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FIDUCIARY ALERT

CHRIS MCCONNELL & ASSOCIATES – JULY 2008

DENIAL OF "TWIN-FLATION™" OR INACTION IS NOT AN INVESTMENT STRATEGY

US Dollar-based trusts face an unprecedented Fiduciary Event

Prudent trustees must take steps NOW to synthesize (gauge, plan, implement and monitor) a trust's asset – liability match, preserving purchasing power is paramount.

For now, the "buck" stops in a Trustee's office as twin US inflation and deflation are upon us; above-trend inflation persists in the basic economic inputs; food and energy complex; yet we see deflation in critical areas like consumption, real estate and labor markets in the form of layoffs and structural overcapacity; notably in the banking, financial and real estate related industries. ***Admittedly, we have experienced these symptoms before, absent the following, making it unprecedented.***

- Since 2002 (the onset of the "free" money era) the US Dollar is down about 25%. Coupled with a veritable $53 Trillion Mt. Everest-like pile of debt (Government, Corporate and Consumer); the inevitable result of 40 years of unfettered leverage and re-mortgaging.

Trustees, as fiduciaries must consider the demise of the US Dollar as the world's reserve currency (or have a defensible opinion otherwise and act accordingly);

- ***Closely scrutinize the use of US Treasury Bills yields; a proxy for the risk-free rate, forecasts of Equity market risk premium & expected Bond yields which are based on constant reinvestment rates.***

Prudent Steps for Trustees - (Also ERISA plans, Trustees of Non-profits, Foundations & Endowments)

- **Assess and determine** the future needs of beneficiaries under several different "what if scenarios"- seek assistance from legal, tax and trained, independent fiduciary advisers.
- **Determine** whether the trust's Asset-Liability funding match appears reasonable; are future funding requirements, investment risk / return assumptions the same as in the past?
- Going forward, **apply,** as appropriate, evidence-based risk, return and correlation assumptions for any changes to expected performance of stocks, bonds, life insurance, real property and other appropriate asset classes. Cost monitoring is critical.
  - Hedge funds, often leveraged amalgams of long and short securities, bear extra attention as risk adjusted returns have shown a predictable reversion to the mean.
- **Implement** portfolios that better reflect both short term and long term liability funding requirements and monitor them on an ongoing basis; trustees are admonished to seek counsel and document decisions including "stay the course".

Perhaps a useful insight may be gleaned by asking ourselves – will Asset risk and return performance from the past 20 years more closely resemble or differ markedly over the next 20?
Of one thing I'm sure; some beneficiaries (and litigation counsel) are going to ask.

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