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Abstract

[extract] The one area in which acceptance of portfolio theory has not been without difficulty is investment of trust funds. The fundamental legal norm governing trustee investment is the principle of prudence. A series of legal rules have been developed by the courts and legislatures over the centuries to give effect to this principle. These rules operate on assumptions which are incompatible with portfolio theory. In particular, the investment rule, the legal list rule, the anti-netting rule, the impartiality rule and the anti-delegation rule are perceived as significant obstacles to the lawful deployment of portfolio management techniques by trustees. Even in the United States, where portfolio management had its genesis, these legal rules have significantly hindered trustee reliance on portfolio management.

Keywords

portfolio investment, trustee investment, New Zealand

Cover Page Footnote

An earlier version of this paper was presented at the 'Equity, Restitution and the Banking Lawyer' Conference held at Bond University, Qld, 23 July 1994, though it has its beginnings in a seminar workshop prepared for the Australasian Public Trustees Biennial Conference, Wellington 1993. I wish to thank the participants at both events for helpful comments and feedback. Thanks are also due to colleagues in the Money & Finance Group of the Faculty of Commerce and Administration, Victoria University of Wellington, to John Gallacher of Southpac Investment Management Ltd for assistance in gathering materials, and to Antony Shaw, Lloyd Kavanagh , Ben Perham and Tony Lee who read the paper and offered constructive comments. I also want to acknowledge the assistance provided by Professor Joel C Dobris of the University of California at Davis who supplied information on the progress being made in revising the Uniform Principal and Income Act put out by the National Conference of Commissioners on Uniform State Laws.

MODERN PORTFOLIO THEORY AND INVESTMENT POWERS OF TRUSTEES: THE NEW ZEALAND EXPERIENCE

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Introduction

Portfolio investment theory has effected a profound change on the behaviour of the investment community. Recent in origin,[1] it has quickly established itself throughout the world as one of the most popular and orthodox theories of investment management, particularly for those who have large funds under their control.[2] The advantage of the theory is that careful application of its principles allows an investor to aim for reasonably good returns with a greater degree of security than was possible under previously popular models of investment behaviour.

At the heart of portfolio theory are a number of key principles. First, the measure of a person's wealth is the value of her portfolio looked at as a whole. Second, the security of the investor's fund can be enhanced by diversifying it across a range of counter-reacting ('negatively correlated') investment vehicles. Third, decisions as to which investment vehicles ought to be included in a portfolio cannot be made in isolation; they must be made in light of the nature of the other elements of the portfolio. Thus, investment vehicles which might

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1 The theory is traceable to a seminal paper by Professor Markowitz entitled 'Portfolio Selection', published in 1952, and a book of the same name by the same author published in 1959: see HM Markowitz, 'Portfolio Selection' (1952) J Finance 77 and HM Markowitz, *Portfolio Selection*, Cowles Monograph 16 (New York: John Wiley & Sons, 1959) respectively. Prior to the development of portfolio theory much of finance research and learning was largely a descriptive field of endeavour, and not very scientific in orientation. Initially, Markowitz's ideas were 'practically unintelligible' to most investment professors and practitioners, as much of the analysis was statistical and algebraic in nature: see, for example, Francis & Archer, below n 10 p 1.

2 In addition, consultation of any of the main texts will confirm the prominence of portfolio theory as a part of the university investment finance curriculum is this area: see the texts referred to in n 9 below. According to Professor Jeffrey N Gordon, 'The Puzzling Persistence of the Constrained Prudent Person Rule' (1987) 62 *NYUL* Rev 52, 73, '[t]he theory [of portfolio management] has been accepted by investment managers since the late 1960s and has been a commonplace of legal academic discussion since the early 1970s.' (footnote omitted, referring to early literature in the fields mentioned).

be thought speculative when considered in isolation, may not be speculative when considered in the context of a portfolio's overall holdings. Fourth, the return on a portfolio reflects both income and capital returns and to separate the two is an artificial exercise.

The one area in which acceptance of portfolio theory has not been without difficulty is investment of trust funds. The fundamental legal norm governing trustee investment is the principle of prudence. A series of legal rules have been developed by the courts and legislatures over the centuries to give effect to this principle. These rules operate on assumptions which are incompatible with portfolio theory. In particular, the investment rule, the legal list rule, the anti-netting rule, the impartiality rule and the anti-delegation rule are perceived[3] as significant obstacles to the lawful deployment of portfolio management techniques by trustees.[4] Even in the United States, where portfolio management had its genesis, these legal rules have significantly hindered trustee reliance on portfolio management.

Moreover, it is important to note that the legal principles governing trust investment apply not only to the traditional private trust, but also in many jurisdictions to superannuation funds, to the investment powers of public or quasi-public bodies, and so on.[5] Thus, a prohibition on portfolio management techniques debars its application in a significant portion of the investment market.

One of the first legislative efforts to come to grips with the perceived incompatibility between portfolio theory and traditional trust law was New Zealand's *Trustee Amendment Act* 1988 ('the 1988 Act'). That Act was passed in light of a series of recommendations suggested by a (Joint) Working Party

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3 I use the word 'perceived' as I am not convinced that all aspects of *English* (as opposed to United States) common law and statute law are necessarily hostile to portfolio theory. Indeed, it may be possible to construct an argument in favour of portfolio theory on the basis of some of the precedents. This project must await another day.

4 See, for example, RT Bartlett, 'The Law Reform Committee's Trust Investment Recommendations - 10 Years On' [1992] *Conveyancer* 425 (concluding that trust investment legislation in need of radical overhaul in light of new investment conditions, but falling short of a recommendation that broad unrestricted statutory investment powers be given to trustees); WA Lee, 'Current Issues for Trustee Legislation' in S Goldstein (ed), *Equity and Current Developments* (Hebrew University, 1992) 237 (discussing *A Model Trustee Code for Australian States and Territories)*; Ontario Law Reform Commission, *Report on the Law of Trusts* (Toronto: Ministry of the Attorney General, 1984) 219 (concluding in favour of legislation consistent with portfolio theory); *Restatement (Third) of the Law of Trusts (Prudent Investor Rule)*, hereafter simply the *Third Restatement*, (St Paul, Minn: American Law Institute, 1992) passim (and see also the Foreword, p ix) (altering previous *Restatements* in view of recent developments in investment techniques), and see *A Model Trustee Code for Australian States and Territories* discussed in Lee, above.

5 For example, in Australia the recently enacted *Superannuation Industry (Supervision) Act* 1993 (SIS) makes trust investment principles applicable to the trustees of superannuation funds. In so doing, the Act makes explicit the previously applicable common law principles: G Halperin, 'SIS or SOS? The proposed new superannuation regime' (1993) 67 *Law Inst J* 936, 937. Likewise in New Zealand, the *Superannuation Schemes Act* requires trustees of superannuation funds to meet the standards of the *Trustee Act* 1956 (as amended by the 1988 Amendment Act), again reflecting previous common law: *Jones v AMP Perpetual Trustee Co NZ Ltd* below n 33. In the United States, the courts have used trust law principles and rules as the point of departure for rulings under the applicable sections of the *Employee Retirement Income Security Act* 1974, 29 USC ss 1001-1461 (1988) (hereafter ERISA): see, for example, N Stein, 'ERISA and the Limits of Equity' (1993) 56 *Law & Contemp Probs* 71, and for the *Uniform Management of Institutional Funds Act* (UMIFA) of 1972 which has been enacted in over 25 of the states.

on Trust Investment Powers.[6] The Working Party concluded that the traditional legal rules acted as an obstacle to the use of portfolio strategies, and suggested that new legislation in the area ought to attempt to facilitate the use of portfolio methodology by trustees.

The purpose of this paper is twofold. First, it considers in the abstract what type of legal rules are necessary to give effect to portfolio theory. This is done by analysing the salient principles of portfolio theory; by examining the incompatibility of the traditional trust investment rules with portfolio theory; and by considering a number of practical problems which legislation embracing portfolio theory must overcome in order to be effective. Second, the paper considers the 1988 New Zealand amendments as a model for legislation designed to give effect to portfolio theory in the trust context. This critique will be based on themes developed in the first part of the paper.[7]

Since the New Zealand Act was passed, the American Law Institute has published the *Restatement (Third) of the Law of Trusts (Prudent Investor Rule)*.[8] *The Restatement* proposes the adoption of a greatly revised rule on trust investment powers, with the stated purpose of incorporating portfolio management ideas as part of trust investment responsibilities. Clearly, the *Restatement* is of importance to the issues raised by this paper, and will be an important point of comparison in critiquing the New Zealand legislation especially since the Working Party's Report made frequent reference to US material.[9]

Portfolio Theory

Portfolio Investment Theory[10]

The price of an asset reflects two important considerations: The first is a

6 *Trustee Investment—The Prudent Man Approach* (Wellington: Government Printer, 1986).

7 A number of themes are not covered by this paper and are best left to another occasion eg the constituency of trustee investment legislation, whether the prudent person rule is preferable to the legal list rule, evidential problems concerning battle of the experts, etc.

8 Above n 4. The *Third Restatement* was adopted in 1990, and published in 1992. Comments on the Restatement can be found in PG Haskell, 'The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory' (1990) 69 *NCL Rev* 87 and in EC Halbach Jr, (the Reporter) 'Trust Investment Law in the Third Restatement' (1992) 77 *Iowa L Rev* 1151.
The Restatements of the Law produced by the American Law Institute do not represent the entire applicable law in the states of the United States. Many of the Restatements *do* reflect in large part the law as understood in most states, but in certain instances (and the *Third Restatement* is one of those) the Restatement embodies principles which the Institute feels ought to become the law of the states.

9 In addition, extensive reference to US state law is made where appropriate, as the US courts have had to consider the issues raised by this paper on much the greater number of occasions than New Zealand (or even Commonwealth) courts. However, the reader should be aware that US law is not on all fours with New Zealand and Commonwealth law and so not all US authority is readily transposable to the New Zealand situation, eg US law is less inclined to recognise delegation powers of trustees, exoneration clauses in trust instruments, and the creation of judicial powers to exonerate for breach of investment duties. Some of those differences have been identified as ripe for reform in the *Third Restatement*, but as yet amendment to state law to give effect to the approach adopted in the *Restatement* is slow. Moreover, note the rider contained in n 3 above.

10 For a useful discussion of portfolio theory by financial economists, see F Amling, *Investments: An Introduction to Analysis and Management,* 4th edn, (Englewood Cliffs NJ, Prentice-Hall Inc, 1978) Section VIII, R Brealey & S Myers, *Principles of Corporate Finance,* 2nd edn, (New York: McGraw-Hill

prediction as to future return (both income return and capital value change), the second is a prediction of the degree of risk[11] that the asset will not yield the anticipated return (ie the degree to which it is likely that the asset's future yield will vary from its anticipated return — measured in terms of 'variance' or 'standard deviation').[12] We know that since most people are averse to risk ('risk-averse') where a person has a choice of buying two assets, A and B, both of which offer an anticipated return of x%, but one of which (say A) has a higher risk of not giving that return, then the person will only buy A if the price of it is lower than that of B. In other words, the greater the risk, the lower the price must be in order to justify or compensate for the higher risk.

