The Development of Collective Investment Funds for Bank Trust Departments

Floyd L. Parks
THE DEVELOPMENT OF COLLECTIVE INVESTMENT FUNDS FOR BANK TRUST DEPARTMENTS

by

Floyd L. Parks

A thesis presented to the Faculty of the School of Graduate Studies in partial fulfillment of the Degree of Master of Business Administration

Western Michigan University Kalamazoo, Michigan May 1964
The writer is Assistant Vice President and Assistant Trust Officer of the American National Bank and Trust Company of Kalamazoo, Kalamazoo, Michigan, and serves as Investment Officer for the Trust Department. Recently the Bank established a Balanced Common Trust Fund which has been in operation for several months. The experience with the Fund thus far has proved very satisfactory and many benefits have already been realized.

While it was recognized that collective investments for trusts offered many advantages, it seemed desirable to explore more thoroughly this method of investment for a deeper understanding of the intricacies involved. The proper approach seemed to be first to review the early history in order to determine the reasons for development and the problems involved. The development was then traced through its various stages, including a thorough analysis of governmental regulations controlling this form of investment. Finally, in order to benefit from bankers who had actual experience in operating funds,
the writer corresponded and talked in person and by telephone to bankers in New York, Chicago, Detroit and several of the smaller communities surrounding Kalamazoo. The cooperation and helpfulness of the bankers contacted is genuinely appreciated. In order to respect the confidence of these individuals, their identity will not be revealed in the chapters that follow.

Certain opinions and conclusions are presented herein which do not necessarily reflect the policies of the American National Bank and Trust Company. It is hoped, however, that this study will in some way contribute to the successful management of the property under the Bank's care.

Floyd L. Parks

Kalamazoo, Michigan

May 1964
TABLE OF CONTENTS

CHAPTER  

I INTRODUCTION 1

II ORIGIN OF COLLECTIVE INVESTMENT 4

Historical Background 4

American Investment Companies 6

III DEVELOPMENT OF COMMON TRUST FUNDS 10

Early Development Problems 10

Regulation F 15

State Regulations 20

Regulation 9 21

IV TYPES OF COLLECTIVE INVESTMENT FUNDS TODAY 29

Definitions 29

Federal Reserve Board Survey 32

Trust Division, American Bankers Association Survey 34

Bank Fiduciary Fund 39

V ADVANTAGES OF COLLECTIVE INVESTMENT FUNDS 41

Diversification 42

Stability of Income 43

Investment Opportunities 44

Investment Supervision 45

Operational Procedures 46

New Business Opportunities 48

IV
<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>VI LIMITATIONS OF COLLECTIVE INVESTMENT FUNDS</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Size of Account</td>
<td>52</td>
</tr>
<tr>
<td>Duration of Account</td>
<td>53</td>
</tr>
<tr>
<td>Tax Considerations</td>
<td>55</td>
</tr>
<tr>
<td>Timing for Establishment of Fund</td>
<td>59</td>
</tr>
<tr>
<td>Unfavorable Publicity</td>
<td>60</td>
</tr>
<tr>
<td>Limited Flexibility</td>
<td>61</td>
</tr>
<tr>
<td>Specialized Funds</td>
<td>63</td>
</tr>
<tr>
<td>VII ADVERTISING</td>
<td>70</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory Restrictions</td>
<td>70</td>
</tr>
<tr>
<td>Interpretation of Regulations</td>
<td>74</td>
</tr>
<tr>
<td>Conclusions</td>
<td>78</td>
</tr>
<tr>
<td>VIII INVESTMENT MANAGEMENT</td>
<td>80</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Objectives and Policies</td>
<td>81</td>
</tr>
<tr>
<td>Dangers of Growth Funds</td>
<td>87</td>
</tr>
<tr>
<td>Fixed Income Funds</td>
<td>90</td>
</tr>
<tr>
<td>Performance of Funds</td>
<td>93</td>
</tr>
<tr>
<td>Conclusions</td>
<td>102</td>
</tr>
<tr>
<td>IX CONCLUSION</td>
<td>104</td>
</tr>
<tr>
<td>BIBLIOGRAPHY</td>
<td>108</td>
</tr>
</tbody>
</table>
CHAPTER I

INTRODUCTION

In recent years the policies of many of our financial institutions have changed to meet the public demands and the degree of competition. It hasn't been too many years ago when most bankers felt that an automobile loan should be repaid in 24 months rather than the 36 month period which is now common. Some lenders today are even offering a 42 month repayment period. It wasn't too long ago when most banks were paying $2\frac{1}{2}\%$ on their savings accounts while the standard rate now is $3\%$, with most banks offering an even higher rate of $4\%$ for funds left on deposit for a full year. The banks previously limited the maturities of the municipal bonds they purchased to ten years; however, within the past three years, partly in an attempt to offset rising costs and higher interest rates on savings, they have changed their policy so that they now buy bonds in the 15 and even 20 year range. Greater emphasis has also been placed on mortgages, with more liberal terms
available. A 20-year loan was the maximum but now some banks have terms up to 25 years, and other lending institutions up to 30 years.

It is sometimes difficult for the layman or a young person entering the field of finance to understand why, within a relatively short period of time, the views of the industry leaders should suddenly change to such a liberal attitude. The financial industry is heavily regulated and many of the changes have taken place because the regulations governing the actions permit such a change. However, many regulatory changes are brought about as a result of the initiative of the men within the industry. It is with this thought in mind that I have undertaken a study of the subject of collective investments for bank trust departments. As in other areas of the financial world, here too, significant changes have taken place which will have an effect on an increasing proportion of those the trust institutions hope to serve.

There is a wealth of information available on the subject of collective investments for bank trust departments, but it pertains to specialized areas of this method of investment. It is not intended here to
develop a manual on how collective investment funds are established and operated, but rather the purpose is to draw attention to the important phases of development, identify the tools available for trust investment, and project its place in the industry.
CHAPTER II

ORIGIN OF COLLECTIVE INVESTMENT

Historical Background

The trust companies did not enter the field of collective investments until the late twenties and then in only a very limited way. Although the idea of collective investment had existed for many years prior to that time, the concept of sharing risks goes back to the very beginning of commercial history. An early example is the sale of shares in vessels and merchant caravans by the Egyptians and Phoenicians to reduce the risk of foreign voyages. Further development took place in Continental Europe, Great Britain, and then finally America.

The earliest formally organized investment company was established by King William I of the Netherlands in 1822 and was known as the Societe Generale de Belgique. The original purpose was to enable individuals to invest in foreign government loans which at that time offered great security and a tempting return. As the Societe
grew, it increased its holdings to such an extent that it gradually became a holding company. A few other investment companies were subsequently organized on Continental Europe but they proved to be of limited importance, and most of them passed out of existence. Investment company development was retarded in Continental Europe because of unfavorable economic conditions, a relatively small degree of wealth, and existing laws which did not encourage their operation.

Conditions in Great Britain were much more favorable toward the collective investment idea because of the country's abundance of wealth from its colonial empire, and its position as a leader of the industrial revolution. Great Britain's industrial leadership brought new prosperity from manufacturing and trade resulting in a greater accumulation of wealth which was available for investment. British investment companies began developing in the 1860's and became increasingly popular in the 1870's and 1880's.

(1) C. Russell Doane & Edward J. Hills, Investment Trusts and Funds, (Great Barrington, Mass. 1960), P.24
(2) Ibid, P.25
American Investment Companies

American investment company development followed the great success of the British investment companies, with the first American companies being organized in the early 1900's. This movement was slow at first. According to the Securities and Exchange Commission, only 40 investment companies were formed prior to 1921. From 1921 to 1926 this number increased to 179, with the major growth taking place during the period 1922-29 when an additional 591 companies were organized. \(^{(3)}\)

The investment company movement gained momentum in the 1920's, undoubtedly encouraged by the speculative attitude of the period which led to the formation of many companies with extremely speculative objectives. When security prices fell sharply, many companies failed and it took many years to reestablish the basic merit of the investment company idea in the public mind. The first American open end investment companies upon which collective investment funds of trust companies were patterned, were formed in Boston during 1924 and preceded

\(^{(3)}\) Ibid, P.28
the major development of the closed end companies which took place between 1926 and 1929. The early growth of the open end companies was slow since they were not adaptable to the speculative atmosphere or the promotion methods of the late twenties. Securities and Exchange Commission records indicated that by the end of 1929 there were only 19 open end companies with combined assets of $140 million, compared with 550 closed end companies with more than $4 billion in assets. The open end funds from the beginning adopted more conservative practices than most of the closed end companies. In their early years diversification was stressed and simple capital structures were used. Borrowing for investment purposes was usually avoided. Shareholders were given frequent reports concerning operations and portfolio holdings. The redemption features served to keep management alert to the importance of shareholder relations. (4)

When the prices of securities began declining in 1929, the merits of the methods of open end companies became more apparent. The enormous losses to investors

---

in certain high-leveraged, closed end companies caused by top-heavy capital structures did not happen to holders of open end shares. Investors saw the market value of their open end shares shrink drastically, just as all security prices declined. Most of the declines were less severe, however, than the drop in average stock prices. No holder of open end shares saw his investment become worthless, and in every known case dividends were paid throughout the depression. (5) Among the well-known open end companies which came through the depression successfully were Income Investors, Massachusetts Investors Trust and State Street Investment Corporation. Some of the better closed end companies also weathered this period successfully, and include General American Investors, Lehman Corporation, Tri-Continental Corporation, and U.S. and Foreign Securities Corporation. (6) During the 1930's many new open end investment companies were formed and patterned after the pre-1929 companies which survived the worst bear market in history. In the late 1930's

(5) Ibid, P.104
(6) Ibid, P.16
the Securities and Exchange Commission conducted a broad investigation of the investment company business and found virtually no instances of dishonesty or management abuses among the open end companies. Many of the constructive provisions written into the Investment Company Act of 1940 were practices that most mutual funds had followed from the start. (7)

(7) Ibid, P.104
CHAPTER III

DEVELOPMENT OF COMMON TRUST FUNDS

Early Development Problems

The first fund for collective investment of trust funds was established by the former Farmers Loan and Trust Company in 1928. This fund and some of its early successors were not set up for the investment of what later was to be known as "bona fide" trusts, but they were rather an attempt by trust companies to furnish an investment medium to individuals through the form of investments in trusts. The early funds were originally granted relief from taxation as separate entities on the grounds that they were truly aggregations of separate trusts which would each be subject to taxation according to its own circumstances or those of the settlor. In 1930 the City Bank Farmers Trust Company of New York, the Guaranty Trust Company of New York, and the Equitable Trust Company of Wilmington, Delaware set up funds which were specifically designed for bona fide trusts. The growth of these funds was restricted though, since
only trusts whose terms specifically authorized this form of investment were allowed to participate. Another hindrance toward their growth developed in 1934 when the Commissioner of Internal Revenue ruled that these collective forms of investment were taxable as associations of persons engaged in the financial business of investing their money together. (8) This ruling was ultimately upheld in 1936 by the Supreme Court of the United States, in the case of Brooklyn Trust Co. v. Commissioner of Internal Revenue, (9) and by the New York Court of Appeals in the case of the City Bank Farmers Trust Company Investment Fund No. 1. (10) These decisions made it clear that the idea of investing trust funds collectively which was sound financially, economically and socially, was likely to founder on the issue of double taxation of the fund itself and the participating beneficiaries.


(9) Brooklyn Trust Co. v. Commissioner of Internal Revenue, 56 S.C. 680, 80 F 2nd, 865 (1936.)

