

Balancing Act: Fiduciary Investment After the Storm

Trustees—indeed all investors—are challenged by the current capital markets environment. Arguably the single most important cause of the recent market collapse was investors' seemingly unquenchable thirst for current yield without proper regard for risk. When the subprime bubble finally burst, risk became the only factor that seemed to matter, as investors fled to the perceived safety of U.S. Treasury securities. But markets have normalized somewhat in the past several months, and investors are beginning (gradually) to reconsider a proper balance between risk and reward when assessing asset allocation.

Establishing and maintaining an appropriate risk-return balance isn't just good fiduciary policy. For many trusts, such a balance is required either by the terms of the governing instrument of the trust or by the provisions of applicable state fiduciary law. Most states have adopted, by statute, some form of the prudent investor rule,¹ as set forth in the Restatement (Third) of Trusts. Unless the governing

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instrument provides otherwise, a trustee operating under the prudent investor rule must invest for both safety of principal and production of a reasonable return on investment. “Safety” includes protecting the purchasing power of trust principal from erosion due to inflation.² “Return” means total return, which contemplates both current income and capital appreciation.

In addition to the duty to invest trust assets prudently, a trustee ordinarily is subject to a duty to manage the competing interests of differently situated beneficiaries in a fair and reasonable manner.³ For example, a trustee who focuses solely on investing for income may do a disservice to the remainder beneficiaries by ignoring the effects of inflation on the trust’s assets. To comply with this duty to treat beneficiaries impartially, a trustee must balance the objective of preserving the inflation-adjusted value of trust principal with the production of a reasonable amount of trust accounting income.

This balancing act has been difficult to sustain of late. Although trustees are often required by the governing instrument or state law to invest for total return, some have recently fled to cash or bonds in a desperate attempt to limit additional portfolio losses in the wake of recent market turmoil. In light of a trustee’s duty to treat all beneficiaries impartially, such a flight to cash or bonds—presumably in a good faith attempt to preserve the nominal value of the trust’s portfolio—seems likely to erode the portfolio’s real value over time, to the potential detriment of the remainder beneficiaries.

Given current market uncertainties, how can a

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trustee best shape the allocation of the trust’s assets in a manner that will comport with the duties of prudent investment and impartiality? And if the trustee decides to invest for total return, does it necessarily follow that the trust’s distribution policy will need to be modified to make the income beneficiary “whole”? We conducted a series of analyses to try to answer these questions.

Ways to Enhance Current Distributions

Arguably, a trustee will have the greatest flexibility to pursue total return when the governing instrument provides broad discretion (e.g., under a “best interests” standard) to distribute trust accounting income and principal among all current beneficiaries. In such a case, the trustee may exercise the discretionary authority to distribute principal to current beneficiaries during periods when the portfolio generates little or no trust accounting income.

Unfortunately, some governing instruments are not drafted quite so flexibly. For example, principal distributions may be subject to a narrow standard (e.g., for the current beneficiary’s “health, support, maintenance, and education”)⁴ or be prohibited entirely. In the current low-yield environment,⁵ one might conclude that investing for total return in the face of such a restrictive principal distribution standard would necessarily violate the trustee’s duty of impartiality as it relates to an income beneficiary. Fortunately, the default provisions of state law may provide some opportunity for relief. These statutory regimes usually take one of two forms:

- First, some states allow a trustee to convert a distribution standard based upon traditional notions of trust accounting income into a standard expressed as a percentage of trust principal—often referred to as a “unitrust distribution.”⁶ Under this model, the trustee simply distributes (or is permitted to distribute) a percentage of the fair market value of the trust assets each year to the income beneficiary or beneficiaries. This approach gives a trustee the ability to invest for total return without penalizing the income beneficiary because that beneficiary always receives (or may receive, pursuant to the income distribution standard set forth in the governing instrument) a fixed percentage of the net asset value of the trust—even in an environment when the portfolio generates little or no current income.

- Second, some states grant trustees broad (but not necessarily unlimited) authority to adjust between trust accounting income and principal—often referred to simply as a “power to adjust.”⁷ Under this model, a trustee is permitted to treat as trust accounting income items that otherwise would be considered principal under applicable state law.⁸ This approach effectively expands traditional notions of income so that the trustee can more readily pursue total return without adversely affecting the interests of the income beneficiary.

