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PRI ACADEMIC NETWORK

# RI QUARTERLY

# FIDUCIARY DUTY

## IN THIS ISSUE



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**The PRI Academic Network**'s goal is to bridge the gap between responsible investment research and practice. We bring academics and practitioners together, showcasing the best academic research to the investment industry, and ensuring that academia is responding to the research needs of investors and producing research that can help create a sustainable financial system.

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**The RI Quarterly** is produced by the PRI Academic Network and aims to be the go-to publication for investment professionals and anyone needing the latest research on responsible investment, but without the time to read through the original papers. Every issue will focus on a number of academic papers around a theme selected by the PRI's Academic Fellow, extracting the essentials of the argument and giving key findings in a clear and concise manner.

**Editor**: Rachel Whittaker, CFA.
Rachel is a sustainable investment specialist with experience in investment research, analysis and communications. Most recently she held positions in Mercer's Responsible Investment team in London, and at Vontobel Asset Management in Zürich.

# INTRODUCTION

BACK

In this second volume of the PRI Academic Network's RI Quarterly we focus on the issue of fiduciary duty. Defining fiduciary duty is straightforward – a legal duty for one party to act in the interests of another party – but interpreting what that means in practice can be highly subjective. From an investment perspective, the interpretation of fiduciary duty has become more difficult over time as the financial markets have become more complex, yet the demand for high standards of fiduciary care has become ever more important as increasing numbers of employees and pension plan beneficiaries are reliant on their trustees to provide for their future financial security.

Implementation of fiduciary duty varies between countries and jurisdictions, but increasingly governments are recognising the need for clarity on investment obligations and risk management as well as issues such as ethics, transparency, and sustainable development. Some are actively examining whether reform is required, such as the UK's Law Commission currently on-going review of the fiduciary duties of investment intermediaries, The PRI seeks to play an active role in supporting these initiatives, since the impact of a well-defined framework for fiduciary duty extends beyond the fulfilment of financial commitments to beneficiaries, to greater confidence and trust in the investment industry and better functioning global financial markets.

The papers summarised within explore the history and future development of the concept of fiduciary duty, from global and country-specific perspectives. The authors examine the evolution of standards of governance in institutional investment and propose new ways of thinking to promote greater emphasis on long-term returns and sustainable financial markets. All of the papers are published in the Cambridge Handbook of Institutional Investment and Fiduciary Duty (due for publication March 2014).

**Helene Winch**
Director of Policy and Research, *PRI*

# THE PUBLIC FIDUCIARY: A CANADIAN PERSPECTIVE

BACK

In this paper Waitzer and Sarro examine the role of pension fund trustees in Canada, and how the Supreme Court of Canada has developed a framework for fiduciary duty that has adapted to changing social and governance challenges. They explain why trustees are increasingly required to take into account longer term issues such as systemic market risk, intergenerational equity and sustainable development, and how this effectively means that trustees are being positioned with public responsibilities as well as private ones. The authors conclude that to fulfil these responsibilities, trustees must take steps to address emerging obligations to beneficiaries, and to collaborate with other market participants to achieve a stable and better investment market for the future benefit of all.

Article summary written by Rachel Whittaker

AUTHORS

Edward J. Waitzer

Douglas Sarro

Today, most trustees rely on investment professionals to manage a complex portfolio of financial assets, with the majority of returns coming from general market exposure as opposed to market outperformance. Factors that affect performance of the whole market therefore have a critical influence on fund performance, and there is increasing recognition that long term issues such as intergenerational equity (protecting returns for future as well as current beneficiaries) and sustainable development are relevant concerns. Canada's approach to fiduciary duty is unusual in that it explicitly aims to not only protect the interests of pension plan beneficiaries, but also to instil public confidence in fiduciary services, thereby supporting the efficient functioning of the financial services sector, economic growth and social wellbeing.

Fiduciaries have two main duties: the duty of care, which for pension fund trustees means they must apply the same skill and diligence that an ordinary person would use when managing the property of another person; and the duty of loyalty, which means that trustees must always act in the best interests of the beneficiaries and act impartially towards multiple beneficiaries with potentially different interests. While the duty of care principle has been criticised for being too vague, over time this vagueness has allowed the principle to adapt and develop to accommodate changing social norms. Similarly, the duty of loyalty principle is increasingly being interpreted as including the beneficiary's position as a responsible member of society, in addition to financial interests.

