What financial advisors should know about

The Financial Skills Trust

Beyond the carrot and stick mentality

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A new dimension in wealth transition

When an English teacher asked her students to write an essay on what they'd do if they had a million dollars, Joey handed in a blank sheet of paper. "Joey, you've done nothing," scolded the teacher. "Why?" Joey replied, "Because if I had a million dollars, 'nothing' is exactly what I would do!"

Well-meaning adults who want to transfer wealth to subsequent generations through a trust are often understandably concerned that the beneficiaries will squander away the principal or be insufficiently motivated to strive for and attain certain life goals. Because of that, they frequently expect family advisors to set up incentive trusts with conditions that encourage or discourage certain behaviors.

It's the classic "carrot and stick" approach: Do what is expected/valued and get the money (and sometimes control of the trust); fail to do so and earn such negative consequences as withheld distributions or ceded trust control.

But does this "rule from the grave" method really work? Three professionals who have extensively studied this issue say no – and they have plenty of research to back it up.

The right motivation: What works

Money-based incentives are not only generally ineffective, they often produce undesirable behavior, according to "The Use and Abuse of Incentive Trusts: Improvements and Alternatives," which was co-written by Eileen Gallo, Ph.D., a licensed psychotherapist who counsels clients on issues related to children and family wealth, her husband, Jon J. Gallo, a partner in the family wealth practice group of Greenberg Glusker Fields Claman & Machtinger, LLP, and James Grubman, Ph.D., an internationally recognized consultant, speaker and educator on wealth counseling.

In the article, the authors contend that trying to control future beneficiary behavior through an incentive trust is often futile.

"The most effective form of incentive is internal motivation, a sense that what we are attempting to accomplish is important and worthwhile," they write. "External motivation, such as using money as an incentive, is far less effective…and may actually decrease the kind of personal growth and self-motivated behaviors that are part of learning to manage money responsibly!"

Their examination of over 100 studies in motivational psychology and business management has revealed that financial incentives are primarily effective only for such repetitive, boring skills as assembly-line work. For anything involving memory, judgment and reasoning – all required for sound financial management – intrinsic motivation has been found to be far more effective.

Some companies address the thorny issue of internal motivation through the use of a "results-oriented work environment," developed by former Best Buy human resources executives. In that model, employees are evaluated solely on how effectively they produce desired results as opposed to when, where and how they complete tasks toward their goals. It also emphasizes autonomy – being in charge of decisions and responsible for the consequences of those decisions – which has been shown by research to be one of the most effective forms of internal motivation.

"If we want to motivate the next generation to manage money responsibly, our approach should be based on using autonomy as the motivator," claim the Gallos and Grubman. "We want to create an environment in which the next generation feels that prudent money management is important and that they are in charge of making responsible decisions rather than using money as a carrot or a stick."

According to the article, the types of provisions often found in incentive trusts – such as rewards for attaining a certain level of education or matching a minimum independently earned income – seem to have very little, if any, correlation with responsible money management. These carrots can lead to unethical behavior, where beneficiaries "game the system" in order to qualify for incentive distributions, and can also be too subjective, inflexible or difficult to administer.

"Although we strongly believe that a college education and employment are important parts of having a fulfilling life, over four decades of working with families has shown that college graduates and full-time employees are capable of making really bad financial decisions," note the authors.

Developing financial skills for life

Financial literacy skills – how to save, keep track of money, get paid what you're worth, spend wisely, talk about money, live on a budget, invest, exercise the entrepreneurial spirit, handle credit and become involved in philanthropy – are often at the very heart of parents' wishes that beneficiaries should demonstrate such subjective virtues as "prudent management of life skills," "work ethic" and "good stewardship of inherited assets." An unfortunate reality, though, is that some inheritors lack many of these financial skills, leaving them passive, dependent on advisors, purposeless or having a sense of entitlement and self-centeredness.

To counter that reality, the authors have developed the concept of a Financial Skills Trust, whose primary goal is to value the results of responsible money management rather than focus on such unreliable and indirectly correlated activities as going to college or maintaining full-time employment. Borrowing from the concept of the results-oriented work environment model, the financial skills trust is created as part of a "Results-Oriented Trust Environment,™," which is based on four keys:

1. Statements of intent and purpose. Through video and print statements, grantors can express their intentions for the trust, how they'd like to see the beneficiary prepared and how much decision-making flexibility will be given to the trustee.
2. Education, not punishment and control. The primary purpose of a financial skills trust is to educate beneficiaries, not punish them or try to control their life choices. If beneficiaries lack the desired financial skills and wish to learn, trustees can provide financial education at the expense of the trust.
3. Increased transparency, objective standards, open communication. Encouraging transparency and open communication between the trustee and beneficiary regarding trust provisions, guidelines and discretionary power (based on objective standards) strongly decreases the likelihood of conflict.
4. Results that are directly and objectively related to responsible money management. When deciding whether to make discretionary distributions of income and/or principal – and perhaps whether and when the beneficiary might become a co-trustee or sole trustee – the trustee considers objectively the beneficiary's ability to learn and demonstrate money management skills.

Results in action

Financial skills trusts can be set up in such a way that they reward clearly quantifiable results – specifically, the ability of beneficiaries to:

- Live within their means
- Save a portion of their income
- Understand and manage credit and debt
- Maintain reasonable financial records
- Use basic investment principles to manage personal assets prudently (or responsibly delegate them to the appropriate advisors)
- Generate additional income beyond trust distributions if necessary or desired
- Use a portion of their income and resources to support charitable activities of their choosing

A trust built upon demonstration of these skills strikes an appropriate balance between parents' legitimate right to expect responsible stewardship of inherited assets by children and children's legitimate right to expect reasonable autonomy in their private lives. It also avoids attempts to control from either the grave (or from the trustee's office) the life choices and non-financial activities of the beneficiaries.

Every day, parents hoping to instill in their children the value of responsible money management seek assistance from their advisors, who can deepen client relationships by collaborating with an independent trust company. Seasoned, hands-on trust company professionals who understand these weighty issues can work with advisors, grantors and beneficiaries to customize a truly individualized financial skills trust that will provide a smart balance of accountability, autonomy, transparency and specificity – so that when Joey inherits a million dollars, he'll be internally motivated to do much more than "nothing."

For a PDF of the article updated by Jon J. Gallo and Eileen Gallo, Ph.D., entitled *Emerging Adulthood and the Results Oriented Trust Environment™: Motivating The Next Generation To Be Financially Responsible*, visit sterlingtrustees.com/resource-and-news.html

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