

Investment Overview & Control

A Guide for Trustees



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INVESTMENT OVERVIEW & CONTROL

In this booklet we seek to provide practical guidance to trustees on the issue of investment overview and control.

In recent years there has been an increased focus on this area of fiduciary responsibility. There are several reasons that account for this trend:

- Financial markets have followed a rollercoaster ride in the last decade, with two severe equity bear markets and a financial crisis that spread to all asset classes.
- The UK Trustee Act 2000 (and similar legislation subsequently enacted in various offshore jurisdictions) introduced a new statutory “duty of care” applying to all trustees and a wider general power of investment;
- As the trust industry matures, there has been an increase in the number of cases where multi-generational issues apply;
- Beneficiaries are becoming more knowledgeable and placing more sophisticated demands on their service providers; and
- The range, scope and complexity of available investment vehicles significantly increased.

BACKGROUND ENVIRONMENT

In UK case law, the standard of care expected of trustees in investing trust funds can perhaps be summarised in two judgements.

In 1887 in *Learoyd v Whiteley* in the judgement, it was stated that, as a general rule, the law requires of a trustee no higher degree of diligence in the execution of his office than a man of ordinary prudence would exercise in the management of his own private affairs. Yet he is not allowed the same discretion in investing the monies of the trust as if he were dealing with his own estate. Rather it was the duty of the trustee to avoid all investments which were attended with "hazard".

In 1980 *Bartlett v Barclays Bank Trust Co (No 1)* it was held that in the case of a professional corporate trustee the duty of care was higher and it was the responsibility of the trustee to ensure that it received an adequate flow of information concerning investment matters.

The UK Trustee Act 2000 took these principles and essentially sought to codify the actions that trustees should be taking in relation to investment overview and control.

This involved three main areas:

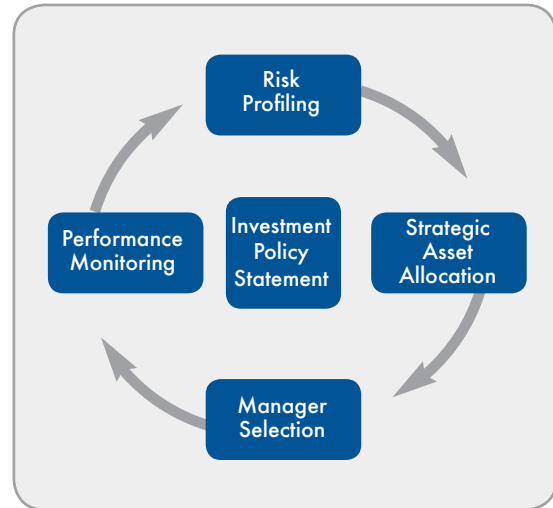
- A statutory duty of care applying to all trustees
- A new and wider general power of investment
- New rules on the appointment of investment managers, custodians and nominees

The principles set out in the Trustee Act 2000 have now been taken as the starting point for legislation in many international financial centres, such as Guernsey, Jersey, Isle of Man, Bahamas and the Cayman Islands.

FIVE CORE PRINCIPLES

1. Prepare, review and revise as necessary the trust's investment policy statement.
2. Match the investment policy statement with an investment "risk" appetite.
3. Review and revise as necessary the asset allocation strategy, investment mandate and guidelines.
4. Appoint/review agreements with outside investment managers and monitor compliance with the investment policy statement, mandate and guidelines.
5. Set appropriate performance measures and conduct regular reviews.

It is critical that throughout this iterative procedure, an audit trail of compliance with the principles is maintained and reviewed with exceptions and actions being noted.



SETTING AN INVESTMENT POLICY

It is a requirement that every trust has a written investment policy statement. Ideally the investment policy statement should be short and explain the investment objectives of the trust.

A good starting point is to recognise that all investors have a combination of the following three objectives:

- Preservation of wealth
- Provision of income
- Capital growth

For any given investor, while these objectives are not mutually exclusive, an element of balancing is required. The difficulty for a trustee is that there is often not a single beneficiary but a multi-generational class with each beneficiary having different requirements and aspirations. The default position is to adopt a generalist “balanced” investment mandate that targets “a balance between income and capital growth” or “capital growth in a conservative fashion”.

