

## What Trustees Should Look At in Choosing Investment Advisers

The whole area of the provision of investment advice is one that is daily becoming more important - and more fraught - for both clients and trustees. The days when one could rest on one's laurels and rely on the investment advisers to do everything and not concern unduly themselves with what the latter did are long gone. There are four main reasons for this:

1. Clients expect their trustees to be able to talk to them with authority about investment matters.
2. Trustees will probably not just be looking at investment in their own jurisdiction, as investment management on an international scale is the order of the day.
3. The Courts are taking a much more strident line on investment matters involving trustees.
4. The multiplicity of investment vehicles has proliferated substantially and does all the time, so where do trustees turn to?

These problems are not restricted to the UK, but are just as apparent for those who are in the trustee field in various jurisdictions around the world. Whilst much of the precedent in this field is inevitably in the UK Courts, there is now precedent in other jurisdictions and litigation in this field will almost inevitably increase.

How do you go about choosing your investment adviser and what are the issues that can arise, particularly where trustees are involved? Indeed, are there legal issues that should be considered?

Consider first of all that in the UK alone, there are thousands of firms offering investment advice - when FIMBRA existed as a self-regulatory organisation, there were some 12,000 firms regulated by them, offering such advice! There are well over 1,000 different mutual funds available in the UK, never mind the plethora of such vehicles offered through Jersey, Guernsey, the Isle of Man, Dublin and Luxembourg, or even the funds that are available from advisers in the Far East. All of these firms say "We are the best, we obtain the best returns, your money is safe with us" or words to that effect and it is amazing how many can produce statistics justifying their claims - there are literally scores of first places. Finding the right manager for your client can be a daunting task.

Before looking at the choice of investment manager, you should consider what a trustee's duties and responsibilities are. A trustee must first of all act impartially and without fear

or favour in the interests of all of the beneficiaries of the trust, including unborn beneficiaries. A trustee's clients are these beneficiaries, not the settlor who created the trust, although that person may well be a member of the beneficial class and he may well think that he alone has the right to be consulted. A trustee must also act as "a prudent man of business would do in the conduct of his or her own affairs", but this has been narrowed down by the courts in the case of investment matters.

Having said that, the trustees must look after the interest of

all the beneficiaries - clearly the settlor has a major role to play, but care must be exercised in this. If the settlor has such "powers" that the trustees make no investment changes without prior reference back, the settlor could be deemed to be a quasi-trustee. It is not difficult to see that certain Revenue Authorities might then deem the mind and management of the trust as being in the settlor's jurisdiction.

If the settlor does wish to be more involved, one possible way round this would be for the appointment of a "protector" of the trust, with the protector having to give his or her consent before investment changes can be made. This can, of course, bring its own problems. The tax position of such a course of action would need to be carefully

considered. Second, the use of a protector in this way could not only add considerably to the expense of operating the trust, but could have the counter effect to that intended. Timing is often of the essence in investment markets, so if trustees have to refer all deals to a protector before they can proceed, then opportunities could be lost with the inevitable consequences for the portfolio.

If the protector does not have to give his or her consent to all investment changes, but is merely there to receive reports on a regular basis from the trustees, this would not cause problems, but it is hard to see what additional benefit the protector then has, when the trustees could do this direct with the settlor in the first place.

I referred earlier to the narrowing down by the UK Courts of the tenet that a trustee must act as a prudent man of business would do. In a case dating back to 1887, which considered the business prudence aspect, the judge in the Court of Appeal stated that whilst businessmen may select investments for their own account of a more or less speculative nature "it is the duty of a trustee to confine himself to the class of investments which are permitted by the trust, and .... to avoid all investments .... attended with that hazard". It is unlikely that modern day



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judges would take any different a line on this and may even be more cautious, bearing in mind the diversity and complexity of many modern investment vehicles.

We only have to look in the press and see how the senior managements of some very august financial institutions have themselves failed to spot the problems that can arise with these vehicles - it is arguable as to whether they ever fully understood the nature of the vehicles in the first place - to realise that these are not, in the author's view, the sort of investments a trustee should consider, unless there are very exceptional circumstances.