Despite the fact that the combination of flexible drafting and state fiduciary law seem to provide ample avenues for relief, trustees seem reluctant to depart from traditional notions of income and principal when developing investment and distribution policies for a particular trust.

Account for Income by Modeling Portfolio Outcomes

One way to help broaden a trustee’s perspective on these matters is to use sophisticated financial modeling to test different potential investment and distribution policies across a wide array of future market scenarios. Some view this kind of financial modeling as too simplistic,⁹ but we believe that truly rigorous forecasting can be instrumental in helping a trustee chart a course. For purposes of this study, we used a wealth forecasting model¹⁰ that begins with today’s initial market conditions and generates 10,000 plausible future paths of investment returns.

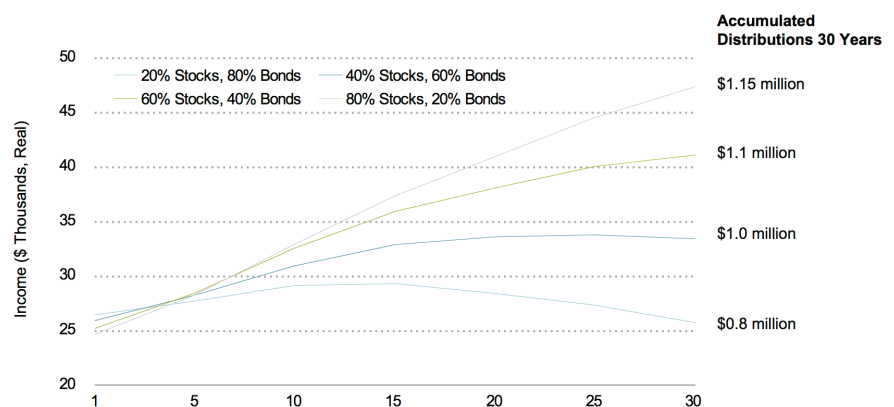
We first examined trust accounting income using our forecasting model. Assume that the governing instrument precludes (or severely restricts) the distribution of trust principal to the current beneficiary. The trustee wishes to maximize distributions to the current beneficiary over the long haul, but not at the expense of the remainder beneficiaries. And the trustee does not wish to convert to a unitrust

or exercise a power to adjust under state law unless absolutely necessary to comply with the duty of impartiality.

In the current market environment, spreads between dividend and bond yields are unusually narrow.¹¹ But to make a truly informed decision about a trust’s investment policy, the trustee needs to know what to expect from the capital markets in the future, not just today: Will current yield spreads persist over time, which might suggest a more stock-oriented allocation—at least for now? Or should the portfolio be positioned toward bonds to take advantage of stronger yields if and when yield spreads normalize?

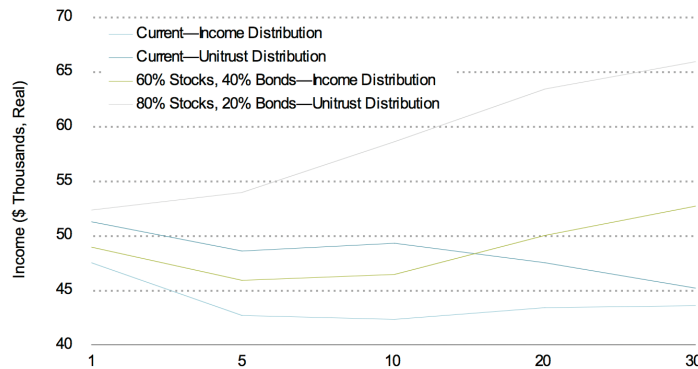
Display 1 tracks after-tax, inflation-adjusted trust accounting income for a \$1 million portfolio over a 30-year period. Although we modeled the outcomes across a wide range of capital market futures, for simplicity only the median results are shown. We tested several different asset allocations, ranging from bond-heavy (20 percent stocks, 80 percent bonds) to stock-heavy (80/20). As shown in Display 1, we would expect that over the next 12 months (“Year 1” on the horizontal axis), very little additional income will be generated by the bond-heavy portfolio relative to the other, more equity-tilted allocations. By Year 5, we would expect the portfolio, on average, to generate roughly the same amount of income, regardless of asset allocation.

Display 1
Different Paths of Trust Income (Median, Real, After-Tax)*



*Based on Bernstein’s estimates of the range of long-term returns for the applicable capital markets. Data does not represent past performance and is not a promise of actual or range of future results. See note 12, supra, for details.

