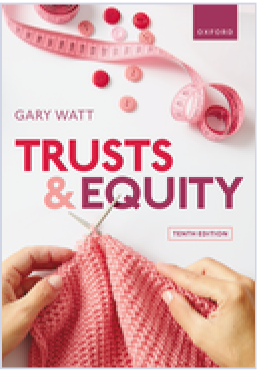


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# 12. Trustee investment

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## Abstract

Trustees must invest in a manner that is prudent and fair, and failure to do so may make them personally liable to compensate for any loss. However, it is difficult to prove a breach of trust, and to prove and quantify the loss suffered by the fund. Even if the trustees admit that they invested imprudently and that the trust fund suffered a loss, there seems to be no effective remedy for improper trustee investment. This chapter deals with trustee investment and shows that the modern trend in trustee investment is towards liberalization, freedom of choice, and the free participation of trust funds in investment markets. After discussing the nature of trustee investment, it considers the goals of trustee investment and the trustees' investment powers. The chapter also analyses types of investment, the trustees' investment duties, liability for improper investment by trustees, and ethical investment.

**Keywords:** trustees, trustee investment, liberalization, freedom of choice, trust funds, liability, ethical investment, investment duties, investment powers, improper investment

## Context

There are a number of reasons for devoting a whole chapter to trustee investment: first, and most obvious, it is an almost universal obligation of trusteeship; second, reform of trustee investment was the principal motivation behind the Trustee Act 2000; third, it provides a context in which to examine the interplay of a number of significant trustee duties, including the duty of care, the duty to act fairly, the duty to exercise a sound discretion, and even the fiduciary duty; fourth, it represents a significant interface between trustees' obligations and beneficiaries' proprietary rights; last, and by no means least, the social significance of trustee investment, and the investment of pension funds in particular, cannot be overstated.

## 12.1 Introduction

Trustees must invest in a manner that is prudent in the light of current investment practice and fair as between beneficiaries with competing interests in the fund. If they breach their trust in either of these respects, they may be personally liable to compensate for any loss caused. This sounds straightforward enough; the authorities suggest, however, that disappointed beneficiaries find it hard to establish that their trustees have invested improperly, let alone that improper investment has actually caused the trust fund to suffer a quantifiable loss. It is difficult to prove a breach of trust, because prudent trustees choose to invest similar funds in widely divergent ways and because it is reasonable for trustees to have quite different views as to which investments are likely to achieve a fair balance between beneficiaries with competing interests in the fund. It is difficult to prove and to quantify the loss suffered by the fund, because of fundamental definitional problems as to what constitutes loss: is it to be assessed in nominal terms or real terms, and how does one quantify real loss? Most difficult of all, however, is the task of proving causation. Even if the trustees were to concede that they had invested imprudently and that the trust fund had suffered a loss, the significant obstacle would remain of proving that the trustees'
p. 408 imprudence had caused the loss. In short, as the law ↵ currently stands, there will, in many cases, be no effective remedy for improper trustee investment. Given the vast amount of social wealth that is held in trust, this should be a cause for concern, but we will see that the modern trend in trustee investment is towards liberalization, towards freedom of choice and the free participation of trust funds in investment markets. In such a climate, a weak regulatory scheme will be tolerated and may even be desired.

### 12.1.1 Investment is a matter of time

Investment returns are compensation for postponed consumption. If I spend my money today on consumables, such as food, or a 'wasting' (depreciating) asset, such as a mass-produced television or a car, it is only a matter of time before I have little, or nothing, to show for it. Conversely, if I purchase shares or land with my money, there is a possibility that I will receive income (in the form of dividends and rent) and long-term capital growth. Land rarely disappoints as an investment over the longer term, because, as Mark Twain once said, '[t]*hey aren't making it any more*'.[1] However, I should be wary of short-term investments: not only because markets for equities (shares) and real estate (land) are notoriously volatile in the short term, but because the purchase of investments incurs transaction costs, such as agents' fees and stamp duty, which will rarely be offset by returns made in the very short term. Sound investment takes time. A short-term venture '*in which the object is the chance of reaping a rapid advantage by a sudden rise in the market price*' is not investment, but speculation.[2]

If time is essential to sound investment, the good news is that many trusts have time in abundance. Indeed, the private trust has been described as a '*gift projected on the plane of time and, meanwhile, in need of management*'.[3] The leading cases on trustee investment have tended to involve trusts established for the medium to long term. These include charitable trusts, pension trusts, and traditional settlement trusts of the form 'to A for life and to B in remainder'. But what happens when time runs out? Taking the example of our traditional settlement trust, what is the effect on the trustee's investment duties if, when A dies, B is *sui juris* and (as the sole beneficiary under a 'bare trust') is able to bring the trust immediately to an end? In such circumstances, uncertainty as to the duration of the trust renders the trustee unable to implement a prudent investment policy. In short, because time is essential to sound investment and time is not a feature of a bare trust, a 'bare' trust can, in no meaningful sense, be 'invested'.[4] Indeed, it is usually said that the trustee of a 'bare trust' has no authority to exercise a positive discretion, but is only required to act according to the beneficiary's instruction.[5]

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## 12.2 The goals of trustee investment

The goals of trustee investment depend upon the goals of the particular trust. According to one distinguished commentator, '*the lodestar which should guide* [trustees] *is the promotion of the purposes of their trust, that is, the best interests of the beneficiaries*'.[6] In the case of a charitable trust, the goals of trustee investment ought generally to be aligned with the charitable purposes,[7] but the rule is not strict. Charity trustees are permitted to hold investments that potentially conflict with the trust's charitable purpose if on balance (taking account such factors as the need for diversification and the danger of reputational damage to donations) the charity's financial health is best served by holding 'conflicting' investments.[8] In most non-charitable trusts there is no guiding or binding purpose beyond that of providing financial benefits to the beneficiaries, and in such trusts '*the best interests of the beneficiaries are normally their best financial interests*'.[9] This means that, in most trusts, the immediate goal of investment, no matter how worthy the ulterior goal, is the selfish, materialistic goal of wealth maximization. With the exception of freehold land, which can now be acquired for occupation by the beneficiary,[10] it is still true that trustee investments must produce wealth and that '*property which is acquired merely for use and enjoyment is not an investment*'.[11]

So, the goals of trustee investment are usually financial, but the question is: which financial goals? It has been said that a balanced portfolio will have three basic characteristics: namely, liquidity, stability, and growth.[12] The liquid component of a portfolio will be readily available as cash and can be used to deal with emergencies, such as repairs to a trust-owned house. The smaller the fund, the greater the proportion that is likely to be kept in a 'liquid' state. Far more complex, however, is the task of identifying the proportions of the fund that should be devoted to stability and growth respectively.

### 12.2.1 The importance of preserving the trust fund

In *Nestle v. National Westminster Bank plc*,[13] Leggatt LJ asserted that 'the importance of preservation of a trust fund will always outweigh success in its advancement',[14] which, at first sight, suggests a bias in favour of stability and against growth. However, the statement begs two significant questions: first, is the

p. 410 real value of the fund to be preserved, or merely ↵ its nominal value?[15] Second, what qualifies as 'success' in the advancement of a trust fund? On the facts of Nestle, the nominal value of the fund increased fivefold over a 60-year period, but, in the same period, its real value decreased fourfold.[16] Is that success? Leggatt LJ's question is unhelpful, because it suggests that the trustees' duty is to achieve particular outcomes. This ought not to be the case, as Hoffmann J stated at first instance in the same case:

> Preservation of real values can be no more than an aspiration which some trustees may have the good fortune to achieve … a rule that real capital values must be maintained would be unfair to both income beneficiaries and trustees.[17]

The trustees' investment duty is not to achieve a particular outcome, but rather to invest the fund in a particular way, namely prudently and fairly.[18] However, before we consider trustees' duties in detail, we must first examine the scope of their powers.

## 12.3 Trustee investment powers

### 12.3.1 The trust instrument

The first guide to a trustee's investment powers is the trust instrument governing his particular trust.[19] The terms of the trust instrument in relation to investment powers are always to be given their natural construction.[20]

### 12.3.2 The general law

Subject to what the trust instrument might say to the contrary, one would expect a trustee, as legal owner of the trust property, to have the same powers as any other legal owner of property, and yet it was not until the Trustee Act 2000 that the law was reformed to allow trustees to make 'any kind of investment' as if they were 'absolutely entitled to the assets' of the trust. Pension trustees were the first to benefit from these wide investment powers.[21] Now, subject to certain exceptions,[22] the Trustee Act 2000 extends them to all trustees,[23] including trustees who, prior to the Trustee Act 2000, were authorized to invest without
p. 411 limitation in accordance with the Trustee Investments Act 1961.[24] ↵ (Any limitations set out in trust instruments prior to the 2000 Act will, however, still apply unless made before 3 August 1961.)[25] The Trustee Act 2000 even authorizes trustees to hold investments jointly or in common with persons who are not trustees.[26] As things turned out, the timing of the Trustee Act 2000 could not have been worse. It changed the law to allow trustees unrestricted power to invest in stock markets just as stock markets reached all-time highs. (At the end of 2011, stock markets had still failed to attain the levels they had achieved at the very end of 1999.)

The Trustee Investments Act 1961, which was repealed by the Trustee Act 2000, had restricted trustees to certain types of so-called 'safe' investments, such as gilt-edged securities,[27] bank accounts, and shares in quoted public limited companies with a good track record and a strong financial base.[28] More creative investment had been permitted only if authorized by the trust instrument or by the court.[29] The 'authorized list' approach laid down by the 1961 Act denied conscientious trustees the freedom to invest positively in accordance with the best available techniques (and, in particular, in accordance with modern portfolio theory),[30] and it also encouraged the indolent to restrict themselves to investments on the 'authorized list' even when they had express authority to invest beyond it.[31] There were even adverse consequences for third parties who had commercial dealings with trusts, because if a trustee purchased investments beyond his authority to do so, the unpaid vendor of such investments would be unable to seek reimbursement from the trust fund in the event of the trustee's personal insolvency.[32]

## 12.4 Types of investment asset

Although the 'general power of investment' provided by s. 3(1) of the Trustee Act 2000 authorizes trustees to 'make any kind of investment', the meaning of 'investment' is nowhere defined in the Act. There is a good reason for this omission: some transactions, if considered in isolation, do not appear to be investments at all. Suppose, for example, that a trustee holds shares worth £100 each and sells X an option to purchase the shares if their value reaches £110 per share.[33] Is the sale of the option an investment? It
p. 412 looks more like a '*relatively short-term bet*'[34] that the value of the shares will not rise much ↵ above £110 each. However, to judge the option in isolation is entirely to miss the point. The option only makes sense as an investment when it is considered alongside another investment—namely, the shares themselves—whereupon it is immediately clear that the purpose of the option was to insure against any future fall in the value of the shares. Had the shares dropped below £100, the loss to the trust fund would have been reduced by the gain made on the sale of the option.

A 1986 survey of trustees and other fiduciary fund managers in the USA[35] revealed that 42 per cent of all respondents were using options and 35 per cent were using futures.[36] The fact that stock index futures had only been approved for trading by the US Securities and Exchange Commission at the end of 1982 suggests that options and futures were very popular. The author of the survey recognized that such investments are, on the traditional view, '*suspect to varying degrees*',[37] but argued that, in modern investment conditions, no type of investment should be ruled out. He suggested that it should be left to the trustees of individual trusts to determine whether a particular investment is suitable to their trust. This argument was accepted and became law in the USA as the prudent investor rule.[38] HM Treasury[39] and the Law Commission[40] proposed that the English law of trusts should undergo a similar reform, and the Trustee Act 2000 was the result. The hallmarks of a 'suitable' investment are set out in the 2000 Act and are considered later, but first we must examine certain types of investment that raise special considerations for trustees.

