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Trustees on trial

The issues trustees need to consider when selecting and monitoring the performance of investment advisors.

The investment of trust property is a trustee's most important duty. After all, without effective investment, a trust's ability to provide for beneficiaries will be constrained and its objectives thwarted.

Many trustees sensibly elect to seek investment advice. However, The Myners Report, whilst focusing on pension trusts, uncovered serious shortcomings in the way many trustees went about this. These included trustees' general lack of investment expertise, the poor evaluation of financial advisors and their advice, lack of clear objectives for investments, the absence of appropriate performance, risk and time benchmarks for fund managers and the poor scrutiny and control of the costs of advice, in particular commissions.

It is essential that trustees have a robust process in place for selecting and monitoring the performance of their advisors. If the trustees are dealing with the correct advisor, much of the monitoring work will be done for them.

There are nine issues trustees need to consider.

- Choice of advisor
- Advice and service proposition
- Advisor remuneration
- Getting to know one's client
- Investment portfolio design
- Charges and costs
- Meeting the trust's income and capital requirements
- Tax planning
- Ongoing review service

1. Choice of advisor

'A fiduciary relationship is one founded on trust or confidence reposed by one person in the integrity and fidelity of another.'

Solicitors act in a fiduciary capacity; trustees have a fiduciary duty imposed by the *Trustee Act* 2000. Why then, would a solicitor acting as a trustee, or providing legal advice to trustees, consider dealing with an investment advisor who does not also behave as a fiduciary?

Historically, trustees have often looked to stockbrokers for investment advice. However, if considering using a stockbroker, trustees need to ensure that: i) the broker will consider other investments and not just focus on direct equities and bonds; ii) that the broker has access to the full range of tax vehicles that can be useful to trusts; iii) that the broker can deliver the required standard of ongoing client care and administration.

If considering an Independent Financial Advisor (IFA), trustees should choose one who can demonstrate a high level of qualification e.g. Chartered or Certified Financial Planner. Preferably they should also have specific qualifications in investment management and trusts. Trustees should avoid IFAs that are 'product sellers' and instead focus on advisors who provide an ongoing, 'consultative' service; preferably one with specific experience in dealing with trusts.

2. Advice and service proposition

A good advisor will employ a logical, structured advice process that will help the trustees to meet their legal obligations on an ongoing basis.

3. Advisor remuneration

Advisor remuneration must be transparent and agreed up front. Importantly, it must be linked to the initial and ongoing services being provided, preferably via a formal investment delegation agreement.

Fee-based arrangements with no commission should be the preferred option. Without commission there is no incentive for an advisor to recommend, unscrupulously or unconsciously, one product over another (or refrain from recommending a product). If commission is taken, the advisor must clearly explain how this is will be funded and what implications it will have for the trust investments.

4. Getting to know one's client

A good advisor will want to find out as much as they can about their client and this process should go far beyond the collection of basic data needed to satisfy their compliance department. Trustees should be wary of any advisor who is eager to skip this process and move onto the sale.

5. Investment portfolio design

'To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.' Warren Buffett.

In my experience, very few advisors, let alone investors, have such a framework. As a consequence, their investment advice is often reactive and influenced by fads and trends – this can be disastrous for investors. A 2007 study showed that between 1992-2003 the average investor, many of whom would have invested via an advisor, only achieved a return of 4.91 per cent per annum. During that same period the FTSE All-share rose by an average of 8.99 per cent per annum.[1]

Trustees should seek out advisors who can demonstrate a logical investment process, backed-up by a published Investment Policy Statement (IPS). The IPS should explain how the advisor will determine the right ‘asset allocation’ for the trust’s investment portfolio i.e. how much should be invested in cash, bonds, property, equity, etc. Spreading funds across a range of variously correlated asset classes, the ingredients in Williams Bernstein’s diversification free lunch,[2] will help expunge non-systemic risk, reduce volatility and maximise returns.

A fundamental investment decision facing trustees, although many do not even realise it, is whether to adopt an ‘active’ or a ‘passive’ investment strategy. Active investment managers attempt to beat their respective asset benchmark by trying to correctly time their investments and/or buy undervalued assets. Passive funds simply aim to track their respective asset benchmark.

Whilst some people may be prepared to take the risk that their active funds will deliver, the fact is that less than one per cent of active investment managers have consistently been able to beat market returns over the long-term. Furthermore, there is simply no way of identifying which investment manager this will be in the future – a fact the FSA warned investors about in their report: ‘Past Imperfect? The performance of UK equity managed funds’, published August 2000.

6. Charges and costs

Charges and costs should be of prime concern to trustees. Initial charges on active funds can be as high as 5-6 per cent (with up to 3 per cent of this payable as commission to the advisor.) In the UK equity sector, the average fund has a ‘Total Expense Ratio’ (TER) of 1.58 per cent per annum.[3] These figures do not include the additional drag on performance caused by portfolio turnover, which the FSA calculate to be 1.8 per cent per annum. In comparison, passive funds do not usually levy an initial charge (they tend not to pay commission) and the comparable TER for UK equity funds is only 0.91 per cent per annum.

In the US, the ‘Prudent Investor'[4] rule effectively deems passive investments the default position for trusts and any move to more expensive, actively managed funds has to be justified. One could argue that the same rule is implied for UK trustees.

7. Meeting the trust’s income and capital requirements

This is one of the biggest headaches for trustees. What is needed is a logical process for setting an appropriate level of income, backed up with supportive data e.g. historic portfolio returns and a cash flow forecast.

If the trust has the ability to distribute capital, there is a strong argument for it to adopt a ‘total return’ approach. A total return (income and growth) figure for the portfolio is agreed and the trustees then decide how best to divide this between beneficiaries. This approach ensures that the asset allocation

of the portfolio is not biased towards income producing assets which will make it less efficient. Furthermore, it avoids the risk of trustees being accused of bias towards the income beneficiaries.

8. Tax wrappers and tax planning

Tax is important, but trustees should ensure the ‘tax tail’ does not wag the ‘investment dog’. A specialist advisor will have a detailed understanding of the tax position of trusts and have access to the full range of tax wrappers.

9. Ongoing review service

A structured, ongoing review service is essential. Formalised within a servicing and remuneration agreement, an advisor’s role and responsibilities can be defined – enabling trustees to assess their performance on an ongoing basis.

Whilst assessing historic performance, trusts’ investment reviews should also look to the future. A ‘cash-flow forecast’ will help trustees appreciate the consequences of differing rates of investment return, and/or income withdrawals, upon the long-term value of the trust’s portfolio.

As a minimum a trust investment review service should include:

- Review changes in trust assets, goals and/or beneficiaries
- Review trust objectives and investment objectives
- Review of Investment Policy Statement
- Investment valuation
- Performance evaluation; comparing trust returns against pre-agreed benchmarks
- Tax-planning review
- Annual income and capital gains tax reports
- Advisor service and remuneration review

Conclusion

Wise trustees can protect themselves by fulfilling their obligations as fiduciaries when seeking investment advice, by selecting advisors that understand this responsibility and themselves behave like fiduciaries. A fee-based, value-added remuneration structure is key, with robust systems for all parts of the planning process including reviews.

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1. *1Lukas, An Examination of the Difference between UK Fund Returns and UK Investors’Returns, 2007.*
2. *2Bernstein, William, The Intelligent Asset Allocator How to Build Your Portfolio to Maximize Returns and Minimize Risk, McGraw-Hill 2000.*

- 3 *Fitzrovia UK Fund Charges January 2008 Restatement (Third) of Trusts', Washington and Lee.*
- 4 *Standards of prudent investment under the Law Review, Winter 1997.*

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