(10) City Bank Farmers Trust Co. v. Graves, et. al. 272 N.Y. 1, 3 N.E. (2nd) 612 (1936.)
The Trust Division of the American Bankers Association had organized a committee on common trust funds on October 22, 1934. This committee worked with the Treasury Department and the Congress, and as a result of their efforts this unfavorable tax situation was remedied by the enactment of an amendment to Section 169 of the Revenue Act of 1936, which recognized collective investment as a proper form of fiduciary service deserving special tax treatment. This amendment provided that any common trust fund established in conformity with the regulations to be promulgated by the Board of Governors of the Federal Reserve System would not be taxable as an entity, but that the tax consequences would flow through to the participating trusts in proportion to their respective interest in the fund. After enactment of the Revenue Act of 1936, the staff of the Board of Governors in cooperation with the Trust Divisions Committee on Common Trust Funds went to work on the regulation which the law required. The result of their efforts was the adoption of Section 17 of Regulation F by the Board of Governors, which became
effective on December 31, 1937.

Public sentiment toward financial institutions was not favorable at the time Section 17 of Regulation F was under consideration. The country had just experienced the worst financial crisis in its history and the public was anxious for increased governmental regulation. An investigation of Stock Exchange practices had been conducted in 1932 and 1933 by the Senate Committee on Banking and Currency. Out of these Hearings came the Securities Act of 1933 for the purpose of preventing fraud in the issuance of new securities, and the Securities Exchange Act of 1934. This latter Act regulated Stock Exchanges in respect to the limitation of speculation, the prevention of unfair practices and the dissemination of information pertaining to securities traded on the Exchanges. The administration of the Act was vested in the Securities and Exchange Commission which controlled trading in securities and in the Federal Reserve Board which controlled extension of credit in security transactions.

(11) Barclay, op. cit. P.20

Other legislation of the period caused the separation of the banking business from the securities business in accordance with the Banking Act of 1933. During the 1930-1933 depression the dangers of the commercial investment banking association became apparent. The loss of reputation of investment bankers in general not only hurt the investment affiliate companies but also heavy financial losses threatened the existence of the parent commercial banks.

The failure of the large Bank of the United States in 1931 was traced directly to its investment affiliate situation.\(^{(13)}\) No one in a position of authority wanted to do anything which might risk reuniting the investment and commercial banking activities. Consequently, the common trust fund regulations enacted at that time contained many restrictions and limitations which existed until just recently, when the authority for supervising trust departments of national banks was transferred from the Federal Reserve Board to the Comptroller of the Currency. The new regulations contain a number of important changes with respect to

\(\text{\footnotesize (13) Charles L. Prather, }{\text{\em Money and Banking,}}\) (Homewood, Ill., 1953), P.453
collective investment. Although many of the original restrictions and limitations of Section 17 have been eliminated, the new regulations are still based on the original document and will be discussed in greater detail later.

Section 17 of Regulation F permitted collective investment whenever the laws of the state in which the national bank is located authorized or permitted such investments by state banks, trust companies or other corporations which compete with national banks. While Section 17 applied only to national banks, all trust companies were obliged to comply with its provisions to obtain tax benefits.

Regulation F

Regulation F was the authority for regulating trust powers of national banks and contained 18 sections. Section 17 of Regulation F was divided into four main headings. Paragraph (a) covered the general information; Paragraph (b) provided for common trust funds for investments of small amounts defined as not exceeding $1,200; Paragraph (c) common trust funds for general investment; and Paragraph (d) common trust funds composed principally
of mortgages. Of greatest importance are Paragraphs (a) and (c).

Under Paragraph (a) of Section 17, a common trust fund was defined as "a fund maintained by a national bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as trustee, executor, administrator or guardian." In order to participate in the common trust fund a trust was required to have a bona fide fiduciary purpose and could not be used as a means for investing personal funds under the pretense of such a trust. Paragraph (a) further provided that participations would not be negotiable. Banks administering such funds were prohibited from advertising the earnings or the value of the assets of their funds, and were not permitted to have any financial interest in the fund except in its capacity as fiduciary.

Paragraph (c) common trust funds for general investment is divided into nine separate sub-sections. It is stated that common trust funds will be subject to all other provisions of the regulation with the exception

(14) Trust Powers of National Banks, Regulation F, Section 17, (Washington, D.C. 1951), P. 12-23
of (b), common trust funds for small amounts, and (d), mortgage funds.

The main provisions specified that in order to establish such a fund, the bank's board of directors would have to adopt a written plan setting forth all of the provisions relating to the operation of the fund. The trust investment committee as defined under Regulation F was required to approve all participations in the Fund. In addition, the value of the assets was to be determined at least once every three months and the Fund had to be audited annually by auditors responsible only to the board of directors.

The fifth sub-paragraph contained miscellaneous limitations. It was originally intended that a common trust fund was to be used only as a means of investing accounts which were not of sufficient size to be invested independently. Because of this, a limitation of $25,000 was set as the maximum amount that could be invested; however, this was subsequently increased to $50,000 and then to $100,000, until its complete elimination under the new Regulation 9.

Aside from the dollar limitation, Regulation F
specified several percentage limitations. No trust could participate in the fund beyond 10% of the total assets of the fund. A limitation of 10% was also set as the maximum that could be invested in any one asset, and further, no investment could be made in one class of security which would cause the total number of shares held by the fund to exceed 5% of the outstanding shares. If a bank administered more than one fund, the 5% limitation applied to the total of both funds.

Since lack of marketability proved to be a significant factor in the difficulties experienced in other methods of collective investment, Regulation F provided that at least 40% of the value of the fund's assets would consist of cash and readily marketable securities, which were defined as "a security which is a direct obligation of the United States, or which is the subject of frequent dealings in ready markets with such frequent quotations of price as to make (a) the price easily and definitely ascertainable and (b) the security itself easy to realize upon by sale at any time." (15)

The sixth and seventh sub-paragraphs specified that

(15) Ibid, P.16
before a distribution was made from the fund, the committee had to determine whether any investments remaining in the fund would be unlawful for any of the participating trusts if they were being invested at that time. In the event that there were unlawful investments, they would have to be segregated and administered in a separate fund before any entries or withdrawals could be made. As a practical matter, the easiest procedure to follow in order to avoid the segregation of assets would be to sell the asset in question before a valuation date arrived.

The eighth sub-paragraph set forth the fees to which the bank administering a common trust fund would be entitled. The charge of a management fee was prohibited although the bank was entitled to charge for reasonable expenses that would ordinarily be chargeable to the participating trusts on a separate basis.

The final sub-paragraph relieved the trustee from any violation of the regulation as a consequence of mistakes made in good faith, providing corrective action was taken as soon as practicable.
State Regulations

Even after the passage of Section 17 of Regulation F, there were obstacles to overcome and the growth was slow. As late as 1941 only eleven states had enacted legislation specifically permitting common trust funds. These included Arizona, Delaware, Indiana, Kentucky, Louisiana, Minnesota, New York, North Carolina, Pennsylvania, South Dakota and Vermont. Three states, Ohio, Oregon and Tennessee had statutes which could be interpreted to authorize funds, while the states of Connecticut, Massachusetts, New Hampshire and Utah were considering the establishment of enabling Acts.

The form of the statute itself was a formidable obstacle to overcome, as differences of opinion existed as to the one that would be most suitable. Trustmen thought that the Uniform Common Trust Fund Statute promulgated by the National Conference of Commissioners on uniform state laws was too simple, while the New York statute was too complicated and made the cost of compliance prohibitive. The Commissioner on Common Trust Funds of the Trust Division of the American Bankers
Association thought about preparing a model statute but the difference in the state laws made the obstacles too great. At that time, (1941), only Pennsylvania had more than one institution which had adopted the common trust fund, and it seemed to be the consensus that Pennsylvania's law was the happy medium between complexity and simplicity, and provided a workable method and a useful tool for administering smaller trust accounts. (16)

Regulation 9

Much of the banking legislation enacted following the financial crisis of the late twenties and early thirties remained in effect until 1963. In view of changing conditions, many of the rules and regulations no longer were appropriate, and trustmen for several years had been advocating changes which would allow them to provide better and more efficient services to their clients at a cost which would not be prohibitive to their institutions. These changes were finally completed by passage of Public Law 87-772 which was proposed to Congress by the Secretary of the Treasury Dillon and signed into law on Sept. 28, 1963

(16) "Development of Common Trust Funds", Trusts and Estates, April 1941, Vol. 72, No. 4, P.367
by President Kennedy. This legislation transferred the authority over trust powers of national banks from the Federal Reserve Board which had governed under Regulation F to the Comptroller of the Currency under Regulation 9, and became effective as of April 5, 1963.\(^{(17)}\) As was the case when Regulation F became effective in 1937, an advisory group composed of many of the outstanding leaders in the trust field assisted the regulatory authorities in revising the old regulations.

Regulation 9 contains 19 separate sections pertaining to the fiduciary powers of national banks, with Section 18 covering collective investments. Common trust funds operated by state banks must also be in conformance with these regulations to qualify for special tax treatment under Section 584 of the Internal Revenue Code. There are three types of collective investment permitted by the new regulation under Sections 9.18(a), 1, 2 and 3. These are:

9.18(a) (1) In a common trust fund maintained by the bank exclusively for the collective investment and

reinvestment of monies contributed thereto by the bank in its capacity as executor, administrator, guardian or trustee under a will or deed;

9.18(a) (2) In a fund consisting solely of assets of retirement, pension, profit-sharing, stock bonus or other trusts which are exempt from Federal Income taxation under the Internal Revenue Code;

9.18(a) (3) In a common trust fund maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as managing agent. (18)

The first type of collective investment fund is the type originally provided for under Regulation F when it was put into effect in 1937. The second has been commonly known as a "pooled fund" and provides a collective method of investment for employee benefit trusts exclusively.

The pooled funds were exempt from compliance with Section 17 of Regulation F in accordance with the 1955 Amendment to Section 10(c) as stated by the Board in its

publication of the Amendment in the Federal Register of May 14, 1955. The greatest significance of that exemption was that these trusts would be free from ceiling limitations on sums that could be invested by the participating trusts. (19) The dollar limitation contained in Regulation F and applied to common trust funds has been eliminated in Regulation 9, so this is no longer a consideration. Ten percent of the fund, as well as 10% of fund limitation on investments in securities of one issuer has been retained, but neither of these apply to qualified profit-sharing and pension trusts. Section 9.18(a) (2) is also intended to include those trusts set up under the new Smathers-Keogh bill which allows a method of providing pensions for the self-employed. (20)

The third type of collective investment fund is entirely new and provides a form of collective investment for a service which did not previously exist. At the

(20) Saxon, op. cit. P.12
present time there is much disagreement among trustmen over the merits of this service. There is also a dispute between the Comptroller of the Currency and the Securities and Exchange Commission as to which governmental agency should properly regulate this form of investment. Up to this time only one institution, First National City Bank of New York, has established a fund of this type but because of a number of technicalities has not yet offered the plan to its customers.\(^{(21)}\)

The new regulation is decidedly more liberal than Regulation F. Several important changes have been made which simplify the administration of collective investment funds and makes them more useful. The concept of "bona fide" fiduciary purpose has been eliminated from the definitions. While his view is not share by all trustmen, Comptroller of the Currency Saxon states that "no one has ever been able to satisfactorily explain that term to me." He goes on to say, "It is obvious whenever a bank is entrusted with the custody of property other than deposits, it holds a fiduciary duty of greater or

\(^{(21)}\) Wall Street Journal, Feb. 26, 1964, P.1
lesser degree to its customers. It has never made sense to me why a trust set up for the purpose of supporting one's children or aged parents has a more "bona fide" fiduciary aspect than a trust set up to support one's self in old age. The net effect of this vague term has been to introduce a great amount of legal and practical uncertainty. This idea of dividing otherwise legally established trusts into two groups, depending on the purpose for which the trust is created, is not followed in any other area of trust law, to our knowledge, and we have consequently abandoned it."

Probably the most important change made in the new regulation is the removal of the dollar limitation of $100,000 on a single participation. Under Sub-Section 9.18(b) (9) the limitation of not more than 10% of the fund per single participation has been retained, as well as the 10% of the fund limitation on the investment of securities of one issuer. The limitation on securities of one issuer does not apply to direct obligations

(22) Saxon, op. cit. P.12
of the United States Government or obligations which are fully guaranteed by the United States Government as to interest and principal. Neither of the percentage limitations apply to collective investment funds for employee benefit trusts under Paragraph 9.18(a) (2) as was the case under Regulation F.