Often an asset's ability to meet its anticipated return yield is affected by changes in the economic environment. We know that not all economic conditions affect all assets in the same way. Thus, to the extent that the reactions of particular assets to changes in the economic environment are likely to move in opposite directions (ie are 'negatively correlated'),[13] it is easy to see that one effective method of reducing the volatility for an investment resource pool is to distribute the pool across a range of assets, the price of which react to certain conditions in opposite directions thus cancelling each other's volatility.[14] This is because the variance of a portfolio is not merely the sum of the variances of the individual assets which make up the portfolio, but also includes the covariance between them: in other words a portfolio's risk is less than the weighted average of the risk of its component holdings provided the different assets are negatively correlated.

Accordingly, in making decisions related to the purchase of new investments (or the retention of existing portfolio holdings) the crucial question must be: what relationship does this asset have to the other assets in the portfolio of assets that the investor holds? If one was to put this in economists' language: what is the covariance value of this asset in light of the portfolio holdings? Conversely, it is not appropriate to consider the riskiness (variance) of the asset in isolation because its effective riskiness is a function of the other assets held in the portfolio.[15] Finally, does diversification have an impact on anticipated return?

Book Co, 1984) Ch 8, EJ Elton & MJ Gruber, *Modern Portfolio Theory and Investment Analysis*, 4th edn, (New York: John Wiley & Sons Inc, 1991), JC Francis & SH Archer, *Portfolio Analysis*, 2nd edn, (Englewood Cliffs NJ: Prentice-Hall Inc, 1979), and JF Weston & TE Copeland, *Managerial Finance*, 9th edn, (Fort Worth: Dryden Press, 1992) Part IV.

Useful descriptions of portfolio theory by legal academics can be found in Haskell above n 8 pp100-104 (Part II.A 'Outline [of Portfolio Theory] by a Layperson for Laypersons'), Gordon & Kornhauser below n 28, Langbein & Posner below n 26.

11 It should be noted that, for the purposes of investment parlance, 'risk' does not refer to its more colloquial meaning of a chance that something bad will happen, but rather means variance from an intended outcome, whether that variance is upside or downside: B Malkiel, *A Random Walk Down Wall Street*, 5th edn, (New York: Norton, 1990) 216-219.

12 Mathematically, the standard deviation is the square root of the variance. According to Brealey & Myers, above n 10 p 122, n 5, 'which of the two we use is solely a matter of convenience. Since standard deviation is in the same units as the rate of return it is generally more convenient to use standard deviation. However, when we are talking about the proportion of risk that is due to some factor, it is usually less confusing to work in terms of the variance.'

13 Or at least the prices are not likely to move exactly together.

14 Brealey & Myers above n 10 p 124.

15 '[T]he riskiness inherent in any single asset held in a portfolio is different from the riskiness of that asset held in isolation. It is possible for a given asset to be quite risky when held in isolation, but not very risky if held in a portfolio.' Weston & Copeland, above n 10, pp 367-368 (emphasis omitted).

The short answer is in the negative. Indeed, by way of contrast to the *risk* of a portfolio, the expected *return* of a portfolio *does* reflect the weighted average of the anticipated returns of the individual assets which make up the portfolio. It is clearly more prudent to diversify the investment resource pool than invest it in a non-diversified form because diversification minimises the likelihood, and the extent, of deviation from the anticipated return rate of the portfolio as a whole,[16] without reducing anticipated return.

Economists distinguish between two types of risk: unique (or unsystematic/ residual/specific) risk and market (or systematic) risk. The former refers to the risk that surrounds an individual asset and that is peculiar to the asset and its immediate nearest equivalents. The latter refers to that type of risk which cannot be diversified away (for instance, the risk that the economy will collapse or that the particular investment market will fall and bring all or a large portion of the market with it). Accordingly, a diversified portfolio cannot reduce risk entirely but in relative terms it does make a significant contribution.

Let us make all of the above a little more concrete. A good example of a negatively correlated portfolio would be one where half of the portfolio is invested in sun tan lotion, while the other half is invested in umbrellas: adverse weather conditions from the point of view of one industry are excellent weather conditions from the point of view of the other. Diversification along these lines means that the investor's exposure to risk due to adverse weather conditions is reduced.

Let us consider another example. Investor A holds $10,000. She sets herself a high return as an important objective. She eschews low-income return Government bonds, and prefers to go for company shares quoted on the stock exchange. The problem here is that even if she were to invest in blue chip stocks there is a chance that the share values of each would drop. Portfolio theory tells Investor A to assess the likelihood of such an event occurring, and to attempt to predict what sorts of events would trigger it. It then tells her to protect against the drop by investing some of the portfolio in companies that react in a direction opposite to that in which the blue chip stocks would move in such circumstances (or in an appropriate options contract which allows for some sort of hedging of risk exposure). Thus, the investment in the second set of companies is motivated not by the likely good return which the second set of stock will provide but rather by a desire to protect the investor against the possibility of the first set falling in value.

Portfolio Theory contrasted with Individual Investment Approach

The 'individual investment' approach was a popular approach prior to the

16 Mathematical proof of this is found in Markowitz, above n 1, and was established as being empirically accurate for the New York Stock Exchange by studies: see, for example, WH Wager & SC Lau, 'The Effect of Diversification on Risk' (1971) 27 *J Financial Analysis* 48. See also Amling above n 10, ch 19 and Brealey & Myers above n 10, ch 8.

development of portfolio theory (and is still popular with those who have small holdings, or who wish to speculate). At its simplest (and not all investors conform to this simple model) the former involves the investor in identifying those investment vehicles which are likely to perform best in the future, and then tells her to invest all of the available investment funds in those vehicles. Any risk that the investment will turn sour just has to be tolerated, and no effort need be made to anticipate a downturn in value. In effect, it requires the investor to assume that her assessment of the probabilities of good performance will be demonstrated to be true.

Portfolio theory, as we have seen, operates on a different assumption, and requires a quite different orientation. It tells the investor that she ought not to assume that the investments identified by her as likely to best achieve her desired return will in fact achieve the desired result. Rather it tells her that if she is serious about realising the desired return, then she ought to try to avoid exposing those objectives to failure by assuming that the return/risk predictions of the individual investments will prove true. By choosing counter-reacting investment vehicles, there is less chance of the return objectives being undermined.

The key difference between portfolio theory and the individual investment approach is that the former sees the investment fund as an organic whole, and is prepared to sacrifice some of the trust fund as an insurance measure; it accepts that investment in risky investment vehicles may be necessary if the risk/return objectives are to be achieved. For example, *on its own*, an investment in futures or options contracts is a speculative venture[17] as the value of the investment can be totally lost, or conversely, the return on purchase price can be high. However, if an investor holds a portfolio which consists of certain shares, bonds, currencies, a futures contract or an options contract over counter-balancing assets can make a lot of sense, providing the whole portfolio with security in case something goes wrong with the economic conditions which determine the price of the underlying assets.[18] In the case that conditions do not turn unfavourable, the options/futures contracts will not be called upon, and the purchase cost will have produced nothing of long-lasting tangible economic value. Those contracts *will* have provided, however, a measure of protection against adverse changes in market conditions, and thus security to the portfolio as a whole.[19] When one bears in mind that, to an investor, the portfolio is the measure of her wealth, the value of portfolio theory concepts of asset management becomes obvious: anything which protects that wealth as a whole, and which protects it from undue exposure to risk, is to be favoured as prudent behaviour.[20]

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17 A Fleming, 'Prudent Investments: The Varying Standards of Prudence' (1975) 12 *Real Prop Prob & Tr J* 243, 251, and *Hazell v Hammersmith LBC* [1990] 2 QB 697, 765 (*per* Sir Stephen Brown P).

18 For example, it is very common in New Zealand for investors to take a hedge position in futures contracts on the NZSE40 so as to eliminate risk from share markets.

19 For an early demonstration of this apparent paradox, see RN Rosett, 'Estimating the Utility of Wealth from Call Options Data' in DD Hester & J Tobin (eds) *Risk Aversion and Portfolio Choice*, Cowles Monograph No 19 (New York: John Wiley & Sons Inc, 1967) ch 7.

20 '[Since] [t]he risk of a portfolio is a function of the interrelation of its component investments a trustee can use securities and instruments that are highly risky viewed in isolation to assemble a portfolio that is safe. ... Portfolio theory justifies the inclusion, in appropriate amounts, of stocks thought to be risky. It also justifies the use of financial instruments, highly volatile in themselves, that may be deployed so as to lower portfolio risk or to attain a portfolio of a given risk at a lower cost.' Gordon above n 2 pp 66-67.

Efficient Market Hypothesis and Portfolio Approach

A particularly important concept, which is often coupled with portfolio theory, is the so-called 'efficient market hypothesis'.[21] The efficient market hypothesis holds that it is in the best interests of a market that all appropriate information be released as soon as possible: quick dispersal of information encourages investors to place funds on the market.[22] The efficient market, therefore, will be a market in which information on significant price-affecting variables is received and processed quickly so as to determine new price levels. Accordingly, there will be little that individual information-hunting can reveal that will not be released to the market within a very quick time-frame after discovery by the investigation. The premium paid to be 'ahead of the posse', so to speak, will often not be justified because investigations will rarely turn up information that will put the investor in such an advantageous position.[23]

The efficient market hypothesis is of particular relevance to investment on stock and bond markets. In an efficient share (or bond) market, current price reflects the amount of information available about companies on the market. Conversely, the current price of a share provides no indication as to what the price of the share will be in the future. The current price only reflects the value of the share in light of the information received by the market. Receipt of more information may affect the price of the share positively or negatively. Thus, research into price trends of a particular share are of no value in predicting its future price.[24] Acceptance of this conclusion undermines the argument that past and current pricing trends are of value in predicting what shares ought to be invested in, and means that research into past trends provides nothing of value and is a waste of money. For a trustee, that word 'waste' should trigger alarm bells in terms of the prudence principle, which, as we shall see, is the test for all trust investments.

The efficient market hypothesis would suggest that from the trust's point of view, the most prudent strategy would be to abandon all investigative efforts designed to out-perform the market. Instead, one ought to concentrate money and resources on considering the risk which the trust is prepared to run, and the consequent level of diversification required. Some commentators have taken this analysis a step forward and argue that the best approach to prudent

21 Seminal works in this area are P Samuelson, 'Proof that Properly Anticipated Prices Fluctuate Randomly' (1965) 6 *Indal Mgmt Rev* 41 and B Mandelbrot, 'Forecasts of Future Prices, Unbiased Markets and Martingale Models' (1966) 39 *J Business* 242. A brief history of the development of this concept (and portfolio theory) is to be found in MC Jensen & CW Smith Jr, 'The Theory of Corporate Finance: A Historical Overview' in MC Jensen & CW Smith, Jr, (eds) *The Modern Theory of Corporate Finance* (New York: McGraw-Hill, 1984) ch 1 and a somewhat fuller survey is found in SF LeRoy, 'Efficient Capital Markets and Martingales' (1989) 27 *J Econ Lit* 1583.

