Accordingly, the rule stated in § 227 recogniZ1is broad authority to delegate in the prudently exercised discretion of the trustee.

§ 227. General Standard of Prudent Investment

The trustee is under a duty to the beneficiaries to Invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to Investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:

(1) conform to fundamental fiduciary duties of loyalty (§ 170) and Impartiality (§ 183);

(2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§ 171); and

(3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§ 188).

(d) The trustee's duties under this Section are subject to the rule of § 228, dealing primarily with contrary investment provisions of a trust or statute.

General Comment:

a. Scope of the rule. Except as otherwise provided by the terms of the trust (see §§ 4 and 228), the trustee is under a duty to preserve the trust property (see § 176) and to make it productive (see § 181). In doing so the trustee must exercise reasonable care, skill, and caution and must act with undivided loyalty to the beneficiaries and with impartiality among them. This Topic deals with the trustee's performance of these duties in making and reviewing investments.

circumstances and requirements of the trust and its beneficiaries, the contents and resources of the trust estate, and the nature and characteristics of available investment alternatives. To the extent necessary or appropriate to the making of informed investment judgments by the particular trustee, care also involves securing and considering the advice of others on a reasonable basis. It is ordinarily satisfactory that this information and advice be obtained from sources on which prudent investors in the community customarily rely. On the effects of a trustee's reliance on the advice of legal and investment counsel, see generally § 201, Comments *b* and *c*.

The exercise of care alone is not sufficient, however, because a trustee is liable for losses resulting from failure to use the skill of an individual of ordinary intelligence. This is so despite the careful use of all the skill of which the particular trustee is capable.

On the other hand, it follows from the requirement of care as well as from sound policy that, if the trustee possesses a degree of skill greater than that of an individual of ordinary intelligence, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill. So also, if a trustee, such as a corporate or professional fiduciary, procured appointment as trustee by expressly or impliedly representing that it possessed greater skill than that of an individual of ordinary intelligence, or if the trustee has or represents that it has special facilities for investment management, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill or of those special facilities. See § 174.

The duty to exercise both care and skill in investment management may require knowledge and experience greater than that of an individual of ordinary intelligence, depending on the investment strategy to be employed. This does not prevent an ordinarily intelligent person from serving as a trustee. In that role, however, such a person may have to take reasonable steps to obtain sufficient competent advice, guidance, and assistance in order to meet the standards of this Section and to formulate and implement a prudent investment strategy for the particular trust. (Also, see Comments *h* and *m*, below, on the use of mutual funds and other investment pools.) In addition, a person who serves as trustee should be capable of reasonably understanding the basic duties of prudent trusteeship. Simple, written guidelines prepared by legal counsel may be helpful for reference or presentation by an inexperienced trustee when conferring with an investment adviser.

The standards of trusteeship are neither excessively demanding nor monolithic. They should neither effectively preclude service by conscientious family members and friends nor permit casual, inattentive behavior by trustees who can, because of their expertise, meet a higher than ordinary standard of conduct and competence. Thus, the applicable requirements of care and skill allow responsible individuals of ordinary intelligence to serve as trustees and to adopt reasonable investment strategies of types that are appropri- ate to their skills. Yet the standards require fiduciaries possessing special facilities and skills to make those advantages available to the trust and its beneficiaries.

Beyond this, the prudent investor rule, with its adaptable requirements of care and skill and its flexible standard of caution (Comment *e,* below), does not prevent trustees from prudently pursuing an expectedly rewarding investment strategy merely because that strategy is highly demanding, provided it is appropriate both to the purposes and circumstances of the trust and to the skills possessed by or available to the trustee. In the implementation of a permissible investment strategy, the trustee has the power and may have a duty to delegate authority to others, as a prudent investor would in the circumstances. See particularly Comment *j,* below. In so delegating, the trustee must exercise appropriate care and skill in selecting and supervising agents and in determining the degree and terms of the delegation. See generally § 225 and also § 171,· Comment *k.*

