



# Why diversify?

JOCHEN VOGLER EXAMINES TRUSTEES' DUTY TO DIVERSIFY TRUST ASSETS

**T**he investment industry is increasingly global, yet diversification of trust assets seems to be a constant challenge for trustees.

In the US, the number of diversification-related lawsuits against trustees is on the rise. This is an important trend to consider not only as a US trustee, but also as a non-US trustee with US beneficiaries. The increasing harmonisation of the regulatory framework in the major developed jurisdictions is likely to exacerbate this trend.

Most litigation seeking compensation from trustees concerns concentrated asset holdings, as opposed to general diversification, without specific reference to regions, currencies, investment styles, or even custodial jurisdictions. However, when looking at the legal background of trustees' fiduciary responsibilities, these factors should be considered.

There are two fundamental forces at work when trustees decide on the investment strategy for a trust: the general regulatory requirements around diversification, and the client's wishes. These two issues may not be fully aligned and need to be carefully examined prior to implementing any investment strategy. Often there is a certain 'home bias', favouring or under-allocating some regions, currencies, or custodial jurisdictions without further analysis or reasoning.

According to foundation consultant Graystone, 'asset allocation is a fiduciary's most critical investment decision',<sup>1</sup> and embracing all possible levels of diversification appears prudent.

## THE REGULATORY BACKGROUND

One of the earliest definitions of fiduciary duties dates back to an 1830 Massachusetts court decision and its 'prudent man rule'.<sup>2</sup> Today, the applicable legislation in the US is the *Uniform Prudent Investor Act*. This Act was established in 1992 by the American Law Institute and by 2004 was adopted by 44 US states and the District of Columbia, with additional partial adoption

by further US states. Other states have adopted the similar *Uniform Trust Code* (UTC) and the *Uniform Principal and Income Act* (UPIA). English and Welsh trust law appears to adopt a similar interpretation of the fiduciary duties of trustees in general and the duty to diversify specifically.

The key advances from the early stages of fiduciary duty definitions reflect a 'modern portfolio theory' and 'total return approach':

- The entirety of a trust portfolio's assets, rather than individual investments, are to be considered when determining trustee liability for losses.
- Diversification is explicitly required.
- No investment categories or types are deemed inherently imprudent, but

suitability for the purposes and needs of the trust and its beneficiaries is the main factor.

- Delegation of investment management and other functions to third parties is permitted, assuming adequate supervision by the trustee (UTC §807).

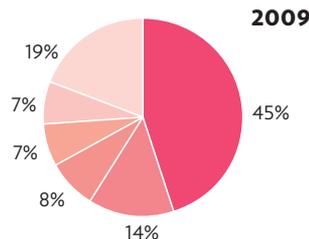
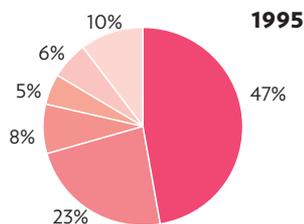
The UPIA then lists the main factors a trustee should consider (which support the argument for embracing all levels of diversification):

- the general economic conditions;
- the inflation or deflation effect;
- the tax consequences of investment decisions;
- the purpose or role of each asset within the trust portfolio;
- the expected total return;
- the other resources of the beneficiary or beneficiaries;
- liquidity needs versus preservation or appreciation of capital; and
- the specific relationship of the beneficiary, beneficiaries or settlor to assets.

## ASSETS OF INSTITUTIONAL INVESTORS BY COUNTRY (IN PER CENT OF TOTAL ASSETS UNDER MANAGEMENT)

### TOP FIVE COUNTRIES

- UNITED STATES
- JAPAN
- UNITED KINGDOM
- FRANCE
- GERMANY
- OTHER



Sources: OECD, and IMF staff estimates  
Notes: data based on the assets under management by institutional investors in 17 OECD countries. Percentages may not add up to 100, due to rounding

## APPLICABILITY TODAY: WHY DOES IT MATTER?

First, all trustees have a duty of diversification in all trust situations and, therefore, one can argue that considering all levels of portfolio diversification (including asset classes, currencies, regions, jurisdictions, and investment styles) is important. This was nicely put in a recent lecture: 'diversification... is designed to limit uncompensated risk... [the] concept is generally applied to concentrations of public stock where →'

- 1 Norman Nabhan, 'Delicate balance', Graystone Consulting, Morgan Stanley (2012)
- 2 *Harvard College v Armory*, 26 Mass (9 Pick) 446 (1830)
- 3 David Baker, Lauren Papenhausen, Carlyn McCaffrey, Michael Kendall, Peggy Quinn, 'Current Issues in Trust and Fiduciary Litigation', a lecture held at McDermott Will & Emery, June 2013. See also *In Re Estate of Scharlach*, 809 A.2d 376 (Superior Ct of Pennsylvania, 2002)
- 4 *Baldus v Bank of California*, 530 P2d 1350 (Washington Ct App, 1975)



nobody pays you any more because you own a lot'.<sup>3</sup> However, it was also argued that 'particular investment allocations are not a basis for liability, regardless of the portfolio value impact, as long as the selection process and parameters are prudently decided and managed'.

Second, trustees have a duty of loyalty to the grantor and beneficiaries, and there are many trusts with grantor wishes and restrictions seemingly limiting or completely eliminating the trustee's duty to diversify. Long-established trust structures may contain some clauses containing the wishes of the original settlor with regard to pre-existing trust assets, often closely held stock of family businesses or accumulated stocks of the lifelong company the grantor worked for. In *Baldus v Bank of California*,<sup>4</sup> the court highlighted three factors to determine whether the trust instrument negated the duty of diversification:

- Is there a direction, recommendation, or just authorisation of non-diversified investments' retention by the settlor?
- Is the retention authorisation for general or specific trust assets?
- What is the character and purpose of the trust and its property?

