Prudence under Pressure

Scott Donald*

*Russell Investments, University of New South Wales

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Abstract

Investment markets have been volatile in recent times and the investment practices of super fund trustees are coming under increasing scrutiny. The law requires that trustees exercise the care and skill of a prudent person in the exercise of their investment powers, and that they formulate an investment strategy that has regard for the circumstances of the fund. What does this mean in the context of volatile markets and current investment practices?
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Speaker:
M Scott Donald
Russell Investments and UNSW
P: + 61 401854152
mscottdonald@optusnet.com.au

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Prudence under Pressure

“If you can keep your head when all about you
Are losing theirs and blaming it on you,
If you can trust yourself when all men doubt you
But make allowance for their doubting too ...
... you’ll be a [prudent] Man, my son!”

The past eighteen months have provided a salutary reminder of Justice Putnam’s famous warning, ‘Do what you will, the capital is at hazard’. The market price of listed shares and non-government bonds has taken a beating. The values of their unlisted counterparts have arguably yet to reflect this re-rating, but it would be dangerous to assume that the wide discrepancies in valuation reported in recent months can continue. The ruins of complex structured products, orphans of once-proud investment banks, lie strewn across a financial wasteland.

Superannuation funds and their trustees have had to negotiate this storm. Industry figures suggest that the average balanced superannuation fund suffered a loss of almost 20% in the twelve months to 31 December 2008. That figure would no doubt have been worse but for the precipitous fall of the Australian dollar, which provided an offsetting currency gain for any unhedged exposures to international assets.

It would be naive to assume that this environment hasn’t unsettled many super fund members, and perhaps a few regulators. Recent market events will inspire scrutiny of the investment decisions taken by super fund trustees of an intensity that few will ever have experienced before. Some members will no doubt take aim at the investment decisions made by the trustees on their behalf. The regulators may also intervene. This paper looks at some of the issues that may arise. In particular it reviews how the law relating to superannuation fund trustees deals with investment risk. It also considers the way that the incorporation of ‘alternative’ type investments and investment strategies into the portfolios of superannuation funds affects the obligations owed by super fund trustees under the general law and the relevant regulations.

The paper starts with a discussion of the general law principles relating to a trustee’s exercise of its investment power, noting in particular the distinction between cases in which the trustee’s action (or more often, inaction) is deemed imprudent and those where the investment itself is deemed to be of a type that is inappropriate. It then considers the impact of the covenants implied by s51(2) of the Superannuation Industry (Supervision) Act 1993 (Cth) (the “SIS Act”) on the exercise of the investment power, as well as the defence contained in s55. Finally it considers the implications of that legal and regulatory background on the due diligence required when super funds invest outside ‘mainstream’ investment types.

The paper largely ignores the complications arising from the interposition of the Corporations Law into the superannuation arena, and employs the term ‘trustee’ to connote the individuals, formally often directors of an incorporated entity acting as trustee, who together exercise powers of decision-making with respect to the trust. These simplifications, in the context of the subject matter of this paper at least, are believed to be benign.

Adapted from Rudyard Kipling, If (1909).

Harvard College v Amory (1830) 26 Mass (9 Pick) 446


For a more detailed discussion on the role of the Corporations Law in this area see Pamela Hanrahan, ‘Directors’ liability in superannuation trustee companies’ (2008) 2(3) Journal of Equity 204.
The position at general law

Trustees are required at general law to take the care and exercise the skill of a prudent person in the exercise of their investment power. They are required to ‘preserve trust capital,’ to exercise ‘caution,’ and to avoid ‘speculation,’ though as we shall see below, the meaning of these requirements has evolved in deference to contemporary expert views on investment. More generally, since Cowan v Scargill, trustees are expressed to have a duty to act in the ‘best interests’ of beneficiaries. This latter requirement serves to ensure that the investment strategy chosen by the trustees is appropriate for the circumstances of the trust, or in terms borrowed from securities regulation, that the investment strategy is ‘suitable’ for the members. These principles drawn from the general law of trusts apply in the superannuation environment notwithstanding the peculiar nature of the superannuation trust.

There is a voluminous body of case law concerning the investment of trust assets, and a no less-daunting array of learned commentary. The focus here will be on the way ‘prudence’ has come to be understood by the courts. The

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7 The “prudent man” of trust law dates back at least as far as 1758; Harden v Parsons [1758] 1 Eden 145; 28 ER 639. The common law flirted with the formulation before concluding, in effect, that it was overly uncertain; Crook v Jadas [1834] 5 B & AS 911; 110 ER 1028 (a negligence case). That said, the courts have not always observed a clean distinction between the prudent man of Equity and the reasonable man of the Common Law. For a recent example, see Blackett-Ord V-C’s placement of the prudent man on the Clapham Omnibus in Mason v Farbrother [1983] 2 All ER 1078 at 1087.


9 ASC v AS Nominees (1995) 133 ALR1 at 12 - 13. But see re Smith [1896] 1 Ch 71, in which Kekewich J noted that ‘it is familiar to us all that there is a class of men, who are prudent but not very cautious ... it seems to me that it is quite open to a trustee … to think fit to [act in that way].’ at 76.

10 Harris v Hanna [1861] 29 Beav 107; 54 ER 567; Bethell v Abraham [1873] LR 17 Eq 24. For a broader description of the courts’ nervousness about speculation in the wake of the South Sea crisis, see Chantal Stebbings, The Private Trustee in Victorian England, (CUP, Cambridge, 2002). For a more recent example, see Re Buckland (Unreported judgment of the Supreme Court of Victoria, Nathan J, 11 August 1993).

11 In this vein, the Administrative Appeals Tribunal has noted that ‘Just what amounts to speculation is open to interpretation’; Re Auton and APRA [2005] AATA 32, at 14.

12 [1985] Ch 270.


14 Cowan v Scargill, above n 12.

first point to note is that there is no duty to exercise ‘prudence’ per se. Rather trustees are required to exercise the level of care and skill that a prudent (business) person in like circumstances would exercise. Prudence thus enters the equation as a benchmark (the level of care of a prudent person) against which the trustee(s) actions will be compared. That nicety aside, the case law contains two strands relating to ‘prudence’; a bifurcation with important contemporary relevance. The first is focused on the behaviour of the trustee and can be thought of as a requirement of ‘cautiousness’ on the part of the trustee. The second is focused on the type of investment itself and inspires the notion of prudence as ‘risk aversion’. This distinction has been described by Millett LJ in the context of the duty of an executor of a will as one between ‘a positive misapplication of the estate assets’ and a ‘failure to protect their value’ (the order is reversed). The nuances in connotation of the synonyms ‘cautiousness’ and ‘risk aversion’, and particularly the contribution made by economic theory in defining risk aversion in the financial context, generates insights of practical relevance to superannuation trustees.

Due diligence risk, speculation and the avoidance of recklessness

The first line of cases arises where, stated loosely, the breach arises from deficiencies in the way in which the trustees themselves executed their duties. The quality of the trustees’ action (or inaction) is sometimes characterised as ‘speculation’ or, in extreme cases, attributed to ‘recklessness’. The want of care exhibited by the trustee need not however warrant such colourful language. Indeed the moral tone of such language can be distracting as the breaches alleged to have occurred are often entirely mundane, attributable more to a lack of diligence than anything more sinister. The trustee who fails to secure adequate security for a loan made from trust monies is the epitome of this line of cases. Other examples include inadequate diligence in following up outstanding debts owed by mortgagees, failure to supervise adequately the affairs of a privately held business, and failure to secure an independent valuation. There has also been criticism of trustees’ failure to employ adequate operational safeguards in the handling of trust cashflows and assets. Moreover, it is often not a single act or omission but a pattern of deficiency that inspires the chagrin of the court. In ASC v AS Nominees, for example, the trustee was...