The paper outlines a number of concepts and recommendations for trustees to support the obligations associated with an expanded framework for fiduciary duty that incorporates public as well as private interests:

- **Duty of obedience:** this concept reflects the legal trend towards fiduciaries with public responsibilities, as it requires fiduciaries not to undertake actions that reasonably could be perceived as unethical, such as failing to adequately oversee compliance or reporting systems, since such actions could damage public confidence in fiduciary services.
- **Giving beneficiaries a voice**: beneficiaries should be given a stronger voice in fund governance, for example via plan member representation on trustee boards, and by giving beneficiaries defined contribution pension plans a voice in choosing their investment options. This would promote transparency towards participants

"Canada's approach to fiduciary duty is unusual in that it explicitly aims to not only protect the interests of pension plan beneficiaries, but also to instil public confidence in fiduciary services."


as well as improved understanding by trustees of the interests and preferences of beneficiaries.

- **Duty to inform and educate**: beneficiaries should be informed about which assets are held by the fund and how they are being managed to meet the needs of current and future beneficiaries.
- **Duty to consult**: while trustees, as fiduciaries, must ultimately be responsible for all decisions, consultation with beneficiaries can be strategically important and encourage both transparency and trust. A consultation process, particularly one that takes into account the interests of future beneficiaries (e.g. through the appointment of a "trust advisor"), increases the likelihood that a trustee's decisions will be seen as fair and provides evidence of a trustee's attention to the interests of all beneficiaries.
- **Duty to be strategic:** trustees should avoid an excessive focus on short-term risk management and give due attention to long-term strategic and operational issues, such as protecting investment portfolios against potential systemic risks.
- **Duty to collaborate:** this concept goes to the heart of the broader framework of fiduciary duty and serving public interest in Canada. The development of a "fiduciary society", where increased complexity makes individuals increasingly reliant on specialized, fiduciary services to achieve desired outcomes, requires collaboration within and between organisations. Pension funds have a responsibility and an opportunity to act collectively, though presently many institutions are reluctant to do so. Activist shareholders are in the minority and many institutions are hiding behind best practice standards and box ticking, which tend to react to past failures rather than anticipate future challenges.

The authors conclude that pension fund trustees must mitigate risk and increase returns by taking a broad view and thinking about how their investment decisions will help bring about those factors recognised as being the long-term drivers of performance: stable financial markets, a stronger economy, and a more sustainable environment.

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James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg, Edward J. Waitzer (Available from March 2014)
*Cambridge Handbook of Institutional Investment and Fiduciary Duty*

# THE BASIS OF FIDUCIARY DUTY IN INVESTMENT IN THE UNITED STATES

BACK

AUTHOR

Jay Youngdahl

In this paper Youngdahl outlines the history and development of the concept of fiduciary duty in the United States. He concludes that the interpretation and implementation of fiduciary duty has and will continue to develop based on a core set of common sense principles. He also cautions that regulation must not constrain trustees' ability to employ the most appropriate tools, and that trustees must be able to consider long-term criteria that are in the best interests of the beneficiaries, even where those criteria have not traditionally been considered.

Article summary written by Rachel Whittaker

The concept of fiduciary duty exists to protect the interests of the beneficiary, but the precise scope and interpretation of this duty varies between situations and jurisdictions, which can lead to practical difficulties in implementation. One problem is the existence of different types of fiduciaries that are not necessarily held to the same responsibilities, such as corporate directors, financial advisors or pension fund trustees. A second issue, particularly relevant for investment fiduciaries, is that the scope of their duty has become entangled within a wider debate about the functioning of investment markets and different interest groups have differing opinions on how fiduciaries should act. Fiduciaries must therefore pay careful attention to the specific legal and regulatory background of the jurisdiction in which they operate.

## A BRIEF HISTORY OF TRUST LAW

The concept of a trust, i.e. a legal entity in which assets are managed on behalf of another entity, is believed to be hundreds of years old, with precursors of modern trusts found in medieval law. In the early twentieth century corporate trusts evolved to help businesses raise capital for new ventures, with other key drivers in the US including the need to protect the property rights of Native Americans, and to promote work-related benefits for employees. In response to concerns over how these trusts were managed, in 1974 the Employment Retirement and Income Security Act (ERISA) codified the general responsibilities of pension fund trustees. This Act remains the most influential legislation relating to fiduciary duty in the US today.

ERISA regulates the administration of pension funds and provides a degree of insurance for beneficiaries. It defines fiduciary duty in terms of acting solely in the interests of beneficiaries, using care, skill, diligence and prudence to provide benefits and minimise losses, while acting in accordance with the stated aims of the pension plan. The definition is one of general principles rather than specific requirements, which has led to criticism and a wide range of interpretations of exactly what is means in practice. Additionally, ERISA only applies to private sector pension plans, so in 2000 the Uniform Trust Code (UTC) was developed to try and bring a common framework of governance to all private and public trusts in the US.