### 12.4.1 Government bonds and Treasury bills

Government bonds (known as 'gilt-edged securities' or 'gilts') are sold by the government for the purpose of long-term borrowing. Treasury bills are similar, but are sold for borrowing over the short term: for example, three months. They both yield income in the form of a lump-sum dividend called a 'coupon' and, on the redemption date, they yield capital equivalent to their nominal face value (known as the 'par' value).[41]

Investments of this type are said to be virtually risk-free. (It is more accurate to say that they are as
p. 413 financially secure as the government that grants them.) They yield a ↵ guaranteed fixed rate of income and the nominal value of the capital is secure. However, because the level of guaranteed income is usually very low and there is no prospect of a capital gain (unless the bonds are acquired below 'par'),[42] the real value of the bonds, which is determined according to their purchasing power, will decrease as the price of standard commodities rise. This general rise in prices, known as 'inflation', is now an endemic feature of the economic landscape.[43] In fact, between 1750 and 1998, prices rose 118-fold, including a 61-fold increase since the outbreak of World War I.[44] The corresponding effect on the nominal value of sterling is dramatic: '*one (decimal) penny in 1750 would have had greater purchasing power than a pound in 1998.*'[45]

These statistics suggest that it would be imprudent to leave a significant proportion of a trust fund in gilts and other so-called 'risk-free' investments over the longer term. This is particularly true of large funds, for which prudent investment would typically lead to a much larger holding of shares relative to gilts. Records show that £1m invested in 1963 and performing in line with the FTSE[46] All Share Index would, in 1994, have been worth £1.5m in real terms—that is, having taken inflation into account. Over the same period, £1m performing in line with the FT 15-Year Gilt Index would have been worth a mere £62,000 in real terms.[47] Having said that, the hallmark of a prudent trustee is that he exercises a sound discretion; a trustee should not assume that what was prudent last year will be prudent this year. If economic indicators suggest, as they do at the time of writing, that there will be low inflation and poor share performance over the next few years, a larger proportion of gilts might well be justified.

## 12.4.2 Shares

Investment in a company can take a number of forms. A trustee may, for example, make a loan to a company at an agreed rate of interest, in return for which the company will issue a promise to repay, in the form of a 'debenture'. Ideally, the debenture will be secured against the company's assets, but it might take the form of an unsecured 'bond'. However, the most common form of investment in a company is in
p. 414 shares.[48] The typical ↵ ordinary share is attractive to trusts, because it yields an income (called a 'dividend') and the possibility of capital growth. If the company is successful and market conditions are favourable, the capital value of ordinary shares in that company will rise. Another significant feature of ordinary shares is that they confer voting rights. Most significant resolutions will be passed if they attract the votes attaching to 75 per cent of the shares; some only require the support of 51 per cent of the shares. This means that a trust that holds anything above 26 per cent of the total shareholding can exert a considerable influence over the company's policy. However, with this power comes responsibility.

In *Bartlett v. Barclays Bank (No. 1)*,[49] the trust held a 99.8 per cent shareholding in a company. Despite this, the trust corporation had been content to receive no more information than an ordinary shareholder would have obtained at the annual general meeting. Brightman J held that this was not the behaviour of a prudent trustee. A prudent trustee would have ensured that the investment was adequately supervised. It would probably have appointed a director or nominee to the board in order to represent the interests of the trust, and to supply the trustees with copies of the agenda and minutes of the board meetings.

### 12.4.3 Land and loans secured on land

If the trust property currently includes land, the trust is a 'trust of land' and the trustees have, in relation to the land subject to the trust, all of the powers of an absolute owner for the purpose of exercising their functions as trustees.[50] This includes the power to acquire land.[51] In exercising their powers, the trustees must have regard to the rights of the beneficiaries[52] and the duty of care under s. 1 of the Trustee Act 2000 applies to them.[53] Beneficiaries who are beneficially entitled to an interest in possession in land subject to a trust of land are entitled to occupy the land at any time.[54]

The 'general power of investment' contained in Part II of the Trustee Act 2000[55] does not permit the trustees to make investments in land, although it does permit them to be parties to a mortgage.[56] However, Part III of the Act provides that trustees may acquire freehold or leasehold land in the UK as an investment, for occupation by a beneficiary, or for any other reason.[57] For the purpose of exercising his functions as a trustee, a trustee who acquires land under this section has all of the powers of an absolute owner in relation to the land. Previously, trustees were only permitted to invest in freehold land if the trust contained freehold land from the outset,[58] or if the trust instrument expressly authorized investment in land; now, trustees have the power to invest in legal freehold and leasehold estates in land[59] (apart from in p. 415 cases of settled ↵ land and university land),[60] although the trust instrument or other legislation may exclude or restrict that power.[61]

Like 'investment', 'land' is nowhere defined in the 2000 Act. An explanatory note to the Act[62] suggests that the definition of land in Sch. 1 to the Interpretation Act 1978 should apply. That Schedule defines land as including buildings and other structures, land covered with water, and any estate, interest, easement, servitude, or right in, or over, land. However, according to the actual text of the 2000 Act, express power to invest in land is restricted to investment in mortgages,[63] and the legal estates of freehold and leasehold. This produces an odd (and presumably unintended) contrast with trustees of trusts that already include land. Such trusts are 'trusts of land' within the Trusts of Land and Appointment of Trustees Act 1996 and the trustees of such trusts are permitted to invest in any interest in land as if they were absolute owners of the fund.[64]

One reason for the law's traditional reluctance to authorize trustee investment in land may have been the problem of valuation.[65] The accurate valuation of land is a task requiring professional expertise and knowledge of the local property market.[66]

Even if the trust is not purchasing land, but merely lending money secured on land, it is crucial that an accurate valuation is obtained. If a trustee lends money without taking expert advice, or lends contrary to expert advice, such failure is prima facie imprudent[67] and the trustee is liable to the full extent of any loss incurred by the trust fund as a result of the breach.

#### 12.4.3.1 A loan secured on land made before the Trustee Act 2000 came into force

This species of investment is still subject to special rules laid down in the Trustee Act 1925. Those rules provide that, if the trustee took expert advice as to the value of the land intended to be security for the loan and loaned no more than two-thirds of the expert valuation, he will not be liable if the land is subsequently shown to be inadequate security.[68] So, if land is valued at £150,000, the trustee will incur no liability if he lends no more than £100,000, even if the land turns out to be worth, for example £50,000. The rules also provide that even if the trustee loans more than two-thirds of the expert's valuation, his liability will be limited to the extent of the excess.[69] So, if land is valued at £150,000 and the trustee lends £110,000, the trustee will only be liable to pay £10,000 compensation if the land turns out to be worth £50,000.

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### 12.4.4 Borrowing to invest

If mortgage interest rates are low, it might make sound financial sense to borrow money on the security of trust-owned land and to reinvest the borrowed funds elsewhere. Such borrowing is, in fact, authorized by most modern trust deeds. In 1996, HM Treasury declined to recommend that such a power should be extended to trustees generally,[70] but Part II of the Trustee Act 2000 now permits trustees to invest in loans secured on land,[71] regardless of whether the trustees are borrowers or lenders.[72] Accordingly, unless the trust instrument provides to the contrary, there is nothing to prevent trustees from borrowing for investment purposes.

### 12.4.5 Personal loans

Secured loans must be contrasted with loans made by trustees on no security other than the borrower's personal promise to repay. Such 'personal loans' are inherently risky, and not merely because the borrower might break his promise. The borrower might be quite willing to repay the loan, but may be unable to do so due to insolvency or impecuniosity. For this reason, it has been said that '*loans on no security beyond the liability of the borrower to repay … are not investments*'.[73] In fact, prior to the Trustee Act 2000, it was clear that trustees were only permitted to invest by means of personal loans if the trust instrument expressly authorized such investments.[74] Since the Act came into force, it is a moot point whether personal loans are authorized under the general power of investment.[75] If one takes the view that personal loans 'are not investments', they will not be authorized by the Trustee Act 2000. However, the better view may be to acknowledge that a personal loan is a type of investment, but one that should be presumed imprudent.

## 12.5 Trustees' investment duties

The law recognizes trustees as having the same investment powers as absolute owners, but whereas an absolute owner may use his property as he pleases—choosing, if he wishes, to gamble and speculate—trustees' legal powers are constrained by their duty to invest prudently and fairly.[76] Absolute owners invest on their own account; trustees are accountable ↵ to beneficiaries. This does not mean that trustees are required to make up from their own funds every loss that befalls the trust fund. They are not insurers of the fund.[77]

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The following passage from a leading US case sets out the essential trustee duties in relation to investment:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[78]

There are several basic duties to bear in mind:

1. The trustee must be faithful: he must not invest in companies he owns or otherwise place himself in a position of conflict.
2. He must exercise a positive discretion: he must make choices in relation to all aspects of investment management, such as when to sell and acquire investments, which investments to sell and acquire, whether or not to delegate investment functions, when to delegate and to whom.
3. The discretion he exercises must be a sound one. This is judged objectively, the question being whether the trustee exercised his discretion prudently and fairly.
4. Speculation is *ipso facto* imprudent and is not permitted. It is sometimes said that one must 'speculate to accumulate' but 'select to protect' is a more appropriate motto for the trustee.
5. The trustee should invest the trust fund fairly as between beneficiaries with potentially competing interests. In a traditional trust under which there is a life tenant and remainderman, the life tenant is generally more interested in income production and the remainderman in capital preservation.

## 12.5.1 The duty to exercise a sound discretion

Prudence and fairness, the principal characteristics of a sound discretion, are considered in detail later. There are, however, several other aspects to the duty to exercise a sound discretion. One is that trustees must not allow the exercise of their discretion to be influenced by matters unrelated to the purposes of the trust.[79] They must manage the fund in the way that is most beneficial to the beneficiaries, even if such a
p. 418 course conflicts with their personal morality[80] (a fiduciary cannot '*make moral* ↵ *gestures*',[81] or have political opinions,[82] or base decisions on any other extraneous consideration).[83] Related aspects of the duty are that a trustee must not exercise his discretion dishonestly, or capriciously, or, subject to the trust instrument providing to the contrary, for his own benefit. However, the most basic aspect of the duty to exercise a sound discretion is sometimes overlooked. It is simply this: that trustees are not permitted to abdicate responsibility for decision making,[84] nor are they permitted unduly to restrict the choices available to them, nor are they permitted to place themselves in a position in which they are powerless to exercise a free discretion. In short, trustees must exercise *some* discretion if they are to exercise a *sound* discretion.[85]

### 12.5.2 The duty to invest with prudence

Prudence is a word that describes a process.[86] One may describe an investment as having been prudently (or imprudently) selected, managed, and retained, but it makes no sense to describe a particular investment asset (such as 'shares in X Co') as being per se prudent or imprudent.[87] As one commentator has put it: '[P]*rudence is demonstrated by the process through which risk is managed, rather than by the definition of specific risks that are imprudent.*'[88] To a layperson, the word 'risk' has negative connotations, but to an economist it is a neutral concept. There is a risk that a trust fund will perform well and a risk that it will perform badly. A prudent trustee recognizes that, whatever he does, the fund is exposed to some form of risk—hence the advice offered to trustees in an old US case: '*Do what you will, the capital is at hazard.*'[89] Even if it is relatively easy to maintain the nominal value of the fund by placing it in a bank account,[90] there is always the risk that inflation, or devaluation of currency for some other reason,[91] will cause the value of the fund to fall in real terms while it is resting in the account.

#### p. 419 12.5.2.1 Prudence as Victorian ideal

The trustee's duty of prudence was established in the Victorian era. Those were the days of the gold standard, when the value of a pound sterling was directly linked to, and therefore remained as stable as, the value of gold.[92] The idea of prudence meant something then. A prudent trustee knew that capital could be made safe, and an income guaranteed, merely by purchasing gilts or placing trust money on deposit with a respected bank. Why expose the fund to unnecessary risk by purchasing company shares? Times change, however, and '*investments which were imprudent in the days of the gold standard may be sound and sensible in times of high inflation*'.[93] It is therefore to the credit of the Victorian courts that, by requiring a trustee to '*conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own*',[94] they laid down a standard of trustee prudence that is adaptable to changing economic circumstances and investment practice. In Victorian times, prudence could reasonably be equated with caution, but it is clear from the leading Victorian case on trustee investment that the overriding duty is not to be cautious,[95] but to invest in a way that is calculated to provide for the beneficiaries:

> The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.[96]

The merit of this formulation is that it holds trustees to certain standards of conduct.[97] The alternative approach,[98] which would require trustees to achieve particular outcomes, may have been appropriate to Victorian England, but it is not appropriate in today's uncertain investment climate.