Law Review 52, and Bevis Longstreth, Modern Investment Management and the Prudent Man Rule, (OUP, New York, 1986) have also been extremely influential, notwithstanding their US perspective:

re Salmon (1889) 42 Ch D 351
See for instance In re Turner [1897] 1 Ch 536 in which the root cause of the breach would appear to have been reliance on the probity of a co-trustee, and Smethurst v Hastings (1885) 30 ChD 490 where there was a general lack of enquiry, which enquiry would have identified the deficiencies of the investment proposed. There are however cases like Re Smith, above n 9, in which the moral probity of one trustee was found wanting. The court in that case was careful to clarify that the investment in an unsecured mortgage was impugned not because the security was inadequate but because one of the trustees had acted dishonestly in accepting a bribe in relation to the investment. It is, moreover, hard not to sympathise with Johnson’s description (applied to the US context but equally applicable here) of “speculation” as the “prudent person’s slipperiest term of art”; Michael T Johnson, ‘Speculating on the Efficiency of Speculation: An Analysis of the Prudent Person’s Slipperiest Term of Art in Light of Modern Portfolio Theory’ (1995) 48 Stanford Law Review 419.
Holmes v Dring, [1788] 2 Cox 1; 30 ER 1; Mills v Osborne [1834] 7 Sim 30; 58 ER 748; re Salmon above n 16; Fouché v Superannuation Board (1952) 88 CLR 609; ASIC v Parker, above n 19.
Fouché v Superannuation Board above n 21.
Re Lucking’s Will Trusts [1967] 3 All ER 726.
Smith v Hassall (1899) 22 LR (NSW) Eq 165; ASIC v Parker, above n 19.
Re Preuss and APRA [2005] AATA 748. See also Knight v Earl of Plymouth [1747] 3 Atk 480; 21 ER 214 in which the court recognised that the loss to the trust resulting from the insolvency of the originator certain bills sold to the trust did not of itself taint the otherwise prudent handling of cashflows by the receiver responsible for administering the affairs of the trust. Above n 9.
found to have breached its duty for (amongst a litany of breaches) failure to pursue a defaulting loan, undue haste in making a decision, failure to achieve adequate security on a loan and an overall ‘laxity of supervision’.

Though these cases span a wide range of circumstances, the common element is the court’s focus is on the conduct of the trustee. The language used by the courts in some of the reported cases suggests attention to the actual state of mind of the trustee, but the test is an objective one. This has two important effects. First, it establishes a benchmark for performance that, in theory, can be applied consistently. This consistency is an important consideration for policy makers and regulators hoping to rely on this rule (and its statutory incarnation, discussed below) to contribute a component of the regulatory mosaic. Second, it relieves the plaintiff of the evidentiary burden of establishing that the trustee had, in fact, a careless attitude. This was important in early Chancery cases because of the limitations of procedure and resource in that Court. In more modern times it somewhat assists beneficiaries overcome the difficulty they face securing trust information to prepare their claim. That trustees are not ordinarily required to provide reasons for their decisions, nor are they required to disclose ‘trust information’ to beneficiaries, cements a major information asymmetry in the trustee/beneficiary relationship.

In each of the cases described above, the trustee(s)’ exercise of the investment power has been characterised as imprudent. Importantly, this does not mean that the type of investment is necessarily a problem for the trust in question. In theory, at least, the trustee might have been able to make those types of investments but for the deficiencies in diligence and/or care identified by the courts. It is for this reason, that this type of breach is aligned with the concept of ‘due diligence’ risk outlined below. However there is a second line of cases that focuses to a much greater extent on the nature of the investments. It to these that we must now turn.

**Risk aversion and appropriateness**

The second line of cases focuses on the nature of the investment itself. The cases typically arise where the trustee has purchased investments outside those expressly nominated in the trust instrument and the beneficiaries are seeking redress for the loss thereby incurred. In these situations the court has to assess whether an investment (or investments) is appropriate (or “proper”) for the trust. Most often that is a question of whether the investment was (or would be) too risky for the circumstances of the trust, as in Adye v Feuilletateau where the practice of lending trust

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27 re Whiteley, above n 6.
29 Re Londonderry’s Settlement [1965] 1 Ch 918 at 928 per Harman LJ.
31 The want of diligence central to many of these cases links them to certain other investment-related cases, such as those directed at a trustee’s failure to pursue with adequate vigour the ‘getting in’ of trust assets (eg Styles v Guy (1849) 1 Mac & G 422; 41 ER 1328) or to invest in a timely manner (eg. Byrchall v Bradford (1821) 6 Madd 13; 56 ER 993; Attorney General v Alford [1855] 4 DeG M & G 843; 43 ER 737.
32 The notion of appropriateness used here approximates the securities law notion of “suitability” which requires that an adviser match the needs and circumstances of his or her client with the features and nature of the investment he or she is recommending to that client; See for instance M. Lipton, “The Customer Suitability Doctrine”, Fourth Annual Institute on Securities Regulation, (1973), 273.
33 See for instance Re Rider’s Will Trusts [1958] 3 All ER 135; Chapman v Browne [1902] Ch 785; Crook v Smart (1873) 11 SCR (NSW) Eq 121; Knott v Cottee [1852] 16 Beav 77; 51 ER 705. Note that trustees are not “prohibited” per se from investing improperly. The effect of the court finding that an investment is not a proper one for the trust in question is that the trustee is deemed to have purchased the security (or otherwise acted) on his or her behalf rather than the trust. As a result, the cestui que trust is entitled to have the trust made good for the capital expended plus such “interest” as would have been earned had the fund been invested properly.
34 Mant v Leith (1852) 15 Beav 524, 51 ER 641. Also ASIC v Parker above n 19 (in respect of the Claireview, investment).
money on personal security was described as ‘a species of gambling’. However the courts have on occasion had to consider claims that the investment strategy was too conservative, as famously occurred in Nestle v Westminster. There is also a parallel set of cases in which the court was asked to empower the trustee to invest beyond the set of investments authorised by the trust instrument, or to provide guidance on whether specific types of investments (usually common stock) fell within the ambit of the express terms of the trust.

Historically the court’s concern about this issue was inspired by a desire to ensure that trustees exercised their discretions impartially, not unduly favouring one class of beneficiary over another. This is clearly an important issue in a family trust where, for instance, a heavily income-oriented investment strategy might be felt to unduly favour the interests of the income beneficiaries at the expense of the capital beneficiaries. However a broader rationale applies in the superannuation and charity context. The rationale in those contexts places greater emphasis on the link between the exercise of the investment power and the imputed purpose for which the power was granted. (“Imputed” because the notion of a settlor’s intention doesn’t fit well in these more commercial contexts in which the role of settlor is purely notional). So for instance Sir Robert Megarry V-C in Cowan v Scargill explicitly linked the proper exercise of the investment power to what he took to be the object of the trust, namely advancing the financial best interests of the beneficiaries. That object provided a reference point for ascertaining the appropriateness of any investment strategy considered by the trustees. Sir Donald Nicholls V-C took a similar approach in Harries v Church Commissioners. His Honour reaffirmed the principle that the investment powers of (in this case, charity) trustees must be exercised for the purpose for which they were given, namely to advance the financial best interests of the charity but recognised that in ‘comparatively rare’ cases, unique sensitivities arising from the mission of the particular charity might place constraints on the exercise of the power.