## EVOLUTION OF THE CONCEPT OF FIDUCIARY DUTY

Over time, as financial markets and the investment industry have become more complex, the role of the fiduciary has also evolved. Initially trust assets could only be invested in 'safe' assets such as government bonds. In 1959 the Prudent Man rule was introduced to allow trustees to invest as if they were managing their own assets, with a focus on capital protection. Following the development of modern portfolio theory in 1992, the Prudent Investor rule was introduced. This rule, which still holds today, requires trustees to take into account the purpose and distribution requirements of the trust and invest in a portfolio of assets with an optimal risk-return trade-off.

However, the financial crisis of 2008 exposed some unanticipated shortcomings of modern portfolio theory when it is applied universally, such as risk control techniques at the portfolio level (e.g. diversification, hedging) leading to increased market risk to the global economy and failing to protect portfolios in times of extreme market stress. Furthermore, the focus of investment practices today have become increasingly short term with share price performance often excessively reliant on quarterly corporate reporting, which many believe runs counter to the principle of trustees' long term duty to beneficiaries, as well as leading to decreased market efficiency and the destruction of long term value.

## CONCLUSIONS

Today, the enormous size of the pool of capital managed within pension funds means that institutional investors wield significant influence. The issue of what actions fiduciaries are permitted to take has therefore become highly political, leading to the earlier-described problem of different stakeholders trying to protect their own interests. For example, corporations attempting to limit shareholder activism, ostensibly on the grounds that it breaches a strict definition of fiduciary duty but in reality out of self-interest. The outcome is that pension fund trustees are challenged with managing pension assets in the face of declining confidence in traditional investment theories, a changing political and social environment, and an increasing awareness that their investment decisions can influence the long-term stability of the economy. Added to this is an evolving view of fiduciary duty, not least on the topic of issues such as environmental, social and corporate governance factors, where evidence is growing that these issues must be taken into consideration if one takes a broad long term approach to fiduciary duty.


James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg, Edward J. Waitzer (Available from March 2014)
*Cambridge Handbook of Institutional Investment and Fiduciary Duty*

# FIDUCIARY DUTY AND SIN STOCKS: IS VICE REALLY NICE?

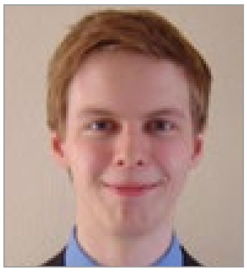
BACK

This paper investigates whether fiduciary duty obliges pension fund trustees to invest over-proportionally in 'sin stocks', i.e. companies operating in sectors traditionally considered unethical such as tobacco, alcohol, gambling and defence. The authors postulate that such an obligation would only exist if these sectors are expected to outperform the market in the future. Following analysis of the only investment fund existing worldwide that invests purely in sin stocks (the Vice Fund) they conclude that, all else being equal, neither an existing sin stock investment strategy nor an existing responsible investment strategy are significantly likely to perform differently to a conventional whole market approach.

Article summary written by Rachel Whittaker

AUTHORS

Andreas G. F. Hoepner



Stefan Zeume

A highly conservative interpretation of fiduciary duty might suggest that trustees of a pension fund are not only unable to ignore certain sectors, but are obliged to invest in any market that is expected to deliver superior financial returns, regardless of any non-investment related impact of that market on the beneficiaries as individuals or on society. This could create a paradox for some pension funds if they were compelled to invest over-proportionally in industries that are considered detrimental to the wellbeing of their beneficiaries from a broader perspective, such as health care companies' pension funds investing in tobacco or other products that have a negative impact on health. Hoepner and Zeume theorise that this paradox would only exist if sin stocks are expected to outperform other sectors in the future. If these sectors can reasonably be expected not to outperform, then pension fund trustees would be acting within their fiduciary duty if they chose to ignore an over-proportional investment in them, however conservatively this duty is interpreted.

Several academic studies have investigated the historical performance of sin stocks and found evidence for superior returns. Some of this is attributed to these stocks being excluded by some investors due to social concerns, leading to a share price depression. This consequently leads to an abnormally high dividend yield, although Hoepner and Zeueme counter that it should be just as likely to lead to underperformance as investors might not buy into this socially concerning dividend yield. An additional hypothesis is that the outperformance of tobacco stocks can be explained in part by the greater legal and excess taxation risk associated with these products. This would suggest that while the returns may be higher, the risk-adjusted return may be no better than other sectors. There is also some evidence that the size of companies in a sin stock portfolio was more influential than the sectors themselves in previous academic studies, with small-cap stocks outperforming large-caps, since equally weighted sin stock portfolios appear to outperform the market but value-weighted sin stock portfolios do not.

