INVESTMENTS

Geoff Clews, Barrister

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Lindsay: I'm pleased to introduce Geoff Clews an Auckland based Barrister who specialises in helping clients with serious tax or trust problems. Geoff's a trustee on a number of charitable trusts, undertook the legal substantiation of the New Zealand edition of Prudent Practices for Investment Stewards & Investment Advisers and he's a member of the Financial Advisers Disciplinary Committee which deals with complaints of misconduct laid against Authorised Financial Advisers. Geoff's also the Chairman of Pathfinder Advisers Group which links professional advisers and their clients of substance with specialist in all aspects of wealth management.

Geoff, you've been a strong advocate for trustees improving their practice standards, particularly around managing better inquiry and decision processes. That fits well with managing trustee investment decisions. Trustees have had to deal with volatile markets and the Global Financial Crisis, which has stripped wealth from many trusts.

Investment decisions aren't always easy ones to make and many trustees have told me it's an area they struggle with. Can you take us through a trustee's role for managing investment decisions?

Geoff Clews: Lindsay, I think the starting point is that a trustee has a number of key duties, one of which is to do everything reasonably possible to preserve the value of the capital that comes into the trustee's hands. We've seen a massive loss of capital wealth through finance company failures and similar losses in recent years, much of which has been on the watch of trustees who may have felt that they had been making reasonable investment decisions. Some trustees who have suffered losses may have acted contrary to their fundamental obligation to preserve the trust capital.

Next, trustees should recognise that while the obligation to preserve trust capital could be seen as somewhat passive, at the same time, the expectations of beneficiaries have increased significantly. There's been an explosion of knowledge and information available to trustees and beneficiaries which means the expectations of what makes for a good investment decision, is forever increasing (as is the bar by which beneficiaries will judge trustees on their investment performance).

These factors lead to the trustee's role being to preserve the assets held under trust, while also having a very weather eye on how to best grow and develop those assets for the future benefit of the beneficiaries of their trust. Trustees have to manage investment decisions in circumstances where many of their beneficiaries will fully understand what's happening in the financial markets and be expecting

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trustees to be similarly aware, and responding accordingly.

Lindsay: Thanks for that context Geoff. It's not a static situation and it's changing constantly. Can you take us through the high level responsibilities that trustees have when it comes to investing?

Geoff: The framework for trustee investing is provided by the Trustee Act 1956 and the terms of the trust deed. Section 13B of the Act requires trustees to exercise "...the care, diligence and skill that a prudent person of business would exercise in managing the affairs of others". That expression is often referred to as the prudent person investment test. The test is amplified for anyone who is a professional trustee and they are held to a higher standard of care under Section 13C. All trustees should have a broad understanding of the requirements of the Act for investing.

Next, trustees have a duty to understand and adhere to the terms of their trust deed, so the starting point for trustee investment decisions, is to know what powers the trustees have for investing. In some cases, the trust deed may override the statutory requirements of the Act so that they don't apply. For example, many, if not most, modern trust deeds are drafted with quite wide investment powers and will often contain what's called a contrary intention clause to exclude Section 13D of the Act so the trust is not necessarily restricted by the investment provisions of the Trustee Act.

However, while the trust deed may contain a contrary exclusion clause and wide investment powers, I'm of the view that trustees still have to act responsibly and prudently to meet the obligations I've mentioned, including the duty to care for the trust capital. Trustees can't be reckless.

Another area for trustees to be mindful of is where a settlor has made certain wishes known to the trustees for investing. The trustees will need to consider those wishes as part of their decision-making. Some trusts may have been established specifically for the purpose of holding certain assets, say, a family farm, or speculative investment assets, or an investment property portfolio. Generally in those cases the trust deed would have been drafted with those purposes in mind.

Lindsay: Thanks for that overview. I mentioned earlier that trustees don't always feel confident about managing investment decisions. You've said beneficiary expectations are increasing and that trustees should know what's happening in the financial markets. What's that mean for trustees?

Geoff: I think an important issue is that the influences that I mentioned are really squeezing out any role for the well-meaning amateur trustee. If you take on a trusteeship, you take on the role with

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all of the obligations that go with it. Those obligations require a trustee to make sure they have the necessary skillset to do the job.

Many trustees may simply not be equipped to be able to firstly, decide what outcomes they want for the investment of trust assets, and secondly, having made that decision, be able to decide whether the advice received from an adviser they've engaged to develop an investment strategy and recommendations, is appropriate in the context of their trust fund.