A paradigm of prudence that judges trustees according to the current practice of ordinary persons of business is both bad news and good news for trusts. The bad news is that trustees may be encouraged to adopt popular practice, even if it is detrimental. It has been suggested, for example, that modern investment practice has become increasingly concerned with the short term, because professional fund managers are in competition and keen to produce early rewards to attract investors.[99] The good news, on

p. 420 ↵ the other hand, is that the trustees are encouraged continually to review best practice. The paradigm might, for instance, encourage ‘ethical’ or ‘socially responsible’ investment if society’s increasing concern for such issues suggests that ethical investment may be financially viable in the medium to long term. It might also encourage a return to investment in bonds and gold, which tends to thrive in periods of political instability and in times of poor stock market performance.[100] However, the main advantage of a flexible paradigm of prudence is that it allows trustees to invest according to modern portfolio theory. Investment according to that theory is ‘*the modern paradigm of prudence*’.[101]

## 12.5.3 Modern portfolio theory

In 1988, just two years after the deregulation of investment business in the UK[102] and the publication of Longstreth’s seminal work, *Modern Investment Management and the Prudent Man Rule*,[103] Hoffmann J held that:

> [m]odern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.[104]

That judgment was reported in 1996 and was referred to, with approval, by HM Treasury in its consultation document published that year.[105] Since then, the Trustee Act 2000 has laid down ‘*standard investment criteria*’,[106] which, according to the explanatory notes accompanying the Act, are intended to facilitate trustee investment in accordance with modern portfolio theory.[107]

The major insight offered by modern portfolio theory is that risks specific to investment in any particular company may be offset by holding a diverse portfolio of shares in other companies. Portfolios containing
p. 421 investments other than shares also benefit ↵ from diversification, but the theory is most applicable to shares, and especially to shares in public companies. The values of shares in public companies are quoted on the stock exchange, so the market in such shares is efficient relative to other markets, in the sense that the quoted value of the shares ought to be an accurate reflection of all published information relating to those shares. Modern portfolio theory originates in the work of Harry Markowitz, for which he was awarded a share of the 1990 Nobel Prize in Economic Sciences. He first published his idea in 1952,[108] hence the authors of *The Trustee Guide to Investment* have jokingly called it the ‘not so “modern portfolio theory” ’.[109] More seriously, 1950s belief that investment policy might tame the unpredictable forces of free market capitalism is surely the very epitome of modernity, to be placed alongside 1950s belief that nuclear weapons might tame the unpredictable forces of international conflict.

### 12.5.3.1 Modern portfolio theory and types of investment risk

To understand portfolio theory, it is necessary to distinguish two types of investment risk. The first is ‘specific risk’, which is risk associated with a particular company, say Z plc. The second is ‘market risk’ or ‘systemic risk’, which is risk associated with the entire market in shares. Systemic risk is the risk that the whole market or ‘system’ will fail. It is sometimes said that the stock market lurches like a roller coaster, and certainly the descriptions for various degrees of systemic failure reflect that: there are ‘dips’, ‘slumps’, ‘dives’, and, if things are really bad, a ‘crash’.

Diversification within an equities market (such as the FTSE 100 or the FTSE All Share) does nothing to reduce the systemic risk of failure across the market as a whole. Such risk is therefore said to be non-diversifiable. However, diversification of shareholdings across companies *within* the market does reduce the risks associated with the failure of any particular company. This is the major insight of modern portfolio theory.

### 12.5.3.2 Non-diversifiable risks

‘Non-diversifiable’ or ‘systemic’ risks include changes in the tax regime, interest rate, and the rate of inflation. Political changes, such as the election of a left-wing government, may also have an immediate detrimental effect on the value of the stock market as a whole.[110]

A particularly potent form of non-diversifiable risk is the fraud or incompetence of human agents; ‘agency risk’ of this sort has even been described as the primary risk that investors face.[111] Trustees are authorized to insure the fund against loss howsoever caused[112] and statutory insurance is available via the Financial Services Compensation Scheme,[113] but the problem is that investment losses are hard to prove. If an agent p. 422 absconds with trust funds, loss will be obvious, but if the investments yield a return, it ↵ will be much harder to establish that the level of return has been reduced due to incompetence or fraud.[114]

### 12.5.3.3 Reducing risk through diversification

If the portfolio is so diverse that it mirrors the composition of the market, specific risks will be entirely eliminated as regards that market, because the portfolio will rise and fall in line with the movement of the market quite regardless of what happens to individual companies quoted on it. Such a market- or index-tracking portfolio can be created by holding shares in every company within the market, the size of each shareholding being proportionate to the capitalized value of the company in which it is held.[115] Of course, it is not possible to track markets in other assets, such as land, in this way.

Few trusts have the means to hold directly the required number of shares to match the market, and if they did the transaction costs and governance duties would probably be prohibitive.[116] Trustees can, instead, invest in tracker funds managed by external fund managers, but that is merely to replace risks specific to particular company shares with risks specific to particular fund managers, including such matters as their honesty, competence, and the level of their charges.

It is at this point that we return to the problem of trustee decision making. A trustee is breaching his trust if he rigidly adheres to an index-tracking portfolio in the belief that modern portfolio theory has absolved him of the need to make investment decisions. A trustee is entitled to be judged by the standards of modern portfolio theory, but he is neither required, nor permitted, slavishly to adhere to that theory. His duty to exercise a positive discretion may require him to remove a company from his portfolio if any prudent person would regard it as a poor investment.

The good news for trustees of funds that are too small to track the entire market is that even a relatively small amount of diversification will offset the greater part of the risk: even investment in two companies is better than investment in one.[117] And, if a trustee is careful which two companies he chooses, the risks associated with one company can be offset quite significantly by investment in the other. So, for example, the risk of investment in an umbrella manufacturer will, in theory, be better offset or 'hedged' by investment in a manufacturer of sunglasses than by investment in waterproof jackets. Further good news for trusts which are too small to hold an index-tracking portfolio of investments is that diversification across different domestic markets (for example, shares, land, and bonds) and different international markets (for example, the UK, the p. 423 USA, and Hong Kong) produces greater insulation against overall risk than diversification within any single market.[118] Of course, the downside to an international portfolio is increased management and transaction costs, and increased numbers of managers means an increased risk of fraud and error.

### 12.5.3.4 Risk management

Historically the trustee investor avoided risk, but today the trustee investor manages risk. As Lord Nicholls of Birkenhead has said:

> [T]raditional warnings against the need for trustees to avoid speculative or hazardous investments are not to be read as inhibiting trustees from maintaining portfolios of investments which contain a prudent and sensible mixture of low risk and higher risk securities. They are not to be so read, because they were not directed at a portfolio which is a balanced exercise in risk management.[119]

This does not mean that trustees are permitted to invest in individual investments that are speculative or hazardous: '*The distinction is between a prudent degree of risk on the one hand, and hazard on the other.*'[120] Nor does it mean that trustees are no longer accountable for risk associated with the investments they choose; it means only that trustees will be judged by the risk associated with the portfolio as a whole and not merely by the risk associated with individual investments.

### 12.5.3.5 Choosing the level of total portfolio risk

What level of total portfolio risk is appropriate to trusts? An economic model known as the 'capital asset pricing model' demonstrates that, having taken into account the level of returns that is expected from the 'risk-free' portion of a portfolio (that part comprising gilt-edged securities, three-month Treasury bills, etc.), additional expected returns will rise in direct proportion to increased risk. This linear correlation is known as the security market line. At the heart of this model is common sense. The model is based on expectations and expectations are based on information. If we assume a world in which accurate information about investments is freely and instantly available (only the market in publicly quoted shares comes close to this), it will follow that the value of an investment as currently quoted will be an accurate reflection of its true underlying value. In this 'efficient market', the hypothetical 'rational' investor will

run greater risks only if there is a corresponding expectation of greater returns.[121] In short, returns can be
p. 424 expected to rise as risk rises, so the ↵ question 'What risks is it appropriate for trustees to take?' becomes 'What returns is it appropriate for trustees to seek?'

It is at this point that the process of trustee investment must be concerned with outcomes. The trustee's first hope—in a traditional settlement trust, at least—is to preserve the real value of the capital and to produce an income. This means that the trustee should seek a portfolio with a low overall risk quotient. In other words, the prudent trustee will be cautious or 'risk-averse' as regards the total portfolio, but he will ensure that assets within the portfolio are exposed to risk, albeit in a managed way.

Of course, the law does not *require* trustees to invest according to modern portfolio theory; it merely *facilitates* it. There are alternatives for the prudent trustee. One of these is to have a smaller, but more carefully selected, portfolio:

> [M]any people believe that by restricting the stocks a manager can invest in must inhibit performance. A simple answer to this is that focussing attention on a smaller universe of stocks can lead to improved quality and quantity of research.[122]

In other words, the most prudent course may be to follow the advice given (so it is said) by the famous industrialist, Andrew Carnegie: '*Put your eggs in one basket. And watch the basket. That's the way to make money.*'[123]

### 12.5.3.6 Obstacles to modern portfolio theory in English law

Prior to the Trustee Act 2000, the English law of trusts presented a number of obstacles to the implementation of modern portfolio theory. The 2000 Act removes them all, either directly or indirectly.

1. Trustees were limited to certain types of investment. Now, as we have seen, the Trustee Act 2000 permits any type of investment.
2. The assumption that the trustees' duty of prudence required trustees to avoid risky investments. We have seen that the trust fund is always subject to risk, if only the risk of inflation. To make gains sufficient to offset the effect of inflation, trustees must expose the fund to a degree of risk. If the exposure to risk is planned (by means of an appropriately balanced portfolio), it will be prudent.
3. The so-called 'anti-netting rule', or the rule against 'set-off' insists that trustees may not set off gains made by one breach of trust against losses arising from another breach of trust.[124] Even before the Trustee Act 2000, there was judicial support for assessing linked transactions together, so as to limit the trustee's liability to the net loss arising from the linked transactions.[125]
4. p. 425 The old rule that trust investments had to yield an income.[126] In essence, it was a rule designed to preserve capital, for if a beneficiary's needs could not be met out of income, the capital would have to be sold.[127] Now, as the explanatory notes that accompany the Trustee Act 2000 make clear, the general power of investment[128] permits trustees to invest in assets that are expected to yield capital growth instead of (or in addition to) income.[129]

## 12.6 The statutory 'standard investment criteria'

According to the Trustee Act 2000, trustees must have regard to the '*standard investment criteria*'[130] when investing on behalf of the trust. It defines the 'standard investment criteria' as 'suitability' and 'diversity'. The type of investment—for example, land—must be suitable to the trust, as must the particular investment of that type—for example, The Old Vicarage, Warwick[131]—and diversification must be pitched at a level appropriate to the '*circumstances of the trust*'.[132] Furthermore, the trust investments must be reviewed '*from time to time*' and the trustees must consider, in the light of the standard investment criteria, whether to vary them.[133]

The explanatory notes that accompany the 2000 Act confirm that courts should judge the *suitability* of particular investments in the light of the overall portfolio of investments. It appears that the size and risk of the investment, the need to produce an appropriate balance between income and capital growth, and 'ethical considerations' will all be relevant in judging whether the portfolio is a 'suitable' one.[134]

p. 426

## 12.7 Obtaining and considering proper advice

Before exercising any power of investment or implementing any decision to vary investments as a result of a review, trustees must '*obtain and consider proper advice about whether, having regard to the standard investment criteria*', they should proceed.[135] This statutory duty is really nothing more than a specific instance of the duty to invest with prudence. Obviously 'obtain and consider' does not mean 'follow': trustees are obliged to exercise an independent discretion. Having said that, trustees depart from expert advice at their peril. Portfolio management is not for amateurs.[136] Indeed, the move to portfolio-based investment has made it necessary to take advice even in relation to investments, such as bank accounts and gilts, which, prior to the 2000 Act, could be made without advice.