22 RJ Gilson & RH Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Va L Rev* 549.

23 See *Third Restatement* above n 4 p 75 (Reporter's notes on Section 227, general note on comments e-h): 'Empirical research supporting the theory of efficient markets reveals that in such markets skilled professionals have rarely been able to identify under-priced securities (that is, to outguess the market with respect to future return) with any regularity.' See also Brealey & Myers, above n 10.

24 See EF Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *J Finance* 383, and see also R Brealey, *An Introduction to Risk and Return for Common Stocks*, 2nd edn, (Cambridge, Mass: MIT Press, 1984).

investment on the stock and securities market is one which attempts to track the performance of the market *as a whole*, not any particular part of it.[25] Thus, total market diversification is called for, and this can be achieved by investment in market or index funds, which track a widely spread market indicator. The advantage of this is that administration and research costs are greatly reduced, and further savings of the trust funds are ensured, resulting in more for the beneficiaries.[26]

Throughout the 1960s and 1970s, it was thought that the relationship between efficient market hypothesis and practice had been shown by empirical data to be true of a number of share markets, and many others were thought to approximate to the efficient market model. It should be noted, however, that some more recent scholarship[27] questions whether the efficient market hypothesis completely comports with reality, and criticises the easy passage of the concept from theory to legal doctrine.[28] Questions have been raised about the empirical data which supports the efficient market hypothesis[29] and the theoretical underpinnings of the concept.[30] This recent research puts in doubt automatic reliance on index-tracking instruments and suggests that research of individual groups of stocks (or bonds) may be necessary.

Even putting these concerns aside, it is trite to observe that not all markets in which an investor may be interested in operating will necessarily approximate closely to the efficiency model. For example, the venture capital or property markets are certainly less efficient than stock and bond markets, as much more

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25 Fama, above n 24 p 388, divides the efficient market hypothesis into a three-part typology. The 'weak' form of EMH is that past price movements cannot be relied on to make predictions as to future prices in any systematic way. The 'semi-strong' form is that information available to the public cannot be used to predict future prices. The 'strong' form is that no informational access will systematically confer a market advantage. Acceptance of the 'strong' form of EMH would be to throw the efficacy of insider trading rules into doubt, and does not receive much support in the economics literature.

26 JH Langbein & RA Posner, 'Market Funds and Trust-Investment Law' (1976) 1 *Am Bar Found Res J* 1, passim.

27 SJ Grossman & JE Stiglitz, 'On the Impossibility of Informationally Efficient Markets' (1980) 70 *Amer Econ Rev* 393.

28 N Wolfson, 'Efficient Markets, Hubris, Chaos, Legal Scholarship and Takeovers' (1989) 63 *St John's L Rev* 511, and JN Gordon & LA Kornhauser, 'Efficient Markets, Costly Information and Securities Research' (1985) 60 *NYUL Rev* 761. Gordon and Kornhauser have been particularly critical of the acceptance of the efficient market concept by the legal community. They state (p 764): 'We think that the legal rush to embrace and apply the efficient market hypothesis [EMH] has been overly precipitous and occasionally unwise. The legal embrace of the EMH has been based principally on economists' empirical tests of the hypothesis in the 1960's and early 1970's. Economic research and controversy about the hypothesis had a second flourishing that began in the late 1970's and continues today.' See also the useful review of the efficient market hypothesis and its impact on the approach to a number of important legal issues (including not just trustee investment but also issues such as insider trading) and the impression on the legal mind it has created in DC Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 *UPaLRev* 851.

29 WKS Wang, 'Some Arguments that the Stock Market is not Efficient' (1986) 19 *UC Davis L Rev* 341.

30 EMH works on the assumption that investors act rationally when making investment choices and that the market works so as to facilitate rational decision-making. Noise theorists, who are in the vanguard of those who attack EMH, take the view that psychological factors play a significant role in price-fixing (explaining short-term price volatility, which EMH fails to adequately accommodate). The noise theorists have succeeded in making EMH a debatable concept in the financial economics field, though as yet have not quite undermined its dominance there. For a most useful discussion of the threat which noise theory poses to EMH, see Langevoort above n 28. For the impact of noise theory on current approaches to securities market regulation, see TL Hazen, 'Rational Investments, Speculation, or Gambling? — Derivative Securities and Financial Futures and their Effect on the Underlying Capital Markets' (1992) 86 *NWUL Rev* 987.

reliance will have to be placed on individual research and assessment of the options, and more effort will have to be expended on attempting to predict the more stable contenders if the trustee wishes to avoid allegations of imprudence.[31]

THE RELEVANT PRINCIPLES AND RULES OF TRUSTEE INVESTMENT LAW: Obstructions To Modern Portofolio Theory?

The Prudence Principle

The principle of prudence is the most fundamental legal principle relating to the investment powers of trustees.[32] As put by Lindley LJ in *In re Whiteley: Whiteley v Learoyd*, the principle requires the trustee '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.'[33] This principle is the universal touchstone of all legal regulation concerning trust investment selection.[34]

The reasons which underlie the prudence principle are readily understandable. Trustees have under their control funds which are to be utilised for the benefit of persons other than themselves. In such circumstances, there might be a temptation to treat the funds as if they were one's own (and engage in speculative or risky investment behaviour - if one is so minded!) or, because they are someone else's funds, one might be tempted to pay rather less than adequate attention to the performance of the trust funds to the detriment of the beneficiaries. Establishing high standards to regulate investment selection and on-going investment management responsibilities acts as a counterbalance to such temptations.

It will be apparent that the prudence principle is a conduct-orientated principle, that is, a principle directed at assessing the conduct of the trustees against an objective[35] standard. The prudence of an investment strategy is not

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31 It may well be that investment in such markets will be a necessary component of a portfolio, so as to ensure that there is some measure of protection against a downturn in the sorts of industries which make up the major proportion of a portfolio's sharemarket holdings.

32 The prudence principle has a long lineage: see references to it in *Brown v Litton* (1711) 1 P Wms 141; 24 ER 529.

33 (1886) 33 Ch D 347, 355 (Eng CA) (approved by Megarry VC in *Cowan v Scargill* [1984] 2 All ER 750, 762 (Eng HC), Dillon and Leggatt LJJ in *Nestle v National Bank of Westminster Plc* [1993] 1 WLR 1260, 1267 and 1282 (Eng CA), and Thomas J in *Jones v AMP Perpetual Trustee Company Ltd* [1994] 1 NZLR 690, 706 (NZHC)). The *Whiteley* formulation was the one adopted by s 52(2)(b) of Australia's *Superannuation Industry (Supervision) Act* 1993.

34 The prudence principle applies both where the trust instrument specifies the investment vehicles which it is open to the trustee to consider, and where the instrument has failed to specify the range of investments open to the trustee and the appropriate statutory legal list provisions are triggered.

35 That the standard is an objective one, and not one to be measured by reference to the subjective abilities of the particular trustee, where the trustee claims not to have the abilities of the ordinary person of business, is clear law: see, for example, *Rae v Meek* (1889) 14 App Cas 558, 569-570 (*per* Lord Herschell); *Shriners Hospital for Crippled Children v Gardiner* 152 Ariz 527, 733 P 2d 1110 (1987). But where the abilities of the trustee are of higher than average ability and the trustee carries on specialised trust management, then a higher standard will be required: *Bartlett v Barclays Bank Trust Co. (No 1)* [1980] Ch 515, 534 (per Brightman J), Leggatt LJ in *Nestle* above n 33 p 1282H. Section 13C of New Zealand's *Trustee Act* (inserted by the *Trustee Amendment Act* 1988, s 3) explicitly adopts a bifurcated standard (see the text accompanying n 97 below), though this bifurcation was a subject of some concern and controversy during its passage through Parliament (see NZPD Vol 490, 5121-5128 2nd Reading, and NZPD Vol 490,

assessed by the outcome of the investment, but rather by an assessment of the prudence in undertaking the particular investment.[36] As has been stated so often, a trustee is not a guarantor nor an insurer of the trust's investment performance.[37] In turn, if it can be shown that a portfolio approach is a prudent course to take in investing trust funds, then, in principle, there ought to be no incompatibility between trust law and portfolio management strategies. Unfortunately, a number of rules derived from the prudence principle have created the perception that the compatibility between the two is not such a straightforward matter. Moreover, there are a number of additional concerns which suggest that acceptance of portfolio theory as an acceptable trust investment strategy could meet resistance. In the sections that follow, we consider both of these issues.

Five Rules of Trustee Investment Law Obstructing Portfolio Management

Five rules pose particular difficulties to the introduction of portfolio theory: the 'investment' rule, the 'legal list' rule; the 'anti-netting' rule, and the rules on 'impartiality' between income and capital beneficiaries. These rules have been applied somewhat differently in each common law jurisdiction, though in almost all, including the United States, all (or combinations of the) five rules have stultified the deployment of portfolio management in the trust investment area.

The 'investment' rule states that only those applications of trust money 'in the purchase of some property from which interest or profit is expected and which property is purchased in order to be held for the sake of the income which it will yield' are investments for the purpose of trust law.[38]

The 'legal list' rule states that trustees are permitted to invest trust funds *only* in those investment vehicles which are authorised by statute (or by judicial fiat), *unless* the settlor has expressed a contrary intention,[39] in which case the range of investment vehicles enumerated by the settlor defines the field of

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5232 3rd Reading), with the Working Party having recommended against it, above n 6 p 8, para 6 and a number of submissions also in opposition. See also New Zealand Law Society, *Submissions on the Trustee Amendment Bill 1987,* 19 February 1988. A useful discussion of the topic is to be found in the *Report on the Law of Trusts* carried out by the Ontario Law Reform Commission above n 4 pp 27-35.

36 The outcome of the investment assumes importance, of course, when the court has to determine the amount of the compensation to be ordered against the imprudent trustee; failure to prove a negative outcome means that the claim will fail: *Nestle* above n 33 p 1269E (*per* Dillon LJ).

37 See *Jones v AMP Perpetual Trustee Co NZ Ltd* above n 33 p 706, where Thomas J accepted the view that 'it is clear that a trustee is neither an insurer nor guarantor of the value of a trust's assets ...' citing *Stark v United States Trustee Co of New York* 445 F Supp 670, 678 (1978) and *DeBruyne v Equitable Life Assoc Soc of United States* 920 F 2d 457, 465 (1990). See also *Third Restatement* above n 4 p 11.

38 *In Re Wragg; Wragg v Palmer* [1919] 2 ChD 58, 65 (HC). Though an old case and one of first instance it is regarded as the leading case on the point in England and has been followed since: *Re Power's Will Trusts, Public Trustee v Hastings* [1947] Ch 572, 575 (HC). See also *First Alabama Bank v Martin* 425 So 2d 415, 427ff (Ala 1982).