I think one of the big issues for trustees is how they educate and up-skill themselves to get some fundamental investment knowledge because, as I said earlier, the bar is lifting all the time.

Lindsay: Geoff, you've just referred to trustees taking advice and then deciding whether to accept that advice. It's been my experience that many trustees have tended to pretty much just accept the investment advice they're given by their adviser. What you're saying implies that trustees still have to check the soundness of the advice they've received. How do you think they should best do that?

Geoff: Well I think that's right Lindsay but firstly, I think it's very important to recognise that trustees are not expected to be experts themselves in all matters. Trustees are expected to take advice from skilled people on any matters that they don't understand or have experience in. It then follows that trustees should be entitled to rely on that expert advice so I don't think it's up to the trustees to try and second guess the investment expert's advice.

However, for trustees, it's not about "just accepting the advice that's been given". Trustees are required to exercise their judgement and are expected to make decisions. That requires trustees to test out the reasonableness or soundness of the advice for their circumstances. So, take an investment decision, the trustees may decide to appoint an investment adviser and get advice. When the advice is received, they then have to decide if they're going to accept it.

We talked earlier about the trustees having a duty to protect the trust capital and prudent trustees being the caretakers of the trust capital. Trustees need to check that the reasoning and underlying assumptions behind the advice are correct before they accept it. That's about checking the investment adviser has correctly captured and understood the needs of the trustees and the beneficiaries in their advice.

It's about trustees asking questions, sometimes hard questions and challenging where necessary, to get a sufficient level of understanding, before they decide to accept the advice that's been given.

Lindsay: What sorts of questions do trustees need to be asking to get

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to the level of understanding you're suggesting?

Geoff: Well, when we talk about understanding, we're talking about a level of understanding to be able to make decisions at more of a strategic level about what shape the trust's investments should take. That's the level where trustees are more likely to be comfortable making decisions if they have the fundamental knowledge and equipment to ask the right questions. So while it's about good questioning, it's also about good knowledge.

The questions at a strategic level to ask would be to better understand the needs and circumstances of beneficiaries, to consider how those needs and circumstances are likely to impact on the time horizon for investing, to assess how they link the risk they are prepared to take to capture the available returns of the investment markets, to understand their appetite for risk because that will also likely affect the investment returns over the investment time horizon, etc.

These are areas where I would expect the investment adviser to help the trustees, but the trustees still need to be involved in the process and ask the questions to understand.

It is important trustees have a basic understanding of what things like volatility means and be able to translate that information into some fundamental decisions about what they want to see in terms of diversification between classes of assets, management of risk and the expected return their investment portfolio will produce, for example.

Essentially we're talking about knowledge, advice and questions that enable the trustees to get to a point where they can decide to accept and implement a suitable investment arrangement for their trust. We call this the investment strategy.

A good place for trustees to start for asking questions is section 13E of the Trustee Act 1956. That section sets out some of the factors that trustees may have regard to in exercising their powers of investment insofar as they are appropriate for the circumstances of their trust. Things like diversification, capital preservation, income needs and inflation. I think Section 13E makes a useful checklist for trustees and I'd suggest you append a copy of that Section to this guide.

Trustees need to ask questions when they review their investment performance and expenses, appointing an investment adviser or reviewing their adviser's performance, or when they're checking the custody of their investments will be secure from theft or fraud.

Lindsay: Thanks Geoff. I'll include an extract of Section 13E and Sections 13B, 13C and 13D that you mentioned earlier, as an appendix to this guide (see **Appendix 2**). You mentioned part of any investment

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decision process is thinking about the needs and circumstances of the beneficiaries. Can you elaborate on that a bit more?

Geoff: Certainly. Trustees are responsible for holding and managing the assets of a trust for the benefit of their beneficiaries, so beneficiary interests, needs and circumstances are really important considerations for any investment decision-making.

Trustees may also need to balance the needs of quite broad classes of different beneficiaries who they're acting for and then arrive at some strategic decisions for what they are looking to achieve over longer periods of time. For example, the trustees may have to balance the needs of the present beneficiaries with the needs of the future beneficiaries or invest in a way that ensures the trust income and capital is not eroded by inflation.

Trustees should also bear in mind that they may owe duties to one generation of beneficiaries now, but could very well owe duties to another generation coming up who may have quite different needs (and views) over what the trustees should be doing (or have done) about investing the trust assets. So balancing those interests and keeping an eye on the fact that what might appear to be a sound decision in one decade, may not look so sound in the next decade.