'Proper advice' is 'the advice of a person who is reasonably believed by the trustee to be qualified by his ability in and practical experience of financial and other matters relating to the proposed investment'.[137] There is no requirement that the advice be given or confirmed in writing, but 'to do so will no doubt be regarded as best practice in many circumstances, and may be necessary for trustees to show compliance with the general duty of care in section 1'.[138] If one of the trustees is qualified to give advice, the trustees are together entitled to rely on the advice of the 'expert' trustee.[139]

There is, however, an important exception to the duty to obtain and consider proper advice: 'a trustee need not obtain such advice if he reasonably concludes that in all the circumstances it is unnecessary or inappropriate to do so'.[140] One relevant 'circumstance' is the size of the investment: if the proposed investment is small, the cost of obtaining advice might be disproportionate to the benefit.[141]

## 12.8 The duty to invest fairly

Beneficiaries with life interests and beneficiaries with interests in remainder will agree that their trust should be administered prudently by trustees who have powers adequate for the task. So, when the trustees in *Anker-Petersen v. Anker-Petersen*[142] applied to court to have their investment powers extended, the judge held that he was not required to give consent on behalf of every category of beneficiary separately, but could consider the beneficiaries' interests collectively in income and in capital. With regard to certain matters, however, the interests of different classes of beneficiary are essentially in direct competition with each other. Thus, whereas the life tenant's interest is in high-income assets with limited scope for capital
p. 427 appreciation (or even scope for depreciation), the ↵ remainderman's interest is firmly in capital retention at the expense of income. The law recognizes this conflict and takes the view that, in exercising their investment discretion, trustees should invest fairly in the interests of every beneficiary and every class of beneficiary:

> [I]t is of the essence of the duty of every trustee to hold an even hand between the parties interested under the trust. Every trustee is in duty bound to look to the interests of all, and not of any particular member or class.[143]

The duty is sometimes expressed as a duty to maintain a fair balance between the beneficiaries. In fact, the word 'balance' can be misleading in so far as it suggests equality.[144]

### 12.8.1 Fairness is not the same as equality

Fairness between competing beneficiaries need not import equality, because an equal approach would automatically place the life tenant (who may be, and often is, the settlor's surviving spouse) on the same footing as the remainderman (who may be a cousin or other remote relative). In such a case, '[equality] *is surely the last thing the settlor ever intended*'.[145] These are the words Lord Wilberforce used in connection with discretionary trusts and it is not by accident that they are used here. The discretion that a trustee must exercise when determining a fair balance of investments is equivalent in breadth to the dispositive discretion that trustees exercise when distributing the trust fund under a discretionary trust. In both situations, the trustees are required, in essence, to second-guess what the settlor would have wanted to provide for the particular beneficiaries. As Hoffmann J said in *Nestle*:

> The trustees have in my judgment a wide discretion. They are for example entitled to take into account the income needs of the tenant for life or the fact that the tenant for life was a person known to the settlor and a primary object of the trust whereas the remainderman is a remoter relative or a stranger … It would be an inhuman law which required trustees to adhere to some mechanical rule for preserving the real value of the capital when the tenant for life was the testator's widow who had fallen upon hard times and the remainderman was young and well off.[146]

p. 428
## 12.9 Specific duties in relation to original investments

Implicit in the general investment power[147] is a power to retain or sell the original investments. There are, however, situations in which this power is replaced by a *duty* to retain or sell the investments in their original form. Family heirlooms, for example, must be retained[148] unless the court orders their sale in an emergency.[149] The duty to sell original investments is more complicated. It may be that the original fund consists solely of gold bullion that is producing no income at all. Or maybe it consists solely of shares in a gold-mining company that are expected to produce great income in the short term but will be worthless within a few years because the mine is nearly exhausted. How are the respective interests of the life tenant and remainderman to be satisfied? Is it incumbent upon the trustee to redress the balance between capital and income? Or, to put it another way, is there a duty to convert the fund?

The explanatory notes that accompany the Trustee Act 2000 make clear that one factor relevant to determining the suitability of a particular investment is '*the need to produce an appropriate balance between income and capital growth*'.[150] What is appropriate will depend upon the '*needs of the trust*'. Certain formal rules used to apply to trusts, but they have been abolished by the Trusts (Capital and Income) Act 2013 for new trusts coming into force after its commencement (on 31 January 2013).[151] In the case of charities, the Charities (Total Return) Regulations 2013 (which came into force on 1 January 2014) empowers trustees to free the endowment fund, or a portion of it, from restrictions with respect to expenditure of capital in order that they might operate 'total return' or 'unitrust' investment, i.e. investment which ignores the distinction between income and capital.

## 12.10 Liability for improper investment by trustees

At the very start of this chapter, the reader was alerted to the difficulties that beneficiaries face when trying to establish that their trustees are liable for improper investment. We noted that there are challenges at every stage, from proving that there has been a breach of trust (which we now know requires proof of imprudence or unfairness),[152] to proving that the trust has suffered a loss (and the size of the loss), to proving that the loss was caused by the breach. The beneficiaries' task is not made any easier by the decision in the leading modern case on liability for imprudent trustee investment, *Nestle v. National Westminster Bank plc*.[153]

p. 429
### 12.10.1 The decision in *Nestle v. National Westminster Bank plc*

'*How do you make a small fortune? Give a bank a large one to manage in trust.*'[154] The joke could have been based on *Nestle v. National Westminster Bank plc*. William David Nestle died in 1922, leaving a fund worth approximately £54,000 on trust for various descendants. The claimant, the testator's only granddaughter, became solely and absolutely entitled to the fund in 1986, by which date the nominal capital value of the fund had increased to nearly £270,000. However, had the real value of the fund been maintained, it would have been worth around £1m in 1986. What is more, the claimant alleged that she would have received almost double that (around £1.8m) had the original portfolio balance between equities and gilts been maintained until 1986. The trustee, the National Provincial Bank (later the National Westminster Bank), had misinterpreted the powers of investment granted to it by the terms of the trust and, choosing to err on the side of caution, had reduced the proportion of the portfolio devoted to equities. The claimant alleged that the bank had done so imprudently and, furthermore, that, through the purchase or retention of fixed interest securities in preference to ordinary shares, the bank had unfairly favoured the life beneficiaries over her.

The Court of Appeal considered it 'inexcusable that the bank took no steps at any time to obtain legal advice as to the scope of its power to invest in ordinary shares'.[155] Their Lordships also held that the bank should have undertaken regular reviews of the investments under its control. Leggatt LJ reached the damning conclusion that '[n]o testator, in the light of this example, would choose this bank for the effective management of his investment'.[156] Yet despite these sentiments, the claimant failed. This led commentators to ask whether there is any effective legal remedy for improper trustee investment:[157]

> Some people might see it as remarkable that the bank incurred no liability notwithstanding the fact that they plainly misconstrued the scope of their investment powers especially since the trustee was a paid professional who supposedly owes higher duties of care.[158]

The outcome in *Nestle* may not be remarkable when one considers how broad is the trustee's discretion to determine a *fair* balance within the portfolio between the interests of life and remainder beneficiaries, but it is most remarkable when one considers the high objective standards of *prudence* against which trustees are supposed to be assessed. The main reason why the trustee in *Nestle* escaped liability for the losses that probably resulted from its undoubted imprudence, was that the three basic elements of liability (breach, loss, and causation) were not kept sufficiently distinct—especially in so far as questions of outcome (loss)
p. 430 were allowed to impinge upon questions of process ↵ (breach of duty). The following passage from the judgment of Staughton LJ exemplifies the confusion:

> The misunderstanding of the investment clause and the failure to conduct periodic reviews do not by themselves, whether separately or together, afford the plaintiff a remedy. They were symptoms of incompetence or idleness … they were not, without more, breaches of trust. The plaintiff must show that, through one or other or both of those causes, the trustees made decisions which they should not have made or failed to make decisions which they should have made … The judge took the view that 'the bank had acted conscientiously, fairly and carefully throughout the administration of [the] trust'. I cannot join in that accolade. But it is not shown that there was loss arising from a breach of trust for which the trustees ought to compensate the trust fund.[159]

His Lordship was quite correct to suggest that the trustee's defaults '*do not by themselves, whether separately or together, afford the plaintiff a remedy*', but his Lordship was, it is submitted, wrong to suggest that '*they were not, without more, breaches of trust*'. The behaviour of a professional trust corporation is judged by a high standard and there can be no doubt that the trustee in *Nestle* had breached its trust. The only scope for argument relates to the quite distinct questions that follow: did the trust fund suffer an identifiable and quantifiable loss, and did the trustee's breach of trust cause that loss? It undermines the deterrent and symbolic aims of high standards of fiduciary behaviour to dismiss a breach of trust as immaterial merely because the uncertainties inherent in the investment process have made it practically impossible to prove that the breach went on to cause a quantifiable loss.[160]

Staughton LJ suggests that, in order to prove a breach of trust, it is insufficient to demonstrate merely that the trustee was incompetent and idle. It is also necessary to show that the trustee made bad decisions as a result. There is nothing wrong with that approach in so far as it suggests that a finding of breach of trust should be based on the totality of the investment process and the manner in which the trustee exercises his discretion. However, it can be read as suggesting that there is no breach of trust—no matter how improper the trustee's decision-making process—as long as the trustee's ultimate decisions are unimpeachable. On that reading, a trustee who selects his portfolio by randomly pricking a pin in the shares pages of the *Financial Times* might be beyond reproach. The process is completely imprudent and involves a total abdication of discretion, but who is to say that a trustee investing prudently would necessarily have chosen a different portfolio? The judgment of Leggatt LJ seems to confirm that this latter, albeit pessimistic, interpretation of Staughton LJ's words is the one that their Lordships approve:

> [I]t does not follow from the fact that a wider power of investment was available to the bank than it realised either that it would have been exercised or that, if it had been, the exercise of it would have produced a result more beneficial to the bank than actually was produced. Loss cannot be presumed, if none would necessarily have resulted.[161]

p. 431 ↵ The problem with this approach is that it puts a heavy burden on the claimant to prove not only that the trustee acted imprudently or unfairly—by, say, taking inappropriate matters into account or failing to take appropriate matters into account (as in *Nestle*)—but also that the ultimate outcome of these errors was 'necessarily' worse than that which would have occurred in the absence of default. If we have learned anything about the process of investment in this chapter, we have surely learned that one can never say of any investment process that it will 'necessarily' produce such and such an outcome; still less can it be said that a trustee's investment would 'necessarily' have yielded such and such an outcome in the absence of default—for that calculation would require one to overcome the unpredictability of the investment market and to overcome the unpredictability of trustee decision making. We have seen that decisions relating to trustee investment involve very broad discretions, in relation to both 'prudence' and 'fairness'. The sheer breadth of such discretions makes it impossible to establish what a trustee would 'necessarily' have done but for his default. It will be even harder to prove causation of loss against trustees who, having imprudently breached their trust by pursuing a certain investment policy, did so in accordance with expert investment advice.[162] Indeed, trustees who do their reasonable best in such a case might be relieved of liability under the Trustee Act 1925, s.61 for any loss caused by their breach of trust.[163]

## 12.10.2 Causation

It must be stressed that it is not enough to prove that a trustee's investment choices 'caused' the trust to suffer a loss. Trustees are only liable for losses that they have caused *by breaching their trust*. If a trustee chooses to invest in X Co and X Co fails, it is clear that, factually speaking, the trustee's choice was one cause of any loss suffered by the trust fund: 'but for' the trustee's choice to invest in X Co, the fund would not have suffered a loss when X Co failed. It does not follow, however, that trustees should be liable as a matter of law to compensate for every loss they cause as a matter of fact. If, on the other hand, a trustee imprudently makes an investment (such as the retention of dilapidated land) which by pure chance happens to do well (due, say, to a general increase in land values),[164] the trustee will escape liability on the *Nestle* principle that imprudent investment does not lead to liability in the absence of proof of loss.

