all states have adopted the UPAIA, there's significant variation in how "fair and reasonable" is defined. Some states grant the power to adjust. Other states allow for the conversion of existing trusts to unitrusts, wherein a specific percentage of the trust assets will be considered "income" and distributed as such. Other states have both. The table below highlights the differences in the laws of just a few states:

States Disagree on Best Course

	Power to Adjust	Unitrust Conversion*
California	✓	No
New York	✓	4%
Florida	✓	3–5% or 1/2 of 7520 rate†
Delaware	No	3–5%
Illinois	No	4% default; 3–5% if all agree

* New York and Illinois allow three-year smoothing; Delaware allows smoothing over any length of time.
† Unitrust % for each year is 1/2 of January 7520 rate (minimum 3%; maximum 5%).

Treasury Regulations Section 643(b): Taxation Policy

The tax consequences of the investment and distribution policies can, of course, dramatically affect the relative interests of the trust beneficiaries—posing a further set of challenges for the trustee. The most basic question is who pays the taxes: the current beneficiary or the trust itself. The latter, of course, means that the tax burden is on the remainder beneficiary. In this regard, the most relevant consideration is how distributable net income (DNI) is defined. Under current Treasury regulations, capital gains are generally excluded from DNI and distributions to the current beneficiary do not carry capital-gains taxes. As such, capital gains are taxable to the trust. However, the Treasury Regulations under section 643(b) of the Internal Revenue Code (currently in proposed form) give the trustee flexibility in defining DNI (*see A Closer Look: Taxation Policy, page 15*). In other words, it allows trustees to require the current beneficiary to pay the capital-gains tax, so long as it is pursuant to a reasonable and consistent exercise of discretion (i.e., the decision may be irrevocable). ■

Given the volatility of unitrust distributions, if protecting the lifestyle of the current beneficiary is a critical goal of the trust, unitrusts will likely fall short, and trustees may very well find themselves having to revisit the distribution strategy not far down the road. Our research suggests that trustees may be better off taking advantage of the flexible nature of trusts by creating a distribution policy that places limits on fluctuations and directly addresses the needs of the beneficiaries.

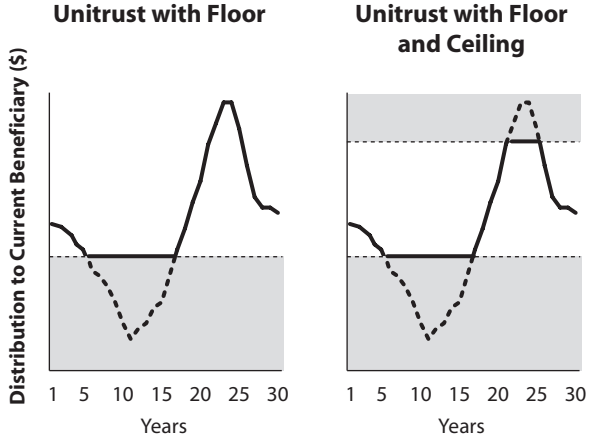
For instance, trustees can pay out a set percentage of the trust assets but set a floor below which the distribution cannot fall—let's say 80% of the initial distribution (*Display 12, left*). This floor can be set at a nominal pretax-dollar amount or at a level that would prevent an unsatisfactory decline in real income. Note that the income received by the current beneficiary would be that amount or greater *minus* the impact of taxes (of course, a floor can be set on an after-tax basis as well). Setting a floor allows the current beneficiary to enjoy the upside potential of a unitrust without putting her lifestyle at risk during difficult market environments. But of course, in the event that the value of the unitrust distribution falls below the floor, the difference is made up from the principal that would otherwise go to the remainder beneficiary. This practice allows a trustee to set a distribution level that will insulate the current beneficiary from the effect of market cycles.

An even more equitable solution may be to have a unitrust with both a floor and a ceiling, wherein the floor might be 80% of the initial distribution and the ceiling 120% (*Display 12, right*). The floor protects the income during bear markets and the ceiling prevents the fiduciary from distributing too much during a buoyant bull market, such as that of the late 1990's, limiting the impact on the principal once the market turns downward.