It should be remembered that the purpose of the investment policy statement is not to set out precisely what an investment manager should do. Rather it is intended to provide the framework within which an investment manager can design and execute an investment strategy that delivers the highest probability of meeting the objectives of the trust.

The suitability and applicability of the investment policy statement needs to be reviewed on a regular basis (at least annually). Any changes need to be communicated to the investment manager on a timely basis and the implications in respect of the existing investment mandate and guidelines considered.

SETTING AN INVESTMENT POLICY (continued)

To adopt a more personalised approach to designing the investment policy statement for a trust, the following variables could usefully be considered:

INCOME ISSUES

- Are there scheduled income requirements?
- In what currency is the income required?
- Can capital be distributed in place of income allowing a total return approach to be taken?
- What is the likelihood and quantum of unscheduled income requirements?

CAPITAL ISSUES

- Are there scheduled capital requirements?
- In what currency is the capital required?
- What is the likelihood and quantum of unscheduled capital requirements?
- How quickly might unscheduled capital requirements be needed?

RISK ISSUES

- What is the impact of failing to deliver the targeted income level?
- What is the impact of being unable to meet capital calls in a timely fashion?
- What is the maximum loss that could be sustained without endangering trust objectives?
- Over what time horizon is investment performance to be assessed?

MANAGEMENT ISSUES

- What is the time horizon of the trust?
- What is the currency of record; is this likely to change?
- Are there any investment constraints (ethical, religious, strategic holdings, etc)?
- Does the current and expected residence and tax status of the beneficiaries mean there are tax or legal implications that dictate investment policy?

ASSET ALLOCATION STRATEGY

Over the long term, equities have undoubtedly been the best asset class to own. Recently published research* examined returns from cash, bonds and equities for 17 countries since the start of the last century; some 105 years of data. The robust conclusion was that for investors with a time horizon of 100 years, history strongly suggests that equities should be the asset class of choice.

But, very few investors have such long time horizons; even those trust structures and foundations that fully expect still to be around in 2100 would find it hard to state with confidence that there would be no circumstances under which capital withdrawals to their investment portfolio might be necessary in the intervening period.

This fact means that the practical investment horizon for most investors ranges from 1 to 20 years. So what effect

does taking a shorter time horizon have on the conclusion that equities are the best asset class to own?

Barclays Capital publishes an Equity Gilt Study each year that examines the performance of cash, bonds and equities in the UK since 1900. The results are interesting and perhaps slightly unexpected.

The probability of equities outperforming cash over any 10 year rolling period is 93% and the probability of equities outperforming UK government bonds (gilts) over any 10 year period is 82%. But, note that equities do not guarantee a positive return over a holding period of even 20 years.

* *Elroy Dimson, Paul Marsh and Mike Staunton: "The Triumph of the Optimist", Princeton University Press*

	Holding period in years				
	2 years	3 years	4 years	5 years	10 years
Probability of UK Equity Outperformance Versus Sterling Cash	67%	71%	74%	75%	93%
Probability of UK Equity Outperformance Versus Gilts	70%	76%	78%	76%	82%

Source: Barclays Capital, Equity Gilt Study 2008

ASSET ALLOCATION STRATEGY (continued)

Partly because equity returns are so unpredictable and partly to meet income and capital withdrawal requirements, trustees should usually look at incorporating other asset classes within a portfolio. Holding these other asset classes makes sense if it avoids the need to sell equities during a period of market weakness.

Moreover, the range of available asset classes has grown significantly over recent years. It is now realistic to consider up to seven separate asset classes for a portfolio: equity; bond; cash; hedge; structured product; property; and commodity.

Not all trusts should seek exposure to all available asset classes but each asset class potentially has a role to play. It is, however, imperative to set not only neutral exposures to each asset class but also acceptable ranges given each asset's characteristics.

The table opposite seeks to highlight seven key asset class characteristics: expected return; volatility; liquidity; complexity; yield; intangible risk; and fees.