In *Bartlett v. Barclays Bank Trust Co (No. 1)*,[165] Brightman J warned that courts must not 'be astute to fix liability upon a trustee who has committed no more than an error of judgment, from which no business man, however prudent, can expect to be immune'.[166] The settlor, and, by implication, the beneficiaries, 'must take the consequences of having intrusted their monies to persons of sanguine temperament who
p. 432 have made a purchase ↵ which turns out to be a bad one'.[167] In short, 'lack of clairvoyance is not negligence'.[168] The merit of these dicta is that they focus on the blameworthiness, or otherwise, of the trustee's conduct as a basis for any liability. In contrast, their Lordships in *Nestle* placed undue emphasis upon outcomes. So when Leggatt LJ accepted counsel's submission that 'loss' will be incurred by a trust fund 'when it makes a gain less than would have been made by a prudent businessman',[169] his Lordship made no reference to the fact that even prudent businessmen are not exempt from bad luck.

## 12.10.3 Quantification

Related to the problem of causation is the problem of quantification. Liability will be difficult to establish if it is not possible to say *how much* loss a breach has caused.

Quantification is relatively straightforward where the trustee was directed to invest in particular investments and failed to do so,[170] but, as with everything in the law of trustee investment, it is far from straightforward where the trustee has a broad discretion. It has even been said that:

> [t]he discretion given to the trustees to select an investment among several securities makes it impossible to ascertain the amount of the loss (if any) which has arisen to the trust fund from the omission to invest.[171]

Nowadays, with the advent of shares indexing, this ceases to be a valid objection: the loss, if any, caused to the fund through an imprudently chosen portfolio can at least be estimated by comparing the performance of that portfolio to the performance of a 'control' portfolio over the same period. The control portfolio should be a balanced portfolio resembling as nearly as possible the disputed portfolio, but varied to estimate what might have been included or omitted had the trustees not breached their trust. Once it is established that the trustee breached its trust and that the breach probably caused loss to the fund, the constitution of the control portfolio will ideally be agreed between the parties, but, in default of agreement, it could be proposed by an independent financial expert acting as *amicus curiae*.

### 12.10.4 The New Zealand approach

The approach in *Nestle* should be contrasted with that adopted by the court in *Re Mulligan (deceased)*,[172] a New Zealand case. There, the testator had died in 1949, leaving his widow a substantial legacy and a life interest in a farm. The widow was one of the trustees of the estate. The farm was sold in 1965 and the estate invested in fixed-interest securities until the widow died in 1990. The other trustee had, between 1965 and
p. 433 1990, tried ↵ to persuade the widow to invest in shares to counter inflation, but she had adamantly refused to do so. That trustee (a trust corporation) was held to be in breach of trust, because it had appreciated the corrosive effect of inflation on the estate capital (which was held to be reliable evidence of the standard of prudence in the industry at the time), but had nevertheless deferred to the widow's wishes. The merit of this approach, over that adopted in *Nestle*, is that breach of trust was determined by reference to the trustee's conduct and not by reference to the outcomes that conduct happened to produce. Although, ironically, if presented with the facts[173] in *Re Mulligan*, it is possible that their Lordships in *Nestle* would also have found for the plaintiff. As Dillon LJ stated:

> If what had happened in the present case had been that the bank, through failure to inform itself as to the true scope of its investment powers, had invested the whole of the annuity fund in fixed interest securities, and no part in equities … then, as on the evidence loss would clearly have been proved to have been suffered, the appropriate course would have been to require the bank to make good to the trust fair compensation—and not just the minimum that might have got by without challenge.[174]

## 12.11 Ethical investment

Earlier, we noted that trustees must set aside their own political or moral views in order to advance the beneficiaries' best interests, but what if the beneficiaries themselves have strongly held religious, political, or moral convictions? Are the trustees permitted—even required—to take such beliefs into account when investing the fund? The courts have answered this question in the negative. Where the trust exists for the purpose of financial provision (as most private trusts do), the trustees are obliged to pursue the beneficiaries' best *financial* interests. The only exceptions to this are where the trust instrument authorizes ethical investments,[175] or the beneficiaries are unanimously opposed to particular investments. As Sir Robert Megarry VC stated in *Cowan v. Scargill*:[176]

> [I]f the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters, condemning all forms of alcohol, tobacco and popular entertainment, as well as armaments, I can well understand that it might not be for the 'benefit' of such beneficiaries to know that they are obtaining rather larger financial returns under the trust by reason of investments in those activities than they would have received if the trustees had invested the trust funds in other investments … the burden would rest, and rest heavy, on him who asserts that it is for the benefit of the beneficiaries as a whole to receive less by reason of the exclusion of some of the possibly more profitable forms of investment.[177]

p. 434 Of course, the purpose of certain trusts—most notably charities—is not merely to make financial provision, but to achieve ulterior social goals. Such trusts are permitted to advance those goals by the manner of their investment, as well as by the way in which they distribute the trust income.[178] It would be perverse if a charity for the protection of the environment through the promotion of cycling[179] were required to invest some part of the fund in the motor industry.

## 12.11.1 Charitable trusts

The Charities (Protection and Social Investment) Act 2016 s.15 amends the Charities Act 2011 to provide that a 'social investment' is made when the charity trustees apply or expose charity assets to the risk of being applied, 'with a view to both (a) directly furthering the charity's purposes; and (b) achieving a financial return for the charity'.[180] It also supplies a general power to make social investments provided it does not use or apply (or put at risk of use or application) the charity's 'permanent endowment' in a manner that is expected to contravene a restriction with respect to expenditure of the permanent endowment. The general power is subject to the express terms of the trust.[181]

## 12.11.2 Non-charitable trusts

In the case of non-charitable trusts, it is difficult for trustees to establish that ethical investments ought, on financial grounds, to be preferred. In *Cowan v. Scargill*,[182] one half of the management committee of the National Coal Board's pension trust sued the other half, which comprised Mr Arthur Scargill and four other officials of the National Union of Mineworkers (NUM). The complaint was that the NUM trustees had refused to invest the pension fund in certain overseas industries. The NUM trustees objected to the fact that the overseas industries were competitors of the British mining industry. They defended their refusal to invest as being in the beneficiaries' best interests. The beneficiaries were, of course, retired British mineworkers. Sir Robert Megarry VC held that:

> the broad economic arguments of the defendants provide no justification for the restrictions that they wish to impose. Any possible benefits from imposing the restrictions under the scheme … are far too speculative and remote.[183]

p. 435 In theory, trustees are not even permitted to prefer the 'more ethical' of two investments with near-identical financial potential, although, in practice, no action could be taken on such a breach, because it would be impossible to prove that it had caused a loss to the fund.[184] However, Lord Nicholls of Birkenhead, writing extra-judicially, has expressed his opinion that the range of investments available to trustees is sufficiently extensive to allow trustees '*to give effect to moral considerations, either by positively preferring certain investments or negatively avoiding others, without thereby prejudicing beneficiaries' financial interests*'.[185]

We should not expect the courts to abandon overnight their long-held assumption that beneficiaries' best interests are their best financial interests. Indeed, Lord Nicholls himself has described ethical investment as '*an example* par excellence *of an instance where, if social conditions today are thought by some to dictate a need for a change in the law, the change ought to be made by the legislature*'.[186] Nevertheless, we know that the paradigm of prudence shifts in line with trends in good investment practice and it may be that, one day, the hypothetical ‘prudent investor’ will also be an ethical investor.[187] Evidence is growing to suggest that ethical portfolios may be a financially strong alternative to comparable, but less ethical, portfolios,[188] especially over the long term.[189]

### 12.11.3 The Trustee Act 2000

The Trustee Act 2000 represented an opportunity for legislative change, but the statute makes no express reference to ethical investment. The Act does, however, require trustees to consider the ‘suitability’ of investments when exercising their investment powers and the explanatory notes accompanying the Act confirm that suitability ‘*will … include any relevant ethical considerations as to the kind of investments which*
p. 436 ↵ *it is appropriate for the trust to make*’.[190] It remains to be seen what weight the courts will attach to that note. They will probably conclude that ‘relevant ethical considerations’ should be identified in the same limited way after the Act as before, but, at the very least, trustees should now be required to show that they have considered the possible relevance of ethical considerations—even if they conclude that there is none. Such an approach is already required in the case of pension trusts.[191] One survey shows that 21 of the 25 largest pension funds intend to implement a policy of socially responsible investing. These include the three largest funds: British Telecom plc, the Universities Superannuation Scheme … and British Coal![192]

### 12.11.4 Ethical investment policies

There are, of course, a number of reasons why the courts will be reluctant to admit ethical considerations as a straight alternative to financial considerations. For one thing, there are the inevitable dilemmas that ethical questions throw up: is it wrong, for example, for a cycling charity to invest in a supermarket that sells petrol? Does it matter that only a small portion of the company’s trade conflicts with the trust’s purposes or the beneficiaries’ views? What if the company invested in is itself ethically sound, but has subsidiaries or associates that are not? What if a company makes its money in ethically dubious ways, but makes a positive social contribution in other ways, as might a chocolate company that exploits producers in developing countries, but sponsors the provision of computers to schools in the UK? The latter example highlights a key distinction between ethical investment policies—the distinction between *excluding* investments which are unethical and *including* those which are ethical. Often, when reference is made to ethical ‘investment’ by trustees, what is really being referred to is ethical ‘disinvestment’. Ethical disinvestment, because it is exclusionary, represents a threat to portfolio diversity. Indeed, some approaches would restrict trustees to a list of investments that are authorized on ethical grounds in much the same way that the Trustee Investments Act 1961 used to restrict trustees to a list of investments authorized on grounds of low risk. The sad fact is that over half of the FTSE 100—the top 100 quoted companies in the UK—could be excluded on commonly used ethical measures.[193] This problem was
p. 437 recognized in *Harries v. Church Commissioners*,[194] where ↵ the Church Commissioners’ existing investment policy already excluded investment in 13 per cent (by value) of listed UK companies, and the Bishop of Oxford proposed further ethical exclusions that would have brought the total level of exclusion to 37 per cent of the total market.