The law has struggled to provide an unambiguous and universally applicable description of what constitutes an appropriate investment for a trust. For a while, the much maligned ‘court lists’ of authorised investments played such a role. Initially a set of guidelines for the appropriate investment of Chancery funds, they acquired a quasi-legislative aura, in effect becoming a reference list of investments that might be made by trustees. This, in turn, inspired a succession of legislators to attempt to address through statute the Court lists’ perceived inadequacies. In retrospect, of course, these statutory interventions shared the hamartia of the court lists, ossifying the standard around prevailing investment prejudices and stymieing the evolution of trust investment practices. They did this directly, through references in trust instruments to ‘authorised’ investments, but also indirectly when the court read down even explicitly broad investment powers to fall within only

35 (1783) 1 Cox. 24; 29 ER 1045 per Lord Commissioner Hotham.

36 Above n 8. Not so famously, this possibility was alluded to by Finn and Zeigler, “The time may not be far away when some trustees may be challenged to justify their [overly] conservative strategies. Conservatism may make life easier for trustees, but not necessarily for beneficiaries’.

37 Above n 15 at 337.

38 As in Re Strang (1941) 41 SR (NSW) 114; Riddle v Riddle (1952) 85 CLR 202; Re Baker (1961) VR 641 and Re Buckland above n 10.

39 As in Re Harari’s Settlement Trusts [1949] 1 All ER 430; Bethell v Abraham, above n 10; re Walker (1903) 3 SR (NSW) 163.

40 See for instance Raby v Ridhalgh (1855) 7 De M & G 104; 44 ER 41. Also Stebbings, above n 10.

41 Crook v Smart, above n 33. For a recent example, see Murdoch v Commissioner of Taxation [2008] FCAFC 86.

42 Above n 12.


For a discussion of the genesis and context of the lists, see Stebbings, above n 10 at 131.
those investments recognised in the court or statutory lists. The conservatism was described by Phillips LJ in 
Singer v Williams thus

'It must be remembered that the Court of Chancery started with the view that there was only one investment
open to trustees Consolidated Bank Annuities, that even investments in other Government stocks... were
only gradually and somewhat grudgingly admitted, and that thenceforward, as from time to time the areas of
trustees’ investments has been extended, either by private investment or by Act of Parliament, the Court has
always looked on each new investment as having the duty of making good its title to admission [to the list].

The influence of the court lists has now been consigned to history and the older, more prescriptive statutory
provisions have largely been replaced by provisions of a more ‘open textured’ nature. This has freed the courts
to accept into evidence expert testimony on the state of contemporary investment theory. It is an invitation the courts
have accepted with increasing alacrity over recent decades.

Of course, increased reliance on the testimony of experts creates its own issues. The image of an expert as an
objective, neutral, impartial and reliable authority is described by Edmond and Mercer as ‘simplistic’.

‘Expertise is not mono-dimensional. Expert knowledge, authority and opinions are regularly contested, and
contested in ways which are sensitive to the standing and credibility of individuals, the organisation of the
discipline, field or profession, the particular (institutional) context, and pervasive public registers of science
and expertise.

Judicial officers appear to share these concerns. In 1998 Freckelton et al found widespread judicial concern about
the potential for bias in expert evidence and the difficulty of understanding highly technical material and in identifying
the basis for expert opinions.

Trust law has not been immune to such issues. It is interesting to compare, for example, the references to expert
testimony in the judgments delivered in Re Baker, where the testimony of Messrs Baillieu, Carah, Merry and Larritt
was apparently accorded some deference, to the genuinely adversarial, almost gladiatorial, use of experts apparent
from the judgments delivered in Nestle v Westminster. In the latter case the presiding Judge, Justice Hoffman at first
instance, effectively had to judge the relative cogency of the experts, a task few judicial officers would relish if the
matter became highly technical. Unfortunately the complexity of some of the investment practices of modern

See for instance Re Braithwaite [1881] 21 Ch D 121; Crook v Smart, above n 33; Bridges v Shepherd (1921)
21 SR (NSW) 220. This circumscription was considered inappropriate by the middle of the following
century; Re Harari’s Settlement Trusts, above n 38.

[1921] 1 AC 41 at 62.

[1921] 1 AC 41 at 62.

In NSW the Trustee Amendment (Discretionary Investments) Act 1997
amended s14 of the Trustee Act 1925 (NSW) to permit a trustee, unless expressly forbidden by the
instrument creating the trust, to invest trust funds in any form of investment. This wide discretion is
subject to a set of considerations for which the trustee must have regard; s14C Trustee Act, and the
broader requirement to act impartially and in the best interests of present and future beneficiaries;
s14B(2) Trustee Act. It is also subject to a duty to avoid investments that are ‘speculative’ or ‘hazardous’,
neither of which terms are defined in the Act; s14B(2) Trustee Act.


Edmond and Mercer, above n 47 at 3.

Ian Freckelton, Prasuna Reddy and Hugh Selby, Australian Judicial Perspectives on Expert Evidence: An
superannuation funds means that the prospect of courts in the (near?) future being required to engage with highly technical material is more than a mere possibility; it is a near certainty. 51

Notwithstanding these challenges, the courts have shown a willingness to embrace a more sophisticated conception of the trustee’s investment responsibilities. One catalyst for the change in attitudes would appear to be concern about the corrosive power of inflation. 52 The outbreak of persistent and significant consumer price inflation in the immediate post-War period (1946-53) highlighted the need for trustees to attempt to protect the ‘real’ value of the fund if the intentions of the settlor were to be met. 53 This in turn forced trustees to contemplate investment strategies attended with risk. Without risk the strategies would not earn a return capable of compensating for the corrosive effects of purchasing power of the fund. This undermined the relevance of the requirement to preserve the ‘capital value’ of the fund, one of the rallying calls of traditional notions of investment prudence. A more sophisticated benchmark would henceforth be required.

The other important catalyst would seem to be recognition of superannuation funds as a differentiable sub-species of trust. 54 The peculiar raison d’être of pension funds and mutual funds, and (following Nicholls V-C in Harries v Church Commissioners) the investment portfolios of charities and endowments, made the financial technology, both in terms of ideas and financial instruments, that started to emerge in the 1960s and 1970s more pertinent. Thus, for instance, regard for the need for diversification in trust investments, whilst not ignored in the older cases 55 is accorded more prominence and articulated in more detail in cases such as Cowan v Scargill, 56 Harries v Church Commissioners 57 and Nestle v Westminster. 58 Similarly, the distinction between capital and income returns, vitally relevant in many family and testamentary trusts, is downplayed in contexts, such as superannuation (pensions) and charities, where impartiality is not an issue and there are fewer taxation consequences. Finally, the notion that assessments of an investment’s suitability must be made with reference to its role in the portfolio as a whole has received increasing attention, 59 as has the need to recognise the validity of employing derivatives contracts for hedging purposes. 60

The open-mindedness illustrated by these developments is important because, as we shall see below, the proliferation of new and innovative investment practices within superannuation fund portfolios shows little sign of abating. Markets will continue to challenge ‘the adaptable wit’ 61 of the prudent man. However, the court’s decision in

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51 The examination of unit-pricing and subscriptions and redemption minutiae required in Basis Capital Funds Management v BT Portfolio Services [2008] NSWSC 766 illustrates this.
52 Price inflation was low for much of the 1900 – 1945 period in Australia, as it has been again since 1990; Keith Hancock ‘Consumer Prices and Wages in the Twentieth Century’ (2002) 28(2) Australian Bulletin of Labour 71. The effect of the outbreak of double-digit inflation in the immediate post war period (1946 – 53) on curial discourse is tangible.
53 See for instance Boyd v Cowell [1952] VLR 288; Trustees of the British Museum v Attorney General [1984] 1 All ER 337. The judgment of Williams J in Riddle v Riddle, above n 37, illustrates nicely the application of this new consideration to the more traditional assessment of the need to balance the interests of life tenants and remaindermen.
55 See for instance Re Baker, above n 37 at 651; Riddle v Riddle, above n 37 at 229 per Fullager J.
56 Above n 42.
58 Above n 8.
60 Hazell v Hammersmith and Fulham London Borough Council [1990] 2 QB 697, per Sir Stephen Brown P at 784.
61 The phrase is borrowed from Longstreth, above n 15.
Re Kolb’s Settlement,\textsuperscript{62} is a salient reminder that the court will not accept uncritically modern investment technology. In that case, the absence of an unambiguous expert consensus on what the terms ‘blue chip’ and ‘first class’ connoted precisely (the general sense was clear) inspired the court to strike down as void the relevant investment power. The state of contemporary investment theory is thus something to be proved by the party relying on it. It is relevant therefore at this point to delve deeper into what ‘expert’ evidence on the state of contemporary financial theory and practice might be expected to contribute.