Whilst it is not unheard of, it is these days rare for the trustees themselves to act as their own investment adviser. Most trust deeds and almost without exception, all modern deeds, have clauses in them enabling the trustees to appoint external advisers, not merely on the investment front, but in many other areas as well. It is also now not uncommon for statute trust laws to have clauses in them on such appointments and in particular that whoever is appointed should be "reasonably competent and qualified" So your friend at the golf club who puts himself forward as being a wizard at investment matters would not fall into this category.

Some settlors like to act as their own investment adviser. If they are suitably qualified, this might sound like the ideal solution, but conflicts of interest could arise, bearing in mind that the trustees must look after the interests of all the beneficiaries. The settlor's view of their interests and the trustees' view might differ and if so, the trustees would face what might be the difficult and unpalatable task of sacking the settlor!

In deciding who would be the best potential investment adviser, trustees should provide their clients with a broad range from whom to choose, rather like an institutional "beauty parade". The trustees should ask them to come and make an oral presentation (there is certainly no harm involving the settlor in this as well), although they should also provide a written presentation. Make them justify what they say, ask them to show how they have performed in the past, ask them to show how they will report back to you and how often, what they will charge, what their policy is on commissions, dealing, custody arrangements, etc..

Trustees should work on the basis that for sums in excess of £1 million or the foreign currency equivalent, no less than six advisers should be asked to make such presentations and there may also be some merit in splitting such sums between more than one adviser. Although it is hard to believe, I have been at a presentation made by the managing director of a highly reputable UK investment house, who could not satisfactorily answer questions on what front end load his firm charged, nor how they had performed. Needless to say, the firm did not get the job!

If your trustees are uncertain as to whom they should go - and in this day and age, most professional trustees will have a panel of investment advisers to whom they can turn - there are a number of firms who provide what might best be termed investment adviser "search" services, similar to

those provided by actuarial consultancies in the institutional market (a list of these firms is included in this volume). Such firms can assist trustees find a suitable mix of investment advisory firms, or if trustees are hampered by having used too many firms in the past - which is far more likely - they can assist in reducing the panel to a manageable size. There is little point in having a panel of 200 advisers, with whom you have one or two accounts each, where there is probably little or no meaningful dialogue. Far better to have a smaller number with whom you can have a regular dialogue, as this is an encouragement for them to perform better, because the consequences are immeasurably greater if they do not.

The other potential advantage of using such search firms is that they can assist trustees by installing decent measurement benchmarks, both quantitative and qualitative. These enable trustees to see how various advisers, whom they might be using, actually perform against these benchmarks and these benchmarks ought to be known by the advisers in question. One of the most difficult problems trustees often face with many investment advisers, is finding out exactly how they have performed. An ability to avoid this simple issue is one some advisers have elevated to an art form!

The other advantage of having a relatively small panel of investment advisers is that the trustees can have regular meetings with the individual panel members. These would not necessarily involve specific aspects on any one client, but deal with aspects such as their overall views on world markets, what new or additional services they might be able to provide and vice versa, introduce new key members of the senior management to one another, how services might be improved and other matters which affect all clients.

**O**bviously in asking any investment adviser to pitch for business, it is incumbent upon the trustees to give such potential adviser an overall view of what will be required and the parameters within which they will have to operate. What overall level of performance and minimum yield will be required, what is the base accounting currency, what income and or capital distributions are contemplated, what is the taxation status of the trust, are there "no-go" investments - it is not that uncommon to see clients who would be happier if their trustees did not invest, in say tobacco stocks, or in companies involved in research where live animals are used.

There may be a minimum level of cash that you would not be willing to see invested - how would the adviser propose to deal with that? If they are suggesting investing in areas that you have no great feel for, or which you would regard as being potentially very rewarding, but with an equally high risk, you should ask why are they suggesting these areas and what safeguards would you have.

Where mutual funds are involved, what is the front end load and how often are dealings - daily, weekly, monthly or

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otherwise? Where it is decided to use investment bonds issued by companies in some offshore financial centres, where the monies are effectively invested in unit trusts, make sure you fully understand what the charging structures are.