> "If 'sin sectors' can be expected **not** to outperform, then pension fund trustees would be acting within their fiduciary duty if they chose to ignore an over-weighted investment in them, however conservatively this duty is interpreted."

While numerous studies have investigated the performance potential of hypothetical sin stock portfolios, the authors claim that only one real investment fund adopts this strategy worldwide: USA Mutual's Vice Fund. A previously published analysis of this fund concluded that it has delivered historically superior returns, however, in this study Hoepner and Zeume find that over a longer period, using more recently developed modelling tools, and when controlling for exposure to small-cap stocks and the greater legal and tax risk of the tobacco industry, the Vice Fund does

not outperform either a conventional or an ethical benchmark.

Hoepner and Zeueme extend their analysis of the Vice Fund by investigating the skill set of the Fund's managers, testing their ability to predict the general direction of the equity market and individual assets, as well as their ability to manage the fund through periods of severe market stress. The results suggest that the managers' investment decisions on each of these factors have reduced the Fund's performance.

In conclusion, the authors believe their findings shows that the Vice Fund does not offer fundamentally better return expectations, and supports the view that responsible investment strategies including sector exclusions can be compatible with fiduciary duty.

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James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg, Edward J. Waitzer (Available from March 2014)
*Cambridge Handbook of Institutional Investment and Fiduciary Duty*

# UNCERTAIN TIMES, PLURAL RATIONALITIES AND THE PENSION FIDUCIARY

BACK

AUTHORS

Liaw Huang

David Ingram

Thomas Terry

Michael Thompson

Huang et al in this paper explore the application of the theory of plural rationality to defined benefit pension fund decision-making. The current and prolonged uncertainty in financial markets has demonstrated that modern portfolio theory is no longer a reliable investment tool. They therefore consider how the plural rationality framework can help trustees make asset allocation decisions in an uncertain environment, bearing in mind that they have a duty to balance the interests of different groups of beneficiaries.

Article summary written by Rachel Whittaker

Private sector defined benefit pension funds in the US operate under a framework determined by the Employment Retirement income Security Act (ERISA), 1974. The trustees, as fiduciaries who administer the pension plans and make investment decisions, must act solely in the interests of pension fund beneficiaries and balance the interests of other stakeholders in the pension system. These include the corporate sponsor of the plan, the participants (which includes current and future beneficiaries) and the government (interested in the long term stability and sustainability of the pension system and in keeping risks under control).

## PLURAL RATIONALITY

The theory of plural rationality was developed by anthropologists and was not initially intended to be applied to financial markets. In contrast to modern portfolio theory, which assumes people will act in the same rational way given the same information, plural rationality suggests that there are four potential views of the state of the world, and the individuals that hold each of these views demonstrate particular characteristics and social relationships. All groups of people can be categorised into these world views, and thinking about beneficiaries in these terms can help fiduciaries better understand and achieve a balance between their specific expectations.

The **nature benign** world view holds that individuals do well when others also do well. In terms of conventional market theory this would equate to a boom market. Its supporters are likely to act in an individualistic and optimistic way chasing ever-increasing prosperity, and from an investment perspective are likely to be the people calling for deregulation, the freedom to innovate and to take appropriate investment risks, and supporting initiatives such as the internalisation of environmental costs. From a pension fund perspective, stakeholders with a nature benign world view might include employers investing to maximise profits for shareholders or future beneficiaries and believing in growth of retirement benefits.

The **nature ephemeral** world view is the opposite of nature benign (a recessionary environment in conventional theory). Believers in this world view are egalitarian conservators; they strive to protect their capital, and would be the ones supporting re-distribution of wealth and calls for changes in human behaviour to minimise our impact on the environment. From a pension fund

> "Plural rationality is essentially a theory of systems that can help fiduciaries understand systemic risks in the financial market ."

perspective this category would include current beneficiaries looking to protect their income against all risks.

A **nature perverse** (or **nature tolerant**) world view is a moderate perspective. Individuals holding this world view are hierarchical managers, and see potential for prosperity only if risks can be controlled. They are more likely to support global stewardship, insisting on global solutions for global problems such as climate change. Governments that permit employers to offer retirement plans that meet their business needs but within pre-defined limits would fall into this category.

The **nature capricious** world view is characterised by uncertainty. No traditional economic theory addresses this state. Holders of this view are pragmatists, focusing on short-term strategies to manage an uncertain future, and fatalistic, likely to avoid concentrated investments and maintain a large cash position. Employees with no interest in retirement planning, or fiduciaries who believe that the future is highly uncertain would fall into this category.