\textit{Risk and risk aversion in finance theory}

Modern finance theory\textsuperscript{63} is far from a settled ‘science’. The dominant paradigm centres on modern portfolio theory (MPT), the capital asset pricing model (CAPM) and the efficient market hypothesis (EMH).\textsuperscript{64} However, even within this paradigm, there exist different factions. Fortunately it is not necessary to accept any of the versions of the theory in totality to make progress.\textsuperscript{65} Value can also be gleaned from the insights on which there is a consensus. The first point of consensus is that the risk of an investment needs to be expressed \textit{ex ante} and seen in its portfolio context. The second is that there are two different types of risks: systematic risk(s) and idiosyncratic risks. The third is that investors are risk averse (however risk is defined) and will expect compensation for assuming risk. Finally, all theories assume away recklessness – investors are presumed to act selfishly, consistently and diligently.\textsuperscript{66} This latter assumption largely excludes ‘due diligence’ risk from that attention of finance academics but, as discussed above, this is not a luxury available to trustees.

There is one last practical point to note before discussing the insights. Some commentators appear to treat the court’s willingness to hear expert evidence on the state of investment thinking as an invitation to provide a lecture on investment theory. That seems naive. It is more likely that the court will be persuaded by evidence pointing to the practice of investment (what might in the current vernacular be termed ‘best practice’) rather than pure theory per se. Undoubtedly the best practice will be informed by relevant theory, but it is to the way experienced investors navigate the markets with the aid of these models, that the courts will address themselves, not the nuances of mathematical models taken to their logical extreme.

\textit{Ex ante risk and the portfolio perspective}

Modern investment theory has established quite convincingly that investors (and by extension, trustees) ought to assess the appropriateness of an investment in light of the portfolio in which it hypothetically or actually appears. An

\begin{footnotes}
\item[62] [1962] Ch 531.

\item[63] See for instance, Zvi Bodie, Alex Kane and Alan J Marcus, \textit{Investments}, (2nd Edn., Irwin, 1993).

\item[64] Importantly, note that the descriptions in this article encompass a family of generally accepted contemporary theories of finance and investment, including multi-factor and continuous time models, and are not limited purely to Modern Portfolio Theory as expounded by Markowitz, Sharpe and Lintner in the 1950s and 1960s.

\item[65] For a thorough discussion of this paradigm, see Ali et al, above n15. Note some of the implications drawn therein contrast with those expressed in this paper.

\item[66] In what may have been a crude attempt to employ the strategy of \textit{reductio ad absurdum}, the 6\textsuperscript{th} edition of \textit{Jacobs Law of Trusts} illustrates the danger of over-zealous application of finance theory to the notion of prudence, at [1828]. This segment of the text has been substantially replaced by the authors of the 7\textsuperscript{th} edition. The extreme view is also to be seen in HAJ Ford and W A Lee, \textit{Principles of the Law of Trusts}, which states “The findings of modern portfolio theory are unequivocal and, subject to any contrary purpose, confront every trustee of a large fund”, at 10.203. Surprisingly, given their otherwise sophisticated treatment of the material, Ali et al also suggest the possibility of an ‘all or nothing situation’; Ali et al, above n 15 at 160.

\item[66] This is not to say that they are ‘rational’ in the sense applied by economics to the term. They may exhibit ‘bounded’ rationality in the sense used by Herbert Simon and later adopted by behavioural finance theorists. See for instance Daniel Kahneman, ‘Maps of bounded rationality: psychology for behavioral economics’ (2003) 95(3) American Economic Review 1449.
\end{footnotes}
investment that appears likely to be extremely volatile (ie risky) when viewed in isolation may appear in a different light in the context of the overall portfolio. An FX forward contract being used to hedge a currency position arising from ownership of a foreign asset is a good example of this. As noted above, this basic premise of modern investment theory has already been recognised by the courts.  

It is however worth addressing a persistent but unfounded misapprehension. As Ali et al note, a portfolio perspective is not inconsistent with the line by line approach traditionally pursued by the courts in assessing the appropriateness of trustee investments. Trustees (or their delegates) still need to evaluate the appropriateness of each investment individually. It is just the criteria for evaluation that have changed. As a result of advances in investment theory the importance of the portfolio context in assessing appropriateness is better understood. Similarly a trustee cannot ‘set-off’ the losses incurred from an inappropriate investment against gains made from proper trust investment, though they may be able to offset losses incurred from improper investments against gains made from improper investments.

Just as important, these assessments have to be made ex ante, that is, in advance. Though the court in reviewing the decision is likely to have the benefit of hindsight, it must judge the trustee’s decision using the information (and the inherent uncertainties) present when the trustee had to make the decision. As Lopes LJ noted:

“It is very easy to be wise after the event; but in order to exercise a fair judgment with regard to conduct of trustees at a particular time, we must place ourselves in the position they occupied at that time, and determine for ourselves what, having regard to the opinion prevalent at that time, would have been considered the prudent course for them to have adopted.”

This discipline is of course made harder by the basic asymmetry in fiduciary relations – beneficiaries only have an incentive to impugn a trustee’s decision if it has adverse consequences for them. Decisions by trustees that result in windfall gains are seldom, if ever, challenged.

**Differentiating idiosyncratic and systematic risk**

There is also consensus in the finance academy of the need to differentiate systematic risk(s) and idiosyncratic risks. Moreover, while both types of risk introduce uncertainty into the performance of a portfolio, only the former (systematic risks) are said to be ‘compensated’. The corollary is that trustees should be wary about when and how they introduce idiosyncratic risks into their portfolios unless they have a reasonable basis for assuming that they will be compensated for the risk (given that on average most investors are not).

Idiosyncratic risk pertains to an individual security or issuer. It arises from the interaction between the volatile earnings streams of the underlying entities and the ‘animal spirits’ of the market participants who attempt to place a value on those earnings streams. Despite its potentially damaging impact, the theory posits that on average  

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67 It also receives support from Lord Nicholls of Birkenhead, writing extra-curially; Lord Nicholls of Birkenhead, “Trustees and Their Broader Community: Where Duty, Morality and Ethics Converge” (1995) 9 Trust Law International 71, at 76.


69 Bartlett v Barclays Bank, above n 18. This possibility presupposes that the court has before it all the investments that were made improperly, and not merely those complained of by the cestui que trust. It is debatable whether the court would countenance the trustee introducing evidence of other improper investments, ones from which the funds had profited, especially given the comments of the Court of Appeal in Nestle v National Westminster Bank that without loss there is no breach of trust; Nestle v National Westminster Bank, above n 8.

70 Re Chapman [1896] 2 Ch 763 at 777-8

71 A term coined by John Maynard Keynes the General Theory of Employment Interest and Money (1935), Ch. 12.
investors are not compensated for assuming this type of risk because they can, in theory, protect themselves from the risk without cost by diversifying.