Illustration:

9. A portion of A's residuary estate was left in trust to help provide for the widow and children of A's deceased son, S, until the youngest child of S reaches age 24. At that time, the trust estate is to be distributed by right of representation to S's then living descendants. The will names A's other son, T, as trustee. T is a successful young chemist with a pharmaceutical company and is well acquainted with and trusted by the beneficiaries, but he has no experience with investment matters. It appears that T is qualified te serve as trustee; the facts do not suggest that he lacks the skill to which he will be held in that capacity.

In the above Illustration, T may need instruction and guidance from responsible legal and financial advisers on the nature of his investment duties (as well as other fiduciary duties) and on the

Thus, these various distribution requirements facing the trustee effectively serve to define the consequences of the volatility risk with respect to a particular trust.

In understanding a trustee's duties with respect to the management of risk, it is useful to distinguish between diversifiable (or "uncompensated") risk and market (or non-diversifiable) risk that is, in effect, compensated through pricing in the marketplace. The distinction is useful in considering fiduciary responsibilities both in setting risk-level objectives and in diversification of the trust portfolio.

In the absence of contrary statute or trust provision, the requirement of caution ordinarily imposes a duty to use reasonable care and skill in an effort to minimize or at least reduce diversifiable risks. Often called non-market risk, or somewhat less precisely "specific" or "unique" risk, these are risks that can be reduced through proper diversification of a portfolio. Because market pricing cannot be expected to recognize and reward a particular investor's failure to diversify, a trustee's acceptance of this type of risk cannot, without more, be justified on grounds of enhancing expected return. What has come to be called "modern portfolio theory" offers an instructive conceptual framework for under- standing and attempting to cope with non-market risk. The trustee's normal duty to diversify in a reasonable manner, however, is not derived from or legally defined by the principles of any particular theory. See Reporter's General Note on Comments *e* through *k* for discussions of asset pricing, types of risk, and the advantages of diversification.

Another aspect of risk management deals with market risk, often called "systemic" or "systematic" risk, or more descriptively for present purposes, simply non-diversifiable or compensated risk. The trustee's duties and objectives with respect to this second category of risk are not as distinct as those with respect to diversifiable risk. They involve quite subjective judgments that are essentially unavoidable in the process of asset management, addressing the appropriate degree of risk to be undertaken in pursuit of a higher or lower level of expected return from the trust portfolio. In this respect the trustee must take account of the element of conservatism that is ordinarily implicit in the prudent investor rule's duty of caution. Opportunities for gain, however, normally bear a direct relationship to the degree of compensated risk. Thus, although an inferred, general duty to invest conservatively is a traditional and accepted feature of trust law, that duty is necessarily imprecise in its requirements and is applied with considerable flexibility. (Despite the flexibility of the trustee's in this respect, it is often possible to obtain usef ul and, in a sense, objective information about degrees of risk associated with a stock or bond or with a portfolio of securities. See Reporter's Notes.)

For purposes of understanding and applying the fiduciary duty of prudent investing, it is essential to recognize that compensated risk is not inherently bad. Therefore, no objective, general legal standard can be set for a degree of risk that is or is not prudent under the rule of this Section. Beneficiaries can be disserved by undue conservatism as well as by excessive risk-taking. Decisions concerning a prudent or suitable level of market risk for a particular trust can be reached only after thoughtful consideration of its purposes and all of the relevant trust and beneficiary circumstances. This process includes, for example, balancing the trust's return requirements with its tolerance for volatility. See Reporter's General Note on § 227, Comments *e* through *h.*

If a trust cannot tolerate adverse outcomes in the short run, the trustee should not adopt a high risk-reward strategy. The principal reason for flexible application of the duty of caution is that trusts differ considerably in their risk-bearing capacities. Risk tolerances also vary from time to time during the life of most trusts, especially private trusts, shifting with the likelihood and proximity of having to liquidate holdings in order to meet major (certain or uncertain) trust obligations.

