Sustainable investing in trusts

Before incorporating ESG into your trusts, consider the long-term impact.

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Key takeaways

- Some states now allow trustees to engage in investing strategies that align with the ESG objectives or other values or beliefs of the trust's interested parties, regardless of investment performance.
- Rather than adding restrictions on what a trustee can do, grantors may want to explore ways to guide trustees to invest sustainably without necessarily requiring it.
- Grantors shouldn't overlook other important aspects of trust planning, which are likely to have a greater impact on the trust's ability to protect assets across generations.

Establishing a trust can be an effective way to help provide financial security for future generations of your family. But while a trust can give you some control over what kind of assets your children and grandchildren might inherit, what kind of world they will inherit is largely outside of your control. In just the last few years, economic disruptions, social unrest, and a global health crisis have shown how our personal prosperity can be upended by large, systemic challenges that require large, systemic solutions.

Increasingly, investors are shifting their focus toward environmental, social, and governance (ESG) factors as they evaluate how their capital can impact the world that we live in. In many cases, their goal is to direct their capital toward the companies most likely to contribute to a more sustainable—and more stable—future. Only recently, however, has this trend begun to find its way into trust planning. Some states have updated their laws to address whether and when trustees may take ESG factors into account.

For sustainably minded trust grantors and beneficiaries who are looking to ensure their investments are aligned to their long-term values, this may sound like an excellent opportunity. But before you begin making arrangements to allow for sustainable investment strategies in your trusts, it's important to consider the impact it could have on beneficiaries in the long term.

A trustee's duties

"Traditionally, trustees have had to balance their duty to prudently invest trust assets with the beneficiaries' desire to maximize the value of the trust portfolio," says Nicholas Beis, a vice president on Fidelity's Advanced Planning Team.

More specifically, trustees have a legally enforceable duty to balance portfolio risk and the potential for return in light of the facts and circumstances of the trust, which includes the needs of the beneficiaries—in some cases, even beneficiaries who may not yet have been born. In most cases, this means a trustee should seek to diversify investments across different asset classes. Failing to fulfill this duty could expose a trustee to legal liability.

Ambiguity around how to assess the performance of sustainable investments has limited the adoption of ESG portfolios by trustees. While it could be argued that making investments with sustainable goals in mind is acting in the best interest of the beneficiaries overall, it's not exactly quantifiable. "Sustainability goals—how much impact an investment has had, or could potentially have, on the world—can be really tough to evaluate in this context," says Beis, "while the risk-adjusted rate of return is easier to measure and quantify." Sustainable investing using ESG factors is largely focused on evaluating behaviors, principles, and outcomes that are integral to a company's long-term performance.

Like any other strategy, investors need to determine whether it suits their risk and return objectives and how it fits into their broader portfolio. It's important to remember that investing based on ESG factors may lead you to forgo certain investment opportunities available to strategies that do not use such criteria. When incorporating ESG factors into your decision-making process, be sure to consider how it may affect your investment goals.

Furthermore, it's worth noting that grantors of revocable trusts are empowered, subject to some limited exceptions, to invest their trust assets as they choose: In most cases the grantor is also the trustee and the primary beneficiary during their lifetime. When the grantor passes on and a successor trustee assumes control of the irrevocable trust, the nature of the trustee's duties shift. The new trustee has legally enforceable duties that are owed to the individual beneficiaries. If, for example, the grantor invested sustainably while acting as trustee, will that investment strategy satisfy the new trustee's fiduciary duties to beneficiaries?

An ESG exception

In August 2021, New Hampshire amended its prudent investor rule to specifically allow trustees to engage in investing strategies that align with the social, environmental, or governance objectives or other values or beliefs of the trust's interested parties (which includes beneficiaries, trustees, and trust protectors), regardless of investment performance. To accomplish these goals, however, the trustee must engage with the interested parties, who must explicitly grant permission for sustainable investing by signing a nonjudicial settlement agreement (NJSA).

While the NJSA may alleviate the trustee's fear of violating their fiduciary duty of loyalty to the beneficiaries, it also technically involves future beneficiaries in an agreement they had no say in. Beis cautions against this. "You might be sitting here in the present, binding your daughter or granddaughter to something 30 years in the future," he says. Even if everyone agrees on the approach today, it's possible that conflict could arise as new beneficiaries enter the picture or attitudes about sustainable investing shift over time.

Finding alignment on long-term values

Values that are "passed down" rarely endure. Rather, enduring values are developed collaboratively, taking everyone's perspective into account. Grantors who are interested in conveying the importance of sustainable investing to the next generation should engage in a dialogue with their beneficiaries. This way, they can express precisely why their values are so meaningful to them so beneficiaries understand where they are coming from, and the beneficiaries can have an opportunity to voice concerns, ask questions, or point out potential issues the grantor may not have previously considered. In fact, unless a trust says otherwise, the New Hampshire law essentially requires grantors and trustees to discuss the ESG investment goals with beneficiaries, and gain their agreement, if they want to be insulated from claims that the investments underperformed. In the end, grantors and beneficiaries will be aligned on a set of shared values that can guide how decisions are made going forward.

While formalizing an ESG-focused investment strategy for a trust may seem appealing at first glance, it's important to not be too restrictive. One option, according to Beis, is to explore ways to guide trustees to invest sustainably without necessarily requiring it. "Generally, it's best to avoid investment restrictions, because we have no idea what the future holds," he says. "Especially for a generation-skipping transfer or dynasty trust, which could be intended to last for multiple generations."

Fortunately, there are other options. For example, grantors can work with their attorney to draft a side letter (also known as a letter of intent), which can clearly capture these shared values and priorities while still giving the trustee the flexibility to make decisions about the assets in the trust based on their assessment of the present circumstances. "I think a side letter is probably your best bet in most cases," says Beis. "It's a good, flexible option when you want to add some color to the role of the trustee and express what you'd like to see them doing." Another option would be to develop a more formal investment policy statement that outlines how the trustee will select appropriate investments, among other things.

However, regulatory scrutiny around what constitutes ESG investing could present a challenge. A recent SEC proposal around ESG research integration and marketing disclosures could narrow the definition of what qualifies as ESG investing, which may make even side letters difficult to implement for trustees. Should the definition be narrowed, it may be difficult for trustees to achieve portfolio diversification as some asset classes may not have enough options that qualify as ESG funds according to the SEC.

Regardless of how the grantor's wishes are memorialized, grantors should engage with the trust stakeholders, including successor trustees, trust protectors, and beneficiaries to help ensure everyone understands the grantor's wishes and is prepared to carry them out. This is especially true for trustees: Given the relatively new focus on ESG investing, grantors should ensure their selected trustees are qualified and comfortable fulfilling the trust's purposes.

Don't forget what a trust is for

Certainly, the option to build sustainable investing strategies into a trust is a welcome trend, and as sustainable investing grows in popularity, it's likely that more and more states will follow the lead of New Hampshire and the other states that provide this opportunity. But Beis cautions that grantors shouldn't overlook other important aspects of trust planning, such as income-tax treatment, privacy, and the ability to last in perpetuity, that are likely to have a greater impact on the primary purpose of the trust—protecting assets across generations. "Being too restrictive is going to limit the ability of the trustee to do what they need to do down the road," says Beis.

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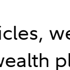

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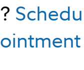

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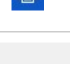

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