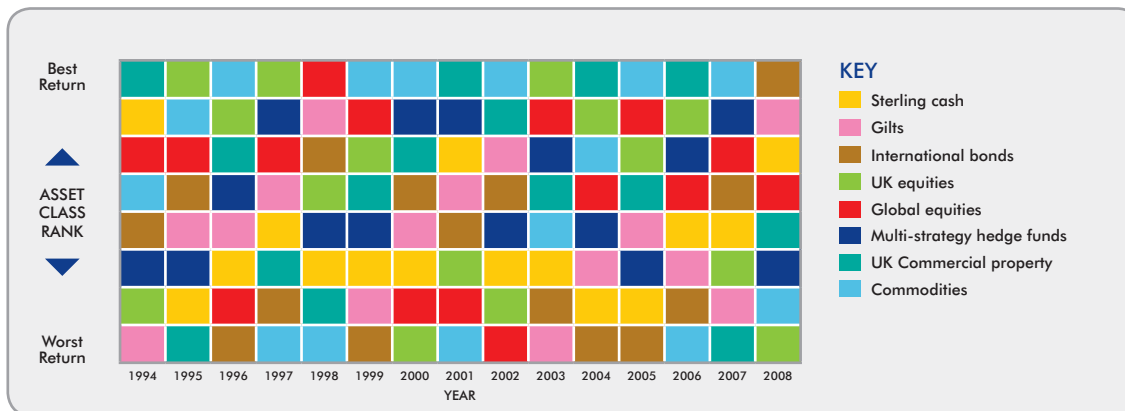
High returns are always associated with a risk trade-off that needs to be identified. It is too simplistic to think of risk as purely the volatility of expected returns. In particular, intangible risks such as exposure to key individuals; institutional strength; settlement risk; and custodial security should not be ignored.

To illustrate further the way in which the fortunes of each asset class can vary from year to year, consider the patchwork quilt diagram opposite. Eight asset classes - Sterling cash; Gilts; international bonds; UK equities; international equities; multi-strategy hedge funds; UK commercial property and commodities - have been allocated a colour. The Sterling-based return for each of these asset classes has then been ranked for each of the 15 calendar years ended 2008.

The top box is the colour of the best performing asset class; the bottom box is the colour of the worst performing asset class. That there is no discernible trend illustrates the difficulty of making investment decisions based on annual data and the danger of short term volatility driving strategic investment decisions.

ASSET ALLOCATION STRATEGY (continued)

	Expected Return	Volatility	Liquidity	Complexity	Yield	Intangible Risk	Fees
Cash	Low	Low	High	Low	High	Low	Low
Bonds	Medium	Medium	High	Low	High	Low	Low
Hedge Funds	Medium	Medium	Low	High	Low	High	High
Structured Products	Medium	Medium	Medium	High	Variable	Medium	Medium
Equities	High	High	High	Medium	Medium	Low	Medium
Property	High	Low	Medium	Medium	High	Medium	Medium
Commodities	High	High	High	Medium	Low	Medium	Medium



MANAGER APPOINTMENT

Once the broad asset allocation is determined, it is often appropriate to appoint professional investment managers. This process should incorporate the following considerations:

- **Type of institution** - boutique, private bank or financial conglomerate?
- **Investment philosophy** - absolute return or relative performance; active management versus index tracking?
- **Portfolio delivery** - segregated account or fund-of-funds; direct investments or pooled vehicles?
- **Management basis** - discretionary, advisory or execution only?
- **Verifiable track record** - model portfolio, fund, GIPS numbers?
- **Key man risk** - reliance on specific individuals or processes?
- **Corporate stability** - impact of corporate change through acquisition or restructuring?
- **Service level** - reporting format, frequency of updates, clarity of presentation?
- **Fees** - annual management fee, commissions, custody charges, ancillary expenses?
- **Implementation plan** - cash or in specie transfer; gradual or immediate portfolio establishment?

The above is by no means an exhaustive list but illustrates the importance of undertaking sufficient background research and not solely relying on stellar historic performance or slick marketing. Some of the best managers neither advertise their expertise nor place great emphasis on presentational skills.

MANAGER APPOINTMENT (continued)

ART & SCIENCE

Selecting an investment manager is inevitably as much art as science. There is often little to choose between the shortlisted managers and the ultimate choice is likely to be driven by qualitative factors. With this in mind, it is often beneficial to visit the offices of managers rather than running a beauty parade at a neutral location as it provides additional insight into the culture of the organisation.

