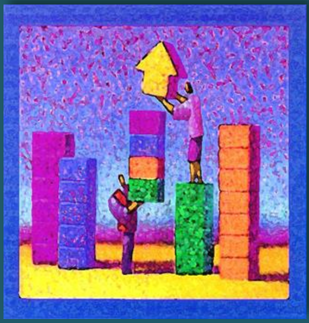

WEEKLY REPORT OCTOBER 2023

Private Asset Management Ltd

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HOW SHOULD TRUSTEES INVEST? – Part 1

The recent articles looking at Discretionary Investment Management Services (DIMS) highlighted the critical role that independent, professional trustees have in ensuring that an investment portfolio is managed well. The series briefly rehearsed what best practice strategies looked like particularly as regards the investment of a trust's funds. Coincidentally a lawyer friend kindly sent me a paper from the May 2023 NZ Law Journal which outlines the issue from a legal perspective. The article, written by Henry Brandts-Giesen of Dentons Kensington Swan, was entitled "The Investment Of Trust Funds: Law and Practice". It's an excellent read and whilst it is written more for the super wealthy ($50m+ Rich Listers) many of the points it makes seem to me to be also relevant for the trustee in charge of more modest sums.

The paper begins by setting out the three core roles of a trustee, as follows:

- Hold the trust property
- Manage the trust property
- Distribute the trust property

The focus of the Brandts-Giesen paper is on the second role – managing and investing the assets of the trust. The author writes "investment strategy, execution, and monitoring are some of the most important aspects of trusteeship. But it is not well understood by a lot of trustees and advisors".

The first important point made in the paper is that a trustee's investment powers are regulated by their duties. The significant legal precedent here is from an 1886 judgment which found that the duty of a professional trustee is "not to take care only as a prudent man would take if he only had himself to consider: the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally obliged to provide". Cutting to the chase this means a trustee should be more cautious and take less risk than if the trustee were investing for himself/herself. A later (1994) case involving Nestle and the National Westminster Bank further clarified the issue defining prudence as "not speculating but diversifying with the overriding objective of maintaining the capital value of the trust fund". Mr BG offers the example of some trusts whose assets are dominated by property and contrasts this with the need to diversify.

The 1994 Nestle case however has relevance for all trustees: in my work I see lots of investment portfolios whose construction is at sharp variance with "not speculating but diversifying" – highly concentrated equity positions with attendant tracking error. For example some financial advisory firms in NZ recommend that exposure to the Australian stockmarket, which comprises 200 relatively large companies, is achieved by the ownership of just 5 - 10 stocks in that market. Back in the mid 80s, when I started in this industry, it was difficult to diversify without paying very high fees, both initial and ongoing. But today diversified portfolios are available for next to nothing - 15 basis points or less - and there is an extensive body of research demonstrating that diversification is pretty much the only free lunch in finance. Trustees in 2023 therefore have no legal defence for not diversifying - owning just 5-10 stocks is speculation. There could be a number of reasons why trustees accept this risky strategy, but the most likely one is because they are unaware of what best practice looks like and the portfolio metrics that institutions focus on to manage risk. My view is that that ignorance is often a function of the "research" that trustees receive from their financial advisors. This tends to focus on the return aspect of an investment rather than the risk component, typically hyping an ability to pick stocks and outperform, and thereby massaging the egos of the (male) trustees.

The obvious question is why do some financial advisors recommend sub-optimal investment plans, at variance with best practice? Back in 2006, writing in the London Financial Times, economist Andrew Smithers made the observation that "economists are in pursuit of the truth and stock brokers of commissions". The deviation from best practice can thus likely be explained by Mr Smithers' caustic remark: the advice of many financial advisory firms is constrained by high fee structures and conflicts of interest. The first factor incentivizes the advisor to construct complicated portfolios on the basis that if the client perceives that there is a complex problem they will be more inclined to entertain an expensive solution. The second factor, the conflict involving investment banking, whereby the IB arm of a bank, stockbroker or financial advisory firm is paid by a third party to sell that company's shares/bonds to its clients, manifests itself in grossly overweight positions in IPOs, most of which are small companies. I often see new client's portfolios which have large holdings in IPOs like My Food Bag and unrated bonds and the suspicion is that the only reason for their inclusion was to discharge the investment banking obligations of the institution managing the portfolio. As well as the obvious implications for risk, highly concentrated portfolios, overweight IPO stocks are also invariably a bad move from the return perspective also. Research, notably by S&P Dow Jones Indices (SPIVA), shows that fund managers invariably underperform the benchmark index for two reasons: their portfolios are narrowly defined relative to the index and because of this they are less likely to own the few stocks that outperform, and fees. Institutional investors might hold 50-100 Australian stocks out of an investable universe of 200. A retail investor owning just 5-20 shares is next level stock picking risk. See article – Diversification: Lower Risk and (probably) Higher Returns – 3 April 2022. Additionally the fact that most IPOs also underperform is well documented. See article - IPOS: More Flop Than Pop – 13 September 2021. To view these articles please click on this link: https://www.cpam.co.nz/specific-articles-of-interest

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.