Display 2 Different Paths of Trust Distribution (Median, Real, After-Tax)*



*Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. Data does not represent past performance and is not a promise of actual or range of future results. See note 12, *supra*, for details.

But over the full 30 years of our analysis, we expect the stock-heavy portfolio to generate considerably more income, both annually and on a cumulative basis. Why? It's not because we project that yield spreads between stocks and bonds will remain tight; in fact, in the median case we expect those spreads to normalize over time. The reason that the stock-tilted portfolio produces more income over time is the superior growth potential of that portfolio. Simply put, by the time yield spreads normalize, we would expect the stock-heavy portfolio to have a much larger principal base from which to produce income. And although Display 1 focuses exclusively on median outcomes, the stock-heavy portfolio produced more after-tax, inflation-adjusted income in the vast majority of the 10,000 capital market futures generated by our model.

Case Study

This outcome suggests that sometimes a simple adjustment to asset allocation may be sufficient to enable a trustee to fulfill both a mandate to invest for total return and the duty to treat beneficiaries impartially. But there are times when a trust's distribution policy, along with its investment policy, may need to be modified to produce an optimal solution. To illustrate this point, we developed a case study

based upon a real-life situation presented to us by an estate planning attorney.

The attorney's clients are guardians ad litem for the remainder beneficiaries of a trust. They were approached by the legal team for the income beneficiary who, together with the trustee, wanted to change the current distribution policy of the trust from an "income-only" model to a 4 percent "unitrust" model.¹² The attorney's question: Would it be in the best interest of the remainder beneficiaries to agree to this change?

The trust is administered in Illinois and had a liquid portfolio valued at \$1.34 million at the time of our study. The trust's current allocation is 59 percent U.S. large capitalization stocks, 19 percent intermediate-term

taxable bonds, and 22 percent cash equivalent investments. The governing instrument provides that each year the trustee must distribute all trust accounting income, or if greater, \$50,000 (nominal) before tax, to the current beneficiary, who is 55 years old and lives in a state that does not have a state income tax. The remainder beneficiaries are minors residing in Illinois. The assets will continue to be held in trust for their benefit upon the death of the current beneficiary, which we assumed for purposes of this analysis to occur in 30 years.

As a baseline for comparison, we first examined the potential outcomes using our wealth forecasting model, assuming no changes to the trust's asset allocation or distribution policy. As shown in Display 2, in typical markets, the after-tax, inflation-adjusted value of trust accounting income hovers between \$42,000 and \$48,000 per year under the current plan. Over the full 30-year period of our analysis, we project accumulated distributions (after taxes and adjusted for inflation) to the current beneficiary of \$1.3 million and a remainder value of \$1.6 million (also adjusted for inflation), as shown in Display 3. Thus our projections suggest that in typical markets, the current beneficiary will receive approximately 46 percent of the total wealth of the trust over 30 years, with the remainder beneficiaries receiving the balance, 54 percent, as shown in Display 4.

Effect of Proposed Change to Distribution Policy

How does this baseline scenario compare to the potential outcomes under the proposed unitrust distribution policy—a 4 percent unitrust? Using the same forecasting model, we project that in typical markets the current beneficiary will receive between \$45,000 and \$51,000 per year (after taxes and adjusted for inflation), as shown in Display 2. This range of distributions is slightly higher than we would expect with the income-only model at the current allocation. As a result, over the full 30-year period of our analysis we project that in typical markets, the current beneficiary would receive an additional \$200,000 in accumulated distributions if the distribution policy were shifted from income-only to a 4 percent unitrust, as shown in Display 3. This additional wealth to the current beneficiary comes at the expense of the remainder beneficiaries and thus changes the percentage distribution of wealth between the current and remainder beneficiaries. More specifically, as shown in Display 4, the share that the current beneficiary is likely to receive increases from 46 percent to 51 percent, while the remainder beneficiaries' share falls from 54 percent to 49 percent.

Effect of Change to Investment Policy

Changing the distribution policy is only one way to affect what both the current and remainder beneficiaries receive from the trust. The other major factor is asset allocation. Should the trustee simply shift the current allocation? How would the current and remainder beneficiaries be affected?