One trustee told me by recounting a bitter personal experience of what he and I consider to be the rather underhand ways in which some of these companies operate - not telling their clients in advance clearly what their fee structures are, charging exorbitant penalties on early encashment - up to 65% - which had never been specified at the outset and the payment of exorbitant commissions to third party introducers.

**P**otential advisers should be made aware that they are but one of a number of advisers in a "beauty parade" and that there is a likelihood - only where substantial sums are involved - the portfolio will be split between two or three firms. This puts them on their guard, they know their performance will be closely monitored and that if they do not perform they will be replaced.

Once you have carried out the initial manager selection and decided which advisers should be used, it is a good idea to meet with the chosen manager again to reaffirm and tighten up on the investment policy they will follow, how often they will report, precisely when and how the charges for their services will be applied, which person or persons will be responsible for looking after the portfolio and - of course - the ultimate signing of the investment management agreement to formalise what has been agreed.

It is important the advisers realise that they can be fired by the trustees and replaced if they do not perform. There are many instances of financial institution trustees using their own in-house investment management services. There is, of course, nothing fundamentally wrong with such arrangements and there are circumstances where such can be very beneficial to all concerned. However, the counter argument is that there can be conflicts of interest and none more so than when the investment department of the institution is not performing. It is easy to say that they can be sacked in the same way as an independent adviser, but in practice there is no doubt that it is more difficult to do, where the trustee's salary is being paid by the firm managing the investment of the funds.

Over the past few years, there has been increasing evidence that clients prefer to have advisers who are independent of their trustees, since they feel it is easier for trustees in those circumstances to dispense with the services of those who do not perform. This latter aspect is critical, as if trustees fail in their duty and do not take action to remove non-performing investment advisers, the Courts, whether in the UK or elsewhere, will take a very dim view of their lack of action, particularly where the trustees are professional trustees.

So far we have concentrated on what happens before the advisers' appointment and how important it is that trustees monitor these advisers and their performance. Monitoring the performance is not just a matter of hoping that valuations will be received from time to time and taking a casual look at these. Trustees should see valuations on at least a quarter-

ly basis and discuss them, both internally - and with their clients. For much larger accounts, it is certainly prudent to have valuations produced by the manager on a monthly basis. Trustees should meet formally with the manager at least once a year and twice or more times a year for larger accounts. These performance reviews should not be a brief run through, nor should they be treated as an excuse for mutual congratulations and a slap-up lunch! The different elements of the investment portfolio should be looked at in detail, if necessary on a line by line basis. Trustees should discuss whether or not any changes in investment policy are advisable, either because of changes in global market conditions, or due to a change in the client's circumstances.

Some trust companies and family offices now employ competent investment professionals to assist them. These professionals are not there to say to trustees "you should not be in XYZ Ltd, but in ABC Inc.". They are there to look at the broader macro-economic picture, to assist trustees in their discussions on investment matters with clients and the investment advisers, to monitor performance and to ensure the panel of investment managers are doing their jobs properly. If trustees do have such professionals working for them and they do their job properly, it should be very difficult for a court of law to rule that the trustees had not exercised their powers correctly, or had not been acting in the best interests of the beneficiaries.

There are now a number of the larger trust companies who not only employ such people, but also produce very detailed questionnaires which any investment adviser who hopes to be engaged must complete fully and support with detailed documentation. For the managers to assume that their reputation will be sufficient to get them the mandate to manage the portfolio, or their failure to complete the questionnaire properly, will ensure they are not appointed to these trust companies' investment adviser panels.

One other aspect of the relationship between the parties is relevant. I have referred to the fact that the clients of the trustee are the beneficiaries. However, these beneficiaries

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are NOT the clients of the investment adviser. The adviser's client is the trustee, although I have seen cases where that distinction has clearly not been understood by the investment adviser (or the settlor). Whilst I would never have any objection whatsoever, to an investment adviser and the settlor and/or beneficiaries having direct contact, it must be clearly understood by all of them, that it is the trustee who is ultimately responsible for what is undertaken. Decisions cannot and must not be taken behind a trustee's back, the consequences of which could spell disaster.

Whilst it goes beyond the scope of this article to consider what trustees should invest in, trustees must consider non-investment aspects in determining the policy to be followed.