Another change is the adoption of the entity theory of common trust funds under Paragraph 9.18(b) (3). This means that a trust may properly participate in a common trust fund without regard to whether an isolated asset might be held in the fund that a trustee might be reluctant to purchase for one reason or another. Regulation 9 also requires publication of a summary of the annual financial report as a newspaper of general circulation once a year as specified in Paragraph 9.18(b) (15). There are restrictions to the effect that no reference can be made to the performance of funds other than those administered by the bank, and no predictions or representations can be made as to future results. The bank is now permitted to charge a reasonable fee for the management of a collective investment fund, provided that the proportionate share of the fee payable by each participating trust shall not exceed that which should have been
charged if the trust had not been placed in the common fund (9.18(b) (12)). Under Regulation F the bank was permitted only to charge the trusts individually, Section 17(b) (8).

There are also a number of changes concerning the general operating provisions. The seven-day requirement for making computations for valuation of the fund has been eliminated. There is no longer a restriction on acquiring more than 5 percent of the outstanding shares of any class of stock of a single corporation. Provisions dealing with mortgages and mortgage funds have been simplified and finally, the position of a bank in advancing funds to an individual trust has been clarified. The new regulations, Paragraph 9.18(b) (8) (1), specify that an unsecured advance to an account holding a participation in the fund shall not constitute an acquisition of an interest by the bank. This eliminates some of the difficulties which previously existed when an account was overdrawn by a small amount through an oversight. (23)

CHAPTER IV

TYPES OF COLLECTIVE INVESTMENT FUNDS TODAY

Definitions

There are several different forms of collective investment funds as described by the new Regulation 9, under the three general classifications of Section 9.18(a), (1), (2) and (3). The best known form of collective investment is the common trust fund, which has been defined by the Trust Division of the American Bankers Association as:

"a fund established by a corporate trust institution in which is combined for the purpose of facilitating investment, money belonging to various trust accounts in its care, the participating contributory interests of said accounts being appropriately evidenced." (24)

The American Bankers Association has also described the common trust fund as an open end mutual investment restricted to sums held by the bank in its capacity as trustee, with the basic difference between the two being that a common trust fund is not subject to Federal income tax.

taxes and capital gains are retained in the fund. In addition, there is no acquisition cost or commission involved, and there are no management fees on the fund other than those charged to each individual trust. In contrast to a mutual fund, all of the net income must be distributed to the participant. (25)

Regulated investment companies including mutual funds do receive special tax treatment, however. The tax rates are generally the same as for corporations. While the investment companies are not allowed the special deduction of 85 percent of dividends received, or the deduction for a net operating loss, as in the case of corporations, they are allowed instead a deduction for dividends paid. Regulated investment companies which distribute currently at least 90% of their dividend and interest income, and meet certain other requirements of the Internal Revenue Code, are not taxed upon amounts distributed to shareholders. Similarly, long-term capital gains that are retained in the fund are subject to a maximum tax rate of 25 percent. If the gains are distributed, the payment of tax is made by the share-

(25) Introduction to Trust Investment, (The Trust Division, American Bankers Association, New York, 1961), P.23
holder, rather than the mutual fund. The effect of these provisions is that the majority of mutual funds pay little or no tax.

Common trust funds are further classified as legal funds, discretionary funds, and specialized or single purpose funds. The legal fund is restricted so that only securities which appear on a legal list approved by state authority can be purchased in this fund. This fund is used only in states which follow the legal list statutes. If the trust instrument gives specific authorization, the trustee can invest funds in non-legal investments subject to the broad meaning of the "prudent man rule."

A fund which can be invested in non-legal investments is known as a discretionary fund. The plan of operation usually provides for broad investment powers.

The most popular type of fund is the balanced common trust fund which is invested in both common stocks and fixed income securities. Some trustees have been using a specialized discretionary fund which can be limited to one type of security. In this case, it would be

customary for the trust institution to have more than
one fund where a participating trust could be invested
partially in a common stock fund and partially in a
fixed income fund.

A collective investment fund for employee benefit
plans is very similar to a common trust fund, except
that it is a trust established exclusively for the
purpose of pooling investments of independently created
pension and profit-sharing trusts. Here too, the funds
can be balanced or specialized, the same as common trust
funds.

Federal Reserve Board Survey

The Board of Governors of the Federal Reserve System
have conducted eight annual surveys of common trust
funds. The latest survey appeared in the Federal
Reserve Bulletin of June 1963 and covered the year
1962. (27) The survey revealed that interest in common
trust funds continued to expand with an increasing
number of banks operating a greater number of funds.
During the eight years the survey has been conducted,

the number of banks operating common trust funds has increased from 174 institutions to 343, while the number of funds operated has increased from 222 to 564. Total assets of common trust funds increased from $1.86 billion in 1955 to $3.577 billion in 1962. The unusually small gain in dollar value of total assets from 1961 to 1962 of only $21 million was attributed to the decline in value of common stock holdings, which was consistent with most common stock indexes. At the end of 1962 common stocks represented 56% of the total holdings, while fixed income securities composed of bonds, notes, certificates, preferred stocks, real estate loans and some small miscellaneous holdings made up 44% of the assets. Single purpose or specialized funds continued to gain favor through 1962. At the end of the year these funds accounted for 292 of the 564 funds with a value of $1.1 billion. There were 234 diversified discretionary funds. However, their dollar value was twice that of specialized funds at $2.2 billion. Of minor importance were the diversified legal funds, with 38 reported having a value of $201 million. Of the 564 funds in existence, 194 were under $1 million. Seventy-six funds were from $1 million
to $2 million, and 131 were from $2 million to $5 million. One hundred fifty-two funds had assets ranging from $5 million to $50 million, while only eleven funds were over $50 million.

The Federal Reserve survey found that while common trust fund activity continued to expand in all Federal Reserve districts, common trust holdings continued to be concentrated in the Northeast, as evidenced by 38% of the total number of funds, and 52% of the total assets of all funds being held in Boston, New York and Philadelphia districts. Common trust funds are found in 47 states and the District of Columbia. Only Alaska has no statutes authorizing the establishment of common trust funds. While Idaho and Wyoming have laws permitting funds, there are none in existence.

Trust Division, American Bankers Association Survey

The most recent information on the number of trust institutions operating collective investment funds was prepared by the Trust Divisions of the American Bankers
Contrary to the Federal Reserve Board's report on common trust funds, this report includes collective investment funds for employee benefit trusts.

The Trust Division survey shows (See Exhibits I and II), that there are now 354 institutions operating a total of 941 funds, as compared with the Federal Reserve Board report of 343 institutions operating 564 common trust funds. The Trust Division recorded 622 common trust funds. It should be safe to presume that the 58 additional funds resulted either from splitting existing balanced funds into specialized funds, or establishing new funds throughout the period. The greatest difference between the two reports is the 294 funds for employee benefit plans under Regulation 9.18(a), (2). The pattern of the funds operated by states is much the same as reported in the Federal Reserve Board survey. Here again, funds are not operating in Alaska, Idaho and Wyoming. Pennsylvania, an early leader in the development of collective investment, has the greatest number of institutions operating funds, with 52 instit-

(28) Collective Investment Funds Operated under or in General Conformity with Regulation 9 of the Comptroller of the Currency, Compiled by Trust Division, The American Bankers Association, Feb. 1964
### COLLECTIVE INVESTMENT FUNDS OPERATED UNDER OR IN GENERAL CONFORMITY WITH REGULATION 9 OF THE COMPTROLLER OF THE CURRENCY

<table>
<thead>
<tr>
<th>Funds Operated Under</th>
<th>Funds Operated Under</th>
<th>Funds Oper.</th>
<th>Other</th>
<th>Total No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sec. 9.18(a) (1)</td>
<td>Sec. 9.18(a) (2)</td>
<td>Under</td>
<td>Funds</td>
<td>of Funds</td>
</tr>
<tr>
<td>Balanced</td>
<td>Single-Purp.</td>
<td>Sec. 9.18(a)</td>
<td>(3)</td>
<td>Operated</td>
</tr>
<tr>
<td>Funds</td>
<td>Funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leg. Disc. CS-FII-T</td>
<td>TEBF</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balanced</td>
<td>Single Purpose</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Funds</td>
<td>Funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leg. Disc. CS-FII-T</td>
<td>TEBF</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| None | Reported | 25 | 941 |

<table>
<thead>
<tr>
<th>Abbreviations of Table Headings</th>
</tr>
</thead>
<tbody>
<tr>
<td>CS = Common Stocks</td>
</tr>
<tr>
<td>Disc = Discretionary</td>
</tr>
<tr>
<td>FII-T = Fixed-Income Investments</td>
</tr>
<tr>
<td>TEBF = Tax-Exempt Bond Funds</td>
</tr>
</tbody>
</table>

### Reference Notes for 9.18(a) (2) Funds

(A) = Fund for Pension Plans; (B) = Fund for Profit-Sharing Plans; (C) = Fund for Pension & Profit-Sharing Plans Combined; (D) = Fund for Self-Employed Retirement Plans

(Exhibit I) Source: Trust Division, The American Bankers Association
<table>
<thead>
<tr>
<th>State</th>
<th>Insns.</th>
<th>Funds</th>
<th>State</th>
<th>Insns.</th>
<th>Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>5</td>
<td>10</td>
<td>Nebraska</td>
<td>3</td>
<td>9</td>
</tr>
<tr>
<td>Alaska</td>
<td>-</td>
<td>-</td>
<td>Nevada</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Arizona</td>
<td>4</td>
<td>10</td>
<td>New Hampshire</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>Arkansas</td>
<td>3</td>
<td>3</td>
<td>New Jersey</td>
<td>11</td>
<td>25</td>
</tr>
<tr>
<td>California</td>
<td>12</td>
<td>48</td>
<td>New Mexico</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Colorado</td>
<td>8</td>
<td>20</td>
<td>New York</td>
<td>22</td>
<td>119</td>
</tr>
<tr>
<td>Connecticut</td>
<td>10</td>
<td>27</td>
<td>North Carolina</td>
<td>9</td>
<td>17</td>
</tr>
<tr>
<td>Delaware</td>
<td>3</td>
<td>8</td>
<td>North Dakota</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>District of Col.</td>
<td>4</td>
<td>9</td>
<td>Ohio</td>
<td>17</td>
<td>50</td>
</tr>
<tr>
<td>Florida</td>
<td>11</td>
<td>21</td>
<td>Oklahoma</td>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>Georgia</td>
<td>6</td>
<td>16</td>
<td>Oregon</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>Hawaii</td>
<td>2</td>
<td>8</td>
<td>Pennsylvania</td>
<td>52</td>
<td>110</td>
</tr>
<tr>
<td>Idaho</td>
<td>-</td>
<td>-</td>
<td>Rhode Island</td>
<td>2</td>
<td>12</td>
</tr>
<tr>
<td>Illinois</td>
<td>9</td>
<td>29</td>
<td>South Carolina</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>Indiana</td>
<td>9</td>
<td>19</td>
<td>South Dakota</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Iowa</td>
<td>1</td>
<td>3</td>
<td>Tennessee</td>
<td>8</td>
<td>13</td>
</tr>
<tr>
<td>Kansas</td>
<td>1</td>
<td>2</td>
<td>Texas</td>
<td>14</td>
<td>29</td>
</tr>
<tr>
<td>Kentucky</td>
<td>6</td>
<td>13</td>
<td>Utah</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>Louisiana</td>
<td>1</td>
<td>1</td>
<td>Vermont</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>Maine</td>
<td>5</td>
<td>16</td>
<td>Virginia</td>
<td>18</td>
<td>36</td>
</tr>
<tr>
<td>Maryland</td>
<td>6</td>
<td>19</td>
<td>Washington</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>16</td>
<td>53</td>
<td>West Virginia</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Michigan</td>
<td>10</td>
<td>26</td>
<td>Wisconsin</td>
<td>9</td>
<td>20</td>
</tr>
<tr>
<td>Minnesota</td>
<td>6</td>
<td>21</td>
<td>Wyoming</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Mississippi</td>
<td>2</td>
<td>4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Missouri</td>
<td>7</td>
<td>25</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Montana</td>
<td>2</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**TOTAL ............ 354 | 941**

**EXHIBIT II** Source: Trust Division, The American Bankers Association
tions operating 110 funds. The State of New York has the greatest number of funds in operation with 119 and is second in number of institutions with 22. The survey shows the State of Michigan with 10 institutions operating 26 funds.