The world can be predominantly within any of these states at different times and people will have different views about how their future will look. The paper suggests that pension fund fiduciaries need to accommodate all of these world views, both in terms of how they balance the interests of their beneficiaries and in terms of how they think about their investment strategy.

Plural rationality is essentially a theory of systems, and the authors believe that it can help fiduciaries understand systemic risks in the financial market that were overlooked in the events preceding the credit crunch.

## CONCLUSIONS

By examining the potential outcome of their investment strategy from the perspective of each of the four world views, fiduciaries can understand the potential benefits and limitations of their investment decisions from a more holistic viewpoint than a single world view, making it less likely that they will be surprised by future developments. For example, the plural rationalities framework requires consideration of extreme scenarios that are typically neglected, such as the total collapse of the financial system. In contrast, modern portfolio theory leads investors to consider only individualistic or moderate world views, an approach that led many investors to be taken by surprise by the tail risk events of the financial crisis. If fiduciaries had taken into account fatalistic perspectives, they may have been less surprised and better prepared to manage their portfolios through a period of extreme market stress.

The authors conclude that the longer the current period of uncertainty continues, the more likely that investors will drift towards a fatalistic world view. However, fiduciaries need to recognise that other pension plan stakeholders may have different perspectives. Disagreements over strategy are never going to go away, but the plural rationality framework offers a way of seeking an acceptable compromise and avoiding the worst of potential surprises.

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James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg, Edward J. Waitzer (Available from March 2014)
*Cambridge Handbook of Institutional Investment and Fiduciary Duty*

# FIDUCIARY DUTY AND THE SEARCH FOR A SHARED CONCEPTION OF SUSTAINABLE INVESTMENT

BACK

This paper reviews the historical legal background to the evolution of fiduciary duty in the UK, with reference to the parallel evolution of the concept in the US. The concept of fiduciaries was intended to promote social welfare, evolving alongside social norms, but this common law approach causes implementation problems in today's complex society. Governments have sought to clarify fiduciary duty using regulatory frameworks, but these tend to be reactionary and backward looking and have expanded the scope of fiduciary duty to include governments, plan sponsors and the public as stakeholders in pension fund governance. Clark concludes that investment innovation has been stifled by this regulatory approach, and the concept of fiduciary duty today is inadequate to promote either the best interests of beneficiaries or sustainable investment.

Article summary written by Rachel Whittaker

AUTHOR

Gordon L. Clark

## LEGAL HISTORY

Two historical legal cases define the nature and scope of fiduciary duty as it relates to investment management – Harvard College vs Amory in the US, and Cowan vs Scargill in the UK. Harvard vs Amory in 1830 allowed trustees to act prudently and with discretion to protect both income and capital, a forward-looking approach at the time. However, this was later repealed and the more conservative English interpretation of fiduciary duty imposed, with a prohibition on trading in listed company securities. Only in the mid-20th century did the Prudent Man rule make a reappearance.

Cowan vs Scargill [1985] is often cited as a definitive legal precedent ruling out the inclusion of social and moral matters in investment decision-making. However the legal decision in this specific case, which dealt with the issue of whether coal industry pension fund assets should be investing in competing energy companies, did in fact acknowledge that non-financial issues such as political stability could be considered where they may impact the long term strength of the economy.

## RECENT DEVELOPMENTS

Clark reminds us that these landmark cases have been stripped of their detail over time to provide broadly applicable codes of fiduciary behaviour, as is the norm with English common law. However the cases dealt with specific issues rather than general concepts, and over time differences in interpretation as well as the growing complexity of both the investment industry and the fiduciary landscape further reduces the applicability of historic interpretations to today's society. Given the uncertainty surrounding the responsibilities of fiduciaries, Clark suggests that it is not surprising that fiduciaries gravitate towards outdated interpretations that have some legitimacy from previous legal decisions, rather than looking forward and adapting to the changing environment.

In recent years the UK government has attempted to address some of the concerns surrounding pension fund fiduciary services in the UK. The Myners inquiry in 2001 found that typical pension fund trustees lacked adequate skills and resources to make effective decisions, comparing them unfavourably with their counterparts in the US. The report also said that pension funds were focusing too heavily on standardised performance benchmarks instead of making asset allocation decisions tailored to their funds' liabilities. It led to the establishment of a pensions regulatory body and the introduction of new codes guiding the responsibilities of pension fiduciaries, an outcome that Clark argues expanded the scope of pension fund fiduciary duty to include the UK government (as an underwriter via the establishment of the Pension Protection Fund) and employers (as corporate pension scheme sponsors) as stakeholders.

"Given the uncertainty surrounding the responsibilities of fiduciaries, it is not surprising that fiduciaries gravitate towards outdated interpretations rather than adapting to the changing environment."