However, is the threat to portfolio diversity overstated? Certainly, an exclusionary approach to ethical investment will render it almost impossible to participate in a full market-tracking strategy, unless the market chosen is a specialist ethical investments market,[195] but, short of that, it is surprising how few investments are required to create a reasonably diverse portfolio. As Sir Donald Nicholls VC observed:

> It is not easy to think of an instance where in practice the exclusion … 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 investments from which to choose a properly diversified portfolio.[196]

The greater danger posed by an exclusionary approach to ethical investment may be that it tends to exclude larger companies, because the scale of their enterprise makes some unethical activity virtually inevitable, and therefore drives trusts to invest in smaller companies for which the risk of company failure may be higher than for larger concerns. There is, nevertheless, a significant financial advantage associated with a negative (that is a 'disinvestment') strategy. It stems from the fact that campaigners are usually far more vociferous in publishing and denouncing unethical activity than in promoting positive ethical activity. Campaigns *against* nuclear armament, animal cruelty, apartheid, and child labour tend to make headlines in ways that campaigns *promoting* wind farms and free-range eggs do not. A consequence of this is that potential donors to trusts will be put off if the trust holds 'tainted' investments.[197] A trust that merely fails to hold ethically positive investments will be less likely to lose donors. Of course, one alternative to disinvestment in a dubious company is to take advantage of the opportunities for corporate governance that accompany a shareholding in the company.[198] One such opportunity might be to prevent company directors from awarding themselves so-called 'fat cat' salaries.[199]

## 12.11.5 Possibilities for reform of the law on ethical investment

Unanimity between beneficiaries on ethical issues will sometimes be hard to establish, even amongst persons who share the same fundamental beliefs. As Sir Donald Nicholls VC observed in *Harries v. Church Commissioners*: '*different minds within the Church of England, applying the highest moral standards, will reach*
p. 438 *different* ↵ *conclusions*' as to the merits of a particular investment.[200] Accordingly, in that case, the Commissioners were vindicated in their decision not to prefer one ethical view over another '*beyond the point at which they would incur a risk of significant financial detriment*'.[201] An argument in favour of unanimity is administrative simplicity. Another is that simple wealth maximization does not impinge upon beneficiaries' freedom to spend their wealth as they please, whereas an ethical investment policy might impinge upon beneficiaries' wealth for the sake of ethical views to which they do not subscribe. The converse of the latter argument is that people are increasingly concerned that their wealth should be acquired in ways of which they approve, and not merely spent in ways of which they approve. As for the administrative simplicity of unanimity-based ethical investment: this need not to be sacrificed completely if, instead of insisting on unanimity, it were possible to identify those issues about which a majority, say three-quarters (by value), of the beneficiaries feel strongly. It could also be made a statutory requirement of trustee investment that the trustees consult the beneficiaries and consider their views.[202]

## 12.12 Conclusion

The law relating to the investment powers of trustees has come a long way since *Anker-Petersen v. Anker-Petersen* was reported.[203] In that case, the trustees sought a variation of their investment powers to allow them to invest in assets of any kind as if they were beneficial owners, to delegate to investment managers, to hold investments through nominees, and to borrow money for any purpose. In retrospect, those requests read like a reform agenda, because every one of the powers requested then is available today as a matter of course to the vast majority of trustees as a result of the Trustee Act 2000. The exercise of their enlarged powers is, of course, subject to the usual trustee duties and, in particular, to the duty to exercise a positive discretion in good faith. The investment discretion must be exercised prudently and fairly, and, above all, in a manner that is appropriate to the particular trust. At least that is the position in theory. In practice, however, the vagaries of the investment environment make it very difficult for disappointed beneficiaries to prove that their trustees have breached their investment duties and caused the fund to suffer a quantifiable loss.

If there is a silver lining to that dark cloud, it is that trust funds will participate more freely in the economy, the fewer the practical constraints on trustees. Trustees may even p. 439 ↵ have the practical freedom to invest in socially responsible ways that would not be possible if the strict letter of the law were obeyed. In fact, it is so difficult to prove liability for improper investment that trustees might sometimes 'get away with' actually preferring ethical to financial ends.[204]

Test your understanding of this chapter with essay questions and problem scenarios *<https://iws.oupsupport.com/ebook/access/content/watt-trustsequity10e-student-resources/watt-trustsequity10e-chapter-12-essay-questions-and-problem-scenarios?options=showName>* and accompanying answer guidance *<https://iws.oupsupport.com/ebook/access/content/watt-trustsequity10e-student-resources/watt-trustsequity10e-chapter-12-guide-answers-to-the-essay-questions-and-problem-scenarios?options=showName>*. Further improve your approach by reading general guidance on answering essay questions and problem scenarios *<https://iws.oupsupport.com/ebook/access/content/watt-trustsequity10e-student-resources/watt-trustsequity10e-general-guidance-on-answering-essay-questions-problem-scenarios?options=showName>*.

Use the flashcard glossary *<https://iws.oupsupport.com/ebook/access/content/watt-trustsequity10e-student-resources/watt-trustsequity10e-flashcard-glossary?options=showName>* to help consolidate your knowledge of key terms.

## 12.13 Further reading

In addition to the following print sources, expand your learning with web links *<https://iws.oupsupport.com/ebook/access/content/watt-trustsequity10e-student-resources/watt-trustsequity10e-chapter-12-web-links?options=showName>* to further reading on this topic.

AMERICAN LAW INSTITUTE, *Restatement of the Law of Trusts (3rd edn): The Prudent Investor Rule* (St Paul, Minn: American Law Publishers, 1992).

BRITISH COLUMBIA LAW INSTITUTE, *Total Return Investing by Trustees*, Rep. No. 16 (August 2001).

CLARE, A. and WAGSTAFF, C., *The Trustee Guide to Investment* (London: Palgrave Macmillan, 2011).

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DOCKING, P. and PITTAWAY, I., 'Social investment by English pension funds: can it be done?' (1990) Trust Law and Practice 25.

FORD, E., 'Trustee investment and modern portfolio theory' (1996) 10(4) TLI 102.

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LONGSTRETH, B., *Modern Investment Management and the Prudent Man Rule* (New York, Oxford: Oxford University Press, 1986).

LORD NICHOLLS OF BIRKENHEAD, 'Trustees and their broader community: where duty, morality and ethics converge' (1995) 9(3) TLI 71.

MCCORMACK, G., 'Liability of trustees for negligent investment decisions' (1997) 13(2) Professional Negligence 45.

MCCORMACK, G., 'Sexy but not sleazy: trustee investments and ethical considerations' (1998) 19(2) The Company Lawyer 39.

MCCORMACK, G., 'OEICS and trusts: the changing face of English investment law' (2000) 21(1) The Company Lawyer 2.

RICHARDSON, B. J., *Socially Responsible Investment Law: Regulating the Unseen Polluters* (New York, Oxford: Oxford University Press, 2008).

## Notes

[1] Quoted in *The Business*, June 2002.

[2] *Compact Oxford English Dictionary*, 2nd edn (1993) at 874.

[3] 44 MLR 610 at 610. See, also, F. H. Lawson and B. Rudden, *The Law of Property*, 2nd edn (Oxford: Clarendon Press, 1982) at 55.

[4] A fitting conclusion, given that 'invest' derives from the Latin 'to clothe'.

[5] *Christie v. Ovington* (1875) LR 1 Ch D 279, *per* Hall VC at 281, but contrast Jessel MR, who was of the view that trusteeship necessarily connotes positive duties and discretion (*Morgan v. Swansea Urban Sanitary Authority* (1878) LR 9 Ch D 582 at 584).

[6] Lord Nicholls of Birkenhead, 'Trustees and their broader community: where duty, morality and ethics converge' (1995) 9(3) TLI 71 at 76.

[7] *Harries v. Church Commissioners* [1992] 1 WLR 1241.

[8] *Harries* ibid, followed in *Butler-Sloss v. Charity Commission For England and Wales* [2022] EWHC 974 (Ch) (where it was held that trustees of charities concerned to counter climate change were not strictly bound to deselect investments that might conflict with environmental best practice).

[9] *Cowan v. Scargill* [1985] Ch 270, *per* Megarry VC at 287.

[10] Trustee Act 2000, s. 8.

[11] *Re Peczenik's Settlement* [1964] 1 WLR 720 Ch D, *per* Buckley J at 723.

[12] J. Stephens, 'Designing an investment portfolio for trustees' (1994) 1 Trusts & Trustees 12.

[13] [1993] 1 WLR 1260, CA.

[14] Ibid. at 1284G.

[15] The same question was left unanswered in *Re Whiteley* (1886) LR 33 Ch D 347, in which Cotton LJ held (at 350) that trustees are '*bound to preserve the money for those entitled to the* corpus *in remainder, and they are bound to invest it in such a way as will produce a reasonable income for those enjoying the income for the present*' (confirmed on appeal in *Re Whiteley* (1887) LR 12 App Cas 727).

[16] See later.

[17] *Nestle v. National Westminster Bank plc* [1988] (1996) 10(4) TLI 112 at 115.

[18] It is respectfully submitted that Lightman J was wrong to suggest in *Don King Productions Inc v. Warren* [1998] 2 All ER 608 at 634a that '*the first duty of a trustee is to preserve the trust property*'. The first duty of the trustee is to pursue a prudent course *with a view* to preservation of the trust property. In the uncertain world of investment performance there can be no duty to succeed.

[19] Trustee Act 2000, s. 6(1)(b). If the trust instrument was made before 3 August 1961, see later.

[20] *Re Harari's Settlement Trusts* [1949] 1 All ER 430.

[21] Pensions Act 1995, s. 34.

[22] Such as occupational pension trusts (Trustee Act 2000, s. 36(3)), authorized unit trusts, and certain schemes under the Charities Act 1993.

[23] Trustee Act 2000, Part II, s. 3(1). The new, wider default power is referred to in the Act as the '*general power of investment*'.

[24] Section 7(6).

[25] Section 7(5).

[26] Explanatory notes to the Trustee Act 2000 (note 20).

[27] Defined later.

[28] Part IV of the first Schedule to the 1961 Act. Furthermore, according to the Trustee Investments Act 1961, s. 2, trustees were permitted to devote a maximum of 50 per cent of the fund to such investments (although the greater profitability of shares, along with other factors, tended over time to increase the proportion actually held). Not until

1996 was the 50:50 rule modified for private companies to allow three-quarters of the fund to be devoted to investment in shares in quoted companies (SI 1996, No. 845). Under the Trustee Act 2000, there is no requirement that any part be held in so-called ‘safe’ investments.

[29] *Re Kolb’s WT* [1962] 1 Ch 531; *Mason v. Farbrother* [1983] 2 All ER 1078; *Trustees of the British Museum v. AG* [1984] 1 All ER 337.

[30] See later.

[31] As occurred in *Nestle v. National Westminster Bank plc* [1988] (1996) 10(4) TLI 112.

[32] See *Re Johnson* (1880) LR 15 Ch D 548 at 552 and *Re Frith* [1902] 1 Ch 342 at 345–6. Two papers critical of this fact appeared in April 1997: *Rights of Creditors Against Trustees and Trust Funds: A Consultation Paper* (the Trust Law Committee), and *Financial Dealings with Trustees* (the Financial Law Panel).

[33] E. Ford, ‘Trustee investment and modern portfolio theory’ (1996) 10(4) TLI 102–4 at 102.

[34] B. Longstreth, *Modern Investment Management and the Prudent Man Rule* (New York, Oxford: Oxford University Press, 1986) at 133.

[35] Ibid.

[36] Under a futures contract, a price is agreed for the sale of an asset, but the payment of the price and the delivery of the asset are postponed until a future date. Whereas an option is exercisable by only one of the parties, a future can be enforced by either of the parties.

[37] B. Longstreth, *Modern Investment Management and the Prudent Man Rule* (New York, Oxford: Oxford University Press, 1986) at 4.

[38] The American Law Institute, *Restatement of the Law of Trusts (3rd edn)*: *The Prudent Investor Rule*, adopted 18 May 1990 (St. Paul: American Law Publishers, 1992). B. Longstreth (author of *Modern Investment Management and the Prudent Man Rule*) was one of the advisers to the American Law Institute in relation to the prudent investor rule.

[39] *Investment Powers of Trustees: A Consultation Document*, May 1996.

[40] Law Commission Report No. 260: *Trustees’ Powers and Duties* (1999). The Scottish counterpart was Report No. 172.

[41] Gilts can now be traded electronically. The Central Gilts Office runs a system of dematerialized gilts. See Gilt-edged Securities (CGO Service) Regulations 1985 (SI 1985, No. 1144) and J. Benjamin, *The Law of Global Custody* (London: Butterworths, 1996) ch. 11 at 148, 151, 160.

[42] That is, below nominal face value.

[43] Although the annual average increase in underlying inflation for 2000 was, at 2.1 per cent, the lowest since 1976 (T. Edmonds, *Economic Indicators*, Research Paper 01/13, 1 February 2001 (Economic Policy and Statistics Section, House of Commons Library) at 10).

[44] R. Twigger, *Inflation: The Value of the Pound 1750–1998*, Research paper 99/20, 23 February 1999 (Economic Policy and Statistics Section, House of Commons Library).

[45] Ibid. at 3. See, also, O. Newman and A. Foster, *The Value of the Pound*, Office of National Statistics (1995).