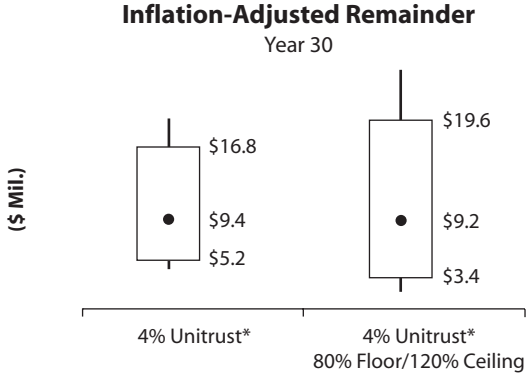
Our research suggests that a unitrust with a ceiling and a floor can be an excellent alternative to consider. But finding the unitrust percentage and the level of the floor and ceiling that best meets the unique needs of each trust requires careful planning. Setting the floor too high can result in the same problem as a fixed distribution: trust depletion. In this case, adding an 80% floor and 120% ceiling (adjusted for inflation) to the 4% unitrust can sharply reduce the chances of a 30% decline from the initial after-tax distribution. While the probability of such a drop at some point during the 30-year term was 59% initially, adding the floor and ceiling reduces the probability to just 12%. Note that such a decline remains possible because of the taxation of the distributions, not trust depletion.

As usual, there is a trade-off to consider. The floor will increase the downside risk of the remainder: In bear markets, the remainder beneficiary is in effect subsidizing the income beneficiary (*Display 13*). As an offset, a ceiling provides greater upside potential. This alternative is likely more attractive than a fixed

DISPLAY 12



DISPLAY 13



Refer to Display 3 footnote on page 6.
*3-Year Smoothing

A Closer Look | Taxation Policy

The UPIA and the UPAIA mandate that trustees consider the effect of taxes when making investment and distribution policy decisions. It is therefore imperative to analyze each trust on an after-tax basis and to consider each beneficiary's specific tax situation.

The Treasury Regulations under Section 643(b) give trustees flexibility in determining which beneficiary bears the burden of paying capital gain taxes. Generally, if the trustee institutes a policy by which capital gain is distributed to the current beneficiary, then the current beneficiary will bear the burden of paying some or all of the tax on that gain. Consequently, the tax burden can be a proportionate amount of the capital gain that year or, if state law allows, it can be pursuant to some "ordering" fashion—for example, ordinary and tax-exempt income first, short-term gain second, long-term gain third, and finally tax-free principal.

The trust's taxation policy is not the only factor that will directly affect how much after-tax wealth will accrue to each beneficiary; so will the decision whether to invest in municipal or taxable bonds. Our research suggests the following (based on a 30-year trust term):

- The current beneficiary benefits from investing in municipal bonds;
- The remainder beneficiary benefits when capital gain is included in distributable net income (DNI) to the current beneficiary;
- The remainder beneficiary benefits when an "ordering" of tax items is utilized, whereby income items are distributed first, short-term gain second, and then long-term gain.

The impact of these decisions should not be underestimated. Consider two alternative taxation scenarios for a $10 million trust invested 60% in stocks/40% in bonds, with a 4% unitrust distribution—one that does not include capital gain in DNI and is invested in municipal bonds, and one that does include capital gain in DNI and is invested in taxable bonds (*Display*). Over a 30-year period, the current beneficiary in the first scenario could expect—in the median case—to pay $1.3 million in taxes (adjusted for inflation), compared to $4.6 million in the second scenario. Moreover, the current beneficiary's share of the trust wealth (after taxes and inflation) would be reduced from 53% to 42%. ■

$10 Million Trust
Trust Term: 30 Years

	Scenario 1	**Scenario 2**
Taxation Policy	Capital gain is not included in DNI	Capital gain is included in DNI*
Bond Holdings	Municipals	Taxables
Tax Levied on Current Beneficiary†	$1.3 Million	$4.6 Million
Current Beneficiary Share of Trust Wealth†	53%	42%

**Tax items are ordered as follows: ordinary and tax-exempt income first, short-term gain second, long-term gain third, and finally tax-free principal.*
†Median case

(Note that the case studies within this article assume capital gain is not included in DNI and the bond portion of the trust portfolio is invested in municipal bonds.)

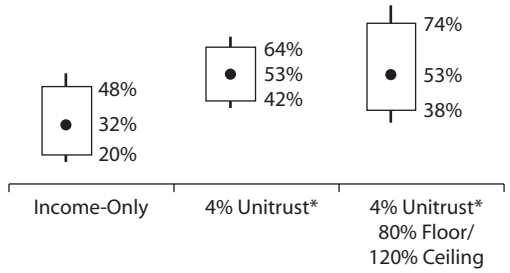
distribution of $400,000, which places all the risk on the remainder beneficiary.