Turning once again to our model, we ran a second alternative scenario in which we maintained the current income-only distribution policy, but changed the asset allocation to 60 percent globally diversified stocks and 40 percent intermediate-term municipal bonds.¹³ This change represents a shift to global stocks versus having a U.S.-only concentration and full investment of the fixed income portion of the portfolio so that the trust doesn't hold cash as

Display 3 Total Wealth—Year 30 (Median, Real, After-Tax)*

Strategy	Income Beneficiary	Remainder Beneficiary
Current Allocation Income Distribution	\$1.3M	\$1.6M
Current Allocation Unitrust Distribution	\$1.5M	\$1.4M
60% Stocks / 40% Bonds Income Distribution	\$1.5M	\$1.8M
80% Stocks / 20% Bonds Unitrust Distribution	\$1.8M	\$2.0M

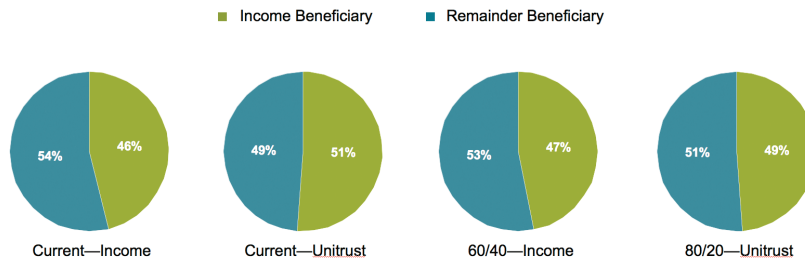
*Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. Data does not represent past performance and is not a promise of actual or range of future results. See note 12, supra, for details.

part of its strategic long-term allocation. As seen in Display 2, this change would provide more wealth to the current beneficiary each year compared with the two distribution policies that we tested at the original allocation. Specifically, at the new 60/40

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allocation, in typical markets we project that the current beneficiary will receive between \$46,000 and \$53,000 per year (after taxes and inflation), or about \$1.5 million in accumulated distributions over 30 years, as shown in Display 3. In other

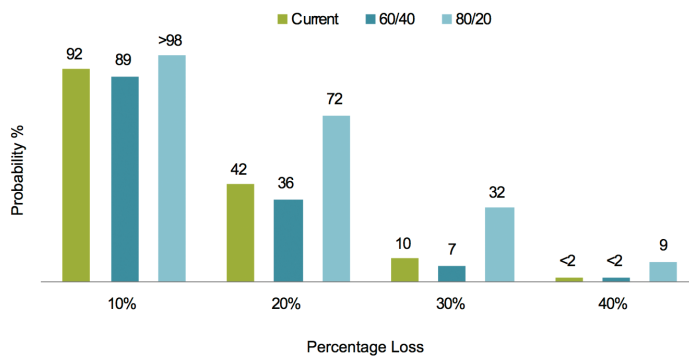
**Display 4
Breakdown of Total Wealth—Year 30 (Median, Real, After-Tax)***



*Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. Data does not represent past performance and is not a promise of actual or range of future results. See note 12, supra, for details.

words, we would expect the current beneficiary to be just as well off over the long haul with a simple shift in asset allocation as she would be with a more complicated unitrust conversion—and this benefit does not come at the expense of the remainder beneficiaries. As shown in Display 3, the remainder beneficiaries would receive \$200,000 more inflation-adjusted wealth at the end of year 30—roughly the same additional benefit that the current beneficiary is projected to receive with the new allocation. And the expected percentages in which the beneficiaries will share trust wealth should not change materially as a result of the proposed asset allocation change.

**Display 5
Probability of Loss over 30 Years***



*Projections indicate the probability of a peak-to-trough decline in pre-tax, pre-cash-flow cumulative returns of 10%, 20%, 30% or 40% over the life of the 30-year forecast. Because the Wealth Forecasting System uses annual capital market returns, the probability of peak-to-trough losses measured on a more frequent basis (such as daily or monthly) may be understated. The probabilities depicted above indicate an upward adjustment intended to account for the incidence of peak-to-trough losses that do not last an exact number of years. Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. Data does not represent past performance and is not a promise of actual or range of future results. See note 12, supra, for details.