STRATEGIC VERSUS TACTICAL ASSET ALLOCATION

Of critical importance is the difference between strategic and tactical asset allocation decisions. The strategic asset allocation should set out the way in which a portfolio is to be invested, on average, over the investment time horizon of the portfolio. The strategic asset allocation should not be influenced by current financial market cycles but by perceived longer term secular trends.

Tactical asset allocation is where investment managers express their views on the current state of financial markets and geographic regions. Based on academic research conducted in the 1980's, it is often stated that at least 90% of the value-added by managers is attributable to asset

allocation decisions rather than stock selection. This figure may be over-stated but it illustrates the potential benefits to be derived from active rather than passive asset allocation.

If managers are to add value through tactical asset allocation decisions, the investment guidelines need to provide sufficient flexibility for managers to express their investment views in a meaningful way. Managers also need to believe that short-term under-performance will not be penalised if they move the portfolio significantly away from the neutral or benchmark asset allocation.

MULTI-MANAGER PORTFOLIO STRUCTURES

Where significant assets are involved, it is prudent for trustees to consider appointing more than one manager. This brings certain complications. Should all managers be given the same mandate or should specialist managers be appointed? If specialists, how can results be compared? Is monitoring the structure and performance of the aggregate portfolio important?

It is common in such circumstances to appoint an investment consultant and/or global custodian to assist in reporting and risk control.

PERFORMANCE ASSESSMENT

Once a manager is appointed, trustees need to establish a framework for assessing whether performance is acceptable over time. This is easier said than done. In particular there are three problems that require addressing:

- Dealing with conflicting time horizons
- Selecting a measurement yardstick
- Adopting a systematic approach to address findings

DEALING WITH CONFLICTING TIME HORIZONS

The investment time horizon for a portfolio is often 3-5 years or longer. However, manager performance data is usually collected on at least a quarterly basis. This means that investors tend to focus on the latest quarter rather than the likelihood of meeting their longer term investment objectives. Indeed, for newly appointed managers, there is little else to focus upon! So how can trustees seek to ensure that the assessment of performance is for an appropriate time horizon while at the same time conducting regular progress reviews?

- Examine both discrete and rolling periods
- If following a model, create artificial rolling performance to compare against target
- Give a new manager at least 18 months but watch for unexpected performance patterns

SELECTING A MEASUREMENT YARDSTICK

Traditionally managers have used financial market indices (such as FTSE All Share; MSCI World Equity; Citigroup World Government Bond; etc) or composites of such indices as “benchmarks” against which relative performance can be measured. More recently, absolute return style mandates have become popular and managers have been moving towards “cash plus X%” benchmarks. Both have their merits but neither should be considered in isolation.

If available, a suitable peer group measure should be considered such as the ARC Private Client Indices which are compiled using actual portfolio performance for discretionary portfolios. See www.assetrisk.com/pci for more details.

PERFORMANCE ASSESSMENT (continued)

Over longer periods, all investors are seeking an absolute return in excess of cash. Yet, over shorter periods, financial market cycles mean that manager performance needs to be assessed using relative measures such as financial market indices and suitable peer group averages. A multi-faceted approach is likely to prove most successful.

- Performance versus a benchmark comprising a composite of financial market indices
- Cumulative and rolling performance versus cash
- Performance versus a suitable peer group of managers and fund structures
- Performance relative to the opportunity set available given the asset allocation ranges

ADOPTING A SYSTEMATIC APPROACH

Once a series of performance yardsticks have been selected, it is necessary to establish a systematic approach to assessing portfolio performance that can be applied across all portfolios. This process needs to go beyond purely looking at returns and encompass risk and consistency. There is no “silver bullet” statistic; rather any quantitative

approach will need a qualitative (common-sense based) overlay.

As a starting point, trustees should consider the following four questions:

- Is return in line with expectation?
- Are the risks that are being taken tolerable?
- Has the return per unit of risk been acceptable given the alternatives?
- Has the pattern of performance produced surprises?