Before implementing a strategic shift from an income-only trust, a trustee might well consider how this move will change the way the trust is shared by the beneficiaries. In the median case, the income-only trust we've described here will largely favor the remainder beneficiary: Only one-third of the total trust wealth will go to the current beneficiary over the 30-year term (*Display 14*). On the other hand, a 4% unitrust will result in a relatively tight range around the median of 53% of the trust going to the current beneficiary. The median for the 4% unitrust with an 80% floor and 120% ceiling is the same, but the range is slightly wider.[5]

DISPLAY 14

Range of Current Beneficiary's Share of Wealth

Year 30



Refer to Display 3 footnote on page 6.
*3-Year Smoothing

Trust income is too low; how can I make it right? Unitrusts can initially boost income but can result in highly uncertain distributions over the course of market cycles—even with smoothing. Trustees can take advantage of the flexible nature of trusts by designing distribution policies that meet the current beneficiary's need for reliable income without jeopardizing the trust principal. A unitrust with a pre-determined floor and ceiling can be tailored to fit the unique needs of most trusts.

CHANGES IN THE INVESTMENT ENVIRONMENT, combined with new trust laws, have made it all the more important for trustees to have a rigorous quantitative framework as the backbone of their decision-making process. At Bernstein, we've dedicated extensive resources to building an analytical model that we believe provides an important service to professional advisors and our shared clients. We've incorporated our best thinking on the capital markets, as well as an in-depth understanding of how trusts work. The result is a research-oriented approach to answering the key questions about trust distribution policies, asset allocation, returns, and volatility—as well as the long-term wealth of the beneficiaries and the sharing of benefits and risk between them. Quantifying the likely range of outcomes not only helps in the planning process, but also should give trustees and beneficiaries the confidence to stand behind their decisions down the road. ■

5 If returns are very good, the ceiling caps the current beneficiary's share of the wealth, as the remainder beneficiary enjoys much of the upside. If returns are very bad, the floor provides the current beneficiary with a larger share of the total wealth.

Notes on Wealth Forecasting System

1. Purpose and Description of Wealth Forecasting Analysis

Bernstein's Wealth Forecasting Analysis is designed to assist investors in making their long-term investment decisions as to their allocation of investments among categories of financial assets. Our new planning tool consists of a four-step process: (1) Client-Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his cash-flow stream is likely to be, whether his portfolio can beat inflation long-term, and how different asset allocations might impact his long-term security; (3) The Capital-Markets Engine: a model that uses our proprietary research and historical data to create a vast range of market returns, which takes into account the linkages within and among the capital markets (not Bernstein portfolios), as well as their unpredictability; and finally (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated range of returns and asset values the client could expect to experience, represented within the range established by the 5th and 95th percentiles on "box and whiskers" graphs. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market, and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

2. Rebalancing

Another important planning assumption is how the asset allocation varies over time. We attempt to model how the portfolio would actually be managed. Cash flows and cash generated from portfolio turnover are used to maintain the selected asset allocation between cash, bonds, and stocks over the period of the analysis. Where this is not sufficient, an optimization program is run to trade off the mismatch between the actual allocation and targets against the cost of trading to rebalance. In general, the portfolio will be maintained reasonably close to the target

allocation. In addition, in later years, there may be contention between the total relationship's allocation and those of the separate portfolios. For example, suppose an investor (in the top marginal federal tax bracket) begins with an asset mix consisting entirely of municipal bonds in his personal portfolio and entirely of stocks in his retirement portfolio. If personal assets are spent, the mix between stocks and bonds will be pulled away from targets. We put primary weight on maintaining the overall allocation near target, which may result in an allocation to taxable bonds in the retirement portfolio as the personal assets decrease in value relative to the retirement portfolio's value.

3. Expenses and Spending Plans (Withdrawals)

All results are generally shown after applicable taxes and after anticipated withdrawals and/or additions, unless otherwise noted. Liquidations may result in realized gains or losses that will have capital gains tax implications.