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The residence of the beneficiaries for tax purposes is clearly important. Placing moneys in markets where there are high withholding taxes, yet the fund is effectively a gross fund, might not be a prudent course of action to follow, particularly if withholding taxes cannot be recovered. If the client's base currency is US Dollars, it would make no sense to completely ignore that and invest in markets, the currencies of which are spiralling downwards against that base currency.

Should trustees be investing in areas such as options, derivatives, futures, swaps, etc.? As an old-fashioned trustee, I would urge considerable caution, although I have

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approved investment into options. I have always worked on the rule of thumb that investments of this nature are in general speculative and as we have seen these are not something a trustee should invest in. Caution and prudence are the watchwords here. If trustees do decide that it would be sensible or reasonable to invest in these types of market, not more than 10% should be invested this way and then only with a house of the highest repute and where there is an established track record.

At the end of the day, we come back to the words I quoted at the beginning, that a trustee "must act as a prudent man of business would do in the conduct of his or her own affairs", bearing in mind the considerable narrowing down of this definition by the courts. In addition, do trustees genuinely understand the nature and potential risks, etc. of these types of investment? If trustees do not really understand such matters, how do you explain their use to your beneficiaries?

There are legal issues that might have a bearing on this subject. Clearly any questions that arise should always be discussed with a competent lawyer.

You should consider the jurisdiction within which you are operating. This would normally be stated in the Trust Deed and you must then see what the law in that jurisdiction says in relation to trustees and investment matters.

1. Establish what cases dealing with investment matters have been heard in the courts of that jurisdiction.
2. Trustees must not be prejudiced in what they invest in, they must exercise fair and impartial judgement and "the circumstances in which (they) were bound or entitled to make a financially disadvantageous investment decisions for ethical reasons were extremely limited".
3. Explore what does the trust deed states itself. Most modern deeds contain extraordinarily wide powers of investment, but this is not always the case. Some trust deeds do place onerous restrictions on the trustees, although this is more likely to be in specialist trusts in the employee benefit and pension fund market.

4. Does the trust deed contain an indemnity or exculpation clause covering, hopefully, the trustees against, costs, claims, etc., in the event of losses? Whilst such may cover many likely problem areas, legislation in some jurisdictions will not relieve or exonerate a trustee from liability for a breach of trust arising from the trustee's own fraud, wilful misconduct or gross negligence.

What is clear is that trustees have to undertake a much more careful appraisal of everything to do with investment matters. This covers choosing who should act, how they should act and interrelate with the trustees and the "clients", how they report, the realisation that trustees must not hesitate to fire investment advisers who do not perform and whether the investment advisers themselves appreciate this fact. In addition, and with the seemingly increasing plethora of investment vehicles available, trustees must exercise great care in the placing of client funds as they cannot be in the business of putting money into speculative investments - and I have little doubt that if a sample of readers of this article was taken, there would probably be as many interpretations of "speculative" as there are readers.

Trustees, whether they like it or not, have to play a far greater role in the investment process, they need to carry out their own research as to who is available, what they offer and what they charge. This publication is an important first step for anyone embarking on this process. The time is coming - indeed and in some cases has already arrived - when trustees must take on board people to assist them who have genuine investment expertise. Sadly, there is little doubt that litigation in this area will increase, as clients expect greater performance and expertise from their advisers. Clients themselves are much more financially sophisticated than they were and they wish to see this sophistication mirrored in their advisers, whoever they might be. Trustees are, therefore, facing increasing demands from their clients and the American litigation disease does appear to be infectious! Unfortunately, the infection is no longer a localised North American virus - it is becoming pandemic.

For clients facing new found freedoms and dipping their toe in international investment waters for the first time, either through trusts or as individuals, real care needs to be taken. Advice from the nineteenth hole at the gold course is no longer good enough. You and your trustees need to approach the international investment scene in a dedicated, professional manner. Doing otherwise will bring considerable problems in its wake. Clients can take heart from the fact that Courts will and do take a much harsher view of professional advisers, including trustees, failing in their duty to their clients. Any trustee ignoring this does so at his or her peril.

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