Systematic risk (also sometimes loosely called ‘market’ risk) cannot be diversified and hence typically attracts a return premium. Investors are said therefore to be ‘compensated’ for this risk, even though in any given period the market may or may not generated positive returns. (As an aside, more recent theoretical models, such as the multifactor models proposed by Rosenberg and Marathe,72 Roll and Ross73 and Fama and French74 and Carhart,75 and the multi-period models developed by Merton,76 break this single ‘market’ factor into more fundamental components which may or may not attract a return premium relative to the market return but which, combined, earn the market risk premium.)

The distinction between compensated and uncompensated risk is important. Since idiosyncratic risk is not compensated, trustees who pursue investment strategies that expose the fund to idiosyncratic risk by under-diversifying expose themselves to potential criticism from the courts.77 However curial distaste for idiosyncratic risk is not absolute. Sir Donald Nicholls VC in Harries v Church Commissioners for England78 made it clear that regard will be had for the materiality of the effect on investment efficiency. He noted that

’it is not easy to think of an instance where in practice the exclusion for [reasons of conflict with the trust’s purpose] of one or more companies or sectors from the whole range of investments open to trustees would be likely to leave them without an adequately wide range of investment from which to choose a properly diversified portfolio.’79

Though stated in the context of charitable trusts, there is no reason why a similarly pragmatic stance would not apply to superannuation funds, especially if, as is noted below, the trustee could point to an honestly and reasonably held belief that the active management giving rise to the incomplete diversification would, in their case, add value to the portfolio.

There is another situation in which the courts might be expected to display a nuanced attitude towards idiosyncratic risk. That is where trustees can demonstrate some reasonable basis for believing that they may be able to ‘beat the odds’ and extract some level of compensation for assuming certain idiosyncratic risks. So for example, trustees of superannuation funds customarily appoint investment managers to manage their assets in an ‘active’ manner.80 The theoretical problem with this is that active management can beanalysed to a zero-sum game; as many winners as losers.81 More importantly, the identity of the winners and losers is highly random.82 For an investment manager to

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77 See for instance Cowan v Scargill, above n 12 at 290, where Sir Robert Megarry V-C, noted that ‘The large size of pension funds emphasises the need for diversification, rather than lessening it’. Notably, the desirability of diversification pre-dates widespread acceptance of Modern Portfolio Theory (MPT), see for instance Re Baker above n37 at 651.
78 Above n 42.
79 Above n 42 at 1246.
81 In fact, as Nobel Laureate Bill Sharpe has pointed out, the existence of transaction costs means that the returns from active management on average must be slightly negative; William Sharpe, The Arithmetic of
succeed in exploiting idiosyncratic risk and generate ‘alpha’, the investment manager must have an ‘information advantage’ that enables them to forecast correctly, more often than not, how a security’s price will move relative to its peers. And a trustee proposing to appoint an active investment manager might reasonably be expected to demonstrate a basis for their belief that they have an ability to identify such an investment manager. Absent such a basis, the courts may be unimpressed by evidence of overwhelming market practice, notwithstanding the general law’s attention to contemporary best practice when judging prudence.

The situation is different when it comes to systematic risk. Modern finance theory suggests that it ought to be acceptable for a trustee to accept a level of systematic risk because systematic is compensated (in an *ex ante* sense) in the form of a return premium. How much systematic risk is acceptable in each case will depend on the ‘risk tolerance’ of the trust. Thus a trustee of a typical superannuation fund might be warranted investing in a diverse portfolio containing local and global equities and bonds, property and so on. The portfolio will not be risk-free, but there is a reasonable expectation that the risk exposures will attract compensating returns.

**Summary**

The requirement that a trustee act prudently will be informed by contemporary thinking on investments. Currently, then, it might be expected to include a requirement to conduct enquiries and other research to eliminate (as far as reasonably possible) due diligence risk and diversification to minimise uncompensated idiosyncratic risk. Systematic risk, given the description presented above, is more a matter for the requirement that trustees act in their members ‘best interests’ rather than a matter for prudence per se. That is to say, the trustee is required to assess which portfolio on the efficient frontier (each having a unique, non-zero level of risk) is most appropriate for the trust. Thus when Finn J comments in *AS v ASC Nominees* that trusteeship carries with it a requirement of ‘caution’ not present in other oft-analysed fiduciary relationships, and when Clarke and Sheller JJA in *Daniels v Anderson* talk about a ‘degree of restraints and conservatism in investment judgments’ distinct from a director’s entrepreneurial flair, this should be taken as referring to the minimisation of due diligence risk (and perhaps idiosyncratic risk), and not an overriding requirement that trustees pursue a more conservative investment strategy than they might in other circumstances.

*A brief digression: the exercise of discretion and mathematical determinacy*

One of the interesting, but seldom noticed, parallels between modern finance theory and trust law is that they both recognise two different types of decisions. The decisions of trustees are sometimes collected under the rubric of exercises of discretion. In fact, as Campbell J noted at this Conference last year, not all decisions taken by trustees

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**Footnotes:**


83 This too is supported by the empirical data; for a recent Australian example, see Chris Bilson, Angela Frino and Richard Heaney, ‘Australian retail fund performance persistence’ (2005) 45 Accounting and Finance 25. In the US see Mark Carhart, above n 75.

84 For evidence that Australian superannuation funds do indeed diversify in this manner in respect of the ‘default’ funds over which they have full discretion, see APRA, *Annual Superannuation Bulletin – June 2007* (APRA, Sydney, 2008), Table 16.

85 n 9, at 12 – 13.

The reason this is important is that the courts have been loath to review the exercise of a trustee’s discretion absent evidence of some improper motive.88 The court has declined to intervene simply because it may hypothetically have come to a different view from that reached by the trustee.89 Trustees are under no obligation to provide reasons but the court may examine the reasons if they are provided.90 However the court may intervene if the decision gave rise to such a grotesque result that a flaw can be inferred.91

Applying this logic to the exercise of the investment power would suggest that the courts might be slow to intervene where the appropriateness of the investment objective (and especially the risk level) is in question, that being a matter for the discretion of the trustee, but more inclined to intervene where the strategy chosen to achieve that objective is claimed to be sub-optimal, or where the securities and instruments chosen are inconsistent with the strategy. Anecdotal evidence suggests that this aligns well with practice in the superannuation industry, where trustees retain substantial involvement in the setting of the investment objectives and strategic asset allocation of the fund but are progressively less involved in decisions that implement those ‘strategic’ decisions.92 The court’s approach may also, paradoxically, encourage trustees of superannuation to mimic their peers (it being harder to characterise a decision as patently improper if it resembles the decisions made by others in the peer group) and to limit documentation of the reasons behind their investment decisions. Neither, it is submitted, is in the interests of members, or more importantly perhaps, in the interests of the superannuation system as a whole.

