for financial advisers only

weighing up trustee investment

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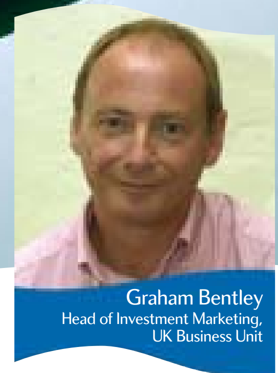
Completing a risk profiler, and building an appropriate portfolio may be relatively straightforward where individual investors are concerned, but Trustee Investment is a somewhat more complex field.

Issues regarding settlors' and beneficiaries' varying requirements can lead to inappropriate investment decisions that may unnecessarily err on the side of caution. Graham Bentley explains why, and how advisers can ensure robust recommendations.



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Current legislation surrounding Trustee Investment may be familiar to advisers, but its implications may be less so. In 1988 Hoffmann J held that:

'Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.'

That judgment from Nestle v National Westminster Bank plc was reported in 1996, and referred to by HM Treasury in its consultation document published that year. Since then the Trustee Act 2000 has laid down 'standard investment criteria', which are intended to facilitate trustee investment in accordance with modern portfolio theory (MPT).

inherent biases

I have discussed MPT as it relates to asset allocation in recent articles, and have concluded that diversification of assets reduces the risks associated with the failure of any particular market or region. As we know, there is a recipe for this diversification, whereby risk-matched portfolios can be calculated via an optimisation 'engine'. Of course, this first requires us to assess the risk appetite of a number of participants.

When it comes to trustee investments, we should account for the inherent biases of the trustees and advisers themselves who may unconsciously overlay their own subjective attitudes onto the portfolio construction process. These biases may reflect misunderstandings of the roles and responsibilities of trustees and their delegated agents. An area of possible misinterpretation relates to risk.

> "When advising trustees advisers need to ensure their risk profiling and portfolio construction processes are robust, along with an easily identifiable audit trail."

managing risk

Historically the trustee investor avoided risk, but today the trustee investor manages risk. Trustees are judged by the risk associated with the portfolio as a whole and not merely by the risk associated with individual investments.

The question therefore arises: what level of total portfolio risk is appropriate to trusts? An economic model known as the 'Capital Asset Pricing Model' demonstrates that, having taken into account the level of returns that is expected from the 'risk-free' portion of a portfolio, additional expected returns will rise in direct proportion to increased risk. This linear correlation is known as the 'Securities Market Line'.

The model is based on expectations, and expectations are based on information. If we assume a world in which accurate information about investments is freely and instantly available it will follow that the value of an investment as currently quoted will be an accurate reflection of its true underlying value. In this 'efficient market' the hypothetical 'rational' investor will only run greater risks if there is a corresponding expectation of greater returns. It is at this point that the process of trustee investment must be concerned with outcomes.

favouring prudence

The trustee's first hope, in a traditional settlement trust at least, is to preserve the real value of the capital and to produce an income. This means that the trustee should seek a portfolio with a lower overall risk level. In other words, the prudent trustee will be cautious or 'risk-averse' as regards the total portfolio, but he will ensure that assets within the portfolio are exposed to risk, albeit in a managed way. Of course, the law does not require trustees to invest according to modern portfolio theory; it merely facilitates it.

Beneficiaries with life interests and/or interests in remainder will agree that their trust should be administered prudently by trustees who have powers adequate for the task. However, the interests of different classes of beneficiary are essentially in direct competition with each other. Thus whereas the life tenant's interest is in high-income assets with limited scope for capital appreciation (or even scope for depreciation), the remainderman's interest is firmly in capital retention at the expense of income.

The law recognises this conflict and takes the view that, in exercising their investment discretion, trustees should invest fairly in the interests of every beneficiary and every class of beneficiary. The duty to maintain a fair balance between competing beneficiaries need not import equality, because an equal approach would automatically place the life tenant (who is often the settlor's surviving spouse) on the same footing as the remainderman (who may be a remote relative). The trustees are required, in essence, to second-guess what the settlor would have wanted to provide for the particular beneficiaries.

challenging 'improper' investment

The beneficiaries face some difficulty when trying to establish that their trustees are liable for improper investment. There are challenges at every stage, from proving that there has been a breach of trust (which requires proof of imprudence or unfairness), to proving that the trust has suffered a loss (and the size of the loss), to proving that the loss was caused by the breach.

The beneficiaries' task is not made any easier by the decision in the leading modern case on liability for imprudent trustee investment, Nestle v National Westminster Bank plc. Despite plainly having misconstrued their investment powers, the trustees in Nestle escaped liability for the losses because the plaintiff had not shown that there was loss arising from a breach of trust for which the trustees ought to compensate the trust fund.

This puts a heavy burden on the claimant to prove not only that the trustee acted imprudently or unfairly, but also that the ultimate outcome of these errors was necessarily worse than that which would have occurred in the absence of default.

On the other hand, a financial adviser who constructs the portfolio at the request of the trustees is vulnerable to challenge by beneficiaries via the ombudsman, if not the courts. In this case, the outcome is likely to be more favourable to the beneficiaries. When advising trustees advisers need to ensure their risk profiling and portfolio construction processes are robust, along with an easily identifiable audit trail. That is where investment tools come in, allowing advisers to build risk-matched portfolios with confidence, and an audit trail to demonstrate that to the regulator. ■

This article is based on Skandia's interpretation of the law as at 31 August 2007. We believe this interpretation to be correct but cannot guarantee it. Tax relief and the tax treatment of investment funds may change.

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