The specialized or single purpose fund operated as a common trust fund under Section 9.18(a) (1), far outnumbered the balanced common trust fund. Under single purpose funds there were 160 used exclusively for common stocks, 148 for taxable fixed income investments and 48 for non-taxable fixed income investments for a total of 356. There were 266 legal and discretionary balanced funds. Balanced funds operated for employee benefit trusts under Section 9.18(a) (2) are not as popular as those operated for common trust funds. There are a total of only 37 funds which are further broken down into classifications as shown in Exhibit I. In comparison, there are 121 common stock funds and 127 taxable fixed income funds. No funds were reported in operation under Section 9.18(a) (3). The 25 other funds reported were established for various purposes, and included a fund for mortgages, a fund for foreign
securities, a fund for private placements, and one described as a "special situations fund."

At the recent mid-winter Trust Conference of the American Bankers Association, it was felt that there was a strong trend toward separate funds for equities, fixed income securities and tax-free securities, though the general feeling was that the historic balanced fund was still a most useful vehicle for smaller trusts. Both the Federal Reserve Board and the American Bankers Association surveys confirm this attitude. (29)

Bank Fiduciary Fund

Another form of collective investment for trusts is the bank fiduciary fund which has been established by two states, New York and Connecticut. The purpose of the bank fiduciary fund is to serve the needs of small corporate fiduciaries within the state whose size does not justify the establishment of their own collective investment funds. This new investment device

was first authorized by the New York State Legislature in April, 1954. (30) The second fund was patterned after New York State's Bank Fiduciary Fund and was established in accordance with legislation enacted by the Connecticut General Assembly in 1957. (31) Investment policies of the New York Fund are formulated by trust officers of participating banks who serve on the Board of Directors, while the management of the fund is entrusted to the Manufacturers Hanover Bank, (formerly the Hanover Bank.) The operation of the fund is similar to a common trust fund although there is a management fee charged in the same manner as a mutual fund. Sponsors of the bank fiduciary fund say that the fee is reasonable, and proportionately less than those of open end investment companies. While several other states have considered the establishment of bank fiduciary funds, there are no others in operation at this time.


Collective investment funds have been described by trust men as the single most important tool ever developed within the industry. The question of whether a bank should establish one or more collective investment funds involves a number of factors which will have to be considered. The reasons for a small bank and a large bank to establish funds will differ significantly. The concept of collective investment has gained rapid acceptance within recent years as the trust business has matured in areas beyond the northeastern section of the country where the nucleus of substantial wealth was originally located. Trustees are becoming more sales-minded and are beginning to offer their services to the growing proportion of moderately wealthy individuals, who are replacing the relatively few who have possessed extremely large estates.

The determination a bank will make about collective investments will depend upon the existence of a basic need, either because the bank presently has a sufficient number
of accounts which can utilize this form of investment or because the presence of the funds will be an incentive for attracting new accounts. Of course, before any funds can be started, a bank must have the minimum number of accounts to justify the establishment of a fund and meet the requirements of Regulation 9. In order to determine the need for a collective investment fund, the bank must make a detailed analysis of the accounts being administered to learn how effectively this method of investment can be used. The large city banks have quite naturally been the leaders in this field, since because of their size it has been necessary for them to explore ideas for more efficient operations. If it is determined that the bank should establish a fund, the many advantages that will be realized can be summarized in one statement -- better service to the customer at a lower cost to the trustee.

Diversification

Diversification of investments is one of the most important advantages, and has long been recognized as the answer for the investment of small trusts. The regulations limit the amount that can be invested in one asset of a common trust fund to 10% of the total fund; however most
trustees follow the principle of investing not more than 5% in any one asset. It would be difficult to properly diversify a trust of $25,000 or $50,000 in a sufficient number of issues, to say nothing of a $3,000 trust. Through the medium of collective investment, the trust can participate in from 30 to 100 different issues of securities and share in a much greater cross-section of industry than if the trust was invested on an individual basis.

**Stability of Income**

Wide diversification of investments also results in better balanced income since income derived from many sources tends to be more stable than just a few sources in the event of economic difficulties. The greater dependability of income makes the common trust fund well suited to the requirements of most trust beneficiaries. Moreover, with a large trust it is usually possible to keep a greater percentage of capital continuously invested and producing income. Collective investment funds, because they are large, are able to keep their assets closely invested, giving the beneficiaries the added advantage of this most effective income-producing factor. If a $50,000 trust had $500 of uninvested cash,
it would probably remain uninvested because of its relatively small size. On the other hand, $1 million collective investment fund having the same percentage of cash amounting to $10,000 would not remain uninvested because the opportunities for investing this larger sum of money would be much more favorable.

Investment Opportunities

Most bonds are not offered in denominations of less than $1,000, and a block of five $1,000 bonds is considered an odd lot by investment dealers. Consequently, the probability of a better return on the purchase of a larger block of bonds is much better than on a small block. Accordingly, common stocks that are purchased for a collective fund would more likely be purchased in round lots than in odd lots, thus saving the one-eighth to one-fourth differential depending on the price of the stocks. Trustees are not in a position to purchase some of the higher priced stocks. IBM, for example, has had an outstanding record of growth over the years and has long been a favorite of institutional investors. Because this stock sells at several hundred dollars per share, it has not been used too frequently for the smaller trusts, since
there is a natural reluctance to hold only two or three shares in an account. Trustees are more inclined to buy stocks of this category in larger trusts. Thus in a collective fund beneficiaries can participate in securities that otherwise would not be purchased. Collective funds are also able to participate in privately placed loans to corporations having top credit ratings and offering yields of one-half to three-fourths of a percent better than comparable corporate bonds sold in the open market. These investments are usually unavailable to individual trusts, since a minimum participation of $100,000 is required.

Investment Supervision

The trustee can give closer and more continuous supervision to a collective fund than he can to all of the participating trusts on an individual basis. According to Regulation 9, trusts are required to be reviewed at least once during each fifteen-month period. If there were fifty trusts invested individually, they would probably hold anywhere from ten to twenty different assets each. This means that during the course of the year, fifty different reviews would have to be prepared showing the description of each asset, its cost basis and its current market value.
Assuming that the fifty accounts held an average of fifteen assets, there would be 750 computations required in pricing the assets, compared to probably less than 100 in a collective fund. The use of a collective fund permits more time to be devoted to the level where policy is established and decisions are carried out. When investment conditions require a change in the portfolios, the transaction can be completed in one operation rather than the multiple operations necessary for separate trusts. Also, as money becomes available for investment in individually invested trusts, each account would have to be reviewed to select a security that would be appropriate for each portfolio. If the accounts were all included in the fund, individual security selections would not be necessary.

The number of consultations with co-trustees are also reduced since after the initial approval by the co-trustees it is not necessary to prepare elaborate letters explaining the recommendations for each security transaction.

Operational Procedures

In addition to the improved supervision of investments of collective funds, there can be a tremendous saving in the cost of the mechanical operations of each trust. Aside from the simplified procedure of individual reviews, there
would be a savings of time in the execution of purchase and sale orders. The number of bookkeeping entries would be reduced and the amount of vault space used for safeguarding the securities could be minimized. For example, suppose money was available for investment in twenty different accounts. After the accounts were reviewed and a security was selected, this would require, assuming one stock for each account, that twenty different buy orders would have to be entered. A like number of bookkeeping entries would be made. Transmittal instructions would have to be given to the broker for each of the orders. Twenty different stock certificates would be delivered by the broker and each of them would be deposited in a separate account folder in the bank's vault for safekeeping. During the course of the year quarterly entries would have to be made for the dividends received, which would amount to eighty entries for the twenty accounts. When this illustration is magnified by the total number of assets held in the trust accounts, it can be seen that the volume of mechanical operations can reach sizable proportions. Moreover, considerable time would be needed to audit the individual records and assets. On the other hand, if each of the twenty accounts was invested in a collective fund, a time-consuming review of the trusts would not be
necessary. The only action to be taken would be to approve the new entries in the fund. On the valuation date the new admissions would be deposited. The assets of the fund would be reviewed, and a decision to buy one security with the collective deposits might be made, thus requiring the execution of only one order. Accordingly, if a decision was reached to sell a security for investment reasons, the sale in a fund could be completed in one step; however, using the same illustration, it would require the execution of 20 different orders. This means that 20 different certificates would have to be removed from the vault and endorsed. A like number of transmittal letters would have to be prepared and delivered to the broker in exchange for the proceeds of the sales, which have to be recorded on the books of each account.

New Business Opportunities

The use of collective investment funds has also proven to be a decisive factor in securing new business since it permits the banks to solicit accounts in which it otherwise would not be interested. It is an excellent method for the investment of new pension and profit-sharing accounts which will grow in size over the years with the
addition of the employers' annual contributions. It can be useful in attracting small trusts for people who might at some time be in a position to add to the trusts, or give the bank additional business, such as naming the bank as executor of their estate.
CHAPTER VI

LIMITATIONS OF COLLECTIVE INVESTMENT FUNDS

While the merits of collective investment are becoming more widely accepted, this form of investment is not the answer for all trust companies. A survey conducted by Charles F. Zukoski in 1958 revealed a number of objections. Many have undoubtedly been overcome, but those mentioned are still representative of how some trustmen feel today. Prominent among the answers received by the survey from over 100 trust institutions was the problem of size. No institution should be persuaded to install a common trust fund unless there is adequate size to justify it. Total assets are not as important as the character of the investments held by the individual trust and the powers of investment contained in the trust instruments. However, it was felt that after trust assets reach as much as $5 million to $10 million, the possibility of establishing a common trust fund deserves a careful analysis.

The answers received by Zukoski revealed that some trustmen were just reluctant to make a change. Others
were opposed to the difficult procedures that might be involved. Some discovered opposition among their uninformed senior bank officials. Some trustmen had not found time to undertake the study. Some feared that it might be an expensive operation requiring additional administrative help. There are those who were not convinced that operating economies would result. Others did not feel their staff was adequate. Some were apprehensive over the outlook for securities. Some argued that small accounts were not profitable so why improve the machinery to handle them. A few banks said a majority of their accounts were large, and small ones were put into investment company shares. Some of the institutions liked mortgages but were concerned over the possibilities of default, as specified under the old Regulation F. Some of the institutions expressed a continuing feeling against commingling trust funds which followed the depression of the thirties. One said that there had been some customer criticism of how other banks had administered common trust funds. Some believed that it was better to analyze the requirements of such a trust and tailor an investment program for it. There were also objections relative to
the capital gains provisions and their effect on the participants of common trust funds.

While many of the objections were recognized as valid, it was pointed out that there had been a strong precedent for the establishment of common trust funds, and it was concluded that the objections were outweighed by the advantages. Nevertheless, these limitations should be considered further. There are some accounts which should not participate in a collective investment fund for any one of a number of reasons. Since the new regulations governing collective investments do not contain as many restrictions, the investment of trust assets in a fund becomes a matter of policy for each institution administering a fund.

Size of Account

One of the first questions to be answered is, "What size account will be admitted?" The development of common trust funds was based on the need for investing efficiently the very small accounts. Now however, there is no dollar

limitation on size and the only restriction is that no account can have an interest greater than 10% of the total assets of the fund. The experience of many trustees is that the accounts they have been putting in are becoming progressively larger. They recognize that size is relative. What seemed like a large account ten or twenty years ago, today does not seem as big. The former limitation of $100,000 still serves as a guide line however, and it is felt that a fund of this size can be given proper and adequate diversification.