It is however perhaps appropriate at this juncture to sound a note of warning. Questions of prudence are sometimes characterised as being about ‘process’ not ‘performance’. This description is apt to mislead. It is no doubt true that the actual results achieved by the investment strategy (its ‘performance’) are not an acceptable way to judge the appropriateness of a trustee’s decision. However to characterise the assessment as being limited to ‘process’ issues is also not strictly correct. Most importantly, it suggests that a “box-ticking” approach in which the steps are carried out but in which genuine engagement is missing might be enough. Moreover, the derivation of an investment strategy appropriate for the fund’s objective in the real world is not entirely mechanical, whatever the finance theory

87 In simple MPT, this is a point on the efficient frontier, in the CAPM it is a point on the capital market line, and in Merton’s continuous time model, it is a unique set of exposures to different financial risks that varies through time.
88 A list of reasons was suggested to Northrop J in Clerical Administrative and Related Employees Superannuation Pty Ltd v Bishop, Wilkinson, Thohey and Wall (1997) 76 IR 139. The suggestion (though not obviously endorsed by Northrop J) appears to have received endorsement both from the Federal Court when the case went on appeal; Wilkinson v CARE [1998] FCA 51, and from the High Court in Attorney-General (Cth) v Breckler [1999] HCA 28; (1999) 197 CLR 83 at [7] (Gleeson CJ, Gaudron, McHugh, Gummow, Hayne and Callinan JJ) [7] and [58] (Kirby J). For a detailed analysis that approves the list and discusses its relevance to superannuation see, Campbell, above n 86. Butler suggests this reluctance might be inappropriate in the superannuation context; Lisa Butler, ‘The Legitimate Bounds of a Trustee’s Discretion’ (1999) 11(1) Bond Law Review 14.
89 Maciejewski v Telstra Super Pty Ltd [1999] NSWSC 341; Re Beloved Wilkes Charity (1851) 3 Mac & G 440; 42 ER 330 per Lord Truro LC
90 Re Londonderry’s Settlement, above n 29.
might suggest. For a start the trustee needs to choose which of the competing sibling theories to apply. The trustee must also decide how to populate the parameter set required by the theory (for instance by forecasting the expected rates of return of candidate investments). There may also be other, trade-offs to be made, such as whether to hire external parties to manage the investments or to build a team ‘in-house’. The answer to that decision will influence the breadth of the candidate investment universe, which is therefore a constraint on the investment strategy process. The reality, then, is more complex and dynamic than the finance theory typically describes, and the court’s attitude to that activity can likewise be expected to be more nuanced and contextual. Simply characterising prudence as ‘process’ masks some of that complexity.

The Impact of the SIS Act

The SIS Act regulates trustees’ exercise of their investment powers in a number of ways. Section 52 invokes, via a set of covenants implied into the governing rules of the trust, general law principles of trustee conduct. Section 62 provides that the fund must be maintained solely for the purpose of providing retirement benefits to members, a provision usually interpreted to codify Megarry V-Cs ruling that the assets of a pension (superannuation) fund are to be employed in furthering the financial best interests of its members and not for other purposes. Part 8 of the SIS Act contains restrictions on investment in ‘in-house’ assets and s109 requires that all investments be made on an ‘arms-length’ basis.

The covenants implied into the governing rules of superannuation funds by s52 of the SIS Act are particularly important. The key covenants for present purposes are:

- (b) to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide;
- (c) to ensure that the trustee’s duties and powers are performed and exercised in the best interests of the beneficiaries;
- ... (f) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:
  - (i) the risk involved in making, holding and realising, and the likely return from, the entity’s investments having regard to its objectives and its expected cash flow requirements;
  - (ii) the composition of the entity’s investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;
  - (iii) the liquidity of the entity’s investments having regard to its expected cash flow requirements;
  - (iv) the ability of the entity to discharge its existing and prospective liabilities;

Importantly, s 52(2)(7) provides that these covenants need to be interpreted so they can operate concurrently. That is, the obligation to have regard for the criteria listed in s52(2)(f) when formulating and giving effect to the fund’s investment strategy is subject also to the requirement that the trustee exercise due care, skill and diligence. Similarly, the investment power must be exercised in the best interests of the beneficiaries.

This approach reads down the role of s52(2)(f). However it echoes the structure of the obligations at general law. Trustees are required to act prudently, as per the first line of cases described above. They are also required as a consequence of being required to ensure their powers are exercised in the beneficiaries’ best interests to derive an investment strategy that is “suitable” in the sense illustrated by the second line of cases. What s52(2)(f) provides is a set of criteria relevant to the assessment of suitability. Moreover the criteria echo the issues identified in modern investment theory; risk, return, diversification, liquidity and liabilities. That it does so inclusively and without prescribing precisely what weight is to attach to each of those criteria renders it flexible to evolving investment thinking. This is an important point. In other words, contrary to the claims of some commentators, these provisions...
do not embed MPT into the SIS Act. All the terms used in the SIS Act (risk, return, diversification, liquidity etc) appear in investment theories before and after MPT. MPT certainly marked an advance in finance theory in the definition and application of (some) of those notions, but the presence of those terms ought not to be taken as implying that the SIS Act endorses MPT. The better view is that the SIS Act, like the general law, accommodates contemporary investment theory but leaves it open to the court to determine precisely which theory or theories it is appropriate to apply to the decision taken by the trustee.

The happy ‘coincidence’ of statute and general law is marred by s55(5) of the SIS Act. It provides

> It is a defence to an action for loss or damage suffered by a person as a result of the making of an investment by or on behalf of a trustee of a superannuation entity if the defendant establishes that the investment was made in accordance with an investment strategy formulated under a covenant referred to in paragraph 52(2)(f).

This section would seem to undo the effect of s52(2)(7). On its terms it would seem to exonerate a trustee guilty of carelessness in investment (and thereby in breach of the s52(2)(b) covenant) if that investment was made in accordance with an investment strategy formulated under the s52(2)(f) covenant. This would appear to mean that the trustee would be in breach if the investment strategy was deficient (eg careless, not directed to achieving the beneficiaries’ best interests or not having had regard to the criteria in s52(2)(f)) but not if the implementation of that strategy (the making of the investment) was deficient. That would be a surprising result.

Read strictly, s55(5) would also be inconsistent with the in-house asset rules and arms-length investment rules, since the investment strategy might properly consider assets of similar type (without specifying the features that cause the assets to fall into one of those proscribed categories), and a trustee might then shelter purchase of those assets under the s55(5) defence as being consistent with the fund’s investment strategy. The courts would be unlikely to accept this outcome.

One can speculate that the legislator may have had a slightly different objective in mind when drafting s55(5). Those responsible for the management of investment portfolios are acutely worried that their actions will be judged with the benefit of hindsight or without regard for the portfolio context. The defence in s55(5) may have been directed towards heading off those possibilities. Investments made by the trustee conforming to those anticipated in an appropriately formulated investment strategy should be unexceptionable, whether or not those investments actually delivered the performance expected when the strategy was formulated. Or as, Lindley LJ noted in Re Chapman, a trustee is not "a surety, nor is he an insurer; he is only liable for such wrong done by himself, and loss of trust money is not per se proof of such wrong. There is no rule of law which compels the Court to hold that an honest trustee is liable to make good loss sustained by retaining an authorized security in a falling market, if he did so honestly and prudently, in the belief that it was the best course to take in the interests of all parties. Trustees acting honestly, with ordinary prudence and within the limits of their trust, are not liable for mere errors of judgment."

Similarly, a trustee’s decision to invest in a particular security or instrument ought not to be impugned without regard for its role in the overall portfolio. As noted above, a loss incurred in respect of a futures contract ought to be seen in light of the overall hedging strategy in which it played a part. Section 55(5) may be directed towards achieving this result.

96. See for instance the very influential Benjamin Graham and David Dodd, Security Valuation, now in its 6th edition but originally published in 1934.

97. Importantly, the court will not apply investment theories retrospectively, as the Court of Appeal in Nestle v National Westminster Bank above n 8 was at pains to point out. The appropriate theory will be that which was current at the time the trustee made the decision, not that current when the court comes to review it (assuming they are different).