Depending on how the settlor's wishes and requirements are phrased, a trustee may either be bound by them, or even forced to ignore them under the duty to diversify. Different phrasing of clauses leads to different outcomes in court – some for and some against the trustee.<sup>5</sup> So, if a client has special wishes regarding concentrated positions, they need to be carefully drafted in the trust instrument to minimise or avoid litigation risk for the trustee. There are vast amounts of proven and tested trust language available. Regular review and revalidation is also prudent. Otherwise, great care should be taken by the trustee to implement a diversified portfolio.

**DIVERSIFICATION DOES NOT ALWAYS MEAN HIGHER RETURNS (BUT CERTAINLY LESS LITIGATION RISK)**

It is equally important to understand that diversification is a double-edged sword. Depending on the markets, or the assets in question, a well-diversified portfolio may underperform or overperform a concentrated asset by a significant magnitude.

The notion of diversifying, rather than not, seems to also be applied by courts. They support trustees whose diversified portfolios underperform previously held concentrated asset holdings.<sup>6</sup> Only in hindsight can we know if adding other industry sectors, currencies and regions to a portfolio actually yielded a higher risk-adjusted return.

However, have a look at the regional and currency allocation of private and public institutional investors. For pension

funds and sovereign wealth funds, global diversification is key to their long-term investment success. Trusts often share their investment horizon and certain liquidity needs – would it make sense to apply the same principles?

**CONCLUSION**

Trustees can easily avoid litigation risks against them by: carefully drafting (and revisiting old) trust deeds to ensure watertight clauses regarding concentrated stock positions or similar undiversified trust assets; and implementing a client-specific diversified portfolio in terms of:

- asset classes (the most important diversification measure of all; matched

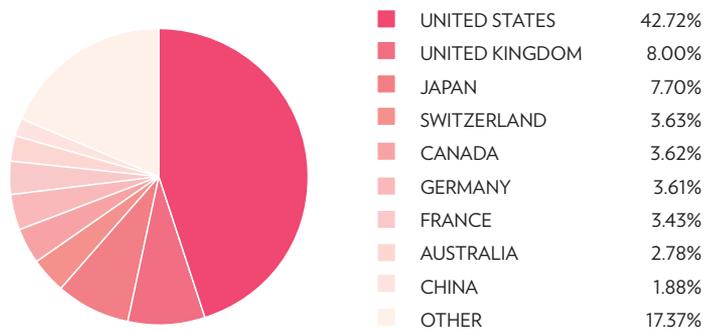
- 5 *Wood v US Bank, NA*, 828 NE2d 1072 (Ohio Ct App, 2005) and *In Re Charles G Dumont*, 791 NYS2d 868 (2004); reviewed in part, 809 NYS2d 360 (App Div 4th Dept, 2006); appeal denied, 813 NYS2d 689 (App Div 4th Dept, 2006); appeal denied, appeal dismissed, 855 NE2d 1167 (2006)
- 6 *In Re Trust Made by Helen M Strong*, 734 NYS2d 668 (NY App Div, 2001) and *In Re Final Accounting of Michael Duffy*, 885 NYS 2d 401, 405 (NY Sur Ct, 2009)

- to the risk and return requirements of each client situation);
  - liquidity/accessibility (liquid versus illiquid assets);
  - currencies (rather than simply the home currency);
  - regions (not just the home region);
  - investment styles (growth versus value, passive versus active, products versus single stocks and bonds);
  - custodian banks (small versus large, local versus global); and
  - jurisdictions (spreading the political risk).
- Today's world is global, transparent and interconnected, and so are clients, their families and their expectations. Diversification is prudent both for clients and fiduciaries, as litigation risk increases proportionally with rising portfolio risk.

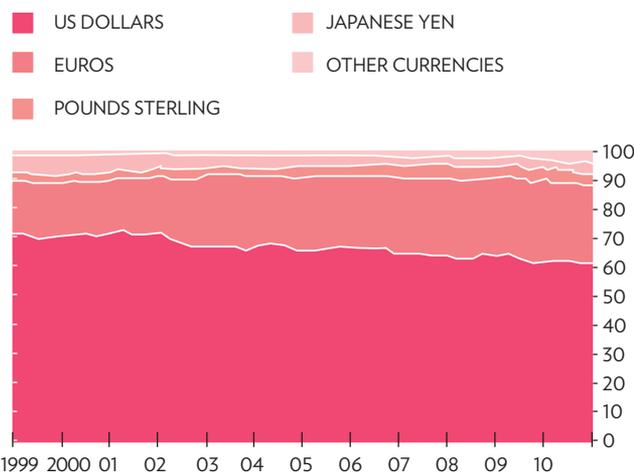


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**COUNTRY ALLOCATION OF ISHARES MSCI ACWI ETF (DEVELOPED AND EMERGING MARKETS) AS OF 21 MARCH 2014**



**CURRENCY COMPOSITION OF OFFICIAL FOREIGN EXCHANGE RESERVE (IN PER CENT)**



Source: IMF, Currency Composition of Official Foreign Exchange Reserves database  
Note: the figure displays allocated reserves only. Over the observation period, unallocated reserves have roughly doubled as a share of total reserves, from 23 per cent in early 1999 to nearly 45 per cent at end-2010