[46] Financial Times Stock Exchange.

[47] HM Treasury Consultation Document, *Investment Powers of Trustees*, May 1996 at 6, n. 5 (quoting Phillips & Drew Fund Management Ltd).

[48] The CREST system for electronic transfer on the London and Dublin Stock Exchanges came into operation on 15 July 1996. See C. Marquand, 'CREST and the shareholder' (1996) 140 SJ 668; 'CREST goes active' (1996) 9 CM 15. Trustees may wish to continue to hold shares in certified (i.e. documentary) form, but they are permitted by the Uncertificated Securities Regulations 1995 (SI 1995, No. 3272) to hold their shares in uncertified (i.e. electronic) form by becoming sponsored members of CREST—unless the particular trust instrument provides otherwise. (See Law Commission Report No. 260 *Trustees' Powers and Duties* (1999) at para. [2.30].) Brokerage fees are generally cheaper for uncertified share dealing than for certified dealing. CREST is a loose acronym for Computerized or Electronic Share Transfer.

[49] [1980] Ch 515.

[50] Trusts of Land and Appointment of Trustees Act 1996, s. 6(1) and (2).

[51] Section 6(3) (acquisition is effected under the power conferred by the Trustee Act 2000, s. 8, see later).

[52] Trusts of Land and Appointments of Trustees Act 1996, s. 6(5).

[53] Ibid. s. 6(9).

[54] Provided that the purposes of the trust include making the land available for occupation by beneficiaries, or the land is held by the trustees so as to be so available (ibid. s. 12).

[55] Trustee Act 2000, s. 3.

[56] Section 3(3).

[57] Section 8(1).

[58] Trusts of Land and Appointments of Trustees Act 1996.

[59] Trustee Act 2000, s. 8.

[60] Section 10(1).

[61] Section 9.

[62] Note 22.

[63] There is no requirement that the mortgage be legal.

[64] Section 6(1).

[65] See G. Lightman QC, 'Sales at valuation by fiduciaries' [1985] Conv 44.

[66] In *Fry v. Tapson* (1884) LR 28 Ch D 268 Kay J said: '*I am most reluctant to visit trustees acting* bona fide *with the consequences of a want of due caution, but … they most incautiously employed the mortgagor's agent … although he was a London surveyor, and it was most important to obtain the opinion of some experienced local surveyor*' (at 282).

[67] *Palmer v. Emerson* [1911] 1 Ch 758.

[68] Trustee Act 1925, s. 8.

[69] Ibid. s. 9.

[70] HM Treasury Consultation Document, *Investment Powers of Trustees*, May 1996 at 12, n. 25.

[71] Section 3(3).

[72] Section 3(4).

[73] *Khoo Tek Keon v. Chen Joo Tuan Neoh* [1934] AC 529, *per* Lord Russell of Killowen at 536. In *Re Peczenik's Settlement* [1964] 1 WLR 720, Buckley J also cast doubt upon investments '*merely upon personal security*' (at 723). In that case, a clause that authorized the trustees to invest '*in any shares stocks property or property holding company as the trustees in their discretion shall consider to be in the best interests of* [the beneficiary]' was held not to authorize personal loans.

[74] The trust instrument in *Re Laing's Settlement* [1899] 1 Ch 593 authorized investment '*upon such personal credit without security as the trustees … think fit*'.

[75] Trustee Act 2000, s. 3.

[76] See *Nestle v. National Westminster Bank plc* [1988] (1996) 10(4) TLI 112, *per* Hoffmann J at 115.

[77] The engagement into which institutional trustees enter '*is not one of insurance. They do not guarantee results*,' *per* Hoffmann J in the High Court in *Nestle*, ibid. This statement, taken from the original transcript of the conclusion to his Lordship's judgment does not appear in the report of the case (ibid.). A similar statement was made by Bacon VC in *Re Godfrey* (1883) LR 23 Ch D 483 at 493.

[78] *Harvard College v. Amory*, 26 Mass (9 Pick) 446 (1830), *per* Putman J at 461.

[79] *Balls v. Strutt* (1841) 1 Hare 146, *per* Sir James Wigram VC at 149.

[80] '*Trustees may … have to act dishonourably (though not illegally) if the interests of their beneficiaries require it*' (*Cowan v. Scargill* [1985] 1 Ch 270, *per* Megarry VC at 287–8, citing *Buttle v. Saunders* [1950] 2 All ER 193, *per* Wynn-Parry J at 195).

[81] *Re Wyvern Developments Ltd* [1974] 1 WLR 1097, *per* Templeman J at 1106.

[82] *Cowan v. Scargill* [1985] 1 Ch 270, *per* Megarry VC at 288A.

[83] *R. v. Lewisham LBC, Ex p Shell UK Ltd* [1988] 1 All ER 938, *per* Neill LJ: '*The wish to change the Shell policy towards South Africa was inextricably mixed up with any wish to improve race relations in the borough and this extraneous and impermissible purpose has the effect of vitiating the decision as a whole.*'

[84] See *Orr-Ewing v. Orr-Ewing* (1884) 11 R 600 at 627; *Gisborne v. Gisborne* (1877) LR 2 App Cas 300.

[85] *Wight v. Olswang* [2001] Lloyd's Rep PN 269.

[86] The *Oxford English Dictionary* defines prudence as the '*ability to discern the most suitable, politic, or profitable course of action, especially as regards conduct, practical wisdom, discretion*'.

[87] See B. Longstreth, *Modern Investment Management and the Prudent Man Rule* (New York, Oxford: Oxford University Press, 1986), esp ch. 4, 'A modern paradigm of prudence', at 111.

[88] Ibid. Nor is it '*inherently negligent for a trustee to retain stock in a period of declining market values' (Jones v. AMP Perpetual Trustee Company NZ Ltd* [1994] 1 NZLR 690 at 706–7).

[89] *Harvard College v. Amory* (1830) 26 Mass (9 Pick) 446, *per* Putman J at 461.

[90] Or in a hole in the ground: see the New Testament 'parable of the talents', in which the faithful servants applied their master's money profitably, whereas the unfaithful servant 'dug a hole and hid his master's money' and boasted that it was safe (Matt. 25: 14–30, *New Testament*, New International Version).

[91] Leaving the European Exchange Rate Mechanism in 1992 produced a dramatic devaluation in the pound.

[92] The gold standard was finally abandoned in 1927.

[93] *Per* Hoffmann J in *Nestle v. National Westminster Bank plc* [1988] (1996) 10(4) TLI 112.

[94] *Re Speight* (1883) LR 22 Ch D 727.

[95] HM Treasury consultation document, *Investment Powers of Trustees*, May 1996, para. 30: '*The duty to act prudently may be breached if the trustees are insufficiently cautious, but also if they are too cautious*.' See, also, *Melville v. Noble's Trustees* (1896) 24 R 243.

[96] *Re Whiteley* (1886) LR 33 Ch D 347 at 355, *per* Lindley LJ. Approved in *Nestle v. National Westminster Bank* [1993] 1 WLR 1260, *per* Dillon LJ at 1267H. See, also, on the moral provision aspect: *King v. Talbot*, 40 NY 76 (1869).

[97] See, also, *Harvard College v. Amory* 26 Mass (9 Pick) 446 (1830) at 461: the trustee should '*conduct himself faithfully and exercise a sound discretion*'.

[98] Endorsed by another of their Lordships in the same case: '*Trustees are bound to preserve the money for those entitled to the* corpus *in remainder, and they are bound to invest it in such a way as will produce a reasonable income for those enjoying the income for the present*', *per* Cotton LJ (*Re Whiteley* (1886) LR 33 Ch D 347 at 350).

[99] S Gardner, *An Introduction to The Law of Trusts* (Oxford: Clarendon Press, 1990) at 125–6.

[100] During the period 1999–2009, when stock markets generally fell, gold more or less tripled in value. Economic studies indicate that gold is effective as a hedge against stock market risk in the long term. R. Aggarwal, 'Gold Markets' in *The New Palgrave Dictionary of Money and Finance* (P. Newman, M. Milgate, and J. Eatwell, eds) (Basingstoke: Macmillan, 1992) vol. 2, 257; D. Ghosh, E.J. Levin, P. MacMillan, and R.E. Wright, 'Gold as an inflation hedge?' (2004) 22 Studies in Economics and Finance 1.

[101] This is the title to ch. 4 of Longstreth, *Modern Investment Management and the Prudent Man Rule* (New York, Oxford: Oxford University Press, 1986). See, also, J. H. Langbein and R. Posner, 'Market funds and trust: investment law' (1976) 1 American Bar Foundation Res J, 3; Friedman, 'The dynastic trust' (1964) 73 Yale LJ 547, 553; M. A. Shattuck, 'The development of the prudent man rule for fiduciary investment in the United States in the twentieth century' (1951) 12 Ohio St LJ 491, 492; S. Lofthouse, *Equity Investment Management*, 1st edn, at 9; J. H. Langbein, 'The Uniform Prudent Investor Act and the future of trust investing' (1996) 81 Iowa LR 641; J. R. Hicks, *Value and Capital* (Oxford: Clarendon Press, 1938) at 177.

[102] The so-called 'Big Bang' brought about by the Financial Services Act 1986. See S. Gardner, *An Introduction to The Law of Trusts* (Oxford: Clarendon Press, 1990) at 122.

[103] Longstreth, *Modern Investment Management and the Prudent Man Rule* (New York, Oxford: Oxford University Press, 1986). See, especially, ch. 4: 'A modern paradigm of prudence'.

[104] *Nestle v. National Westminster Bank plc* [1988] (1996) 10(4) TLI 112 at 115.

[105] HM Treasury Consultation Document, *Investment Powers of Trustees*, May 1996 at paras [40](iii) and [35](ii).

[106] See later.

[107] Note 25.

[108] H. Markowitz, 'Portfolio Selection' (1952) 7(1) The Journal of Finance 77–91.

[109] A. Clare and C. Wagstaff, *The Trustee Guide to Investment* (London: Palgrave Macmillan, 2011) 177.

[110] K. Redhead, *Introduction to Financial Investment* (Harlow: Prentice Hall/Woodhead-Faulkner, 1995) at 7.

[111] J. A. Franks and C. Mayer, *Risk, Regulation, and Investor Protection* (Oxford: Clarendon Press, 1989) ch. 6 at 151, part C, para. 2.15.

[112] See Chapter 11.

[113] See ibid.

[114] See later.

[115] '*The most ardent practitioners of modern portfolio theory, when they invest in the share market, construct a portfolio which exactly replicates it*': W. A. Lee, 'Modern portfolio theory and the investment of pension funds', ch. 10 in *Equity and Commercial Relationships* (P. Finn, ed.) (North Ryde, NSW: The Law Book Co, 1987) 284 at 298. See, also, Butler (1995) 16 NZULR 349.

[116] One alternative is the use of common investment funds (CIFs). These allow trusts (typically charitable trusts) to pool their funds for investment purposes. However, one disadvantage of CIFs (as with unit trusts) is that investors may not entirely appreciate the nature of their shareholdings (see D. Morris, 'Charity investment in the UK' (1995) 3 Web JCL1.). Charities may also use common deposit funds (CDFs) to pool cash on deposit in order to obtain higher returns of interest.

[117] Witness the disaster that befell the trust fund in *Wight v. Olswang* [2001] Lloyd's Rep PN 269.

[118] In 'Time for change: charity investment and modern portfolio theory' (1995) 3(2) CL&PR, Harvey P. Dale and Michael Gwinell suggest that the choice of asset type is estimated to account for 80–90 per cent of portfolio performance, but only 10–20 per cent reflects choice between investments of that type.

[119] Lord Nicholls of Birkenhead, 'Trustees and their broader community: where duty, morality and ethics converge' (1995) 9(3) TLI 71.

[120] *Bartlett v. Barclays Bank Trust Co (No. 1)* [1980] Ch 515, *per* Brightman J at 531G.