Myners also argued that corporate engagement should be a central component of an expanded definition of fiduciary duty, a view that eventually resulted in the UK's Stewardship Code in 2010.

## INNOVATION AND INVESTMENT

Advocates of a common law approach to fiduciary duty, as opposed to a 'rules and regulations' approach, believe that it should avoid bureaucratic inefficiencies while promoting behaviour consistent with social welfare. However the legislation created by governments to fill in perceived gaps in the fiduciary duty concept, such as the comply or explain codes of practice to promote transparency in the UK and ERISA-defined standards of qualification for pension fund trustees in the US, may be impeding innovation. Clark argues that such legislation drove the near-universal adoption of modern portfolio theory by pension fund trustees, which has proven to be fundamentally flawed in light of the recent financial crises. Clark suggests that the investment industry is now open to innovative new investment decision making tools, such as best practice case studies, collaborative research, international standard setting sponsored by independent professional organisations rather than governments, and a greater emphasis on academic research.

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James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg, Edward J. Waitzer (Available from March 2014)
*Cambridge Handbook of Institutional Investment and Fiduciary Duty*

# CHALLENGING CONVENTIONAL WISDOM: THE ROLE OF INVESTMENT TOOLS, INVESTMENT BELIEFS AND INDUSTRY CONVENTION IN CHANGING OUR INTERPRETATION OF FIDUCIARY DUTY

BACK

AUTHOR

Danyelle Guyatt

This paper examines how investment tools, beliefs and industry conventions impact the interpretation of fiduciary duty in the investment industry. In particular, it focuses on the broadening interpretation of fiduciary duty to include environmental, social and corporate governance (ESG) issues. Though the interpretation of fiduciary duty is subjective, a combination of new analytical methods, evolving investment beliefs and changing industry conventions are leading to a wider interpretation than has been the norm in the past. The author concludes that recent economic crises provided a catalyst for investors to question the assumptions and conventions underpinning the investment industry, with new tools and changing beliefs laying the foundation for a longer-term investment approach that integrates ESG criteria into investment decisions.

Article summary written by Rachel Whittaker

Pension fund trustees are generally not required to have specialist investment knowledge, so in practice this means they often rely on external advisors. This can create a conflict of interest if the advisors are incentivised to maximise their own profit. A set of norms has evolved to promote prudent behaviour, including a duty to monitor investments and delegated managers and to adhere to the principle of diversification. However, these processes are often backward looking and may actually impede the forward looking analysis that would be in the beneficiaries' best interests.

## OVER-RELIANCE ON HISTORICAL RELATIONSHIPS

Guyatt focuses on Markowitz's mean-variance optimisation framework (Modern Portfolio Theory) to illustrate this. The model relies on expectations of future performance that tend to be based on historical data without sufficient attention to forward looking expectations, leading to construction of an 'optimal' portfolio that is anything but. The recent financial crisis showed that a mean-variance approach to portfolio diversification fails to provide downside protection during periods of extreme market stress, which can result in the breakdown of the effectiveness of portfolio diversification following tail risk events.

## IMPROVING UNDERSTANDING OF RISK

A potential solution to this problem is to improve analytical methods by including more rigorous forward-looking analysis and a broader definition of risk, including consideration of ESG issues. A factor approach to risk analysis would consider portfolio risk in terms of the source of potential risk, such as macroeconomic variables, market risk, demographic profile and technological changes, with the aim of achieving diversification across risk factors within the portfolio. Trustees would be encouraged to discuss a broad range of potential risk factors in a qualitative and meaningful way, spending more time formulating the quantitative outputs than is generally the case with traditional mean-variance analysis. Such qualitative discussions better facilitate consideration of the impact of tail risk events, as well as less tangible factors such as ESG issues particularly where there is no (or limited) historical data available such as with climate change risk. Guyatt argues that mean-variance analysis still has a place, but within a more holistic approach recognising its limitations.

Investment beliefs are also an important part of the decision making framework. Typically they are agreed upon by the trustees and guide future investment decisions and policies, and can include reference to ESG issues, (particularly if the fund is a signatory to an organisation such as the Principles for Responsible Investment). However, it can be difficult to translate these beliefs into investment related action. While some funds clearly set out specific actions and targets, ESG issues can become overshadowed by other investment issues.

Guyatt refers to her previous research looking at how trustees and their advisors prioritise ESG issues relative to other investment issues, and whether ESG issues feature in their definition of fiduciary duty. While the majority of trustees felt that ESG issues as a whole are important, when asked which factors are most important to consider when reviewing performance, ESG issues were pushed far down the list of priorities and relative returns versus the benchmark were seen as the most important factor. Guyatt posits that despite their apparent individual views, trustees tend to revert to the predominant conventional thinking when it comes to implementation, perhaps for fear of appearing too different from peers or of contradicting advice from consultants.

