



**Gerard Kilpatrick**

# Trustees And Investment

*When it comes to investment, trustees are required by law to exercise the care, diligence, and skill that a prudent person of business would exercise in managing the affairs of others. **Gerard Kilpatrick**, a partner in the Warkworth Lawlink firm of Webster Malcolm & Kilpatrick, looks at what trustees must do, and the liabilities they may incur if they fail to invest as the law requires.*

The role of trustee in a trust should not be assumed lightly. The responsibilities undertaken are very real, and can give rise to personal liabilities. In this article, we propose to look at one only of a trustee's responsibilities, that is, the "prudent person" obligation which trustees must apply in investing the trust's assets. Although we look primarily at investment from a trustee's perspective, what we say about managing an investment portfolio may be useful in the management of a personal investment portfolio as well.

Section 13B of the Trustee Act 1956 provides:

*... a trustee exercising any power of investment shall exercise the care, diligence, and skill that a prudent person of business would exercise in managing the affairs of others.*

This is known as the "prudent person" test. Note that it is not sufficient that a trustee making investments should make investments as though he or she were investing their own money; rather the standard is that of "a prudent person of business". Many trustees, including most accountants and solicitors, will not be able to satisfy this obligation without taking advice from a person who does have the necessary background and qualifications.

The effect of this obligation is demonstrated in a decision of the High Court in *Mulligan (deceased) v Pyne Gould Guinness Trust Ltd & Anor* [1998] 1 NZLR 481. Mulligan (who died in 1949) had left his estate to his widow and Pyne Gould Guinness as trustees. The widow was entitled to the income from the estate for her life, and on her death, the capital of the estate was to be divided between the deceased's 10 nephews and nieces.

The widow insisted, against the wishes of Pyne Gould Guinness as her co-trustee, that the capital of the estate be invested in fixed interest securities, and refused to consider investing in shares or other equities. Fixed income securities produced more income, and thus favoured the widow. This was to the disadvantage of the nephews and nieces, who were deprived of the opportunity for capital gain over a lengthy period.

When the widow herself died, the beneficiaries took Pyne Gould Guinness to court, alleging a breach of trust in so far as the trustee had failed to take steps to protect the estate from inflation. The court held that Pyne Gould Guinness had not been entitled to defer to the views of the widow. Damages were assessed against Pyne Gould Guinness on the basis of what a prudent trustee was likely to have achieved. These damages totalled \$170,640 – a considerable sum, given that the original estate was only \$108,000.

The warning is clear. Trustees cannot just place the trust capital in a bank at interest. Trustees must, as prudent persons of business, invest the capital in such a manner that it is protected from inflation. Trustees who do not do so will be liable to the beneficiaries for the capital losses the trust incurs in real terms. The exceptions to this rule include where the trust deed directs a specific form of investment, where the trustee has the consent of all beneficiaries, and where there is an order of the High Court to the contrary. Trustees must note that minors cannot give the necessary consent.

## HOW MUST TRUSTEES INVEST?

Most of us (and this includes most professionals, such as accountants and solicitors) do not have the skills to analyse the share and other equity markets and give proper investment advice. It is not

sufficient to read the papers, listen to hot tips in the bowling or golf clubs, or act on a "gut feeling". That is equivalent to backing a racehorse called "Birthday Boy" because it is your birthday. Trustees can make themselves informed, by all means, but must not think they are experts. Trustees should, as prudent persons of business, protect themselves by consulting a certified financial planner, or outline their circumstances to a good sharebroking firm and ask for a written report. Having obtained a report, they should ask questions, but not discount the report and substitute their own judgment. Many New Zealanders mistrust intangibles and have an instinct to do things themselves and, in planning investments, this must be resisted. Skilled advisers work from research bases developed by specialists, usually outside their own firms, who might be considered as wholesalers of research and advice. Besides, the trust will be paying for the advice, and it is no use having the trust incur the adviser's fee if the trustees are going to substitute their own judgment.

Trustees who invest on the basis of proper advice will, in most circumstances, be protected from liability if the trust does make a loss – which will happen occasionally.

## INTELLIGENT DIVERSIFICATION

Diversification is one of the keys to safe investment in equities. A \$100,000 portfolio is likely to be spread among five or six different holdings. An adviser might recommend, say, \$20,000 in Australia, \$20,000 in New Zealand, \$20,000 in good fixed interest, \$20,000 in New Zealand property shares, and \$20,000 in other international holdings. If one of these holdings decreases in value, that loss is likely to be outweighed by gains in the other sectors – but hopefully, all should give a good

return, at least over a three to four-year period.

### RISK

Many potential investors preface their instructions by saying something like "Oh, I don't want to take any risk". It is important to understand that with investment, the term "risk" is a relative term; there is a risk even with government stock. A good adviser will tell a trustee the level of risk with any proposed investment, which may be very low, or it may be higher.

It is important to understand also that risk and return are co-relative. The greater the potential return, the greater the risk. Trustees are bound by the prudent person law, but most non-trustee personal investors strike a balance. Of course, spreading investment over a range of different risks is part of diversification. If you are investing your own money, a good investment adviser will talk this through with you to establish your personal risk profile. Can you sleep at night with your investments? If you are a worrier, then your risk profile will be lower, and your adviser will take this into account and recommend a more conservative portfolio for you.

### CHOOSING AN ADVISER

Take care in choosing an adviser. The better advisers are generally fee-based rather than commission-based. That is, if they receive commissions for placing your investments, they rebate these to you and charge you a fee, which is generally less than the possible commissions they could earn. Likewise, be aware of any interests your adviser might have. For example, if the adviser works for a financial group that has its own investment funds, the adviser may be inclined to place your investments in their own funds. This is an awareness and disclosure issue – there are many good advisers working for financial institutions who act fairly and impartially.

Your Lawlink lawyer will help you choose an investment adviser, and some firms may have qualified advisers in their own staff.

### FINANCE COMPANIES

Trustees and other investors must be wary of sometimes glossy newspaper, radio, and television advertisements placed by finance companies offering high rates in return for deposits. The companies offering these rates may or may not be sound. Many are risky indeed, especially so if they use your

money to invest solely in one asset class (lack of diversification). The first rule of investment must always be not to lose any capital, and regrettably that risk is there with a number of these companies. They could have liquidity problems on an economic downturn. Do not invest in these companies unless your adviser recommends it. It is better to accept 7% from a bank than risk losing capital for the sake of one or two percent more. Be warned. History shows that it does happen and investors lose money, again and again.

### REVIEW YOUR INVESTMENTS

Finally, the prudent person rule requires that an investment portfolio be reviewed at least at six-monthly intervals, or when circumstances change. The adviser will charge a fee, but that is usually a tax deductible expense. Some care is necessary not to do too much buying and selling, or you or the trust are at risk of being deemed a dealer and having to pay tax on capital gains. Your adviser will take this risk into account when making recommendations.

### SUMMARY

1. Trustees, in most circumstances, must apply the prudent person test when making investments. Otherwise, they risk incurring personal liabilities.
2. Ensure the trust's investment portfolio is properly diversified among several different asset classes.
3. Understand how the word "risk" is used in an investment context – "risk" is a relative term; every investment has a risk, even if that risk is low.
4. Choose the trust's adviser carefully, and preferably choose a fee-based adviser rather than one who is commission-based – your Lawlink lawyer will help you with this choice.
5. Avoid finance companies that offer high interest unless they have been properly investigated and are recommended by your adviser.
6. Keep the trust's investments under review – have them reviewed at least six-monthly.

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