39 Since the end of the Second World War it has been common practice for the draftspersons of trust instruments to authorise trustees to invest in such investment vehicles as they in their discretion think most prudent: see, for example, Waters below n 46 p 766. Of course, the settlor's power to specify which investments a trustee could invest also allow him/her to authorise the trustee to invest in a smaller range of investments than those set out in the legal list: see, for example, *Perpetual Trustee Co Ltd v Molloy* (1923) 23 SR (NSW) 395.

acceptable choice.[40]

The 'anti-netting' rule says that where a trustee has been found to have invested imprudently, she cannot offset losses from such investments against investment gains.[41]

The 'impartiality' rule is to the effect that as between the income beneficiaries (the life tenants) and the capital beneficiaries (the remaindermen) the trustee's selection of investments must be impartial, neither favouring one nor the other, *unless* it is the intention of the settlor otherwise.[42]

Without doubt, the first three rules demonstrate that traditionally the paradigmatic trust investment pattern has been the individual investment approach. Each of the rules strengthens the conclusion that in setting review standards for trustee activity, courts and legislatures took the view that each element of the investment package had to be considered *in isolation*.[43] First, because each element of the holding had to be invested prudently, trust money could not be applied on any property unless it was intended that the item of property be retained in the medium to long term, and retained for the purpose of the income stream it would produce: 'short-term investment' was, therefore, an oxymoron.[44] This rule becomes objectionable to such common investment devices as derivatives (eg swaps, options, etc) because it inevitably classifies these as speculative even though they can add significantly to the stability and

40 It is interesting to note, however, that even where a settlor has drawn up a broad investment power, there is 'the tendency of many corporate fiduciaries to disregard broader powers no matter how clearly stated or how positively expressed the exoneration language may be' (Fleming above n 17 p 254-255), a reason that Gordon ascribes to the application of a constrained prudent person rule, which analyses investment decisions essentially in line with the individual investment approach (Gordon above n 2 pp 52-53, and see n 1, p 53). Both Gordon and Fleming note the reluctance among corporate trustees to utilise futures and options, margin purchases and short-selling, because of fears that even though these devices are *prima facie* allowed by the trust instrument the courts will classify them as speculative if they turn sour. See also Langbein & Posner above n 27 p 6.

41 See, for example, *Dines v Scott* (1828) 4 Russ 195, 38 ER 778; *Re Barker, Ravenshaw v Barker* (1898) 77 LT 712. In *Bartlett v Barclay's Bank Trust Co Ltd (No 1)* above n 35, Brightman J (as he then was), having recognised the general rule, took the view that on the facts of that case it would be unjust to deprive the defendant of the profit made on one speculative investment as a set-off against the loss on another. His Lordship referred to the rule as being based on cases that were 'not altogether easy to reconcile' and all of which were 'centenarians'. Jill Martin has referred to the rule as 'harsh': see J Martin, *Hanbury & Maudsley's Modern Equity* 13th edn (London: Stevens & Sons, 1989) p 604.

42 See, for example, the judgment of Staughton LJ in *Nestle* above n 33 p 1279D. For a description of the rules which have grown up to give effect to the impartiality rule see Martin above n 41 pp 508-522.

43 See the US cases discussed by Gordon above n 2 pp 70-74 which demonstrate a predeliction on the part of courts to consider (p 73) 'each challenged security in isolation, not in relation to the portfolio as a whole.' Gordon says that the US approach is informed by AW Scott's *Treatise on Trusts* and Scott's work in preparing the *First* and *Second Restatements of the Law of Trusts*, which operate on the assumption that 'only if each investment is safe, measured in isolation, will the collection of investments (the portfolio) be safe.' According to Langbein and Posner above n 26 p 24, 'The Courts characteristically apply the prudent man standard to each investment decision of the trustee rather than to the trust portfolio as a whole', while Professor Haskell has noted that under the First and Second Restatements, 'The standard of prudence is applied to each investment in isolation. Each investment is either in compliance or it is not, without regard to its relationship to other investments in the portfolio.': Haskell above n 8 p 93. See also RD Blair & AA Hagestaad, 'The Prudent Man Rule and Preservation of Trust Principal' [1978] *U Ill Law Forum* 79, 88-89.

44 See eg *First Alabama Bank v Martin* , above n 38, where it was said *inter alia* that, '[O]ne who buys common stocks with the idea of selling them on the market is speculating. One who is making prudent investment examines the stock's intrinsic values and purchases them for a long-term investment.'

long-term prospects of the fund.[45]

Second, only a certain number of investment vehicles could be considered sufficiently 'safe' *in abstracto* to be labelled *per se* prudent; lists were compiled of 'safe' investments, and investment in other vehicles was proscribed (unless a contrary intention was expressed by the settlor). In many Commonwealth countries such lists still remain in place.[46]

Third, because each element was to be considerd in isolation, it was not open to a trustee to claim that investment in a 'risky' instrument was so intimately linked to the purchase of a more stable instrument, that she ought to be allowed to set one off against another. Thus, if a trustee invested imprudently (either by investing in unauthorised investments or in choosing to invest in items which though authorised by the list were imprudent to invest in in the circumstances[47]) then she could not offset any losses from such investments against investment gains made.

As Fleming has noted, the combination of these rules in the United States has been such:[48]

> [as] to make trustees overly conservative; their portfolios underdiversified; their policy being one of concentrating on a small number of 'safe' securities; and their general approach one of adhering to predetermined bond-stock ratios regardless of market trends or conditions.

In all of this it should be noted that the old law did not necessarily frown on diversification as a concept of trust fund management.[49] However,

45 Indeed, in the recent *Hazell v Hammersmith LBC* [1992] 2 AC 1, 35 case (not a trusts case), the House of Lords held that buying into interest rate swaps was in essence 'akin to gambling' (*per* Lord Templeman). In the same case Lord Ackner (giving the only other speech in the case) stated his view (p 46) that 'swap transactions are essentially speculative methods of raising money in the hope of reducing the burden of interest payable on money already borrowed.' Clearly the preferable approach to this issue is embodied in the judgment of Sir Stephen Brown P in the Court of Appeal decision in the same case ([1990] 2 QB 697, 765). Sir Stephen recognised that while '[f]utures markets are notoriously attractive to wealthy gamblers', in certain situations engaging in swaps transactions can provide 'a form of insurance.' In short, to denounce all uses of certain financial instruments as speculative is too undiscriminating; the context is all important. The benefits of derivatives are usefully discussed in M Adams, 'Practical Issues for Trustees in the Application of Trust Fund Moneys in the Use of Derivatives' [1994] *J Banking Law & Prac* 20, and Hazan above n 29. For a discussion of the implications of the *Hazell* decision see Adams generally and see also G Fitzgerald, 'Swaps: *Hammersmith* and the powers of New Zealand statutory bodies to enter swap contracts' in J Prebble (ed) *Dimensions in Business Finance Law* (Wellington: Butterworths, 1992).

46 For a description of the operation of the legal list approach in some Commonwealth jurisdictions, see HAJ Ford & WA Lee, *Principles of the Law of Trusts*, 2nd edn, (Sydney: Law Book Co, 1990), Ch 10 (Australia); DWM Waters, *Law of Trusts in Canada*, 2nd edn, (Toronto: Carswell, 1984), Ch 19 (Canada); BM Gandhi, *Equity, Trusts and Specific Relief*, 2nd edn, (Lucknow: Eastern Law Book Co, 1993) Ch XIV.A.13 (India); DJ Hayton, *Underhill & Hayton Law of Trusts and Trustees*, 14th edn, (London: Butterworths, 1987) 498-537 (United Kingdom). For a description of the law in Ireland, see R Keane, *The Law of Equity and Trusts in the Republic of Ireland* (Dublin: Butterworths, 1986) Ch10.

47 As to the latter, see *United States National Bank v First National Bank of Portland* 172 Or 683, 142 P 2d 785, 791 (1943) and *Stevens v National City Bank* 544 NE 2d 612 (Ohio, 1989), where the Court held that a trustee had to dispose of otherwise proper investments if they were imprudent because they were not properly diversified. See also Hayton above n 46, pp 530-531.

48 Above n 17 p 249.

49 In England and Wales, s 6(1)(a) of the *Trustee Investment Act* 1961 directs a trustee to have regard 'to the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust.' The First and Second Restatements (of 1935 and 1959) recommended diversification as a principle of trust investment. For recognition of the importance of diversification in the US case law see *First*

diversification could not be relied upon as a justification to invest in an item which was not authorised by the appropriate judicial or legislative list, nor to invest in any item that was regarded as intrinsically speculative when considered on its own.[50]

Because the three rules are inspired by the individual investment approach, they are, to a significant degree, incompatible with the portfolio approach. The riskiness of an asset is assessed in isolation, whereas portfolio theory posits that the riskiness of an asset can only be judged when considered in light of its effect on the portfolio of assets held by the investor trustee. Accordingly, adoption of portfolio theory requires, as a minimum, a remoulding of each of these rules.

What would be required? A pro-portfolio legal regime would need to declare that no property is *per se* imprudent for the purposes of trustee investment. It should also state that the anti-netting rule will only apply against those individual investments which are high risk *and* which *increase* the net risk of the portfolio.[51] The latter makes sense since the only justification for investment in a high risk item is that it is part of a portfolio strategy designed to *reduce* the risk of that portfolio; to protect conduct that increases net risk is to sanction speculation. Finally, reforming legislation ought to clearly encourage trustees to look at trust investment holdings as an interlocking whole, not just at its individual elements.

Let us turn now to the 'impartiality' rule. As mentioned above, this rule states that as between income beneficiaries and capital beneficiaries, the trustee must be impartial. The investment package must not discriminate in favour of one or the other. Thus, it would be imprudent for a trustee to invest all the trust funds in an asset or assets that show a capital increase in value and only a low income return, as this would favour the remainderman. The issue is of importance not only to private family trusts, but also to superannuation fund trustees as well. As regards the latter, questions arise as to who owns the capital of the fund, and the purpose of the fund may well determine the allocation of funds as between present and future beneficiaries, as well as the ultimate destination of the residual capital.

Alabama Bank v Spragins 515 So 2d 962 (Ala, 1987) and the well-known decision of the Court of Appeals of New York in *Bank of New York (Spitzer)* 35 NY 2d 512, 323 NE 2d 700 (1974) and see also the cases referred to in the Reporter's Notes to *Third Restatement*, above n 4 p 84.
Therefore, to the extent that Professor Lee has suggested that 'diversification is foreign' to the legal list approach, he is, with respect, overstating the case: WA Lee, 'Modern Portfolio Theory and the Investment of Pension Funds' in PD Finn (ed) *Equity and Commercial Relationships* (Sydney: Law Book Co, 1987) 284, 291.

