Delegating responsibility

Henry Brandts-Giesen considers the benefits of delegation of investment management

The objective when investing the trust fund is to preserve and enhance for the future the present day purchasing power of money. Failing to invest the trust fund in an appropriate manner will result in the value of the trust fund being eroded by inflation over time. It therefore follows that the investment of the trust fund is one of the most important aspects of trust administration.

Whilst the diversity of investment products available to a trustee can be advantageous it also increases the responsibility on the trustee to ensure that it is maximising the opportunities available. In a competitive market beneficiaries expect their trustee to have the full range of investment products and services at their disposal. For many trustees, investment management is not their core business and nor do they have the necessary expertise or resources to adequately manage the investment portfolio. In such situations it becomes necessary to consider delegating investment management to a competent and qualified professional.

Historically, at common law, a trustee could not delegate his powers to administer a trust. However, nowadays the investment opportunities available to trustees are increasingly sophisticated and complex and modern trust legislation in most common law jurisdictions allows a trustee to delegate administrative and dispositive responsibilities under the trust.

Delegation is generally only permitted to a manager whom the trustee reasonably considers competent and qualified to manage the investment of trust property. It is improper to appoint investment managers on the basis of a personal relationship or the corporate hospitality provided. Furthermore, it is inappropriate to make appointments simply on the basis that the appointees are from the same group of companies as the trustee.

A trustee should ensure that the agent, to whom it proposes to delegate investment functions, is reasonably competent and qualified by choosing a reputable institutional investment manager or a recognised stock broker whose past performance and present offering has been thoroughly scrutinised against its peers in the same market.

One issue that often arises is the question of the trustee exercising its discretion to appoint the settlor, protector or a beneficiary as the investment manager of the trust. Ostensibly it may seem that there is nothing wrong with this but in practice this is a situation that is best to be avoided. If the trustee was to consider such an appointment it should take particular care to ensure that it can be satisfied that the individual is not only competent and qualified but also has practical experience investing in the financial markets.
His credentials need to be thoroughly examined and performance closely scrutinised to an even greater degree than an institutional professional. Otherwise experience shows that the trustee could be subjected to a claim from the beneficiaries for negligently appointing the settlor as investment manager when there were other more appropriate appointees available. The fact that the beneficiaries potentially bringing the action may be members of the same family as the delegate should be of no comfort to the trustee in this situation.

Limiting risk exposure

Of utmost importance to a trustee is the fact that, provided it is objectively satisfied that the investment manager is reasonably qualified, the trustee would be absolved from liability for loss arising from negligent investment mismanagement or other default committed by such investment manager. Delegation can therefore be an effective means of a limiting a professional trustee's exposure to risk. However, the law will generally make it clear that exoneration from liability for the default of the agent can only be obtained if the trustee takes reasonable steps to supervise the agent.

The trustee must carry out regular reviews of the investment portfolio and measure the performance against the prior agreed benchmarks. Furthermore, a trustee's overriding duty is to act in the best interests of the beneficiaries, which, in part at least, entails reviewing the fees and other costs of the investment manager to ensure that the best and most reliable service is being provided at the lowest possible cost. Where the delegate underperforms or overcharges the trustee compared to its peers or the market as a whole the trustee must consider terminating the relationship and appointing a replacement – even where the manager is within the same group of companies as the trustee.

Of paramount importance is that the trustee understands and periodically reviews the circumstances of the beneficiaries to whom it is ultimately answerable. Once achieved the trustee can then make an educated decision as to the appointment it ultimately makes. It may be useful for the trustee to follow the following five-step process.

Step 1: Meet with beneficiaries to discuss investment objectives.

At this meeting the beneficiaries should be asked to complete a confidential client questionnaire to address issues such as their ages, family circumstances, career and retirement plans, existing pension arrangements, personal assets, income requirements, base currency preferences, liquidity and capital needs, investment time horizon, previous investment experiences, attitude to risk and tax position. Once this information is received and analysed the trustee can procure an investment mandate and then work towards its implementation.

Step 2: Meet with a range of prospective investment managers.

At this meeting the trustee should explain to the investment managers the findings of the client questionnaire and ask them to explain what makes them the best qualified to deliver the service required. Each investment manager should then be asked to complete an investment manager questionnaire to address matters such as:

- The business: ownership and management of the business, history, investment philosophy, core business, ratio of clients to staff, administration and support, client base and track record.
- The people: recruitment and retention of talent policies, qualifications, training, staff turnover.
- Investment process: committee based or key person? Whether leverage is to be used, use of derivatives or other methods to reduce exposure to negative markets, asset allocation philosophies, and implementation of investment (funds or direct, passive or active, manager discretion, compliance).
- Fees: how are they calculated?
- Valuations/reporting: how and when?

It will also be very important at this point to emphasise the role of the trustee and explain that, contrary to the popular belief of some investment managers, a trust is not a mere 'wrapper'. Even if the relationship between the investment manager and the beneficiaries is a familiar one, they should not deal directly with each other leaving the trustee out of the loop.

Step 3: The investment manager is selected, asset allocation model formulated and benchmarks set.

Formulating the asset allocation model is one of the most important stages in the process. The analysis of data by Brinson, Hood and Beebower in *Determinants of portfolio performance II: an update* reveals that portfolio performance is determined, primarily, by asset allocation (91.5 per cent) and, then far less significantly, by individual investment selection (4.6 per cent).

Essentially, at this stage, the trustee and investment manager notionally allocate in percentage terms the trust fund available for investment between asset classes (such as equities, bonds, cash, property and hedge etc). Once the asset allocation model is then agreed composite benchmarks can be set for each asset class and against which the performance of the investment manager will be assessed. It should be noted that the asset allocation model is not usually set in stone and typically an investment manager adds value in two ways. Firstly, by deviating from the model by increasing or decreasing percentages invested in particular asset classes in accordance with its outlook of market conditions, and secondly, by the actual stock selections made within the various asset classes.

In supervising the investment manager the trustee needs to understand the two stages to asset allocation. The first stage is strategic allocation to reflect the relevant investment objectives. The second stage is tactical allocation, which requires the trustee to adjust the strategic position to reflect its current investment view.

On the other hand, it may be agreed that the investment manager's role be a less active one in which it uses tracker funds to comply with asset allocation model. In such cases a lower management fee should reflect this more passive approach.

Step 4: Reporting.

It should be agreed in the investment management agreement that the investment manager provide quarterly performance reports to the trustee. In normal circumstances reporting more frequently than this can be counterintuitive whilst annual and bi-annual reports might allow a loss position to go unnoticed until it is too late for the trustee to react.

Upon receipt of the quarterly performance report, the trustee should make its assessment of the investment manager against the following indices:

1. the official cash rate prevailing during the period;
2. the benchmarks agreed at the asset allocation stage; and
3. the performance of other investment portfolios under the administration of the trustee.

Crucially, most trustees assess their investment managers against 1 and 2 above but fail to assess against 3. Professional trustees are in a prime position to assess investment managers against their peers by comparing the relative performance of the various investment portfolios under their stewardship. This analysis can reveal arguably the most enlightening statistics as an investment manager may beat the various composite indices it is set against but when compared against other investment managers operating under the same market conditions they may be performing below their potential. Obviously the converse can also apply.

Step 5: Review on an annual basis

The final stage involves the trustee conducting an annual review of the circumstances of the beneficiaries and the performance of the investment manager. Where the investment manager has underperformed then it may be necessary for the trustee to remove it and go through the appointment process again. Similarly this might be an opportunity for the fee arrangements in place to be renegotiated.

Henry Brandts-Giesen TEP is a solicitor with Mourant