4. Modeled Asset Classes

The following assets or indexes were used in this analysis to represent the various model classes:

Asset Class	Modeled as...	Annual Turnover Rate
Intermediate-Term Municipals	AA-Rated in-State Municipal Bonds of 7-Year Maturity	30%
Intermediate-Term Taxable	Taxable Bonds with Maturity of 7 Years	30%
U. S. Value	S&P/BARRA Value Index	15%
U. S. Growth	S&P/BARRA Growth Index	15%
Developed International	MSCI EAFE	15%
Emerging Markets	MSCI Emerging Markets Free Index	20%

5. Volatility

Volatility is a measure of dispersion of expected returns around the average. The greater the volatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volatility for each asset class used in this analysis is listed on the Assumptions page. In general, two-thirds of the returns will be within one standard deviation. For example, assuming that stocks are

expected to return 8.0% on a compounded basis and the volatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will be between (8.9)% and 28.8%. But with intermediate government bonds, if the expected compound return is assumed to be 5.0% and the volatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between (1.1)% and 11.5%. Bernstein's forecast of volatility is based on historical data and incorporates Bernstein's judgment that volatility of fixed-income assets is different for different time periods.

6. Technical Assumptions

Bernstein's Wealth Forecasting Analysis is based on a number of technical assumptions regarding the future behavior of financial markets. Bernstein's Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs which summarize the current condition of the capital markets as of October 1, 2002. Therefore, the first 12-month period of simulated returns represents the period from October 1, 2002, through October 1, 2003, and not necessarily the calendar year of 2002. A description of these technical assumptions is available on request.

7. Tax Implications

Both the income generated by the trust portfolio and the income included in distributions from the trust are modeled as taxable according to the rates displayed in the table in paragraph 8. The trust is taxed on ordinary income only to the extent it is retained by the trust (not paid out to the income beneficiary) in any given year. The ordinary income included in the annual Distribution from the trust is assumed to be taxable to the income beneficiary, and these taxes are assumed to be paid directly from the annual distribution. All capital gains and/or losses are assumed to result in tax liabilities and/or credits to the trust portfolio only. Before making any asset allocation decisions, an investor should review with the investor's tax advisor the tax liabilities generated by the different investment alternatives presented herein, including any capital gains that would be incurred as a result of liquidating all or part of the investor's portfolio, investments in municipal or taxable bonds, etc.

Notes on Wealth Forecasting System (*continued*)

8. Tax Rates*

Bernstein's Wealth Forecasting Analysis has used the following marginal tax rates for this analysis:

Start Year	2003	2009	2011
End Year	2008	2010	2042
Federal Income-Tax Rate	35.00%	35.00%	39.60%
Federal Capital-Gains-Tax Rate	15.00%	20.00%	20.00%
State Income-Tax Rate	6.85%	6.85%	6.85%
State Capital-Gains-Tax Rate	6.85%	6.85%	6.85%

** The federal income-tax rate represents Bernstein's estimate of either your maximum marginal tax bracket or an "average" rate calculated based upon the marginal rate schedule. The federal capital-gains-tax rate is represented by the lesser of your maximum marginal income-tax bracket or the current cap on capital gains for an individual or corporation, as applicable. Federal tax rates are blended with applicable state tax rates by including, among other things, federal deductions for state income and capital gains taxes. The state tax rate generally represents Bernstein's estimate of the maximum unified rate, if applicable.*

9. Assumptions—Capital Market Statistics

	Annualized Compound Return	Average Annual Return	Average Annual Income	1-Year Volatility	30-Year Annualized Equivalent Volatility
Int-Term In-State Municipals	3.4%	3.6%	3.2%	4.2%	5.5%
Intermediate-Term Taxables	4.9	5.2	4.7	5.8	6.0
U. S. Value	8.2	10.1	2.7	18.1	12.8
U. S. Growth	8.2	10.4	1.4	19.7	15.3
Developed Int'l	8.8	11.1	2.7	19.4	13.2
Emerging Markets	7.8	12.2	0.9	27.5	23.7
Inflation	2.5	2.5	n/a	1.4	6.8

BERNSTEIN WAS ESTABLISHED IN 1967 to manage investments for private families and individuals. Its mission grew to include sell-side research and institutional asset management, but advising private clients has remained a central focus throughout our successful history. Today, as a unit of Alliance Capital Management L.P., Bernstein Investment Research and Management oversees some $40 billion in private capital for a clientele including some of the nation's most prominent families and individuals.

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