# WEEKLY REPORT NOVEMBER 2023

## Private Asset Management Ltd

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## HOW SHOULD TRUSTEES INVEST? – Part 3

Two weeks ago the second column looking at “How Should Trustees Invest” focussed on the fact that trustees have a major incentive to get things right in that if they don’t interpret the trust’s objectives correctly in terms of asset allocation etc and embrace best practice they could be personally liable for any losses. Such losses are calculated on the basis of a comparison of the outcomes resulting from what they did versus what they should have done. One of the most important local cases which touched on this topic is known as the Mulligan case and it all happened in the Christchurch High Court back in 1996. It is fair to say that the results of this case shook up the trustee world as every trust company realised that if they got things wrong their reputations and profitability could take a very big hit. Bottom line: it was no longer okay to sit around drinking cups of tea and being polite with their co-trustees – they needed to think carefully about what they were doing, keep up with the play in terms of portfolio management and have an absolute focus on their trustee obligations to clients.

The details of the case were as follows: Mr Mulligan died in 1949 leaving his widow as the income beneficiary of his estate with his nieces and nephews as residual beneficiaries. In other words the widow Mulligan got all the income and the nieces and nephews were entitled to whatever capital had been accumulated when Mrs Mulligan died. So clearly there was a potential conflict here – Mrs M prioritised cash income therefore wanted to promote the ownership of asset classes producing high levels of current income, i.e. bonds whereas the residual beneficiaries preferred assets that produced capital gain, i.e. shares. The trustees therefore had a duty to act even-handedly as regards safeguarding the interests of these two parties.

The trustees of the estate were a trustee company and Mrs M. When Mr Mulligan died the prime asset of the trust was a farm which was eventually sold in 1965. At that time and until her death in 1990, at the direction of Mrs M, the estate only invested in fixed-interest securities and Mrs M refused to allow the trust to invest in shares. Over that period various employees of the trust company attempted to persuade the formidable Mrs M steadfastly refused to diversify the portfolio but not only did she decline those requests she also did not allow the trust company to have any contact with the residual beneficiaries.

When they got the details the of their inheritance and were able to determine why the value of the trust was disappointingly low the residual beneficiaries sued the trustees for breach of trust on the basis that just investing in fixed interest (for the benefit of Mrs M) did not treat the income and capital beneficiaries fairly. The impact of this asset allocation decision was exacerbated by the fact that, over the 1965 – 1990 period NZ inflation averaged 10% pa, reaching a high of 17.2% in calendar 1980. The result was that when Mrs Mulligan died in 1990, the capital value of the estate was, in real terms, a fraction of what it was in 1965. To illustrate the diminution in the capital value of the trust, in real terms, in the trial the plaintiffs highlighted the fact that back in 1965 the assets of the trust ($108,000) were sufficient to buy 14 average residential properties in Christchurch. However by 1990 the residual assets ($102,000) could barely purchase one average house in Christchurch. A very compelling argument.

The trustees denied breach of trust and relied on S73 of the trustee act which provided that a trustee acting honestly and reasonably could be excused for breach of trust. However the court found them guilty and included in the judgement was the following statement: "The discharge of a trustee's duty to act with due diligence and prudence was flexible and changed with economic conditions and contemporary thinking and was therefore judged applying the standards of the relevant period. A trustee had to be strictly impartial and even-handed between income and capital beneficiaries in the circumstances of the case (including those of the beneficiaries). The trustees were in breach of trust because the trust company officers all recognised the corrosive harm of inflation to the estate capital (which was reliable evidence of the standard of prudence in the industry at the time) and should have attempted to persuade the widow by explaining trustees' duty to be even-handed or applied to the Court for directions rather than deferring to her wishes, particularly given her self-evident conflict of interest and preoccupation with maximising income from the estate."

What are the key lessons for trustees from the Mulligan case? The first and most salient lesson is that trustees should have regard to the interests of all the beneficiaries of a trust, obviously. The most important investment lesson is that, whilst fixed interest investments might produce a pre-tax return close to and sometimes in excess of inflation, if all of that return is withdrawn and spent, the capital value of a fixed interest portfolio will almost inevitably decline substantially in real terms.

If we look at the latest Stocks, Bonds, Bills and Inflation Yearbook it contains a table that calculates the return of various bonds excluding their coupons i.e. it models the return of a fixed interest portfolio where all the interest payments are spent. The data is in USD and interest rates and inflation have been lower in the US than in NZ but it still illustrates the point. The data demonstrates that for an individual that retired 25 years ago in 1997, investing solely in US five year Government bonds over the period 1997 to 2022, if the interest was reinvested the total return was 153%, compared with total inflation of 84%. That's fine, however if all the interest was spent the capital only return over the period falls to 26%. So in real terms the value of a bond portfolio, where the trustees spent all the income, would have declined in value by more than 50%. This is particularly important for a trust that has the typical dual objectives of producing a high level of income and protecting the real value of the assets. The data suggests that these dual objectives may be unrealistic, even before fees, and virtually impossible when the portfolio contains a large allocation to bonds and the beneficiaries intend to live off all the income.