Effect of Change to Distribution and Investment Policies

We also considered a third alternative: an adjustment to both the distribution policy and the asset allocation of the trust. In this alternative scenario, we modeled a 4 percent unitrust distribution combined with an asset allocation of 80 percent globally diversified stocks and 20 percent intermediate-term municipal bonds. As seen in Displays 2 and 3, all parties appear to benefit from this strategy over the 30-year horizon of our analysis. In the median case, the current beneficiary will receive more on an annual basis and more total wealth (\$1.9 million after tax and adjusted for inflation), while the remainder beneficiaries also stand to benefit (\$2

million adjusted for inflation) upon termination of the trust in 30 years. The current beneficiary's share of total wealth should increase modestly from 46

percent to 49 percent under this strategy, as shown in Display 4.

Although this third alternative has the potential to deliver the most wealth to both the current and remainder beneficiaries, moving from an allocation of approximately 60 percent stocks to 80 percent stocks significantly increases portfolio risk. In fact, as shown in Display 5, an 80/20 portfolio is twice as likely to experience a 20 percent downturn and more than four times as likely to experience a 30 percent downturn over the next 30 years compared to a 60/40 portfolio, based upon our model.¹⁴ Given investor anxiety in the current environment, such a shift in risk is likely to be difficult to tolerate. More importantly, such volatility can wreak havoc on the annual distribution of the current beneficiary.¹⁵ A trustee needs to balance this volatility risk against the potential long-term benefit of a more stock-tilted allocation. Each situation must be analyzed based upon its own unique circumstances; there is no one right answer.

Conclusion

Our analysis demonstrates the tradeoffs of changes in asset allocation and distribution policy for both the current and remainder beneficiaries. In the current environment, a simple shift in asset allocation—in this case, global diversification of the stock portion of the portfolio and moving out of cash and into intermediate-term bonds—can benefit all parties over the long haul. In more complex situations, a shift to a unitrust distribution policy may be warranted, but this method works best when the trustee is willing to invest for total return. Given the heightened volatility in the stock market, optimizing the allocation and sticking with the current distribution policy seemed a good first step.

This analysis highlights the benefits of testing the likely outcomes of various strategies through the use of sophisticated financial modeling. It enables trustees to better understand the factors involved and their effects on all beneficiaries prior to determining the desired approach. **ii**

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Endnotes

¹"The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust." Restatement (Third) of Trusts § 227.

²A flight to Treasuries, in an attempt to preserve the nominal value of trust principal, does not seem to satisfy this standard, which contemplates preservation of real, inflation-adjusted value.

³"In addition, the trustee must ... conform to the fundamental duties of loyalty ... and impartiality." *Id.* § 227(c)(1).

⁴Such a standard is said to be "ascertainable" within the meaning of Section 20.2041-1(c)(2) of the Treasury regulations.

⁵As of this writing, the dividend yield on a portfolio of S&P 500 stocks is 2.18 percent, and interest on a 10-year Treasury security is 3.45 percent.

⁶See, e.g., 760 ILCS 5/5.3 (the Illinois "total return trust" statute). Provisions vary from state to state, but the terms of the Illinois statute are fairly representative of those found in other states. Under Illinois law, a unitrust conversion is possible if the governing instrument "describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines that conversion to a [unitrust] will enable the trustee to better carry out the purposes of the trust and the conversion is in the best interests of the beneficiaries." [*Id.* § 5.3(a)(1).] Upon conversion, an Illinois trustee must invest for total return, "without regard to whether that return is from income or appreciation of principal." [*Id.* § 5.3(a)(2).] The trustee may effectuate the conversion by unilateral action (with proper notice to certain trust beneficiaries), by agreement of the trustee and "all the primary beneficiaries" of the trust, or with court approval, depending in each case upon specific circumstances. [*Id.* § 5.3(a)(3), (b), (c).] Upon conversion, the term "income," as used in the governing instrument, is redefined under the Illinois statute to mean a percentage of the net fair market value of the trust assets averaged over the preceding three years—a so-called "smoothing" rule. [*Id.* § 5.3(d).] In a unilateral conversion by an Illinois trustee, the unitrust percentage will be 4 percent. [*Id.* § 5.3(d)(3).] In a conversion by agreement, the unitrust percentage must be between 3 and 5 percent. [*Id.* § 5.3(b).] An Illinois court may select any unitrust percentage it wants. [*Id.* § 5.3(g)(1).] Generally, "a state statute providing that income is a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of the trust assets" will be respected for federal income tax purposes. See Treas. Reg. § 1.643(b)-1.