Duration of Account

Trust assets are invested in collective funds, with long-term investment objectives in mind, and should be considered reasonably permanent. The definition of "long-term" will vary for different accounts, but a ten-year period is thought to be reasonable by many trustees. Exceptions should be made where, due to account circumstances, it seems advisable to admit a trust terminating in a shorter period. There are two extremes which will be considered. The first is a small guardianship account for a minor who will reach majority sometime near the end of the arbitrary ten-year period. The probability of periodic
withdrawals for a minor's support, plus the uncertainty of the level of the market at the time the assets are to be distributed, suggests that a more prudent investment would be government obligations rather than a collective fund. Of course, if there was no expectation of using the funds prior to termination of the guardianship, the collective fund could be entirely appropriate. The other situation involves the elderly beneficiary whose trust will terminate upon death. Correspondence with a New York City banker revealed that when they established their first common trust fund they were reluctant to invest funds where the beneficiary was well along in years, on the theory that the common trust fund was being invested from a long-term point of view whereas trusts with aged beneficiaries would be with them only a very short time. As a result of their experience they now feel that trusts of this type may be with them for some period of time. Consequently, they are willing to invest in a common trust fund without any hesitation when the beneficiaries are in their seventies. Furthermore, they feel that participation in a common trust fund provides a simple way to close out such trusts on the
death of the beneficiary.

Tax Considerations

There are three tax situations of concern to trusts participating in a fund. The first is a possible capital gain tax on the sale of securities to convert to cash for investment in the fund. The second is that accounts will be subjected to capital gains tax while they are in the fund. The third is that there will be a capital gains tax on units of participation withdrawn from the fund.

According to a Treasury Department ruling as reported in Public Debt Bulletin No. 21 of March 6, 1945, only cash, Series G bonds or certain other Government obligations which have since matured, can be admitted to a common trust fund. Consequently, unless an account consists entirely of cash or Series G bonds, it will be necessary to sell the securities held, thus subjecting the trust to a possible capital gains tax. Since the majority of trusts entering a fund are small, the tax is usually comparatively small. However, in accounts where this tax could prove substantial, it

can be minimized by staggering the entry period over two or three taxable years.

There is no tax problem with respect to income because the entire income earnings of the fund are regularly determined and distributed to participants on each valuation date, thereby keeping the income tax liability on a current basis. However, the situation is different with capital gains. The Internal Revenue Code provides for taxing all gains on the sale of assets held in the fund on the basis of their cost to the fund, rather than on the basis of value of the asset at the several times the participating trusts purchased their units. The effect of this procedure is the taxing of paper profits so far as participants are concerned, since there has been no liquidation of their participating units. The American Bankers Association has considered the sponsorship of an amendment to correct this inequity, but has taken no action on it. In order to minimize this difficulty, trustees have spaced sales in such a manner as to offset gains with losses, and to prevent gains substantially in excess of exemptions from being taxable to trusts in any particular fiscal period. (34)

(34) Zukoski, op. cit. P. 61
Another problem, aside from taxing paper profit, concerns accrual of capital gains tax liability in the fund until sold and the cost basis applied to securities affecting participants, irrespective of date of entrance in the fund. The problem arises from the fact that all or part of a gain on a security has been accrued prior to the participation of a particular trust. In effect, that trust is purchasing a future tax liability for which it will never be compensated. For example, a stock purchased in the fund at an original cost of 40 might be valued at 80 upon the admission of a new participant. Assuming a later sale at 78, the participating trust has suffered a loss of two points as to its unit price applied to that stock; nevertheless, it is proportionately taxable with all other participants on a realized capital gain of 38 points. (35) The inequity of this is apparent and further magnified when a trust wholly invested in the common trust fund must liquidate units to pay its tax liability. On such involuntary liquidation still further taxable gains may result if units are redeemed for more than cost. The consequence would not be too

bad, however, since it would usually involve an irrerevocable trust, would be the only item of earnings in the trust taxable to the trust, and probably would be covered by the trustee's income tax exemption. In the case of revocable trusts where such capital gains are taxable to the recipients of other income, there is a more serious problem. Higher income tax brackets with less exemptions are represented, and the trustee is given cause to hesitate in making rules which would result in gains for fear of consequences, even though the contemplated sales are dictated by prudent investment judgment at the time. When gains are taken, the changes should be made before a valuation in order that new trusts coming into the fund would not be liable for these realized gains. Regulation 9 permits distributions to withdrawing participants either "in cash or ratably in kind."(36) At times, especially when a trust terminates, it would be desirable to distribute in kind but this method is usually impracticable since it would have to include a portion of every security held. The alternative is to operate on a cash basis.

(36) Regulation 9, Section 9.18(b) (6), P.7
This requires the sale of securities with their tax consequences to the extent that withdrawals exceed new admissions to the fund. The possibility of this forced liquidation of securities could not only create a tax liability for the other participants as discussed earlier, but also will subject the withdrawing participant to a gain or loss, depending on the cost basis of the redeemed units.

Timing for Establishment of Fund

Once a trust institution has determined the need for a collective fund, the question of when to start it is difficult to answer. There has been a reluctance to establish a new fund during periods of high markets because of a greater possibility of a decline in the value of the fund. To postpone action on the basis that market may be too high, though, is itself a speculation that the market is going lower. In addition, since the basic principle of trust investment is diversification, the improvement resulting in a common trust fund should be an important protection against the possibility of a declining market. Furthermore, the opinions the trustees have about the level of the market and its
direction can be controlled by the proportion of types of securities chosen for the portfolios. This problem was discussed with several different bankers and they all admitted that it had been a concern at the time their first fund was established. The consensus of opinion was that the best time to start a fund was when it was needed, regardless of the level of the market. The fund should not be considered as a short-term investment and when given a reasonable period of time for operation, the results in most funds have proved quite satisfactory.

Unfavorable Publicity

The decline in the value of a fund can create some unfavorable situations. Market fluctuations of common trust funds are more noticeable to beneficiaries, since there is only one unit to watch rather than a variety of individual security prices. Experience has proven, however, that it is not too great a concern. Proper education of both the trust personnel and the bank's clients is the key to satisfactory relationships

(37) "When to Start a Common Trust Fund", Trusts and Estates, October 1950, Vol. 89, No. 10, P. 633
when confronted with depressed values of the fund. The loss of good will on the reduction in value of a collective investment fund presents the same situation the trustee is faced with in an individual account. Furthermore, it is probable that because of the fund's greater diversification compared with an individual account, the decline would be minimized. It should also be recognized that when unit values are depressed, all participants are not affected in the same manner since unit costs will vary with each participant. Moreover, when fund values are down it is quite likely that the general security indexes will also be down. If these conditions are satisfactorily explained to the bank's clients, there will likely be no adverse reactions.

Limited Flexibility

The inclusion of a trust in a fund limits the degree of individual planning or tailoring to the needs of the specific account. There was a time when everyone was urged to start a diversified fund rather than any other type, and that accounts for the large number of diversified funds created and still in existence. As
trustees have gained experience with collective investments, they have found that circumstances vary and beneficiaries have differing needs which cannot be satisfied properly with a single fund. It is impossible to achieve proper results for more than a few trusts through the use of a balanced fund. The beneficiaries may have high income requirements or they may be interested more in capital appreciation. They may be concerned with a greater degree of stability, or they may have outside income which places them in a tax bracket where it is beneficial for them to receive tax-free income. The investment objective of an older person dependent upon income received from a trust will differ from that of a child for whom the income is being accumulated for reinvestment.

Accordingly, the investment objectives of pension and profit-sharing trusts will differ. The profit-sharing trust in most cases should be more aggressive, while the pension fund should be more conservative and higher-yielding. The problem of an account with high income requirements which cannot obtain a sufficient yield from the common trust fund can be solved by with-
holding a portion of the trust and investing it in a higher-yielding mortgage. In order to supplement income it would be possible to put $40,000 of a $50,000 trust in the fund and buy a $10,000 6% mortgage with the balance. This will provide a high rate of income, plus some principal, which could be used or accumulated for reinvestment in the fund.

Specialized Funds

Other varying beneficiary needs, however, cannot be solved so simply when invested in a balanced common trust fund. The answer to the lack of flexibility problem is to establish specific funds so that every account can be serviced according to its needs. The concept of using two or more common trust funds to provide different types of pooled investment media goes back to the early 1940's. St. Louis Union Trust Company established a common trust fund in 1942 to be devoted primarily to investments in common stocks. In 1945 Connecticut National Bank of Bridgeport added a second fund which, under ideal conditions could be invested 100% in equities.

The use of specialized funds enables the trustee

(38) "Why Dual Common Trust Funds?", Trusts and Estates, December 1959, Vol. 98, No. 12, P.1207
to clearly define the investment objectives for each trust. They allow the trustee greater flexibility and permit the change of investment portion of accounts as circumstances of beneficiaries change, while still maintaining overall balance and diversification.

There are several disadvantages of balanced funds that can be overcome with specialized funds. One situation involves a trust previously having a satisfactory ratio in stocks and bonds. If reinvested in a balanced fund, that ratio may be upset, whereas in dual funds it could be invested in the same desired proportion. Another disadvantage of a balanced fund is that earlier participants can be penalized through the use of a fixed ratio for bonds and stocks.

Balanced funds are often operated as a formula investment program with perhaps 50% in equities and 50% in fixed income. While this is not an undesirable practice, it tends to reduce sharply capital gain possibilities in a rising market. The reduction of capital gain possibilities probably would not occur in individual trusts, since capital gains would be cut back only once near a market top at the time the account was reviewed, rather than on each quarterly valuation date.
all the way up on a market rise. The balanced fund, however, does have the advantage that losses on bonds can be offset by profits on stocks and bond proceeds may be reinvested in higher-yielding bonds with improved income and reduction in capital gains liability. However, it may take the sale of a substantial amount of bonds to provide losses to offset the sale of just one common stock. (39)

The operation of specialized funds does present some disadvantages. Most prominent is the increased cost of operation. With the operation of two funds, bookkeeping costs will nearly double as there will be twice as many monthly or quarterly distributions. Furthermore, monthly entry and withdrawal dates may be more desirable than quarterly dates since a three months waiting before making a desired bond stock ratio adjustment could prove costly and embarrassing. Other costs such as auditing fees and preparation of tax returns will increase. The administrative duties are also increased since the portfolio balancing is transferred to the participating trusts and reviewing

(39) Ibid, P.1208
officers will find it necessary to adjust the bond stock ratio for individual accounts. In contrast this was previously done automatically through the operation of the diversified fund. In a rising stock market or where the bond fund has been used to meet necessary cash requirements, it will be necessary to liquidate units of one fund for reinvestment in the other. The use of specialized funds increases the number of consultations with co-trustees. Since the market fluctuations of dual funds are more pronounced than they would be in a combined fund, it is possible that more time will be required with explanations to beneficiaries. There might be an undesirable degree of pressure by the co-trustee or beneficiary to over-emphasize the equity fund over the bond fund which the trustee would not experience with the balanced fund. In a declining bond market, the bond fund could show losses for prolonged periods of time, and any losses taken would be irretrievable unless discount issues were used. Realized losses, however, would be passed on to the participants and could be used to offset realized gains from the stock fund, or become a part of the account's capital loss carry-over and used
accordingly. Some concern has also been expressed that the reinvestment problem would be severe in the event that a situation developed where common stocks should be sold. This problem would be no more severe for accounts participating in an equity fund than it would be for accounts independently invested, however.\(^{(40)}\) Bond funds do offer many advantages, but a substantial change in interest rates will slow up the operation of a bond fund. There is a point at which the fund must be ignored for new admissions except for investment of small odd sums. Very little can be done to raise the yield on a bond fund of substantial size which is compounded because of the reduced level of net additions to the fund.