Normally, in investing the funds of a trust, the trustee's strategy must make preservation of the trust estate (including its purchasing power) a significant consideration. In most trust situations (see Comment *i,* below, and also § 232), the amount and stability of income (again, normally including its purchasing power) must also be given serious consideration.

As a result of cost-consciousness and the duty of caution, the general emphasis in the typical trustee's asset management program is on long-term investment. Changes in a company's circumstances, adaptation to trust and capital market developments, fine-tuning, and the like may, of course, justify the selling and buying of properties as an aspect of a prudent plan of asset allocation and diversification (see Comment *g,* below). This is consistent with the trustee's ongoing duty to monitor investments and to make portfolio adjustments if and as appropriate, with attention to all relevant considerations, including tax consequences and other costs associated with such transactions.

duty of caution: reasonably sound diversification is fundamental to the management of risk, regardless of the level of conservatism or risk appropriate to the trust in question. Therefore trustees ordinarily have a duty to diversify investments. See Comment *g*, below. The purpose of diversification (apart from the role it may play in discharging the trustee's duty of impartiality) is not only to moderate risks that are inherent in investing but also to reduce risks that are not justified by some prospect of gain.

Illustration:

11. T is trustee of a trust that pays its income to L for life, with remainder thereafter to pass to R or R's issue. T has adopted a continuous, long-term strategy of investing the trust estate in short-term bank and federal obligations. Although in a sense cautious, this investment program would ordinarily be viewed as failing te take adequate account of the fiduciary duty of caution as it applies to safeguarding the real value of capital, and even of protecting L's longer range interests with respect to income. Thus, unless specially justified by T, the investment program is improper for a trust with the above beneficial provisions.

The amount and stability of income are important considerations in investing trust funds, but so is preservation of the trust estate. The latter objective ordinarily includes protecting the purchasing power of principal and usually that of its income stream in the future, here over L's lifetime.

Possible justifications for the pattern of investment in Illustration 11 are discussed in connection with Illustration 7, above, involving the often related duty of impartiality. In addition, secure, short-term debt investments like those in Illustration 11 may well be acceptable and prudent in the case of a trust of relatively short duration administered, for example, primarily for the benefit of one beneficiary until he or she attains a specified age. Or, even assuming fundamentally different successive beneficial interests, such a pattern of investment may be suitable to a trust in which either the investment program may properly favor the income beneficiary (for example, if this is a permissible alternative to invading principal) or the amount of income does not determine the rights of the various beneficiaries (such as when income may be accumulated or when distributions are based on support needs). Compare generally Comment *i* (on impartiality) and Comment *g* (on diversification), below. See also § 232.

Illustration:

12. W bequeaths her estate to T in trust for H (W's surviving spouse) for life, with any remaining principal at H's death to go to a defined class of W's relatives. T, personally a successful investor, invests the bulk of the trust funds in the common stock of three carefully analyzed and selected corporations of the "emerging growth variety" in which T had made his own fortune. This failure to exercise reasonable caution constitutes a breach of trust. Therefore, if the investments do badly, T will be personally liable for the losses that result from this breach. If the investments are successful, of course, H and the other beneficiaries of the trust will receive and retain the benefits.

The possible surcharge of T in the above Illustration is not simply based on the results obtained. The test of prudence is one of conduct, not one of performance. If liability results in this case it is because T, in violation of his duty of caution, has failed reasonably to diversify the trust's investments and also appears to have undertaken excessive risks in quest of high returns.

Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill. See Reporter's Notes; also see Comment *m,* below, on the use of mutual funds and other pooled investment arrangements for this purpose. On the other hand, the prudent investor rule is considerably more flexible in addressing questions concerning the degree of compensated risk, essentially questions of conservatism. This flexibility is appropriate because of the tradeoff between risk and expected return, and because a consideration of the purposes, obligations, and circum- stances of the trust is proper in evaluating the suitability of a trustee's investment strategy. Nevertheless, the facts of Illustration 12 suggest no justification for the described degree of commitment to a high-risk-and-reward strategy. · The reason, however, is not that the investment of trust funds in relatively un-established enterprises is impermissible if done in a prudent manner in appropriate trust situations. See Comment *p,* below, and, more generally, Reporter's Notes.

On the measure of loss from a violation of the duty to diversify, or from other breaches of trust, see §§ 205, 210, and 211; also compare § 213.

If one or two of the corporations in the foregoing illustration had performed very poorly and the other or others had done very well, the question would arise of whether the gains and the losses from multiple breaches of trust may be offset. This question is considered in § 218.

Comment on Prudent Investing:

f. Background principles for prudent investing. There are no universally accepted and enduring theories of financial markets or prescriptions for investment that can provide clear and specific guidance to trustees and courts. Varied approaches to the prudent investment of trust funds are therefore permitted by the law. This does not mean, however, that the legal standard of prudence is without substantive content or that there are no principles by which the fiduciary's conduct may be guided and judged. A trustee's approach to investing must be reasonably supported in concept and must be implemented with proper care, skill, and caution. Further· more, although competing theories of investment provide some conflicting signals, they also offer some consistent themes with respect te matters on which there is general agreement.

Generalizations based on the latter are central to understanding and applying the prudence standard of this Section. See particularly paragraphs (1) through (5) at the end of the Introduction, above, to this Topic 5 for a summary of the principles developed throughout this Section. Also see Reporter's General Note on § 227, Comments *e* through *h.*

Beyond the general principles discussed in Comments *d* (on care and skill) and *e* (caution), above, several generalizations are appropriate to note concerning prudent investing by trustees:

(1) Trustees, like other prudent investors, prefer (and, as fiduciaries, ordinarily have a duty to seek) the lowest level of risk and cost for a particular level of expected return - or, inversely, the highest return for a given level of risk and cost.

(2) Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio. (See Comment *g,* below.) The same is true of specific courses of action, such as the "defensive" use of options seeking to reduce the risk of an investment strategy and to do so at a lower "price" in terms of program goals than might be exacted by converting to a more conservative portfolio of assets.

(3) Diversification is fundamental to the management of risk and is therefore a pervasive consideration in prudent investment management. So far as practical, the duty to diversify ordinarily applies even within a portion of a trust portfolio that is limited to assets of a particular type or having special characteristics.

(4) Passive investors raise the expected return of efficient, diversified portfolios by increasing their degree of market risk. This increase in risk requires a fiduciary judgment that a trust, in light of the amounts and timing of its cash needs and obligations, is in a position to accept the resulting risk of greater volatility in asset values, and therefore in portfolio performance for any given year or period. (Thus, a particular danger to be considered is that of having to raise significant amounts of cash for distribution in a down market.) The volatility associated with a strategy involving increased risk will ordinarily have considerably more impact on the trust's principal account than on its income account.

(5) Departures from an ordinarily suitable, diversified portfolio may be justified by special circumstances or opportunities of a particular trust or by peculiar risks facing its beneficiary families. Departures might also be justified by: specialized investment cap- abilities of or available to the trustee; special interests or managerial abilities of beneficiaries; or special settler objectives, including particular asset holdings that are preferred or encouraged by the terms of the trust (see § 228, Comments *d* through *g*). The greater the departure, the heavier the trustee's burden to justify the strategy in question.

g. Risk and the requirement of diversification. The objective of prudent risk management imposes on the trustee a duty to diversify trust investments unless, under the circumstances, the objectives of both prudent risk management and impartiality can be satisfied without doing so, or unless special considerations make it prudent not to diversify in the particular trust situation. On the relationship of the diversification requirement to the trustee's duty of impartiality, see Comment *i,* below, and also Illustration 7 in Comment *c,* above. See also, especially when Treasury and other essentially "safe" debt securities are involved, Illustration 11 and the accompanying discussion in Comment *e,* above.

