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Private Asset Management Ltd

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HOW SHOULD TRUSTEES INVEST? – Part 2

In my last column, we looked at investment best practice from a legal perspective and highlighted the duty of trustees to be more cautious and take less risk than if they were investing in a personal capacity. One of the big take-aways from this important obligation is that trust portfolios should be properly diversified – probably over different asset classes and certainly within each asset class. While the advantages of owning a diversified portfolio of equities, e.g. 200 Australian shares instead of just 10, have been amply demonstrated ad nauseum by numerous academic papers and annual publications like S&P Dow Jones Indices (SPIVA) there is another more tangible incentive for trustees to get this right: personal liability. In his paper - "The Investment of Trust Funds: Law and Practice" Henry Brandts-Giesen of Dentons Kensington Swan writes: "A good way to get the attention of trustees is to remind them that they can be personally liable for breaching their duty to invest prudently. Generally in an investment context a trustee is at most risk from a claim by a beneficiary arising from negligence. When considering whether a trustee has breached their duty to invest prudently the court may consider whether the trust investments have been diversified appropriately and whether the investment was made in accordance with any properly formulated investment strategy."

For a family member or other nonprofessional trustee of a family trust this is potentially scary stuff but the reality is not as bad as it sounds. Mr Brandts-Giesen points out that the law will have regard to the trustee's skills and knowledge, the reason for which the trustee was appointed and, importantly, whether they are paid for being a trustee or not. Additionally, the law is conduct focussed rather than just looking at results. In other words, if a trust had bought a diversified US equity portfolio just before the crash of 29 and performed rather badly for the next 20 years or so the courts wouldn't necessarily view that decision as being imprudent. Mr BG explains "The fact that a trust lost value over time is not necessarily evidence of a breach of duty by the trustee if the trust lost value because market circumstances beyond its control. As with many aspects of trusteeship, the process is more important than the outcome".

The courts however have a more rigorous approach as regards reviewing the conduct of professional trustees. They are required to have a higher level of skill than is required from your average individual. "Professional trustees are benchmarked against the knowledge and experience reasonably required of another professional person within that industry. Mr BG cites a 1980 case which concluded that "a higher duty of care is plainly due from someone like a trust corporation which carries on a specalised business of trust management. A trust corporation holds itself out in its advertising literature as being above ordinary mortal therefore a professional trustee is liable for breach of trust if loss is caused to the trust fund because it neglects to exercise the special care and skill which it professes to have". This is a potentially big issue for the average accountant or lawyer with a cursory knowledge of the investment world who is a professional trustee for a client and deals with an advisory firm which does not have a good understanding of best practice. If things turn out badly and a beneficiary makes a claim for damages it may be that the responsibility for not addressing any deviations from best practice responsible for the underperformance will fall primarily upon the professional trustee.

Mr BG adds that a practical requirement of this "higher duty of care" is that professional trustees should regularly review the quarterly performance reports that brokers and advisors produce and be prepared to disagree with lay co-trustees if they believe that the decision is not consistent with best practice. Whilst that is good advice both of these strategies are potentially problematic – firstly most quarterly performance reports offer little in the way of perspective in that few, if any, detail the performance of a relevant benchmark. Trustees can see how their portfolios have performed but rarely are able to determine how well they have done compared to the market. Relative performance can be especially important when compounded over the very long term. For example $2m invested in a balanced portfolio back in September 2003 which underperformed the benchmark by 3% pa over that 20 year period would be worth $2.8m less than a portfolio that matched the index. A beneficiary of a trust with this portfolio who was made aware of the underperformance and was already on bad terms with the trustees might ask the courts to determine whether that the bad outcome was due to a breach of the duty of care required by the trustees. Relative performance can also provide an insight into various important portfolio metrics including asset allocation, stock selection, fees and portfolio turnover. Similarly a professional trustee who disagrees with the lay trustees can cause problems too - whilst a professional trustee could decide to make a stand and veto a proposed strategy by his/her lay co-trustees this could be bad for business in that the trust could terminate his/her trusteeship and if they were an accountant or lawyer they might also lose the business associated with the trust.

Many of these issues seem to have featured in the famous case of Re Mulligan (Deceased) in the Christchurch High Court back in early 1996. We will look at the Mulligan case in two week's time.