98. Above n 70.
The other source of uncertainty related to s52(2)(f) (and indeed s55(5)) is that the phrase ‘investment strategy’ is not anywhere defined in the SIS Act. Section S2(2)(f) nominates certain factors to be taken into account but there is little guidance provided as to what constitutes an investment strategy nor of the level of detail required. APRA’s detailed Superannuation Circular No. II.D.1. Managing Investments and Investment Choice outlines APRA’s interpretation of what is required and would no doubt prove influential, or perhaps the courts would engage in what some would term ‘bootstrapping’ (and others might be tempted to call circular thinking) and use industry practice as a guide to what should be contained in the investment strategy. But even that might not be enough to revive the common sense that a requirement to formulate and give effect to an investment strategy is of little value if there is no concomitant requirement to do so with due care, skill and diligence. Perhaps, assuming the trustee’s investment strategy was silent on the matter, the courts might imply into the investment strategy an undertaking by the trustees that the investment strategy would be implemented with due care, skill and diligence so that even if s55(5) negates the effect of s52(2)(b), the common sense requirement is not extinguished? Again that remains to be seen.

Implications for ‘due diligence’ of evolving investment practices

The general law and the SIS Act provide important signposts for trustees in the exercise of their investment power. Regard must be had both for the investment characteristics of the investment under consideration (to ensure it is consistent with the fund’s investment strategy) and for the terms, conditions and consequential obligations appertaining to that investment. This latter set of investigations is sometimes termed ‘due diligence’, though that term, like many in this area, can connote different things to different people. In the context of this paper it is however apt to align the due diligence risks identified above with the governance processes called ‘due diligence’.

This section highlights some of the issues inspired by the investment practices of Australian superannuation funds. They are intended to be illustrative and certainly do not exhaust the list of complexities and challenges. To a large extent it deals with the due diligence risks that arise rather than the other investment risks.

Alternative investments

Australian superannuation fund trustees have demonstrated an appetite over the past decade for what is sometimes euphemistically called ‘alternative’ investment strategies and instruments. Examples include private equity, infrastructure, hedge funds, ‘portable alpha’ strategies, ‘overlay’ products, CDOs, performance swaps and structured products. Ignoring for present purposes the investment rationale for such decisions, the result of this adventurousness has been a dramatic increase in the due diligence required prior to and after investment. Demonstrating that due care has been exercised when the legal structure constituting the investment is new, atypical or resident in another jurisdiction is non-trivial. The court’s instinctive nervousness about investments outside its jurisdiction has perhaps faded with the globalisation of finance, but issues of contractual interpretation and of enforcement remain important given that many of the new structures are established in jurisdictions perceived to have a light regulatory touch. This is especially true where the investment structures under consideration have a novel (and in some cases no) legal personality.

Transparency

Ensuring adequate transparency (for a prudent business person would certainly not purchase a ‘pig in a poke’) in some hedge fund or private equity vehicles might also prove a challenge. So for instance, Ali articulates a checklist for fiduciaries contemplating hedge fund investment but it might well be argued that the problem is not knowing what

99 March 2006, paras [13-36]. Notably the APRA guidance focuses heavily on the formulation of the investment strategy and almost ignores the second element of s52(2)(f), the requirement to give effect to it.
100 For a discussion of a sub-set of the peculiar legal risks relating to direct private equity investing, see Nuncio D’Angelo, ‘Private equity investing by financial institutions: Navigating hidden reefs in treacherous waters’, (2003) 31 ABLR 311.
101 See for instance Re Baker, above n 37; Re Walker, above n 38. But cf In the Will of Gibson [1922] VLR 715.
information would be useful so much as being confident about being able to secure that information in good times and bad. Moreover, whilst lack of transparency could be an issue from an investment perspective, as recent Ponzi scheme victims have discovered, opacity with respect to other unit-holders can also raise taxation (CFC), regulatory (Corporations Law and the SIS Act) and criminal law (AML) problems.

The requirement to stay abreast of developments within the investment portfolio is underscored by cases such as Re Lucking’s Will Trusts. 102 In that case the main assets of the trust were shares in a closely held private company. The court found that the trustees had a duty in that case to monitor closely the activities of the company, such as might have been expected had they been directors of the company. That requirement, if applied to the superannuation context, would impose a heavy burden on trustees and their agents. However the facts of Re Lucking’s Will Trusts may limit its application to superannuation funds. Importantly, there was a strong identity between the trust and the underlying company; the shares were the major asset of the trust and the trustees qua trustee were the major shareholders of the company. Only in exceptional circumstances would superannuation funds find themselves in an analogous situation. Though superannuation plans could conceivably find themselves as substantial shareholders of companies in their ‘private equity’ dealings, seldom would the shareholding of the company be a substantial portion of their portfolio. Similarly, where superannuation funds offer ancillary services to members through the mechanism of a wholly or partially-owned subsidiary, the subsidiary is unlikely to constitute a major portion of the trust’s assets. 103 Thus the risk to the superannuation fund is mitigated by the diversification of its portfolio. However, the customary loss mitigation strategy available to trustees, the “wall street walk” (ie sale), may be difficult or even impossible to achieve. Thus though it is probably safe to say therefore that trustees may not be required to exercise the degree of care, skill and diligence required by the court in Re Lucking’s Will Trusts in respect of these assets, something more than the supervision required in ordinary ‘portfolio’ investments might be required.

Redemption and other key terms

Recent market events, including fund closures and redemptions freezes, have intensified attention on the precise terms of the constituent and offer documents of many investments held by superannuation funds. Close attention to unit-holder redemption provisions (including notice periods and the terms under which redemptions could be suspended), and unit pricing protocols has certainly been important. Evidence of this can be seen in Basis Capital Funds Management v BT Portfolio Services104 in which the complexities of the unit pricing and the application and redemption procedures proved to be critical in determining the nature of the interest held by the parties in funds in which redemptions had been suspended. As discussed below, the issues surrounding unit pricing and application/redemption in the investments made by super fund trustees becomes even more complex when regard is had for the terms existing between the super fund and its own members.

Valuation

Trustees investing in alternative asset types and strategies also have to face the issue of how to value the assets. The approach for listed assets, and those which trade at par, is well understood and practiced. The same is true for some unlisted assets, such as many property and infrastructure assets, where there is a long-accepted practice of trustees employing independent valuers to appraise the current value of the asset. Those processes become more difficult when trustees are attempting to value more complex assets, such as some structured products and certain collateralised debt obligations (CDOs). These are often traded over-the-counter and are not subject to independent valuation or market pricing. The models used to value the assets can be incredibly complex, requiring high level legal, mathematical and financial skills, if not ‘proprietary’ analytical tools. Direct investment by trustees into such investments certainly raises the ‘due diligence’ bar very high indeed. Investment via intermediaries shifts that burden to the intermediary but nonetheless does not relieve the trustee of the responsibility for ensuring that the intermediary has the expertise and processes to deal with such assets. Failure to do so exposes the trust to the risk of member

102 Above n 23.
103 This of course may give rise to issues with respect to the ‘arms length’ provisions of the SIS Act and the controlled entity provisions of the Corporations Law.
104 Above n 51.
inequity (for instance when applications and redemptions are processed at incorrect valuations) or nasty surprises in the event of an unexpected default by the issuer of the underlying security or instrument.

Peer Group Pressure

Finally, and on a more general note, one of the other troubling aspects of the push into ‘alternative’ assets by Australian superannuation funds has been anecdotal evidence of the role peer group comparisons have played in influencing trustees. Many superannuation funds have apparently been inspired by stories of ‘best practice’ in which large allocations to ‘alternative’ investment such as private equity, hedge funds and forestry have coincided with eye-catching return histories. In recent times however this does seem to have acquired a momentum all its own, with funds comparing their strategies to those of their peers (not just the ‘best practice’ exemplars) as a regular part of the decision process. Of course aspiring to learn from best practice is laudable. It is even arguably a corollary of the prudent person requirement, in so far as keeping abreast of contemporary thinking is an element of that requirement. However it is also arguable that close attention to the needs of a fund’s own members should prevail over the considerations of competitiveness and peer-risk management that lie behind much peer comparison. It is perhaps too late now to point out that the exemplars have been drawn, usually, from the United States, and often from foundations and endowments, such as those associated with Yale and Harvard. The difference in liquidity requirements of defined benefit plans and endowments compared to the typical DC-oriented, public offer superannuation fund in Australia cannot be under-estimated. It remains to be seen whether the mooted ‘runs’ on an Australian superannuation fund eventuate. Hopefully that remains a theoretical possibility only, for the sake putatively of its members. However the more worrying observation is that it appears as though trustees may have allowed themselves to be diverted from their single-minded pursuit of members’ interests by the clamour of a rampant bull market. That distraction is more obvious now that the tenor of the market has turned almost 180 degrees, but therein lies the next assault on trustee rationality. How, in the alarmed clamour of a global financial crisis, will they react?