## FORWARD LOOKING AND HOLISTIC THINKING REQUIRED

Guyatt concludes that investment belief statements need to be supported by changing industry conventions for ESG issues to become embedded within the concept of fiduciary duty. Yet for new conventions to be accepted the old ones must be challenged and, despite the financial crisis, the investment industry still predominantly relies on outdated theories of asset valuation and portfolio construction. Changing conventions, incentivisation structures, attitudes and behaviours is difficult as people tend to resist change, so the finance industry needs new leaders, with more diversity of values, skills and perspectives. This will allow the status quo to be challenged and promote long term decision making.

"Despite their apparent individual views, trustees tend to revert to the predominant conventional thinking when it comes to implementation."

James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg, Edward J. Waitzer (Available from March 2014)
*Cambridge Handbook of Institutional Investment and Fiduciary Duty*

# THE VOICE OF THE BENEFICIARY

BACK


AUTHORS

Christine Berry

Charles Scanlan



Berry and Scanlan argue that beneficiaries should be consulted on the general policies of their pension fund, and that trustees should take their wishes into account when making investment decisions. They discuss and refute some of the common objections to beneficiary consultation, drawing on examples from the UK pension fund landscape to illustrate why and how beneficiaries' views should be heard across a full spectrum of issues: financial, "quality of life" and "ethical preferences". The authors conclude that the legal framework in the UK supports a broader interpretation of fiduciary duty than is often claimed, both in terms of beneficiary involvement and consideration of all such issues, though clarification of the law would support greater engagement in the future.

Article summary written by Rachel Whittaker


## THE CASE FOR BENEFICIARY ENGAGEMENT

Historically, beneficiaries of private family trusts have been passive in their relationship with fiduciaries. Pension scheme beneficiaries are, however, fundamentally different because they have paid for their benefits. In defined benefit schemes, where the employer bears the investment risk for guaranteeing future benefits, some residual paternalism may be at least understandable. Increasingly, however, pension schemes are defined contribution schemes where the beneficiaries shoulder all the risk, making such an attitude even less defensible.

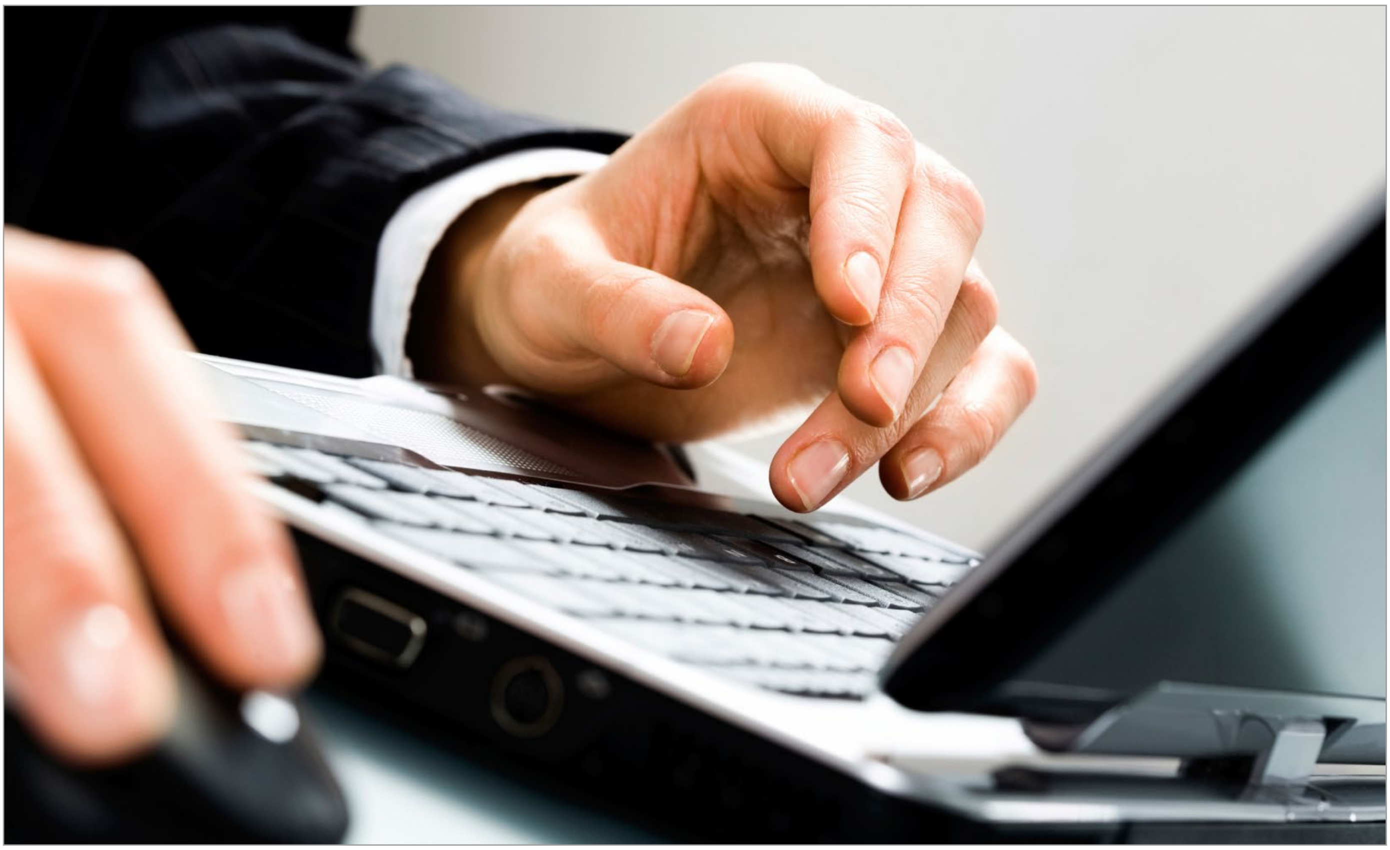
## EXPLORING LEGAL AND PRACTICAL BARRIERS