While the establishment of specialized funds does offset the economies experienced with a single fund, the answer will be found depending on whether management thinks it is more important to operate as economically as possible, or whether the accounts should be given the service they are entitled to; providing of course, that there are a sufficient number of accounts to justify

this service. Based on the experience of those who have established dual funds, it has been felt that the additional expense has been small in relation to the advantages, and that the over-all administrative work has not been increased. One trustee felt that statistical proof of savings was impossible. Using his example, he felt that the average small trust individually would have at least 10 asset items involving perhaps 30 income entries a year. With dual funds, the asset items will be reduced to 2 and the income entries to 8. Multiplied by several hundred the reductions are substantial. The review of two asset items of well-known characteristics identical in each account is little more burdensome to committee members than relating a single fund investment to the account situation, and the savings in investment committee time may be greater because of the larger number of trusts that can be admitted to participation in a dual set-up. Whether the assets of the funds themselves are held in a single fund or two separate funds will not greatly affect the work of appraisal collection and review. The slight additional work of operating two funds is of a clerical nature and lends itself to mechanical handling. (41)

(41) Trusts and Estates, Dec. 1959, op cit. P.1208
trustees felt that the increased amount of paperwork and cost was very small, particularly when compared with trusts handled on an individual basis. It was further pointed out that the same plan could be used for both funds, both annual reports could be put in one booklet, both funds could be covered in the same committee minutes, and the same internal forms could be used. It is true that specialized funds will show a greater degree of fluctuation. However, some do not share the view that fluctuations of common stock should be hidden in the stock portion of a balanced fund. A drop in the stock market produces a greater drop in the unit of an equity fund than of a balanced fund, but the equity fund also reflects increases to a greater degree. Most clients realize that stocks fluctuate in value and it is very likely that the major stock indexes will have experienced fluctuation consistent with the change in value of the equity fund.\(^{(42)}\)

\(^{(42)}\) Ibid, P.1244
The subject of advertising for collective investment funds deserves special attention since restrictions which have created disagreement among trustmen have been contained in both the old and new regulations governing the publicity for this form of investment.

Regulation 9 provides that a financial report will be prepared at least once during each twelve-month period. The following excerpt from Regulation 9 covers the publicity provisions:

"The financial report may include a description of the fund's value on previous dates, as well as its income and disbursements during previous accounting periods. The report shall make no reference to the performance of funds other than those administered by the bank and no predictions or representations as to future results.

A copy of the financial report shall be furnished, or notice shall be given that a copy of such report is available and will be furnished without charge upon request, to each person to whom a regular periodic accounting would ordinarily be rendered with respect to each participating account. The report, in such
Excerpt from Regulation 9 (Continued)

summarized form as prescribed by the Comptroller of the Currency, shall be published in a newspaper of general circulation in the place where the principal office of the bank is located. In addition, a full report shall be furnished upon request to any person, and the fact of the availability of such material may be given publicity solely in connection with the promotion of the fiduciary services of the bank. Except as herein provided, the bank shall not advertise or publicize its collective investment fund(s). The cost of printing, publication and distribution of the report shall be borne by the bank." (43)

While the wording of Regulation 9 as it relates to publicity has been changed from the wording of Regulation F, the intent of the restrictions is the same with two important exceptions: The Trust Division's Committee on Common Trust Funds at the invitation of the Comptroller of the Currency recommended that provision for newspaper publication should be permissive rather than mandatory. (44) A number of bank and trust companies feel that the mandatory publicity requirements may create some unfortunate experiences.

(43) Regulation 9, Section 9.18(s), (iii), (iv), P.7

The Committee on Common Trust Funds at the recent Mid-Winter Trust Conference said that the mandatory requirement was undesirable, both as being unfair to the banks to subject them to the cost of printing copies for strangers to the fund, and as making possible comparisons of performance based on bare figures and without knowledge of the reasons for a particular investment policy and performance.\(^{(45)}\) The second change in Regulation 9 was the elimination of the term "bona fide fiduciary purpose", which is frequently referred to in connection with publicity.

It is evident, however, that there is still some reluctance on the part of many trustmen. They feel that they should continue to adhere to the high ethical standards which they have followed in the past and should not aggressively promote the service to the extent that it would be misrepresented. This attitude was stated in an official expression of policy by the Executive Committee, Trust Division of the American Bankers Association adopted on February 5, 1945 as follows:

WHAT THE PUBLIC SHOULD BE TOLD
ABOUT COMMON TRUST FUNDS BY
INSTITUTIONS OPERATING SUCH FUNDS

"Foreward:

"This statement of policy has been formulated because the number of states in which common trust funds may be established is constantly increasing, as is the number of such funds which are actually being established, making it advisable for trust institutions maintaining common trust funds to conform to a general standard of practice in presenting such funds to their customers and prospective customers.

ARTICLE I.

It is appropriate for a trust institution to advertise that it maintains and operates a common trust fund and to outline its uses and advantages, particularly in view of the fact that the public knows little of them. In all advertisements it should be made clear that the use of the fund is limited to bona fide trusts administered by the trust institution.

ARTICLE II.

A trust institution maintaining a common trust fund should so phrase its advertising that the public will not be encouraged to make comparisons between the results obtained by different trust institutions, particularly with respect to unit values and income yields, since such emphasis by competing trust institutions might tend to result in a less conservative investment management of such funds. A common trust fund should be offered only as a facility for rendering trust service."(46)

(46) Trust Principles and Policies, (The Trust Division, American Bankers Association, New York, 1950, P.16
Interpretation of Regulations

The past regulation and statement of policy has been subject to considerable interpretation as to meaning and intent, and the new regulation is already raising questions. Much of the earlier ambiguity centered around the term "bona fide fiduciary purpose."

The Board of Governors expressed an opinion on this subject concerning the advertising of common trust funds and the solicitation through such advertising of revocable trusts. The Board placed considerable reliance upon the individual institutions to exercise sound judgment in determining the true nature of a revocable trust. This true nature depended not only on the provisions of the trust instrument, but in considerable measure upon other facts and circumstances relating to the creation and use of the particular trust. They felt that the use of a common trust fund by individuals primarily seeking investment management of their funds should be avoided. They further indicated that advertising which failed to make clear that a common trust fund was solely a facility for investment or estate building
purposes would be consistent with the applicable restrictions on publicity of such funds. (47)

In discussing the bona fide fiduciary purpose, the American Bankers Association in their Common Trust Fund Handbook points out that the common trust fund is an excellent competitive asset for trust instruments, enabling them to attract smaller estates and trusts to their management. By use of the common trust fund, it is possible to handle trusts from $50,000 to $100,000 at a satisfactory profit. They caution, however, that the corporate trustee must restrict its new business effort for potential participations in the common trust fund to accounts having a definite fiduciary character, and must never regard itself as a competitor of exclusively investment media. (48)

The intent of the regulations is clear. While the new regulations are more liberal, there is every indication, based on the attitudes of trustmen, that the spirit of the old regulations will be followed for some time. The old


regulations did not restrict advertising, but they wanted to assure adherence to sound policies of trusteeship. Such funds should be distinguished from investment company or mutual fund operations and avoid competition based on limited performance records. In fact, in order to properly serve its community, it should be the duty of any properly qualified bank to bring to the attention of its customers and community an understanding of how its service can be helpful to those in need of building, protecting and gaining best usage of their estates and trusteed savings. There has never been an objection to publishing the total assets, number of accounts or investment composition of such funds, but an annual report designed to advertise unit values or income yields has been prohibited. This does not prohibit inspection upon request by interested parties to a trust. It has been felt that such information can also be shown to trust prospects or their representatives as long as the data is not published.

The restriction on publicity of unit values or income yields has been prohibited on the basis that comparisons may be misleading, and may also encourage a competition for capital gains or over-reaching for income.
The differences in investment policies of various banks and the time of starting the fund or the date of participation of trust accounts make comparisons between fund values and yields difficult. Furthermore, yields to individual accounts vary with the date of participation or entry.

Any publicity or solicitation concerned with common funds should emphasize the services or use of a trust and not the fund itself. The fund is simply a method by which certain advantages are made available to trusteeship accounts that are otherwise too small or expensive to administer to mutual benefit. The functions of trusteeship are to preserve, not to create wealth. However, today preservation of purchasing power as well as of dollar value has become a desirable objective. Since there are no "gains certain" media of investment, the balancing of dollar security with diversified calculated risk of equity security has become generally recognized as prudent and protective where needs and obligations are not attainable with fixed dollars. The common trust fund should never be advertised as a means of assuring capital gains or increasing the principal value.

(49) "Common Trust Fund Publicity", Trusts and Estates, December 1954, Vol. 93, No. 12, P.1074
CONCLUSIONS

While the potential trust market has expanded significantly in recent years, it still remains a limited market where services are sold to a select group of prospects on an individual basis through personal contact. Circumstances will vary, depending on the nature of the economic area served by a particular bank, but in most cases collective investment funds will not be promoted through media of general circulation such as newspapers and magazines. Brochures available for direct mailing or for use when calling on a prospective client would seem to be the most appropriate form of advertising. Since stockholders of a bank are also potential users of trust services, it would be advisable to include some information on collective investment funds in the annual report.

From the foregoing restrictions that were discussed, it appears that the following ideas should be avoided when using any form of advertising. The earnings of the fund should not be publicized. The yield of unit value should not be stressed. The performance of the fund should not be compared with another fund. The impression
should not be created that the bank is offering units of a common trust fund or that if a person establishes a trust the funds will be invested in a common trust fund. Finally, it should not be implied that other banks are at a disadvantage by not having a common trust fund.

This is what can be done when advertising to the public, to eligible beneficiaries, co-trustees and lawyers. The uses and functions should be stressed such as better investment diversification, greater protection of principal, and stability of income, increased efficiency of operation and greater economy in administration. When advertising collective investment funds, emphasis should be placed upon the benefits of trusts, such as protection for dependents, building an estate, providing for childrens' education, old age retirement, helping charities, relief from burdens of managing property, and conservation of estates by taking advantage of existing tax laws. Trusts should be advertised as a medium for protecting property and making it productive with a collective investment fund used as a method for spreading the risks through diversification.

(50) "New Business Aspects of Common Funds - Advertising", Trusts and Estates, November 1952, Vol. 91, No. 11, P. 860
CHAPTER VIII

INVESTMENT MANAGEMENT

Investment policies for collective investment funds should be similar to those appropriate for the participating trusts. Trustees agree that the proper approach toward the preservation of principal and the production of income is through an appropriate balance in investment portfolios between equity securities and fixed income securities, in line with the particular requirements and policies of individual accounts. Bonds or other fixed income securities are generally looked upon as being the major income producers, while common stocks are purchased primarily for appreciation. The ratio between these two types of securities will depend upon the individual bank's attitude for the economic outlook. The investment objectives for collective funds will be determined by the policies of the individual institutions and will depend to a degree upon the number of funds in operation.
As we have seen, the multiple fund approach toward separate funds for equities and fixed income securities is becoming more widely accepted. The elimination of the dollar restriction of Regulation F has especially encouraged the establishment of municipal bond funds. While this strong trend exists, the committee on common trust funds at the 1964 Mid-Winter Trust Conference generally felt that the historic balanced fund was still a most useful vehicle for smaller trusts. The extensive use of more than two specialized funds at this time seems to be limited primarily to the large city banks.

Objectives and Policies

In an effort to determine various approaches toward management of collective investment funds, the subject of investment objectives was discussed with several different bankers whose institutions were operating one or more funds. One city banker described their balanced common trust fund as primarily emphasizing income rather than capital appreciation. Their investment policy was to keep

(51) In order to respect the confidence of the individuals interviewed, neither they or their institutions will be identified. Likewise, the source of annual reports for collective investment funds referred to in following pages will not be identified.
stocks at 50% to 60% of the total fund. The fund is now ten years old and when it was started the stock ratio was 40%, but through appreciation had increased to 60%. At the time of the interview the average return on stocks was about 3%, while the return on long-term corporate bonds was about 4.4%. Their projection for the year to come was a return of 3.75 on their fund. With respect to their bond portfolio, they tried to space their maturities equally for each five-year period up to thirty years, so that they would realize an average return as interest rates fluctuated and proceeds from maturities were available for reinvestment. Depending on their outlook for interest rates, they might put greater emphasis on the long or short end of the maturity schedule. Their bond purchases were restricted to obligations rated "A" or better by Moody's, and Standard and Poor's. In purchasing bonds they did not buy discount issues, but tried to get current income. They looked at the coupon on the bond rather than the yield basis since the income beneficiary shares only in the coupon. They tried to purchase their bonds as close to par as possible because of the resulting principal loss as premiums reduce through the life of the bonds.
Appreciation of common stocks was used to offset bond premiums rather than using any discounts to offset the premiums.