50 Adams above n 45 p 30 has observed, 'It would appear that English trust law, under the influence of statute [s 6(1)(a) of the *Trustee Investment Act* 1961, which is reproduced in the footnote immediately above], has gone half way on acceptance of modern portfolio theory. The English courts appear to accept that trustees need to adopt a diversified portfolio but do not take the extra step to require trustees' investment decisions will be judged by reference to their investment strategy as a whole and not by review of each type of individual investment.'
As to the situation in the US, Haskell above n 8 p 94 has noted that in contrast to portfolio theory, '[t]he prudent person rule ... requires diversification, but only among unspeculative investments because none other is permitted.'

51 TD Johnston, 'Prudence in Trust Investment' (1975) 8 *J Law Reform* 491, 526 and Gordon above n 2 pp 94f and Halbach above n 8 pp 1180-1181. Acceptance of this modification of the application of the anti-netting rule has been made in the *Third Restatement* above n 4, s 213.

It will be clear that the assumption that underlies this rule is the view that the life tenant obtains the gains which accrue in the form of income, while the remainderman receives the benefit of all the gains made in capital value. This split between capital and income return has long been a feature of trust law, and is firmly imprinted on most lawyers' (and judges') minds.[52] However, the idea of separating income and capital return on an asset is regarded by most financial economists as a completely artificial exercise.[53] The corollary of this is that no financial strategy should be built on the assumption of a split between the two and, for the purposes of financial forecasting, income and capital returns are to be aggregated and regarded as one unit. Indeed, the correlation values among different assets in a portfolio are calculated on the basis of a total return definition. Accordingly, in devising a portfolio, financial theory tells the investor to choose that portfolio of assets which will best realise the return she seeks, regardless of whether the return is in the form of capital return (ie gain) or income return (ie income). The 'impartiality' rule tells the investor trustee that such a course of action is not possible; she must take into account the income/capital split. If this rule is retained it could well hinder the choosing of the portfolio best designed to secure the return desired by the trustee.[54] Of course, to some extent these problems exist absent the portfolio theory — for example, investment in interest-bearing bonds can work to the disadvantage of the remainderman in times of rapid inflation — but adoption of portfolio theory underscores the inadequacy of the traditional income/capital split, so beloved of trust law. It has been recognised in the United States that this issue is an important one if optimal portfolios are to be adopted by large fund managers, and the National Conference of Commissioners on Uniform State Laws has appointed two reporters to revise the (Revised) Uniform Principal and Income Act ('UPIA'), which has been a model upon which state income/capital allocation laws have been based,[55] to take account of these issues.[56]

Though obviously not the simplest of issues to resolve, even for financial

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52 Gordon above n 2 p 99 states that, 'No principle in the law of trusts seems more settled than the rule that income beneficiaries receive ordinary cash dividends from common stock ownership and remaindermen receive capital gains if the stock is sold.' (footnote omitted) In its *Report on the Law of Trusts*, Cmnd 8733 (London: HMSO, 1982) the English Law Reform Committee suggested reforms in this area, with a duty on the trustees to be fair as between the income and capital beneficiaries (p 19). See also the *Model Trustee Code* discussed by Lee above n 4 pp 253-254.

53 See, for example, EM David, 'Principal and Income—Obsolete Concepts' [1972] *Penn Bar Assoc Q* 247.

54 See, for example, Ontario Law Reform Commission's *Report on the Law of Trusts* above n 4 p 262. In similar vein, Gordon above n 2 p 99 observes that 'Acceptance of portfolio theory, however, would undermine the traditional rule.' A series of Ford Foundation reports in the 1960s and 1970s brought into focus the fact that the impartiality rule contributed to the adoption of conservative, portfolio theory-averse investment strategies by colleges and universities, leading to reduced returns for these institutions: see JC Dobris, 'Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending from Endowments: a Visit to the World of spending Rules' (1993) 28 *Real Prop, Prob & Tr J* 49, 52 (Dobris 'Endowments'). See also JC Dobris, 'The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future' (1993) 28 *Real Prop, Prob & Tr J* 393, 411-412 (Dobris 'Future').

55 That Act sets out rules as to which returns are to be classified as accruing for the benefit of income beneficiaries and which for the benefit of the capital beneficiaries.

56 See *Third Restatement* above n 4 pp 89-90 (Section 227, comment i, Reporter's notes). The Reporter, Edward C Halbach Jr, observes that 'one of the concerns leading to the initiation of this project is the possibility that, without some adaptation or increased flexibility in accounting principles, the ability of a trustee to pursue an optimal (especially total return) investment strategy will be impaired in some trust situations because of 'income productivity' requirements.' See also Gordon, above n 2 pp 99-112.

economists, a range of possibilities are open, and deserve serious scrutiny and consideration. In a lucid and incisive article, 'The Puzzling Persistence of the Constrained Prudent Man Rule', Professor Jeffrey Gordon (then of New York University Law School) presents a number of options which might solve this difficulty.[57] Also active on this front is Professor Joel Dobris of UC Davis, who is a Co-Reporter on the revision of UPIA.[58]

One obvious solution (referred to as the 'prudent trustee payout' by Gordon) is to allow the trustee to 'determine the appropriate allocation of returns'.[59] Gordon points out, however, that such a rule 'will inevitably put the trustee in the very difficult position of balancing the interests of life beneficiaries and remaindermen'.[60] He noted that there has been resistance in the past by corporate trustees in the United States to any proposal for a discretionary rule as a substitute for the UPIA,[61] which sets out a statutory guide as to which returns are income and which are capital.[62]

Dobris admits that there are legitimate concerns about the 'reallocation' approach. It exacts an efficiency cost and it can give trustees powers they can use arbitrarily. However, he argues that giving trustees the power to reallocate as between income and capital gains ought to be given serious thought as the preferred method to deal with the problem. He argues that such an approach offers great flexibility and would be suitable to all types of trust situation because it 'free[s] the sophisticated trustee without forcing the ordinary trustee to operate in an *avant-garde* fashion.'[63] Moreover, a move in that direction, he argues, is far from dramatic. The existing law (which gives the trustee a discretion as to which type of assets to invest in) clearly embraces a range of possible returns for income beneficiaries by allowing trustees to choose assets that best suit the needs of the trust. Would it not be better that the trustee be able to determine the allocation of resources produced by the trust at the stage when the returns are realised, rather than estimate in advance and be hamstrung by subsequent events which contradict the prediction made? As Dobris says:[64]

> because a trustee already has a power to vary the return to beneficiaries on a *de facto* basis, giving the trustee this power formally is not extraordinary, especially when it may allow the trustee to invest for a higher total return and to achieve greater fairness.

Interestingly, in its *Report on the Law of Trusts*, the Ontario Law Reform Commission proposed the adoption of a reallocation power as a method of

57 Above n 2, pp 99-112.
58 See the articles by Professor Dobris referred to above n 54.
59 Gordon above n 2 p 102.
60 Above n 2 p 102.
61 Above n 2 p 103, n 208, referring to a panel discussion on the UPIA set out in (1962) 101 Tr & Est 894, 896.
62 Most states in the US have adopted either the *Uniform Principal and Income Act* 1931 or the revised Act of 1961: KL Hirsch, 'Inflation and the Law of Trusts' (1983) 18 *Real Prop Prob & Tr J* 601, 604.
63 Dobris 'Future' above n 54 p 424.
64 Dobris 'Future' above n 54 p 424.

resolving the difficulties which current law poses.[65]

The other solutions considered by Gordon are the 'fixed nominal payout', the 'fixed real payout', the 'fixed portfolio percentage payout', and the 'payout of adjusted real yield'. Of these four, Gordon takes the view that the last-named approach is best suited to producing the maximum real return on the portfolio and ensuring a close effectuation of the settlor's objective of a steady real income stream, yet which admits of some variation.[66] The approach bases payout on the total portfolio returns (income and capital) for a period. Its major problem is that a stable income stream will not be readily maintainable. To overcome this problem, Gordon suggests that a tentative payout assumption be made based on long-term average real yields and that a stabilisation account be constructed so as to reflect surpluses or shortfalls, thus smoothing out variability in actual payouts. Nonetheless, Gordon recognises that there are 'many technical, financial and legal problems with the approach'[67] and these need to be resolved before it could be adopted. Moreover, such a sophisticated approach to income/capital allocation would not be appropriate for a significant number of smaller and medium sized trusts.[68]

However, in discussing the difficulties associated with alternatives to the impartiality rule it must be recalled that the important point is that the rule itself is an obstacle to portfolio management and needs to be modified if portfolio theory is to be given the green light.

Rules on Delegation

Turning now to the rules on delegation to professionals and advice, we have noted earlier that portfolio theory is a theory which is particularly efficient for large trust funds. However, it is also a highly sophisticated theory of investment management which requires good knowledge of investment models and techniques. In short, to implement it requires a high degree of professional knowledge. Accordingly, it would appear sensible for trust law[69] to facilitate the deployment of portfolio theory concepts by allowing trustees to delegate their investment powers to professionals. The problem here, however, is that traditionally trust law has been resistant to the notion of allowing trustees to place their responsibilities in the hands of non-trustees.[70]

65 See ss 40-42 of the Draft Bill proposed by the Commission, and the discussion of the issue in the Commission's Report above n 4 pp 261-304.

66 Above n 2 p 107.

67 Above n 2 p 107.

68 Dobris takes the view (in the context of university endowment funds), Dobris 'Endowments' above n 54 p 65, n 59, that operating a stabilisation fund is too complicated to be required of all trustees, and that any smoothing procedure for private trustees will be difficult unless it is simple to explain, understand and operate.

69 Davis has observed 'The so-called anti-delegation doctrine of trust law, while not strictly speaking a breach of the 'prudent person' rule figures importantly in the fabric of legal constraints on investment management by trustees.': RL Davis, *A Guide to Trustee Investment Under a Prudent Person Approach* (Wellington: Butterworths, 1990) 19.

70 In his Conference paper, John Lehane details the law on delegation and the use of agents at greater length. See pages 36-49 of this edition 'Delegation of Trustees' Powers and Current Developments in Investment Funds Management'.

The Commonwealth law on delegation of investment powers is in an unsatisfactory state. Section 23(1) of the English *Trustee Act* 1925 (which is the model for s 29 of the New Zealand Act and other provisions throughout the Commonwealth) allows a trustee to appoint any person 'to employ and pay an agent' for the purpose of doing various acts in relation to the execution of the trust, and shall not be responsible for the default of any such agent if employed in good faith. Arguably, this section could be invoked as providing authority for the appointment of an investment company with power to alter investment strategy and make investment choices suitable to the trust. For example, the Ontario Law Reform Commission noted in its *Report on the Law of Trusts* that the delegation provision allows that 'any duty may be delegated, whether or not it is discretionary, and, *a fortiori*, any power may be delegated whether it is administrative or dispositive in nature.'[71] However, in its Twenty-Third Report entitled *The Powers and Duties of Trustees*,[72] the English Law Reform Committee took the view that s 29(1) did not give the trustees a general[73] power to delegate investment decisions.[74] Thus, while it is perfectly acceptable for trustees to appoint agents to *implement* decisions which the trustees have made, under traditional law it is another matter entirely for the trustees to so rely on others to the extent that investment decisions in relation to the trust cannot be truly said to be those of the trustees.[75] The latter would be regarded as *de facto* delegation.[76]

The position in the US has been traditionally even less liberal than that obtaining in the Commonwealth.[77] Few states have legislation in place which allows for delegation of investment decisions in any meaningful sense. Indeed, the anti-delegation doctrine has been cited by a number of commentators as being a significant obstacle to the adoption of portfolio management strategies.