Leverage

Financial leverage has frequently been cast in the role of villain in the ‘global financial crisis’ that is reflected in the performance of many investment markets. Though superannuation funds are precluded from employing leverage directly, many of the investments they have made have leverage within them, including most hedge funds and many private equity structures. This of course is nothing new. Most listed companies are financed by a mix of debt and equity, and hence contain ‘leverage’, so this internalised leverage has long been a part of investment portfolios. What perhaps is different in more recent times is the extent of the leverage (many hedge funds were leveraged over ten times, and some many more), the complexity of the leverage (for instance from the imperfect netting out of positions in long/short and arbitrage portfolios) and the way some of the instruments (such as collateralised debt obligations were structured to create ‘enhanced’ exposure to the underlying economic drivers. The lack of transparency in many investments allowed these risks to go unnoticed by many investors but these risks, in theory, can be priced. In a transparent and contested market, investors would have received adequate reward from their exposures. That they didn’t, points to failures in investors’ due diligence processes, perhaps caused by peer group pressure to participate. Ignorance of the true level of leverage embedded in an investment portfolio, either through the strategies or instruments employed, no matter how difficult to discover or disentangle, would prima facie seem to be evidence of imprudence. The fact that (many) others were similarly imprudent is unlikely to be a compelling defence.

Risk cascades and interdependence

Indeed recent press reports indicate that these exemplars are themselves feeling under pressure in the current market environment. See for instance ‘Harvard Hit by Loss as Crisis Spreads to Colleges’, Wall Street Journal, 4 Dec 2008; ‘Yale Tops Harvard Loss’, Globe and Mail, 17 Dec 2008.

Section 67, SIS Act.
One of the practical challenges for trustees and advisers is that the two strands of prudence, whilst distinguishable in theory, are often closely related and even interdependent. Take for instance a clause in the governing rules of a target investment (such as a managed investment scheme) that permits the manager to suspend redemption of units in certain market conditions. These terms are not uncommon and serve to preserve unit-holder equity in the event that volatile markets make the precise valuation of assets unreliable. A narrow focus on the target investment might conclude that such a term, implemented appropriately by the manager of the target investment, is an important safeguard. A halt in redemptions of the target fund might however place the superannuation fund investing in the target in a difficult position if that possibility is not accommodated in its processes and/or offering documents to members. Suppose a member sought to redeem its assets out of the investment option containing the target investment. The issue is not simply one of having cash available to meet the member’s redemption because superannuation funds can borrow for a short term to meet redemption requests. However it might be unclear precisely what value to place on the units in the target investment. It may also be difficult to impose the costs of the borrowing to the outgoing (or switching) member. The problem arises not from the provision in the target investment’s governing rules but from the interplay between those rules, the rules of the superannuation fund itself and the market-based valuation protocols imposed by accounting standards. Though it is tempting to characterise such scenarios as ‘worst case’, it is worth recalling the words of Romer LJ, as relevant today as they were a century ago, ‘a prudent investor ought to contemplate the possibility of [bad times] happening …’. That is, prudence proves its value not when times are smooth, but when challenges arise. This suggests that due diligence processes need to encompass not just the risks endogenous to the investment or instrument under consideration, but also the exogenous risks that could affect it.

**Duty to secure relevant expert advice**

The trustees of superannuation funds are typically assisted by a number of advisers. This is in part a reflection of the complexity of some of the issues, especially in areas such as actuarial and investment advice, but also reflects the breadth of the trustees’ role in a modern superannuation fund. There are however sometimes assertions than trustees have a ‘duty’ to secure advice, and that failure to do so is tantamount to imprudence on the part of the trustee.

For what it is worth, this notion appears to have its genesis in the statutory interventions of the nineteenth century. When the early statutory lists were widened to include investments beyond gilts, the legislators attached a requirement that any excursions by trustees into these riskier investments must not proceed without the trustees first securing advice from relevant experts (brokers and bankers, typically). On occasion the courts have employed this safeguard when exercising its ‘expediency’ jurisdiction.

The SIS Act does not, in any case, impose such a ‘duty’ on trustees. Nor, in reality, does the general law (absent the statutory injections described above). It is certainly true, as Megarry V-C noted in *Cowan v Scargill* that

‘[The trustee’s] duty includes the duty to seek advice on matters which the trustee does not understand, such as the making of investments...’ (emphasis added)

Further, as the court in *Meinhardt v Unisys Corporation* concluded:

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107 Section 67(2)(a), *SIS Act*.
108 *Chapman v Browne* [1902] Ch 785.
110 *Re Baker* above n 37, at 650.
111 Above n 12.
‘... a trustee is required to use due care, which means he must investigate the safety of the investment and its potential for income by securing reliable information, and may take into consideration the advice of qualified others, as long as he exercises his own judgment’. (emphasis added)

This places the requirement to secure advice within the more general requirement to exercise prudence, which is where it belongs. A trustee possessed of expertise in an area, either from familiarity with assets of the fund (as often occurred in Victorian-era family trusts) or because they were appointed for their expertise (as often occurs with independent trustees in large superannuation funds), would surely be under no obligation to secure further advice, unless they were conflicted or their independence was in some way impaired. However where the expertise is not available to the trustees from within their ranks, ordinary business practice would be to seek and consider the advice of relevant experts. To that end, s56(3) of the SIS Act provides

‘Nothing in the governing rules of a superannuation entity prohibits a trustee of the entity from seeking advice from any person in respect of any matter relating to performance of the duties or the exercise of the powers of a trustee.’

There is a practical issue that remains, though. The large number of specialist experts typically assisting in the administration of a superannuation fund gives rise to a need to supervise and coordinate those experts. Of particular relevance to this paper is the danger that due diligence reviews are rendered incomplete because of gaps in the mosaic of advice received. Legal and other advisers need to be clear on the scope and parameters of the review they have been commissioned to provide, but equally trustees need to ensure that the terms of reference, taken together, address the issues comprehensively. The existence of ‘exogenous’ risks, in particular makes this vital.

Concluding Comments

The past eighteen months have provided ample opportunity for the trustees of superannuation funds to test their mettle. Declining markets and sharp volatility have placed great pressure on the investment strategies put in place in the bull markets of past few years. But risk is the sine qua non of investment. Without risk, investors can expect only nominal returns from the assets they purchase. Therefore, acting in the best interests of members almost always means exposing the trust’s assets to some risk and prudence cannot equate to the absolute avoidance of risk. Rather, it is the task of trustees to ensure that their funds are not exposed to uncompensated risks, such as those arising from carelessness, lack of diligence or from naive exposure to diversifiable risks. That demands attention to detail and discipline as well as the ability to stand apart from the cacophony of markets and the pressure of comparison against peers. Beyond that, the duty they owe to act in the best interests of members requires that trustees identify and maintain a level of ‘compensated’ risk that is appropriate to the needs and circumstances of the fund. And in a volatile market environment that can indeed feel like a thankless task.