It is not customary to amortize bond premiums in common trust funds because of the nature of valuing the interest of participants. It is required that individual trusts desiring to participate in a fund shall purchase a share on the basis of the then market value of the securities owned by the fund. Likewise, it is required that participating trusts which leave the fund be paid out on the basis of the then market value of the securities covered by the fund. Thus if a bond had been bought at 105 in the fund and has been amortized to 101 but is selling at 102, a trust purchasing a participation in the fund must purchase its share in this fund at 102 and a trust withdrawing from the fund must sell to the fund its share in this bond at 102. Therefore, a carrying value of 101 for the bond is meaningless. (52)

The composition of the bond portion of the fund was most heavily represented by utility issues and included railway equipment trust certificates for the

shorter maturities. Both government obligations and securities of government agencies were used. It was recognized that the yield obtainable on similarly rated finance company obligations were better than those of utility or industrial issues. However, because of the heavier debt structure of those companies, use of this type of obligation was limited to 10% of the total fund.

Their view toward the stock portion of the fund was to maintain a balance between the higher-priced, lower yielding stocks and the lower multiple higher-priced stocks. The higher multiple stocks admittedly offered greater potential for capital appreciation and for that reason are priced accordingly. They also, however, are more volatile and are subject to much greater price fluctuations which could work to the disadvantage of individual participants if their units were withdrawn at a time when prices were down. At the time of this study, higher-priced stocks yield from 1% to 2%, while the lower-priced stocks yield closer to 4%. The net effect of these combinations is to obtain a yield on stocks of about 3%.

An interview with another banker revealed that their policy was to buy almost entirely stocks of the
higher-yielding variety. The effect of this policy was to produce a yield of almost 4% for the year based on the unit valuation at the end of the year, October 31, 1963.

This policy has some merit and could particularly be favored by the income beneficiary who does not share in any principal distributions from his individual trust. This idea was discussed in an interview with another banker. While it was agreed that it had some merit, a review of the individual securities held in the fund raised the question that some were of dubious quality. The stocks were priced accordingly, thus resulting in a higher yield. It was also pointed out that even though the purchase of higher multiple stocks necessitated a current low rate of return, these were the securities that were most likely to appreciate in value and eventually increase their dividend payout. Even if the income beneficiary had no interest in the principal of his trust, a participant in a fund has a long-term investment outlook and will eventually share in the increased distributions.

It has been primarily the larger banks which have pioneered the use of specialized funds. The Fidelity Trust Company of Pittsburgh, which started its common
stock fund in 1952, explained their policy by saying that they have used a list of about 50 issues which they consider to be the most desirable, aggressive type of common stock. They have made a conscious effort to keep out the so-called "conservative" or "defensive" type of common stocks such as utilities and bank and insurance stocks. They have also made a conscious effort to avoid investment too heavily in the low-yield growth type stocks. They believe that the fund should provide a yield in keeping with the various industrial stock averages but expect it to be subject to wide fluctuations in value. (53) The policies of other common stock funds have not been quite as aggressive. Howard C. Judd of Morgan Guaranty Trust Company described their common stock fund as neither a so-called capital appreciation fund or an income fund. What they have tried to do is achieve an appropriate balance between the two extremes. (54) The New England Merchants National Bank of Boston has two common stock funds which were explained by the late Joseph H. Wolf. The first is

(53) Paul D. Remington, "Multiple Common Trust Funds", Trusts and Estates, April 1957, Vol. 96, No. 4, P. 354

a fund composed of common stocks selected with the objectivity of balancing reasonable current income rates with potential for long-term increase in value. The second is a fund comprised of common stocks selected with emphasis on long-term potential increase in value while subordinating considerations as to current income. (55)

Dangers of Growth Funds

The dangers of the common stock funds which are invested exclusively in the growth stocks are illustrated by an examination of the historical records of a fund of this type called the "special fund" - and comparison with a more conservative stock fund. The following unit values were obtained from the annual reports of the trustee:

<table>
<thead>
<tr>
<th>Date</th>
<th>Stock Fund</th>
<th>Special Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 1, 1961</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>July 31, 1962</td>
<td>8.509</td>
<td>7.032</td>
</tr>
<tr>
<td>January 31, 1963</td>
<td>9.786</td>
<td>8.057</td>
</tr>
<tr>
<td>July 31, 1963</td>
<td>10.261</td>
<td>8.387</td>
</tr>
</tbody>
</table>

These funds are used exclusively for employee benefit trusts in conjunction with a third fixed income fund. The objective of the stock fund is stated as invested in good quality common stocks of companies with above average prospects of steady increases in earnings and dividends. The anticipation is moderate current income plus moderate long-term growth of principal and income. The purpose of investing in units of this fund is to participate in the future growth of these companies and the economy in general. They caution that it should be recognized that the market value of the stocks, and hence the unit value of the fund, can be expected to fluctuate with the short-term fluctuations of the stock market.

The special fund is also invested in common stocks and is intended to supplement the stock fund. The percentage of individual trust assets invested in this fund depends on the nature of the trust and attitude of the employees' advisory committee regarding investment policy and objectives. The investment objective of this fund is long-term growth and appreciation of capital. This fund is invested in faster growing companies whose earnings are expected to increase substan-
tially over a period of years. Because of the nature of the stocks held and their higher price-earnings ratio, they say it can be expected that the market value of the stocks and the unit value of the fund will fluctuate more widely than the market in general.

At the last valuation date, the special fund unit value was $8.387 down from its original value of $10.00, whereas the common stock fund was valued at $10.261 up from an original value of $10.00. In other words, over this period the growth fund had done nothing but lose money, while the stock fund has shown some appreciation. It is true that all participants did not enter the special fund at $10.00 unit price. Some entered on July 31, 1962 at $7.032 and are consequently showing a gain rather than a loss. It is also true that no trust is invested 100% in the special fund, and that the objectives are long-term, while the period examined is short-term. Nevertheless, the historical record is meaningful. A performance such as this can provoke questions regarding the investment ability of the trustee.

The degree of specialization can be carried to extremes. It has already been suggested in visualizing
the future that funds could be operated for each of the basic industries such as one for public utilities, oils, bank stocks and so forth. The large city banks have sufficient assets under their administration to justify the establishment of specialized stock funds if they choose. For the majority of country banks, however, a common stock fund with better balanced securities seems more appropriate.

Fixed Income Funds

The funds which are proving to be the most beneficial are the bond funds, both corporate and municipal. One Chicago banker with whom these funds were discussed felt that there would eventually be no reason for any of their accounts to own a corporate or municipal bond when they could participate in a fixed income fund. He said that they were excluding the fixed income portion of accounts that were of sufficient size to be invested individually. Another banker said that many of their customers had ideas about common stocks and liked to hear the trustee's reasons for favoring one over another. The customers did not have this same interest with bonds, however, and they seemed to be very satisfied
to have their account invested in a fund. Howard C. Judd of Morgan Guaranty felt the operation of their municipal bond fund has been very successful. It has been in operation for only two years and is already their second largest fund. Their experience was that they had eliminated 2,778 separate holdings from the individual participating trusts. As of their last valuation date, the fund itself held only 137 separate issues so they have had a net reduction of 2,641 separate holdings. Moreover, they feel that with a much broader portfolio and a better spacing of maturities, future income and capital values should be better maintained. (56) Another banker interviewed said they were obtaining a better yield on their taxable fixed income fund than they could by investing accounts individually by using mortgages in their portfolio. Formerly, trustees were reluctant to use mortgages in their funds because of the necessity of segregating defaulted mortgages. Payments on individual mortgages are not made with the same regularity that interest payments are made on corporate and government obligations

(56) Judd, op. cit. P.30
and dividends paid on stock. Very often a mortgage payment will be received several days late, and the mortgage is considered in default until the receipt of the payment. If this takes place over a valuation date no new entries can be admitted to the fund unless the mortgage is segregated in a separate fund. The alternative to segregation was to sell the mortgage before the valuation date, but since mortgages have limited marketability there was not a feasible solution. Consequently, to avoid complications trustees refrained from using this type of security in their funds. Now under Regulation 9 the segregation of defaulted mortgages has been made optional. Alternatives are now possible, such as setting up a reserve to which defaulted interest may be charged, or the bank can purchase the mortgage in cases where the cost of segregation would be greater than the loss to the trust incurred by the disposition of the asset. Despite the simplified procedures for handling mortgages, their use is not favored by all. One banker objected to their use in a fund because of the mandatory requirement of

publishing the assets of the fund and the confidential nature of local mortgages. It was felt, however, that FHA mortgages purchased from another locality would overcome this objection.

Performance of Funds

Because of the publicity restrictions, it is difficult to obtain sufficient information to make a judgment on the success of the trustee's policies in reaching their investment objectives. The annual reports of nine different balanced funds revealed little in the nature of the past record of the fund's performance. Only two of the reports examined listed a valuation amount for preceding years. In all of the reports studied several included comments on the increased income to the beneficiaries.

The following are representative of the comments:

"We are pleased to report an increase in the income distributed per unit for the tenth consecutive year. Income paid to participating trusts during the past year amounted to $1.46 a unit representing a yield of 3.87 at market on October 31, 1963."
"The purpose of this fund is to provide the participating trusts with broad investment diversification and an income return consistent with conservative investment policy. In the year just ended, income distributions amounted to $.0550 per unit compared with $.0538 the previous year. The principal unit value on January 31, 1963 was $1,70546. Based upon these results, the current rate of return is 3.22%. The rate of return to each trust depends, of course, upon the cost of its units and the annual income distribution.

Income beneficiaries will be happy to note that income distributions per unit for the tenth year of operation amounted to $.548974 as compared to $.543279 for the prior year. The audited statements and schedules herewith presented furnish the details of administration of the fund during the year."

"For the tenth successive year, there was an increase in income distributed per unit. The unit distribution in 1962 was approximately 54.5 cents as compared with approximately 52.5 cents a year earlier."

Two of the annual reports contained indirect comments about the increase in unit value of the funds:

"On November 1, 1949 the fund was inaugurated with the investment of $3,113,000 by 173 trust accounts in units of an initial value of $100 each. The fund has grown during the thirteen year period and by October 31, 1962 had an aggregate market value of $22,603,451.67, with 572 trusts participating. It will be noted that the value of the units is now $161.91.

We are happy to announce that the earnings per
"unit have again increased and for the fiscal year which ended October 31, 1962, the distribution totaled $6.3775. This compares with $6.16 for the fiscal year which ended October 31, 1961."

"The fund was commenced on August 1, 1950 with the investment of $681,130 by 27 fiduciary accounts in units of an initial value of $10.00 each. On July 31, 1963 there were 293 participants and the aggregate market value of the fund was $19,117,014.31.

In formulating an investment policy for the fund, it has been our desire to obtain a fair income return for beneficiaries of participating accounts with due regard at the same time for preservation of the principal of the fund. Income earnings of $.655770 per unit were distributed to participants in the fund during the fiscal year covered by this report and the capital value of each unit at the end of the year was $19.0259."

The other reports made no comment in their message to the beneficiaries and co-trustees about the amount of income distributed compared with previous years or the change in asset value.