Some of the common objections to greater beneficiary involvement include confusion between the roles of trustee and beneficiary, and beneficiaries' lack of qualifications to express a view on trustee decision-making. Greater beneficiary involvement has also been seen as a potential breach of the trustee's duty of impartiality. Berry and Scanlan refute the first objection by citing examples where a degree of consultation is undertaken or mandated without negative consequences. For example, in the UK occupational and personal pension schemes are required to consult with employees on certain matters, and the recently established National Employment Savings Trust (NEST), a defined contribution scheme set up by the government targeted at low paid workers, undertook a consultation survey of its target demographic (future beneficiaries) for the specific purpose of informing its investment strategy. The second objection relating to beneficiaries dependence on trustees is true to an extent since most beneficiaries are not equipped with the technical skills to participate in decision making on asset allocation or complex investment products, but it is difficult to see why beneficiary views on issues such as risk tolerance, shareholder engagement and ethical questions would not be highly relevant.

The third objection, that fiduciaries risk breaching their duty of impartiality if they take into account any views of beneficiaries unless there is a complete consensus, poses a particular barrier to considering environmental, social and governance (ESG) issues and ethical questions. However, Berry and Scanlan point out that beneficiaries are more likely to differ in their awareness of the issues and in their order of priorities, rather than be in direct conflict with one another. In any case, balancing the varied interests of beneficiaries is already one of the tasks of fiduciaries since beneficiaries do not all have identical financial requirements. The alternative to finding a compromise would be to deny all beneficiaries any opportunity to voice their opinions. They argue disempowering everyone is surely a suboptimal outcome.

## THE NEED FOR TRANSPARENCY

The authors also discuss the need for greater transparency and accountability in the fiduciary relationship for beneficiary participation to be effective. Currently trustees are not legally required to disclose the reasons behind investment decisions to beneficiaries, and delegation to



external asset managers appears to reduce transparency even further creating a "broken link in the chain of accountability". Improved accountability would help to restore the trust in the financial system that has been eroded in recent years.

## CONCLUSIONS

The authors' review of legal precedents for incorporating 'quality of life' and ethical factors finds the predominant view of lawmakers to be that such factors can be considered provided that there is no likelihood of significant financial detriment. The authors argue that since the benefits of portfolio diversification have been shown to be greatly reduced above approximately thirty stocks, as long as there are no sweeping sector exclusions, there are sufficient investment opportunities for a responsible investment policy-driven portfolio to have the same expected return as one managed purely for return maximisation.

Considering the future direction of beneficiary engagement on issues beyond purely financial matters, Berry and Scanlan cite the example of Denmark, where pension plan member engagement is more widely accepted. In Denmark, fiduciaries are still legally obliged to seek the best possible return for beneficiaries, however they have developed responsible investment policies that reflect member views and do not compromise the funds' ability to deliver returns. While developments such as the UK's voluntary Stewardship Code are broadly supportive and continue to evolve, the authors conclude that further legislative reform is needed to encourage engagement with pension fund beneficiaries.

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James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg, Edward J. Waitzer (Available from March 2014)
*Cambridge Handbook of Institutional Investment and Fiduciary Duty*


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