⁷See, e.g., NY EPTL § 11-2.3(b)(5) (describing a trustee's "power to adjust" under New York law). Provisions vary from state to state, but the terms of the New York statute are fairly representative of those found in other states. Under New York law, a trustee may exercise the power to adjust if (i) the New York Principal and Income Act otherwise applies; and (ii) the governing instrument "describes the amount that may or must be distributed to a beneficiary by referring to the trust's income." [*Id.* § 11-2.3(b)(5)(A).] In such circumstances, "the [New York] prudent investor standard ... authorizes the trustee to adjust between principal and income to the extent the trustee considers advisable to enable the trustee to make appropriate present and future distributions ... if the trustee determines, after applying the rules [of the Principal and Income Act] that such an adjustment would be fair and reasonable to all of the beneficiaries, so that the current beneficiaries may be given such use of the trust property as is consistent with the preservation of its value." *Id.* A New York trustee is precluded from exercising the power in certain limited circumstances (e.g., exercise of the power would jeopardize a gift or estate tax marital deduction; or the existence of the power, without more, would cause an individual to be treated as deemed owner of the trust assets for income tax purposes). See generally *id.* § 11-2.3(b)(5)(C) (listing nine circumstances in which a New York trustee cannot exercise a power to adjust). "[A] state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust," and thus ordinarily will be respected for federal income tax purposes. See Treas. Reg. § 1.643(b)-1.

⁸The reverse is also true—a trustee may treat as trust accounting principal an item that otherwise would be considered income if such treatment is necessary (or in some states, desirable) to fulfill the trustee's duty of impartiality.

⁹See, e.g., Elizabeth Laise, "Some Funds Stop Grading on the Curve," *Wall Street Journal* at C-1 (Sept. 8, 2009) (the author suggests that a typical simulation would have set the odds that a 60 percent stock, 40 percent bond investor would lose 20 percent or more in 2008 at about one in 111); Elizabeth Laise, "Odds-On Imperfection: Monte Carlo Simulation," *Wall Street Journal* at B-1 (May 2, 2009) (market simulators "often assign miniscule odds to extreme market events").

¹⁰The analyses use a Monte Carlo model that simulates 10,000 plausible future paths of returns for each asset class and inflation and produces a probability distribution of outcomes. However, the model does not randomly draw from a set of historical returns to produce estimates for the future. Instead, forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of an analysis; and (4) factor in a reasonable degree of randomness and unpredictability.

¹¹Income is defined as bond and cash interest together with stock dividends.

¹²The proposal includes “three-year smoothing,” so the amount to be distributed to the current beneficiary in a given year would be 4 percent of the average net value of the trust assets at the close of each of the three preceding years. This method helps stabilize the annual distribution in volatile markets but carries the danger of depleting the trust in a declining market—like the one we just experienced. For example, if the assets of a trust had declined from \$1.5 million at the end of 2006 to \$1.25 million at the end of 2007, and to \$1 million at the end of 2008, the average net value of the trust assets under a three-year smoothing rule would be \$1.25 million. Four percent of that is \$50,000, which is actually 5 percent of the net value of the trust assets at the end of 2008. As a general rule, any method (like three-year smoothing) that adds certainty for the current beneficiary adds uncertainty for the remainder beneficiaries and vice versa.

¹³Globally diversified stocks include 35 percent U.S. value, 35 percent U.S. growth, 25 percent developed international, and 5 percent emerging markets. In the alternative asset allocations the bonds are intermediate-term municipal bonds. While the bonds in the current portfolio are taxable, a separate analysis illustrates the municipals produce more after-tax wealth for all parties.

¹⁴Note also that a modest adjustment to the current allocation—global diversification of the stock portion of the portfolio and shifting cash to intermediate-term bonds—should actually decrease portfolio risk over time.

¹⁵A three-year smoothing rule, described *supra* note 12, can help dampen this volatility but does not eliminate it entirely. In certain cases, we have found it useful to model an inflation-adjusted “floor” on the amount of the current beneficiary’s annual distribution to reduce the impact of portfolio volatility even further. Such a floor on distributions shifts some of the volatility risk to the remainder beneficiaries, who can be compensated for that additional risk by simultaneously imposing a “ceiling” on current distributions. The floor protects the current beneficiary in declining markets; the ceiling compensates the remainder beneficiaries for that protection when markets eventually recover. See, generally, *Managing Trusts: Better Decisions in an Uncertain World*, Bernstein Investment Research and Management (June 2003). A copy of this publication may be requested from the authors or from any Bernstein Global Wealth Management office.

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