The difficulty of comparison of investment performance is illustrated in the following exhibit. The unit values are shown as of the end of the fiscal year as reported in the annual report of each fund. Except in a few cases, the original unit value was not given, but it can be presumed that the unit value at the inception of the fund was in multiples of either $1, $10 or $100,
which is consistent with operating procedures of the funds:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Years of Operation</th>
<th>Orig. Unit Value</th>
<th>Latest Unit Ratio</th>
<th>Stock %</th>
<th>Fixed Income and Cash %</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-31-63</td>
<td>11</td>
<td>$10</td>
<td>$ 15.83</td>
<td>51</td>
<td>49</td>
</tr>
<tr>
<td>10-31-63</td>
<td>11</td>
<td>10</td>
<td>14.58</td>
<td>64</td>
<td>36</td>
</tr>
<tr>
<td>10-31-63</td>
<td>10</td>
<td>10</td>
<td>15.85</td>
<td>43</td>
<td>57</td>
</tr>
<tr>
<td>10-31-62</td>
<td>13</td>
<td>100</td>
<td>161.91</td>
<td>62</td>
<td>38</td>
</tr>
<tr>
<td>11-30-62</td>
<td>10</td>
<td>10</td>
<td>14.83</td>
<td>64</td>
<td>36</td>
</tr>
<tr>
<td>1-31-64</td>
<td>18</td>
<td>1</td>
<td>1.80</td>
<td>63</td>
<td>37</td>
</tr>
<tr>
<td>7-31-62</td>
<td>12</td>
<td>10</td>
<td>19.02</td>
<td>69</td>
<td>31</td>
</tr>
<tr>
<td>7-31-62</td>
<td>11</td>
<td>100</td>
<td>139.53</td>
<td>64</td>
<td>36</td>
</tr>
<tr>
<td>10-31-63</td>
<td>11</td>
<td>(*). 24.52</td>
<td>37.77</td>
<td>49</td>
<td>51</td>
</tr>
</tbody>
</table>

(*) As stated in annual report.

No valid comparison of the funds can be made one with another. However, it seems that the results achieved by the trustees have been satisfactory and that over a period of years a reasonable degree of appreciation has been attained. While the level of the security market on the various dates affects not only the unit value but also the percentage in stocks, it is interesting to note the apparent differences in the philosophy of the various trustees as reflected in their individual proportions of stocks and bonds. It should be kept in mind that these are all balanced funds and essentially for the same purpose. It appears that each trustee will
have to defend his own philosophy and performance against other forms of investment competition such as mutual funds.

Collective investment funds have been considered an answer to the competition from mutual funds, although the funds should not be considered as competitive with mutual funds, either in intent or purpose, due to the divergence of their basic purposes. It should not be the intent of any trustee to compare the results of a stock fund serving the general investing public. This attitude goes back to the period when the first regulations governing collective investments were established for the purpose of restraining what might develop into speculative policies, in an attempt to be competitive with other forms of investment. A prohibition against comparison has existed both in the regulations and in the opinions of trustmen to some degree ever since. Some trustmen feel that mutual fund and trust institutions are competing for the same type of account. An officer of one of the larger mutual funds stated that the average investment was considerably less than what is commonly accepted as a minimum satisfactory size for a trust account. On the other
hand, a booklet prepared by the Investment Company Institute suggests that investment company shares can be useful to banks in the management of trust accounts. They state that it is well-known that small accounts have frequently been unrewarding to bank trust departments, particularly the smaller departments because of the time and expense involved in setting up and managing numerous small portfolios. They go on to say that trust officers are understandably reluctant to turn away any clients, especially those who may do business with other departments of the bank. Through the use of investment shares and, where necessary, appropriate trust instruments, banks can solve this problem and also simplify tax and estate matters to the satisfaction of all concerned. (58)

Furthermore, "Investment Companies", published by Arthur Wiesenberger & Co., which is considered perhaps the most comprehensive and authoritative source on the subject of investment companies, contains several

(58) Investment Companies - An Aid to Bankers, (Investment Company Institute, New York, 1961.)
sections on various phases of estate planning, including the advantages of living trusts. They say:

"The suitability and desirability in any individual circumstances of one or more of the types of trusts briefly described in this chapter are the most important considerations. But in those cases where full investigation of all pertinent facts indicates an affirmative answer, investment company shares may make practicable a program which could otherwise be difficult, if not impossible, to carry out." (59)

The suggestion from both of the foregoing illustrations is that investment company shares are suitable primarily for the very small accounts and the very small trust departments. Indeed, the shares have been used in both instances. However, the examples used in the Wiesenberger summary include asset figures of a size that any trustee would not only be willing to accept, but actually solicit. In another section entitled "Why Large Investors Use Investment Companies", they say that trustees are recognizing the favorable investment attributes of many investment company securities, and their acceptance as trust investments is steadily increasing. They say that a sharp increase in fiduciary holdings of

investment companies reflects several developments of the recent past. First was the widespread acceptance of common stocks as appropriate, prudent and necessary trust instruments. Another was the need for diversification and continuous professional supervision for trust accounts. Many trustees, however, hesitated to use investment company shares lest they be accused of delegating their investment powers. They say this question has been settled in twenty-five states where legislative enactments or court decisions now specifically permit fiduciaries to invest in investment company securities, in some cases, with certain limitations. Furthermore, the shares are a proper investment if the trust instrument grants the trustee discretion to so invest. (60)

At this point then, investment companies are encouraging the use of their shares as trust investments, but trustmen are opposed to making any comparisons to substantiate their position. W. Howard T. Snyder in an article entitled "Measurement of Trustees' Investment Performance" recognizes this as a problem. He points

(60) Ibid, P.78, 79
out that vigorous growth has been shown by other media of investment which compete daily for trust departments' new business. The mutual funds, he says, have grown from a minor segment of the American economy to a giant industry that has an important influence on national security markets and the financial economy. Trust institution planners frequently are obliged to demonstrate the advantages of trust investing over mutual fund investment, and so to answer claims of competing investment media a workable means of investment performance measurement is needed. The comparison of mutual funds and collective investment funds does present a difficult problem. Mutual funds vary greatly in their investment aims, and even more so in the composition of the assets in their portfolio. Many are concentrated in assets of a single type - chemical equities, electronic equities, growth equities and other specialized funds. If the balanced mutual funds are used for comparison to a trust, there are the distortions caused by management fees and the impact of income and capital gains distributions in cash or shares. Furthermore, the balanced mutual funds are very often balanced in proportions that
differ from the common trust funds. (61)

Conclusions

Trustees have a common responsibility to their beneficiaries, but the approach they take to discharging their obligations and satisfying their objectives will differ. Several ideas toward management of collective trust funds have been presented. The results of the programs decided upon will not be uniformly satisfactory, but each individual trust institution is best in a position to judge the circumstances of the particular situation and justify these actions. As new and different approaches to investment are originated by the more aggressive institutions, they will be examined and used if considered to be appropriate as they have been in the past. Certainly, a different philosophy has been adopted by trustees since the end of World War II when they first started purchasing common stocks in volume for their portfolios, in order to guard against the dangers of inflation.

This marked a notable departure from what formerly was considered prudent investing. The use of collective funds itself is a significant development. Ideas for even more specialized funds have been suggested. Experiments for portfolio management, with the assistance of computers, are being conducted by the computer manufacturers and several banks currently. Differences of opinion will continue, but new ideas will be developed which will benefit both trustees and those they serve.
CHAPTER 24

CONCLUSION

In the preceding chapters, the important phases of development of collective investment funds have been identified. The important problems, the advantages, and the limitations have been reviewed. We have seen that the idea of collective investment is very old and has been borrowed by trustees only recently. Their experience with this form of investment has covered a relatively short span of time. Significant difficulties have been overcome to bring collective funds to the stage of development at which they are today. Through legislation, the early issue of double taxation was overcome. With the adoption of Section 17 of Regulation F, trustees were given sufficient authority to establish funds. The early regulations were very restrictive in nature and restrained the usefulness of the funds. The enabling laws of the various states were not enacted uniformly. Accordingly, the development took place in certain regional areas under severe handicaps. The Regulations of the Comptroller of the Currency which
are presently in effect have allowed trustees more freedom in their operation, but still adequately protect the interests of the public.

The original concept of collective investment was to provide a means of investment for only those trusts which were too small to be invested independently. With the elimination of dollar restrictions on the amount of money that can be invested the use of funds has been expanded to areas which originally were not served. The principal advantages of collective investment - diversification, stability of income and investment opportunities - can be made available to accounts of all sizes and there is a trend toward including larger accounts. While limitations do exist, they can be avoided or overcome through proper knowledge of collective investments and a thorough understanding of the account circumstances of the various trusts considered for investment therein.

The extent of use for individual institutions will depend on the complexity of their investment problems. It is felt that a single balanced fund may provide the best answer for a small trust department having sufficient size to justify the establishment of a fund. As the size increases and more accounts are included, or if greater flexibility is desired, specialized funds for common
stocks and fixed income could be employed to provide better service for new and existing accounts. If assets are of sufficient size, the trust institution might consider operating the specialized funds in conjunction with the balanced fund. However, by use of appropriate ratios the specialized funds can serve the same purpose as one balanced fund for those accounts which would normally be invested in a balanced fund. As the number of funds increase, the cost of operation will rise. After the desired level of flexibility is attained it does not seem advisable to open multiple funds unless assets administered are of substantial size. Probably only the very large banks should consider the use of more than two funds, but size is relative and only the management of each individual bank can determine their best course of action after proper study of the factors involved.

At the present time, banks can serve the financial needs of the public by providing them a place to deposit their reserve funds in some form of savings accounts. When a customer's assets reach rather sizeable proportions he can turn to his bank's trust department for supervision of his property. But there is a void in the services the bank can offer its customers who have accumulated $10,000 or $20,000 beyond their immediate needs. They may prefer
to invest these surplus funds in something other than a savings account. The solution to this problem is the collective investment funds for agency relationships as permitted under Section 9.18 (3) of Regulation 9. The dispute between the Comptroller of the Currency and the Securities Exchange Commission has postponed the establishment and operation of these funds, but if past history can serve as a guide, this obstacle will most certainly be overcome. Bills have been introduced in Congress already, which if passed, will resolve this conflict.

While it is far from becoming a reality, we can visualize that the complete investment problem of a trust department can be satisfied through the use of several different collective funds for varying investment objectives in the same manner that the bank invests depositors' funds in loans and discounts, United States Government securities and municipal obligations. The success of individual funds depends on the objectives and capabilities of management. The basic idea has proven successful and beneficial to both trusts and trustees. It appears that funds will be used by trust institutions to an even greater extent than they have been in the past.
BIBLIOGRAPHY

Books


Doane, C. Russell and Edward J. Hillis, Investment Trusts and Funds, Great Barrington, Massachusetts, 1960

Investment Companies, Arthur Wisenberger and Co., New York, 1959


Prather, Charles L., Money and Banking, Homewood, Illinois, 1953


Cases

Brooklyn Trust Co. V. Commissioner of Internal Revenue, 56 S.C. 680, 80 F 2nd, 865 (1936.)

City Bank Farmers Trust Co. V. Graves, et. al. 272 N.Y. 1, 3 N.E. (2nd) 512 (1936.)

Government Document and Reports


108
Periodicals


"Common Trust Fund Publicity", Trusts and Estates, December 1954, Vol. 93, No. 12, P.1072


"Development of Common Trust Funds", Trusts and Estates, April 1941, Vol. 72, No. 4, P.367


Remington, Paul D., "Multiple Common Trust Funds", Trusts and Estates, April 1957, Vol. 96, No. 4, P.352


"Why Dual Common Trust Funds?", Trusts and Estates, December 1959, Vol. 98, No. 12, P.1207


The Wall Street Journal, February 26, 1964, P.1, Column 5

Reports and Pamphlets

Collective Investment Funds Operated Under or in General Conformity With Regulation 9 of the Comptroller of the Currency, Trust Division, American Bankers Association, New York, 1964

Introduction to Trust Investment, Trust Division, American Bankers Association, New York, 1961
Investment Companies - An Aid to Bankers, Investment Company Institute, New York, 1951

Trust Principles and Policies, Trust Division, American Bankers Association, New York, 1950