Lindsay: Let's pick up on that point about sound decision making. Can you take us through what you would consider to be good practice for trustees when they are managing investment decisions?

Geoff: I think the goal for trustees is to define and implement an investment strategy that the trustees want to pursue, given the context of their trust, the beneficiaries in whose interests they are acting and the terms of the trust deed under which they are operating. Being able to develop an investment strategy for the trust would be the first thing

From a good practice perspective, my view is that good process is the only answer for prudent trustees. By that I meaning for trustees to:

1. Initiate a review and consider the requirements of the trust deed, the law and any settlor wishes.
2. Evaluate the needs and circumstances of the beneficiaries of the trust (present and future).
3. Decide what outcomes the trustees want for the trust and the investment of trust assets.
4. Appoint competent advisers where special knowledge or experience is needed (for example, an Authorised Financial Adviser, a specialist tax adviser) to assist the trustees to develop their investment policy and to recommend a strategy and plan of

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investments which:

- Ensures an appropriate and reasonable balance between risk and return, and
- Diversifies where and when appropriate.

5. Evaluate the advice and recommendations, ensure they are appropriate in the context of the trust fund (ask relevant questions; check the reasoning and assumptions; assess answers; accept or challenge; clarify the advantages and disadvantages; understand what's proposed).
6. Document the trustees' investment policy (preferably using an Investment Policy Statement) and record the decision to approve the investment policy, strategy and plan.
7. Implement the investment policy, strategy and plan.
8. Monitor and review investment reports and performance, investment costs and investment adviser performance, explain significant variances and if needed, modify the policy and plan.

That's the sort of broad high level process that I would suggest trustees could adopt (accepting there is a lot more detail that would need to underpin each of the steps I've described).

Lindsay: Geoff, you mentioned trustees documenting their investment policy in an Investment Policy Statement. Can you take us through what that is and what sort of things you'd see in it?

Geoff: An Investment Policy Statement (or "IPS") is a document which I think is going to become much, much more prevalent and much, much more important, as time goes on. If you're dealing with any investment advisory organisation now, it will have been apparent that the requirements imposed on them by the Financial Markets Authority include a very significant emphasis on the importance of advisors making sure that their clients (whether they're trustees or not), understand the advice that they have received.

An IPS is really the business plan for investing and it supports the trustees' paper trail. Some of the things you would expect to see in a well drafted IPS would include:

- An overview of the trust and its governing documents.
- The roles and responsibilities of parties in the investment process (trustees, investment adviser, investment managers, custodians).
- The investment time horizon.
- The investment objectives.

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- The investment assumptions and expected investment returns.
- The assets classes and weightings that will be used to achieve the investment objectives.
- Rebalancing guidelines.
- The criteria that will be used to monitor investment managers, performance and costs.

I'd add a word of caution though. Once an investment policy, strategy and plan is approved and implemented, it is essential for the trustees to then keep it under close monitoring and review as investment markets and beneficiary circumstances can change very quickly.

Lindsay: I'm an advocate for using Investment Policy Statements. It's a document that makes the trustees investment policy and investment strategy very clear. I think the process and conversations that take place between the investment adviser and the trustees while they develop the investment policy, helps to clarify roles and responsibilities and build the trustee investment knowledge and understanding that you referred to earlier. Geoff, do you have any final comments?

Geoff: Yes, I'd make a couple of final points. Not all trustees will have the need or luxury of being able to implement a Rolls Royce type investment process and I don't want to give the impression that everyone has to be operating at that level because many trusts will not be sitting on large pools of investment assets.

However, the nature of assets in a trust may change significantly over the course of a trust so trustees need to keep that in mind (for example, a trust may start with just a house which may be sold at some point and the proceeds invested). The high level framework I've described should help steer trustees in the right direction.

Finally, I mentioned earlier that trustees aren't expected to be experts in everything. They won't always get their decisions right and they will make mistakes. That said, if trustees follow appropriate practices and process, they will make more prudent decisions and minimise the risk of a mistake or the possibility of a claim being made against them. So, if a claim was ever made relating to an investment decision, I think it would be very helpful to a trustee to be able to point to a diversified investment strategy and show the process they used to develop, implement and monitor the investment strategy for their trust.

Lindsay: Geoff, thank you very much for outlining your thoughts for managing trustee investment decisions. If someone wants to make contact with you, they can do that through your website www.taxcounsel.co.nz.

Geoff: My pleasure Lindsay.