[121] The capital asset pricing model is based on this 'efficient market hypothesis'.

[122] John Thornton (of Friends Provident): a paper delivered to the NAPF Euro-Pensions Conference 1996. (The author is grateful to the Institute of Actuaries for providing a copy.)

[123] Of course, the advice given was originally aimed at entrepreneurs, rather than trustees.

[124] *Dimes v. Scott* (1828) 4 Russ 195.

[125] *Bartlett v. Barclays Trust (No. 1)* [1980] Ch 515, *per* Brightman J.

[126] See E. M. David, 'Principal and income: obsolete concepts' (1972) 43 PA Bar Assoc Q at 247.

[127] By keeping the capital (the means of income production) in private hands, the trust, especially the traditional settlement trust, demonstrates its capitalist credentials (see Karl Marx, *Das Kapital*, for a wider conception of capital as the 'means of production').

[128] Trustee Act 2000, s. 3.

[129] Judges had begun to relax the rule even prior to the Act: '*prima facie the purposes of the trust will be best served by the trustees seeking to obtain therefrom the maximum return, whether by way of income or capital growth, which is consistent with commercial prudence*', *per* Sir Donald Nicholls VC in *Harries v. Church Commissioners* [1992] 1 WLR 1241 at 1246. See, also, Megarry VC in *Cowan v. Scargill* [1985] Ch 270 at 287. The decisions of the Charity Commissioners Vol. 3, No. 4, Dec. 1995 confirmed that capital growth is a form of investment return acceptable to a charity.

[130] Trustee Act 2000, s. 4(1). This section is essentially a re-enactment of the Trustee Investments Act 1961, s. 6(1).

[131] Section 4(3)(a).

[132] Section 4(3)(b). The same words, which appeared in s. 6(1) of the 1961 Act, were held to include circumstances such as the size of the trust fund. As Megarry VC stated in *Cowan v. Scargill* [1985] Ch 270, '*the degree of diversification that is practicable and desirable for a large fund may plainly be impracticable or undesirable (or both) in the case of a small fund*' at 289E–F. Another relevant circumstance is the presence of beneficiaries with competing interests in the fund (see 'The duty to invest fairly', later).

[133] Section 4(2). The duty to conduct periodic reviews was recognized before the 2000 Act: *Nestle v. National Westminster Bank plc (No. 2)* [1993] 1 WLR 1260, *per* Leggatt LJ at 1282G.

[134] These factors are listed in note 23 of the explanatory notes accompanying the Act.

[135] Trustee Act 2000, s. 5(1) and (2).

[136] J. H. Langbein, 'Reversing the non-delegation rule of trust-investment law' (1994) 59 MLR 105, 110.

[137] Trustee Act 2000, s. 5(4).

[138] Explanatory notes accompanying the 2000 Act (note 28).

[139] Section 12(1).

[140] Section 5(4).

[141] Explanatory notes accompanying the Act (note 26).

[142] (1991) 16 LS Gaz 32, Ch D.

[143] *Re Tempest* (1866) LR 1 Ch App 485, CA, *per* Sir G. J. Turner LJ at 487.

[144] Hoffmann J disagreed with the view of Sir Robert Megarry VC in *Cowan v. Scargill* [1985] 1 Ch 270 at 286–8, that the trustees' duty is to hold '*the scales impartially between different classes of beneficiaries*'. He disagreed partly because it suggests equality, but partly because '*the image of the scales suggests a weighing of known quantities whereas investment decisions are concerned with predictions of the future … but there is always a greater or lesser risk that the outcome will deviate from those expectations. A judgment on the fairness of the choices made by the trustees must have regard to these imponderables*' (*Nestle v. National Westminster Bank plc* [1988] (1996) 10(4) TLI 112 at 115).

[145] *McPhail v. Doulton* [1971] AC 424, HL, *per* Lord Wilberforce at 451.

[146] *Nestle v. National Westminster Bank plc* [1988] (1996) 10(4) TLI 112. See D. Hayton, 32 Vand J Transnational 555 at 561: '*This duty to act fairly confers a wide discretion upon trustees enabling them to act partially but honestly*.'

[147] Trustee Act 2000, s. 3.

[148] See *Re Hope* [1899] 2 Ch 679.

[149] See Chapter 9.

[150] Note 23.

[151] See the section on the 'duty to invest fairly'.

[152] Proof that the statutory 'standard investment criteria' of 'suitability' and 'diversity' were not adhered to is prima facie evidence of a breach of trust, and can be pleaded in addition to a plea based on the common law duties of prudence and fairness.

[153] [1993] 1 WLR 1260, CA.

[154] J. Dukeminier and J. E. Krier, 'The rise of the perpetual trust' (2003) 50 UCLA L 1303, 1335.

[155] Ibid. *per* Dillon LJ at 1265E–F.

[156] Ibid. at 1284G–H.

[157] G. McCormack, 'Liability of trustees for negligent investment decisions' (1997) 13(2) Professional Negligence at 45; G. Watt and M. Stauch, 'Is there liability for imprudent trustee investment?' (1998) 62 Conv 352.

[158] G. McCormack, 'Liability of trustees for negligent investment decisions' (1997) 13(2) Professional Negligence at 50.

[159] [1993] 1 WLR 1260, CA.

[160] See the quotation from the judgment of Leggatt LJ.

[161] [1993] 1 WLR 1260, CA, *per* Leggatt LJ at 1283B.

[162] *Daniel v. Tee* [2016] EWHC 1538 (Ch).

[163] Ibid. On relief from breach of trust see Chapter 13.

[164] See *Jeffrey v. Gretton and Russell* [2011] WTLR 809 (Ch D), which the judge described as '*fortunate for the trustees, but … fortuitous. This is not a case of a judicious breach of trust; it is a case of a thoughtless breach of trust that happens to have turned out well*' (para. [84]).

[165] [1980] Ch 515.

[166] Ibid. at 531H. Trustees '*do make mistakes from time to time*' (Lord Nicholls of Birkenhead, 'Trustees and their broader community: where duty, morality and ethics converge' (1995) 9(3) TLI 71 at 73).

[167] *Overend, Gurney & Co v. Gurney* (1868–69) LR 4 Ch App 701 at 720.

[168] *Hamilton v. Nielsen*, 678 F.2d 709 (1982), *per* Circuit Judge Posner at 713.

[169] *Nestle v. National Westminster Bank* [1993] 1 WLR 1260 at 1283*C.*

[170] *Re Massingberd's Settlement Trusts* (1890) 63 LT 296. See *Shepherd v. Mouls* (1845) 4 Hare 500.

[171] *Shepherd v. Mouls* (1845) 4 Hare 500 at 504.

[172] [1998] 1 NZLR 481.

[173] The court in *Re Mulligan* distinguished *Nestle* on its facts.

[174] *Nestle v. National Westminster Bank* [1993] 1 WLR 1260 at 1268H.

[175] As Sir Donald Nicholls VC acknowledged in *Harries v. The Church Commissioners for England* [1992] 1 WLR 1241, '*trustees would be entitled, or even required, to take into account non-financial criteria … where the trust deed so provides*'.

[176] [1985] Ch 270. If the trust was a pension fund trust and, as such, was a trust for the provision of financial benefits.

[177] At 288E–G.

[178] The Charity Commission's 2016 publication *Charities and investment matters: a guide for trustees* (CC14) confirms that '*charities may pursue their charitable purposes … through the provision of loans, loan guarantees or the subscription or purchase of shares or through the letting of land and buildings*', collectively known as 'social investments'. Richard Nobles, in 'Charities and Ethical Investment' (1992) 56 Conv 115, makes the point that charity trustees are permitted to *give away* trust property to meet the charitable purposes of the trust, and so logically they should be permitted a wider discretion to *invest* with a view to meeting the charitable purposes. It is not, however, always clear what those purposes are: in *Harries* (earlier) Sir Donald Nicholls held that the trustees of a Church of England organization were not obliged by their Christian ethics to sell trust-owned land at an undervalue in order to assist low-income families when '*the local planning authority has taken a different view*'.

[179] *Sustrans* is one such charity.

[180] s.292A.

[181] Section 292B.

[182] [1985] 1 Ch 270.

[183] Ibid. at 296.

[184] Megarry VC in *Cowan v. Scargill* [1985] 1 Ch 270. '*The assertion that trustees could not be criticised for failing to make a particular investment for social or political reasons is one that I would not accept in its full width. If the investment in fact made is equally beneficial to the beneficiaries, then criticism would be difficult to sustain in practice, whatever the position in theory*' at 297F.

[185] Lord Nicholls of Birkenhead, 'Trustees and their broader community: where duty, morality and ethics converge' (1995) 9(3) TLI 71.

[186] Ibid. at 75. Social conditions do indeed appear to be changing: a survey carried out by the Ethical Investment Research Service (EIRIS) in February 1999 found that 73 per cent of the UK adult population would like to have pension funds run on ethical lines. Perhaps more surprisingly, almost a third of those questioned would have been prepared to accept some reduction in their pension benefits as a result (*The Independent*, 10 March 1999).

[187] See J. H. Langbein and R. Posner, 'Social investing and the law of trusts' [1980] 79 Michigan LR 72. The 1997 Social Investment Forum (SIF) Report on Responsible Investing Trends in the USA found that 10 per cent of all managed funds were managed in some consciously socially responsible way.

[188] The CAPS survey of UK equity pooled funds at 30 June 1996 showed that the largest ethical fund manager (Friends Provident Stewardship) had outperformed the Median UK Equity Fund year on year for the previous ten years. In the same ten-year period, the Median outperformed the market (the FT All Share Index) only once.

[189] '*A good environmental record may be a sign of long-term potential*' (*The Ethical Investor*, EIRIS November/December 1999).

[190] Note 23.

[191] From 3 July 2000, pension scheme trustees must disclose '*the extent to which social, environmental, or ethical considerations are taken into account in the selection, retention and realisation of investments*': the Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc.) Amendment Regulations 1999 (SI 1999, No. 1849). The Regulations do not require trustees to adopt an ethical policy, but they must state that they have no ethical policy if there is none, although no reasons need be given to explain the absence of an ethical policy.

[192] E. Borremans makes reference to the survey, carried out by Environmental Resource Management, in 'New policies, new demands', *Pensions Management*, August 2000.

[193] A FTSE 4 Good Index Series has been implemented, which purports to 'measure the performance of companies that meet globally recognised corporate responsibility standards'.

[194] *Harries v. Church Commissioners for England* [1992] 1 WLR 1241, Ch D.

[195] See earlier.

[196] *Harries v. Church Commissioners for England* [1992] 1 WLR 1241 at 1246H.

[197] Ibid. at 1247A.

[198] *The Merlin Ecology Research Bulletin*, Winter 1989, at 3 (Merlin Jupiter Unit Trust Management).

[199] Lord Nicholls of Birkenhead, 'Trustees and their broader community: where duty, morality and ethics converge' (1995) 9(3) TLI 71 at 76–7.

[200] *Harries v. Church Commissioners* [1992] 1 WLR 1241 at 1251H. See an open letter to the Bishop of Coventry that appeared in *The Independent* on 9 February 1995 outlining contrasting views within the Church of England on the issue of animal welfare. See, also, 'Differing over a religious matter: Church Commissioners' investment in armaments', an article in *The Standard*, 28 June 1985.

[201] *Harries v. Church Commissioners* [1992] 1 WLR 1241 at 1251.

[202] There is a precedent for this in relation to trusts of land (Trusts of Land and Appointment of Trustees Act 1996, s. 11).

[203] (1991) 16 LS Gaz 32, Ch D, Transcript, 6 December 1990.

[204] D. Hayton, *Underhill & Hayton's Law Relating to Trusts and Trustees*, 14th edn (London: Butterworths, 1987) at 530: '*trustees can quietly invest ethically … because the uncertainty in the stock market acts as a shield to liability*'. See, also, P. Docking and I. Pittaway, 'Social investment by English pension funds: can it be done?' (1990) February TL&P at 25.

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