There are a number of technical difficulties in implementing a systematic, standardised approach to performance assessment including: data collection issues; treatment of fees and charges; impact of investment constraints; and how to deal with strategic holdings. However, without a systematic process, evidence of an audit trail becomes much harder to maintain and making a decision to change a manager becomes a purely qualitative judgement.

By adopting and rigorously following a systematic escalation procedure, the visceral aspects of manager change are ruled by the statistical rather than the other way around.

MULTI-MANAGER PORTFOLIO RESPONSIBILITY MATRIX

When dealing with a complex multi-manager portfolio structure, it is easy for there to be an element of uncertainty over the responsibility split between trustees (and consultants, if any) and investment managers.

The tables below are intended to help clarify the roles and responsibilities of each party for a typical “core-satellite” multi-manager investment structure.

TRUSTEES/CONSULTANTS

Investment Objective

- Time Horizon
- Risk Tolerance
- Reference Currency
- Liability Profile

Strategic Asset Allocation

- Neutral asset class weighting
- Permissible asset classes
- Investment constraints
- Investment style preferences

Manager Selection/Monitoring

- Design of investment mandates
- Appointing managers
- Performance assessment
- Aggregate portfolio analysis

INDIVIDUAL INVESTMENT MANAGERS

Tactical Asset Allocation

- Projecting asset class returns
- Adjusting asset class weightings
- Portfolio risk exposure management
- Investment style decisions

Fund/Stock Selection (as permitted)

- Currency in which to hold cash
- Bond currency, credit & duration
- Equity sectors, regions, capitalisation
- Type, style & liquidity of alternatives

Reporting

- Quarterly (or monthly) valuations
- Portfolio asset allocation breakdown
- Performance versus agreed metrics
- Confirmation of adherence to mandate

SIX KEY IMPLEMENTATION DECISIONS

1. WHAT TYPE OF PORTFOLIOS?

The first decision that needs to be made in implementing an investment suitability and performance review process is to define the universe. The following are some of the considerations in defining the scope of coverage.

- Should portfolios without an appointed investment manager be included?
- Should all portfolio types (discretionary, advisory or execution only) be included?
- Should non-financial assets such as physical property, art, boats, cars and collections be included?

2. ARE EXCEPTIONS ALLOWED?

Not all investment portfolios follow standard construction criteria. This raises the question as to whether exceptions should be allowed to opt out of the process. Reasons for exceptional circumstances include:

- Illiquid and/or infrequently priced assets;
- A dominant single holding held for strategic reasons; and
- Strict ethical or moral investment restrictions.

3. WHAT SIZE OF PORTFOLIOS?

Having determined the type of portfolio to be incorporated into the review process and the basis for allowing exceptions, the next decision relates to the size of portfolios to be covered.

- Is there a de minimis level at which the cost of the review process outweighs the benefits?
- Is there a portfolio size at which the basic review process needs to be enhanced?

4. WHAT LEVEL OF AGGREGATION?

Investors often have portfolios with more than one manager in order to diversify investment, operational and corporate risk. This practice raises the issue of whether portfolios should be aggregated and at what levels.

- Portfolios within the same legal entity;
- Portfolios under the same legal parent (say a trust or holding company); or
- Portfolios with the same class of beneficiaries or within a defined family group.

SIX KEY IMPLEMENTATION DECISIONS (continued)

5. HOW IS DATA TO BE MANAGED?

For any investment oversight and review process to work, data handling must be achieved in an efficient and timely manner. Planning and organisation are paramount if data management is to work smoothly.

- How much data collection can be done electronically rather than manually?
- Where will the basic static portfolio information be gathered? Direct or indirect sources?
- How is the ongoing portfolio performance information to be collected? Monthly or quarterly?

6. CAN OUTSOURCING HELP?

Outsourcing all or part of the investment oversight and review process is becoming commonplace and can take many forms. Typically one of the following three strategies is followed:

- Using a computer system designed to deal with private client portfolios with technical support;
- Outsourcing data collection and performance appraisal reporting; or
- Employing an investment consultant to advise on all aspects of portfolio structure and performance.

Designing and implementing an effective investment oversight and performance review process undoubtedly requires a significant commitment in terms of time, resource and patience. However, done well, relationships with investment managers and clients can be deepened and strengthened.

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