Interestingly, in the *Third Restatement* it has been proposed that a radical

71 Above n 4 p 46. The Commission noted that there is some dispute in England as to whether the provision allows only ministerial duties to be delegated or goes further in the manner suggested by the Commission.

72 Above n 52 p 38 (paras 4.16-4.20).

73 Of course, the trustees have the power to delegate trustee discretions and powers for up to one year under s 25 of the *Trustee Act* 1925 (UK).

74 Further, the Committee rejected arguments presented by certain parties which supported a power to delegate investment powers to suitable professional investment advisers. In his paper to this conference, John Lehane makes a conclusion similar to that reached by the Committee: 'the trustee does not, by the appointment [of an investment manager] shed the duty to determine investment policy and to supervise the manager's performance of the acts and entry into the transactions, delegated to it.' Above n 70 pp 36-49.

75 See for example, *Rowland v Witherden* (1851) 3 Mac&G 568; *Speight v Gaunt* (1883) 22 Ch D 727, 739, *Allan v Erlank's Trustee* [1908] TS 1187 (S Afr).

76 However, a somewhat more liberal approach to delegation was taken by Hoffmann J in *Steel vWellcome Trustees* [1988] 1 WLR 167. In that case, the Court was asked to approve a new investment scheme for the gigantic Wellcome Trust (valued at GBP 3,200m). The scheme provided *inter alia* for the delegation of power to choose investments to external advisors in order to build up a diversified portfolio. The power was subject to a number of conditions notably a power to revoke delegation and regular (quarterly) reporting to the trustees. Under the scheme the trustees would not be liable for any loss unless the loss was due to the negligent choice of advisors or failure to require remedial action to be taken by agents where requiring such action would be the prudent thing to do. Hoffmann J approved the scheme noting that delegation was a practical necessity for the trust, and commenting upon the reasonableness of the liability exclusion clause.

77 For a comparative analysis of the rules surrounding delegation in the United States and England, see Baringhaus, 'Trustee's Power to Delegate: A Comparative View' (1974) 50 *Notre Dame L Rev* 273.

change to state law be made. In the comments accompanying s 227(c)(2),[78] a number of relevant propositions are advanced:[79]

1. The trustee is not required to perform all aspects of the investment function personally.
2. Where the trustee seeks to employ agents to implement trust policy, he/she must select agents with care and exercise prudence in monitoring or supervising their activities.
3. The trustee must personally define the trust's investment objectives.
4. The trustee must also make the decisions that establish the trust's investment strategies and programmes, at least to the extent of approving plans developed by agents or advisers.
5. Beyond these generalisations, there is no invariable formula concerning the functions that are to be performed by the trustee personally.
6. Many factors affect the nature and extent of prudent delegation, such as the size, objectives, and circumstances of the trust, the skills and expertise of the trustee, as well as the investment techniques employed to realise the goals of the trust.

Moreover, the illustrations which accompany this part of the text of the *Restatement* (Illustrations 22 and 23) indicate that delegation ought to be implemented on a practical basis, with significant leeway allowed to trustees where appropriate, and particularly where portfolio management is chosen as the method of trust investment.

This examination of Commonwealth law and the law of the United States demonstrates that in both systems assistance in the ongoing formation of investment portfolios is sufficiently questionable as to discourage trustees from engaging professional persons for such tasks. This is unfortunate, for as Halbach has observed, '[t]he need for delegation is perhaps most apparent when specialised programs and challenging investment strategies are pursued, even by skilled trustees managing large, diverse portfolios.'[80] Pro-portfolio legislation would need to address the subject of delegation in a head-on fashion.

A related issue is that of reliance upon the advice of an advisor or agent or delegate. The problem is particularly acute where a portfolio approach to trust investment is in use. The sophisticated plans required to adequately implement such investment management, of necessity, require significant reliance on advice from third parties, and require the trustee to accept the good faith and experience of the advisor in recommending a particular course of

78 Above n 4. Section 227 of the Restatement reads as far as is relevant: '**S. 227. General Standards of Prudent Investment (c)** [T]he trustee must: ... (2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (s 171); ...' Section 171 reads: '**S 171 Duty with Respect to Delegation** A trustee has a duty personally to perform the responsibilities of the trusteeship except as a prudent person might delegate those responsibilities to others ...'

79 Above n 4 pp 38-40.

80 Above n 8 p 1174.

action. Recognition of this exposure to the reliability of advice received is essential if portfolio strategies are to be adopted. If no such recognition is given, then cautious trustees will be put off the adoption of portfolio strategies as they lose too much control over the research and implementation decisions.

A proposal along these lines was put forward by the Ontario Law Reform Commission in its *Report on the Law of Trusts*. The Commission suggested that a provision be included in any new trustee legislation, to the effect that trustees should not be liable for any loss to the trust if they rely reasonably and in good faith on a written statement of an agent who is a duly accredited member of the legal, accounting, engineering, medical or other profession.[81] As the Commission said 'if the advice obtained seems satisfactory to the trustee on any reasonable basis, there seems no good reason why he should be concerned to obtain a second opinion.'[82]

Other Difficulties of a Change to Portfolio Theory

Apart from the need to depart from the rules mentioned above, further problems are associated with a legislative move towards a regime favourable to portfolio theory. Those difficulties are: monitoring by beneficiaries and trustees, judicial review, constituency of the legislation, delegation to professionals, and advice.

Monitoring Difficulties

One of the purposes of trustee legislation is to provide guidance to both trustee and beneficiary alike. The trustee needs guidance so as to know when and whether he is acting prudently. The beneficiary likewise needs the law to provide some sort of indications as to what amounts to prudence, so as to facilitate her ability to monitor the conduct of the trustees.

In the case of a legal regime that wants to encourage trustees to rely on portfolio theories of management, it is imperative that the legislation not rule out any investment vehicle as *per se* imprudent. An investment can only be said to be imprudent, when considered in the context of the particular portfolio package which the trustee is constructing. In turn, this means that the legislation which embraces portfolio theory must be permissive and directory in approach. For both trustees and beneficiaries this can be problematic in that clear rules (such as those embodied in the legal list) make the task of review more straightforward than the application of generalised criteria derived from an abstract guiding principle such as prudence.[83] Obviously, something a little more detailed than 'be prudent' is required, and so legislation ought to enumerate the relevant criteria by which decisions related to trust investment are to be taken.

81 See s 5(4) of the Draft Bill proposed by the Commission above n 4 p 488.
82 Above n 4 pp 53-54.
83 The difficulties for people affected by legislation expressed in broad language are examined in JF Burrows, 'Statutes and Judicial Discretion' (1976) 7 *NZULR* 1. Lee above n 49 p 241 has noted that '[p]erhaps the most difficult and jurisprudentially the most significant issue for trustee legislation is that of the degree of abstraction required.'

The literature, legislation and practice of trust investment disclose a number of matters to which trustees ought to have regard when setting out to pursue a portfolio management approach. These include:

1. The purpose of the trust.
2. The needs and circumstances of the beneficiaries.
3. The duration of the trust.
4. The aggregate value of the trust estate.
5. The need to diversify.
6. The administrative costs involved in the formation and maintenance of a portfolio.
7. The costs of professional advice in forming a portfolio.
8. Taxation consequences.
9. The division of gains between life tenants and remaindermen.
10. Liquidity and marketability of investments.
11. The relationship of investments to one another.
12. Desirability of formulating an investment strategy which clearly outlines risk and return objectives.
13. The projected term and structure of liabilities/obligations.

Judicial Review

The introduction of sophisticated investment models as the bedrock of trustee legislation is a reflection of emerging reality: most trust investment management activity today is carried out by professional trustees, such as banks, trust companies, and investment houses.[84] Trust investment is highly professionalised, and trust legislation should be written to cover the people most affected by the law's operation. These people in turn are well used to measuring investment decisions by reference to the portfolio theory model and have little difficulty in understanding its broad concepts; the only points of disagreement are likely to be the choice of strategies which will best implement the theory in practice.

Currently, the judicial image of the paradigmatic trustee is the lay family trustee. A switch to the portfolio theory therefore requires an alteration of this image. It also requires the courts to accept that with professionalisation comes the need to give more leeway to the professionals in recognition of their admitted expertise in the area of investment. Reforming legislation has to make this transformation of image clear and apparent.

If we recall how difficult Markowitz's ideas were for the financial economists of his time, replete with algebraic formulae and statistics,[85] one can readily appreciate that switching review standards to the portfolio orientation may prove less than easy for judges. The problem is, as Gordon has pointed out, that:[86]

84 Gordon above n 2 at p 93, n 169.
85 See n 1 above.
86 Gordon above n 2 at p 93.

> [t]he portfolio theory model complicates the determination of prudence, both as a matter of theory among financial economists and as a matter of proof before a court. ... Courts will be called upon to evaluate complicated strategies, not simply specific investments viewed in isolation. Instead of referring to a list of imprudent investments, the Courts will have to evaluate conflicting expert testimony. Courts may fear that portfolio theory will serve as a smokescreen for trustee incompetence.

Courts have to accept that they must 'adopt a new way of understanding investment strategies under a complicated model.'[87] This will be difficult if it is true, as Professor Dobris has claimed, that 'the reform of the prudent person rule [to meet portfolio theory requirements] will probably be counter intuitive for many judges.'[88] To be effective, new legislation which attempts to give effect to portfolio theory must communicate the salient features of that model to the judges whose previous orientation has been so different. This is particularly so as a court may be tempted to fall back to the individual investment standard of review (it being easier to apply), unless the legislation succeeds in communicating alternative investment models. Thus, new legislation must have more than an emphasis on diversification - as we noted, even legal list regimes mentioned this as an element of prudence[89] - but must also adopt an explicit portfolio focus. For example, an acceptance that one ought to be able to offset losses and gains, specific enumeration of the need for a portfolio view of investments, and an emphasis on the need to reduce costs of administration, research, and so on.

Apart from difficulties in understanding the economic models on which portfolios may be based, there is the additional problem that judicial understandings of the more sophisticated types of financial derivatives deployed in a portfolio can be naive. The classification of interest rate swaps as outright speculation by the House of Lords in *Hazell*[90] is a good illustration of this problem. For the trustee, this means that the use of certain commonly applied financial instruments, which would figure in a portfolio strategy, would be potentially off-limits. In turn, this means that participation in certain investor groupings may be ruled out as such groups would consider the use of derivatives, such as swaps, as part of their investment strategy. In this way, beneficiaries' interests in securing good returns on investment are exposed to compromise.