Asset allocation decisions are a fundamental aspect of an investment strategy and a starting point in formulating a plan of diversification. They deal with the categories of investments to be included in a trust portfolio and the portions of the trust estate to be allocated to each. These decisions are subject to adjustment from time to time as changes occur in economic conditions or expectations or in the needs or investment objectives of the trust. Basic asset classifications might begin with cash equivalents, bonds, asset-backed securities, real estate, and corporate stocks, with both debt and equity categories further divided by their general risk-reward or income/growth characteristics, by the domestic, foreign, tax-exempt, or other characteristics of the issuers, and the like.

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

Investment values are based on projections of future return, which take account of changes in market price as well as cash receipts. Value depends, however, not only on expectations concerning average return from an asset but also on volatility and the risk of departures ("variance") from that average. For example, common stocks can be expected to outperform bonds in the long run but yet to have poorer returns-even negative returns-during some periods. Because investors are risk averse, they require extra compensation for increased risk. The investor's reward for accepting a greater likelihood of volatile returns follows from the lower market price at which the investor is able to purchase the investment.

Events affecting the economy do not affect the value of all investments in the same way. Thus, effective diversification de- pends not only on the number of assets in a trust portfolio but also on the ways and degrees in which their responses to economic events tend to cancel or neutralize one another. Consequently, an otherwise dubious, volatile investment can make a major contribution to risk management if the shifts in its returns tend not to correlate with the movements of other investments in the portfolio. This is a major reason why diversification is valued and why the prudence of a trustee's investment is to be judged by its role in the trust portfolio rather than in isolation. See Comments *e* and /, above.

As a result of the tendency of the value fluctuations of different assets to offset one another, a portfolio's *risk* is less than the weighted average of the risk of its individual holdings. A portfolio's *expected return,* on the other hand, is simply a weighted average of the expected returns of the individual assets. Thus, the expected return is not affected by the portfolio's reduced level of what is often called "specific" or "unique" risk-insofar as those terms are used to refer to risks that can be reduced by diversification. Other types of risk, however, are generally compensated through market pricing, so that the expected return from an investment or portfolio is directly affected by the level of these risks that cannot be diversified away-the so-called "market" or "systematic" risks. Accordingly, a trustee's duty of prudent in- vesting normally calls for reasonable efforts to reduce diversifiable risks, while no such generalization can be made with respect to market risk. See discussion of risk management in Comment *e,* above, dealing with the duty of caution.

Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries. and having other differences in their qualities. Broader diversification, however, is usually to be preferred in trust investing. Broadened diversification may lead to additional transaction costs, at least initially, but the constraining effect of these costs can generally be dealt with quite effectively through pooled investing. See Comment *m,* below. Hence, thorough diversification is practical for nearly all trustees. The ultimate goal of diversification would be to achieve a portfolio with only the rewarded or "market" element of risk.

The rationale of the trust law's requirement of diversification is more than conservatism or a duty of caution, which admonishes trustees not to take excessive risks-that is, not to take risks higher than suitable to a trust's purposes, return requirements, and other circumstances. The general duty to diversify further ex- presses a warning to trustees, predicated on the duty to exercise care and skill, against taking bad risks - ones in which there is unwarranted danger of loss, or volatility that is not compensated by commensurate opportunities for gain. Thus, while risk-taking cannot realistically be forbidden, or subjected to an arbitrary ceiling, it is required to be done prudently. A central feature of such prudence ordinarily is the reduction of uncompensated risk through diversification.

This generalization does not apply to non-diversifiable, compensated risk. In constructing a portfolio, the degree of such risk in a trust's investment program is properly a matter of conscious