A further problem is raised by Gordon. We know that one of the supposed advantages of portfolio theory, when coupled with the efficient market hypothesis, is that research and investigative costs can be eliminated to a large degree, if a market or index fund is purchased. If one accepts that a sharemarket is efficient then there will be no need to engage in research aimed at assessing

87 Gordon above n 2 at p 94. In a small number of cases judges have taken on board portfolio concepts: see, for example, *Leigh v Engle* 858 F 2d 361, 368 (7th Circ, 1988) cert denied 109 S Ct 1528 (1989) and *Nestle v National Westminster Bank plc*, (unreported, High Court, Ch Div, 1897/1984, 29 June 1988).

88 Dobris 'Future' above n 54 p 405.

89 Above n 49.

90 Discussed above n 45.

each element of the portfolio. One will just invest in the index. However, if the courts fail to appreciate the methods by which portfolio theory operates, they may substitute an assesment of the prudence of an investment strategy by procedural checks — that hallowed device of the lawyer. For example, a review of investment decisions may be made on the basis of an assessment of the formal procedures followed by the trustees in forming the investment package, and so paper trails will be imperative. The unfortunate result is obvious: '[a] process standard uninformed by theory could conceivably find [a trustee's] approach imprudent.'[91]

The New Zealand Legislation: Sufficient to Justify Portfolio Management

Introduction

In 1988, amendments (by means of the *Trustee Amendment Act* 1988) were made to the *Trustee Act* 1956 ('the Act'). The purpose of the amending legislation was to give statutory effect to the recommendations of the Joint Working Party Report on *Trustee Investment - The Prudent Man Approach?*[92] The Working Party recommended the abolition of the legal list approach and the adoption of a more explicitly conduct-orientated test of trust investment, in the shape of the prudent person rule. The Working Party was not specifically asked to propose a scheme which would allow for the implementation of portfolio management, though it did note in the course of its Report[93] and in its earlier Discussion Paper[94] that the legal list was an obstacle to the adoption of such investment strategies. Moreover, it took the view that:[95]

> [w]here an overall investment strategy, shown to be sensible and prudent, has been adopted, the prudence of selecting or retaining particular investments ought not to be judged, we think, only by the characteristics of those investments each viewed in isolation, but their setting within the overall strategy ought also to be taken into account.

The purpose of this section is to consider whether the amendments to the trustee legislation are sufficient to justify portfolio management as a legitimate method of trust investment in New Zealand, in light of our more abstract analysis in the previous Part.

As a result of the amendments, the Act now contains a reiteration of the basic common law rule as to prudent investment, with a somewhat higher standard demanded of professional trustees.[96] Sections 13B and 13C state:

91 Gordon above n 2 at p 90, n 159.
92 Above n 6.
93 Report of the Working Party above n 6 p 12, para 20(a).
94 Discussion Paper reproduced in the Report of the Working Party, above n 6 p 38.
95 Above n 5, p 12, para 20(a).
96 See the references above n 35 to the common law treatment of this issue of higher standards and the parliamentary debate on this issue. Davis above n 69 p 5 has opined that s 13C means that a professional trustee ought to be acquainted with methods of investment management and have the ability to adapt those methods in a prudent manner for the needs of trust beneficiaries.

> **13B. Duty of trustee to invest prudently—**Subject to sections 13C and 13D[97] of this Act, a trustee exercising any power of investment shall exercise the care, diligence, and skill that a prudent person of business would exercise in managing the affairs of others.
> **13C. Duty of certain persons to exercise special skill—**Subject to section 13D of this Act, where a trustee's profession, employment, or business is or includes acting as a trustee or investing money on behalf of others, the trustee, in exercising any power of investment, shall exercise the care, diligence, and skill that a prudent person engaged in that profession, employment, or business would exercise in managing the affairs of others.

On one view, portfolio management will pass the prudence threshold. First, it is a recognised method of investment, which reduces risk exposure and therefore enhances the likelihood of securing desired returns. Second, the Minister of Justice in introducing the amending 1988 legislation noted that one of the defects of the 'legal list' approach and the then current regime under the *Trustee Act* 1956 was that of 'inconsistency with a portfolio-management approach'.[98] Third, we have seen that the Working Party itself expressed the view that a portfolio strategy ought not to be regarded as necessarily being an imprudent or improper investment methodology.

On the other hand, portfolio theory was not developed with trustee investment in mind, but rather as an investment strategy of general application. As Professor Lee observes: '[t]he theory is not a theory about the investment of trust funds as such and does not suggest that trustees should place the entire capital of their fund in [eg index-tracking funds].'[99]

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97 Section 13D(1) permits trust instruments to state that trustees do not have to comply with the standards set out in ss13B or 13C. Section 13D(2) states that to the extent that a clause in a trust instrument expresses an intention contrary to ss 13B or 13C trustees may have the advantage of exoneration clauses in their favour. In introducing the legislation, the Government took the view that the provisions of s 13D ought to ameliorate the concerns of the professional trust companies over the higher standard imposed by s 13C. Readers may be interested to know that s 222 of the *Second Restatement of the Law of Trusts* (St Paul, Minn: American Law Institute, 1959) would permit similar exoneration clauses, although the law in the individual states is equivocal as to the acceptability of such clauses: see Ontario Law Reform Commission's *Report on the Law of Trusts* above n 4 pp 29-32. This provision has not been affected by the proposals contained in the *Third Restatement*. For a discussion on the issues of principle involved see the Ontario Report at pp 39-42.
It should be noted however that exoneration clauses do not necessarily operate in the field of pension funds: for example, *Superannuation Schemes Act* 1989 (NZ) s 8(b) and ERISA (29 USC s 1110(a)). The exclusion of exoneration clauses in the superannuation context is effected in a somewhat obtuse manner under the New Zealand Act. Section 8(b) of the Act (the text of which is set out below n 125) states that notwithstanding anything to the contrary in s 13D(1) of the *Trustee Act* 1956, it shall be an implied term of every superannuation scheme registered under the Act that the trustees exercise their functions in accordance with the prudence standards set out in ss 13B and 13C of the 1956 Act. Section 13D(2) of the 1956 Act retains any rules or principles of law relating to any provision that purports to limit or exempt liability for breach of trust, *but only applies where the trust instrument expresses a contrary intention for the purposes of s 13D(1)*. Since by virtue of s 8(b) of the 1989 Act a superannuation deed cannot express a contrary intention for the purposes of s 13D(1), then s 13D(2) cannot be said to be triggered and so exoneration clauses in registered superannuation deeds are ineffective.
Professor Lee has pointed out that provisions of the *Superannuation Industry (Supervision) Act* 1993 (Cth) (namely ss 56(2) and 52(2)(b)) are arguably inconsistent on the exoneration issue: WA Lee, 'Industry Superannuation in Australia: Politics and Structure' 9-10 (paper delivered to the International Conference on Equitable Doctrines and Principles, Queensland University of Technology, Brisbane, 6-8 July 1994).

98 NZPD Vol 490, 5121 (Rt Hon Geoffrey Palmer).

99 Lee 1987, above n 49 p 307.

In addition, the Working Party recognised that the mere introduction of the prudent person rule would not be sufficient to secure the acceptance of the lawfulness of portfolio management techniques.[100] It stated in its Report that:[101]

> [t]he introduction of the 'prudent man' rule while it could have beneficial short-term effects might itself involve difficulties unless accompanied by alternative methods for overall review of contemporary practices in trustee investment. Moreover, the courts may continue to place their present emphasis on the propriety of individual investments rather than investment performance taken as a whole so that a new law might not in actual practice translate directly into better investment results for the beneficiaries of trusts. This latter problem could, however, be overcome by expressing the rule in such a way as to incorporate the portfolio approach.

On this point, the Working Party noted that despite the fact that the prudent person rule was the basis of American law on the subject, a number of rules relating to the implementation of the prudence principle obstructed the recognition of portfolio management theory as an acceptable investment strategy in the United States. It noted that, in particular, the individual investment model of analysis and the application of the anti-netting rule have militated against judicial approval of the portfolio approach in the United States.[102] We have already identified these as problems which must be resolved by any legislation serious about facilitating portfolio management strategies.

Detailed Assessment of New Zealand Legislation

Let us now begin a more detailed assessment of the new legislation by reference to its treatment of the three rules, which, we observed earlier, could pose particular difficulty to the adoption of a portfolio management approach: the legal list rule, the anti-netting rule, and the impartiality rule.

Investment Rule and the Legal List Rule

The amended Act (s 13A) abolishes the legal list rule, and replaces it with a provision which empowers a trustee to 'invest any trust funds, whether at the time in a state of investment or not, in any property.'[103] This provision achieves the first objective, which is to declare all property in principle open to

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100 See the Discussion Paper reproduced in the Report of the Working Party above n 6 ppm 32-33.

101 Discussion Paper reproduced in the Working Party Report above n 6 p 40.

102 There is good reason for concluding as the Working Party did about the interaction between the prudent person rule and portfolio management theory. The American literature bemoaning the failure of the courts and legislatures to accept portfolio theory as meeting the prudence standard is voluminous: apart from Professor Gordon's excellent article above n 2, see, for example HE Bines 'Modern Portfolio Theory and Investment Management Law' (1976) 76 *Col L Rev* 721, Fleming above n 17, Johnston above n 51, Langbein & Posner above n 26, B Longstreth, *Modern Investment Management and the Prudent Man Rule* (New York: Oxford University Press, 1986), Note, 'Trustee Investment Powers: Imprudent Application of the Prudent Man Rule' (1975) 50 *Notre Dame Lawyer* 519.

103 Section 2 of the 1956 Act defines property as 'includ[ing] real and personal property, and any estate, share, and interest in any property, real or personal, and any debt, and any thing in action, and any other right or interest, whether in possession or not'.

consideration for trustee investment. No pre-conceptions are expressed about the suitability of a particular investment vehicle for trust investment purposes, and this in turn is encouragement to those who would like to pursue a portfolio approach.

It was noted earlier that those investments in 'risky' items which have the effect of increasing the nett risk of the portfolio ought not to receive the protection of trustee legislation. The retention of the word 'invest' in s 13A presumably outlaws such speculation because the power to buy into any property cannot be motivated by any concern other than to make an investment.

Anti-netting Rule

Two new provisions of the Act (ss 13M and 13Q) are of interest in terms of the anti-netting rule. Those provisions read as follows:

> **13M. Court may take into account investment strategy in action for breach of trust—**In considering whether a trustee is liable, in respect of any investment made by that trustee, for any breach of trust in respect of any duty—
>
> [imposed by sections 13B or 13C]—
>
> the Court may, if it thinks it appropriate, take into account—
>
> (c) Whether the trust investments have been diversified, so far as is appropriate to the circumstances of the trust; and
>
> (d) Whether the investment was made pursuant to any investment strategy formulated in accordance with the duty referred to [above] ...
>
> **13Q. Power of the Court to set off gains and losses arising from investment—**(1) In considering any action for breach of trust arising in respect of or in relation to any investment by a trustee as a result of which any loss or losses have been, or are expected to be, sustained by the trust, the Court may set off, as it thinks just, all or any part of the loss or losses resulting from that investment against all or any part of the gain or gains resulting from any other investment, whether in breach of trust or not.
>
> (2) The power of set off conferred by subsection (1) of this section shall be without prejudice to any other power or entitlement to set off all or any part of any loss or losses against any property.

Section 13Q is clear authorisation for a Court to consider offsetting the losses which accrue from an individual investment turned sour against gains made on other investments. The discretion to offset is activated where the Court 'thinks just'. The problem with the section is that it fails to delineate the circumstances in which it will be just to relieve a trustee of liability for losses suffered by an individually imprudent investment.

The Explanatory Note to the *SIS* Bill said that the purpose of the section was to allow a court to make allowances for an investment strategy. However, the section makes no mention of investment strategy as a pre-condition to the exercise of the court's discretion, neither does it state that the investment needed to have been prudent when considered in the context of the portfolio as a whole. The absence of these prerequisites was noted by the New Zealand Law Society in its submissions on the Bill. The Society took the view that if the purpose of the section was to give effect to the offsetting of losses in the context of an investment strategy, then the section was 'sensible'. But it queried whether the section did not go too far in that '[a]s presently worded, the court would be entitled to relieve a trustee from an investment decision made in breach of trust by offsetting the loss against any other gain or gains, *whether or not* both were related to a common investment strategy.'[104]

In its Report, the Working Party took the view that where a trustee invested trust funds imprudently, and some of those investments turned sour, yet others turned to the good, then the trustee ought to be allowed to offset the two against each other. This proposal, it was said, would reverse the rules developed by Equity in this area,[105] but would be in line with the application of the general principles of damages.[106] Clearly, on its terms s 13Q gives effect to this particular recommendation, and is not necessarily designed to achieve the purpose ascribed to it in the Explanatory Note to the Bill.

Section 13M allows the court to have regard to two matters in determining whether a trustee has acted prudently. First, it is open to the court to consider whether the investment was made pursuant to an investment strategy (s 13M(d)); second, the court may also have regard to whether the trust investments have been diversified (s 13M(c)). In its Report, the Working Party observed:[107]

> Where an overall investment strategy, shown to be sensible and prudent, has been adopted, the prudence of selecting or retaining particular investments ought not to be judged, we think, only by the characteristics of those investments each viewed in isolation, but their setting within the overall strategy ought also to be taken into account.

Arguably the purpose of s 13M is to implement the Working Party's recommendation that new legislation clearly articulate acceptance of the prudence of portfolio management: after all the section allows the court to have regard to diversification, and also allows a court to consider whether the investment was pursuant to an investment strategy (and presumably portfolio strategy falls within the meaning of investment strategy).

In addition to a court's powers under ss 13M and 13Q, there is the general power in s 73 of the *Trustee Act* 1956, which permits a court to relieve a trustee either wholly or partially from personal liability for breaches of trust, provided that he or she 'has acted honestly and reasonably' and 'ought fairly to be excused for the breach'. This power has often been relied on to excuse the purchase of investments which have not been authorised by statute or by the trust

104 See New Zealand Law Society, *Submissions on the Trustee Amendment Bill 1987*, 19 February 1988, p 3 (emphasis added).

105 It should be noted that in *Bartlett* above n 35 p 538, Brightman J (as he then was) held that the cases on this point were 'not altogether easy to reconcile' and allowed setoff on the facts of that particular case. The Working Party referred to this development in recommending that a provision along the lines outlined in the text be enacted: above n 6 p 13, para 20.

106 See Report of the Working Party above n 6, p 13, para 20(b).

107 Above n 6, p 12, para 20(a).

deed.[108] Presumably a trustee who invested in accordance with portfolio theory would be able to invoke this provision, in addition to the newly enacted provisions of the Act.

Impartiality

We have noted earlier that the impartiality rule has been regarded as a barrier to the full implementation of portfolio theory in the United States' trust law because it skews the choice of investment vehicle which trustees have for the purposes of constructing a portfolio. The trustees have to create a portfolio of such dimensions and shape that the portfolio is impartial as between income and capital beneficiaries, and this in turn restricts the type and shape of the portfolio of investments open to the trustees.

The treatment of the impartiality rule is perhaps the most disappointing aspect of the amending legislation for those committed to instituting a portfolio methodology. It has been observed that, '[t]he most important aspect of trust law cast into doubt by the acceptance of an unconstrained [prudent person] Rule on portfolio theory grounds is the traditional allocation of investment returns.'[109] Indeed, by implication, the Working Party recognised that the impartiality rules acted as an obstacle to portfolio theory, saying '[t]hey [ie the impartiality rules] have a considerable potential to distort the investment pattern of trust moneys ...'[110] In its earlier Discussion Paper, the Working Party considered the issue at some length, observing:[111]

> [s]ome of the present trustee investment rules are inspired, in part, by the view that in any long-term trust there will be both income and capital beneficiaries, and any investment should give due reward to each class. This approach is to some extent inimical to any general principle of 'spreading' investment among different types of asset, though normally if a trustee takes both high interest bearing deposits, and low yield company shares, the one will balance out against the other. Difficulty arises, however, if over a prolonged period the one produces a considerably better return than the other ... . Thus, what may have been a very sound strategy of 'risk spreading', based on the assumption that one or other of these investments must do well no matter what the economic conditions, could result in an imbalance between the two classes; moreover, the trustee might even be chargeable for breach of trust in allowing that to happen. There may be a case for allowing the trustee, or the court, much greater discretion in determining what is to be treated as income and capital ...

In its report, the Working Party did suggest that it might be desirable for the trustee to be given wider powers of distributing gains (whether income or capital) among the remaindermen and the life tenants. However, the legislation

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108 Similar provisions are in force in England (*Trustee Act* 1925, s 61) and Australia (see Ford & Lee above n 46 pp 782-786). Interestingly, few states in the United States have statutory exoneration provisions of this type.

109 Gordon above n 2 p 99.

110 Report of the Working Party above n 6 p 13.

111 Discussion paper reproduced in the Report of the Joint Working Party above n 6 p 42.

did not make any significant alterations to the rules governing income/capital allocation; indeed, by virtue of the new s 13F, the 1988 amendments have codified the common law position.[112]

No reform proposals have yet been instituted and, as the Working Party predicted, since a number of trustees are concerned about the risks of being labelled impartial, many funds adopt traditional asset-purchase policies which reflect a desire to be neutral between the capital and income beneficiaries. This is a shame as there are solutions, as we have seen, available which would improve the current unfortunate situation. However, at least the suggestions mark a realisation that the issue cannot be allowed to sit and requires attention.

In the meantime, for those settlors who wish to make clear an intention that the traditional impartiality rule is not to apply in such a way as to interfere with the smooth operation of portfolio management, the best solution would be to draft a clause which gives the trustee a power of invasion for the income beneficiary.

Delegation and Advice

We have noted earlier that there is substantial uncertainty as to the law on delegation. It will be recalled that s 23(1) of the English *Trustee Act* 1925, upon which s 29(1) of the New Zealand Act is modelled, could arguably be invoked as providing authority for the appointment of an investment company with power to alter investment strategy and make investment choices suitable to the trust. However, there is respectable authority to the contrary opinion. Bearing in mind the sophisticated nature of portfolio management it would be expected that reforming legislation would take the opportunity to declare that the delegation power is as ample as necessary to allow for responsible delegation to professionals who have the appropriate expertise. Unfortunately, the amending legislation made no significant alteration to the rules on delegation which operated prior to 1988. In light of the observations made above, this is disappointing.

In one sense the Working Party's approach to the issue made it inevitable that little progress would be made in the amending legislation. In its Discussion Paper the Working Party noted that the anti-delegation rules created difficulties for trustees, but made little by way of proposals to alter the situation. In its Report, the Working Party took the view that investment of trust funds in common funds or unit trusts ought not to offend the prudence principle, nor the anti-delegation rules.[113] The Working Party did concede, however, that under

112 Section 13F reads: '**13F Trustees' duties at law preserved -** All rules and principles of law which impose any duty on a trustee exercising a power of investment, including, without limiting the generality of the foregoing, all rules and principles which impose-
(a) Any duty to exercise the powers of a trustee in the best interests of all present and future beneficiaries of the trust:
(b) Any duty to act impartially towards beneficiaries and between different classes of beneficiaries: ... shall remain in force ...'

113 Above n 6 p 14. The decision of Thomas J in *Jones v AMP Perpetual Trustee Company NZ Ltd* above n 33 would appear to confirm the Working Party's view.

the present law a trustee could not delegate the entire responsibility for selecting and holding investments to a manager (unless the delegatee were a trustee corporation).[114] The Working Party took the view that before there could be departure from the current rules, separate study would be required. To the author's knowledge no such study has been undertaken and the old rules remain in place.

As to advice, the Working Party recognised that '[a]s the opportunities for trust investment expand, the need becomes greater for sources of adequate and wide-ranging advice.'[115] It also recognised the increasingly more sophisticated conditions of investment in which trustees would find themselves operating; yet it did not propose anything similar to the Ontario 'reasonable reliance' clause referred to earlier.[116] The failure to do this may discourage trustees from engaging sophisticated portfolio advice that they may not be able to fully comprehend and/or implement, and so hinder the adoption of portfolio investment techniques by trustees.

Monitoring Difficulties and Judicial Review

It will be clear from our analysis thus far that certain opportunities to convey the compatibility of portfolio theory with the 1988 Act have been missed. In particular, the Act's treatment of the anti-netting rules are somewhat obtuse, and its failure to deal with the rules on impartiality and delegation are unfortunate. As pointed out earlier, it is vital that the courts and those affected by the legislation be given clear signals as to how they should exercise their powers, be it a power of review, or the power of investment.

To some extent the acceptability of portfolio management is hinted at in s 13E of the 1988 Act. That section reads:

> **13E. Matters to which the trustee may have regard in exercising power of investment—**Without limiting the matters that a trustee may take into account, a trustee exercising any power of investment may have regard to the following matters so far as they are appropriate to the circumstances of the trust:
> (a) The desirability of diversifying trust investments:
> (b) The nature of existing trust investments and other trust property:
> (c) The need to maintain the real value of the capital or income of the trust:
> (d) The risk of capital loss or depreciation:
> (e) The potential for capital appreciation:
> (f) The likely income return:
> (g) The length of the term of the proposed investment:
> (h) The probable duration of the trust:
> (i) The marketability of the proposed investment during, and on the determination of, the term of the proposed investment:
> (j) The aggregate value of the trust estate:

114 *Trustee Act* 1956, s 29(2A) allows for such delegation.
115 Discussion Paper reproduced in the Report of the Working Party above n 6 p 35.
116 See the text accompanying notes 81 and 82 above.

(k) The effect of the proposed investment in relation to the tax liability of the trust:
(l) The likelihood of inflation affecting the value of the proposed investment or trust property.

Of particular concern for our purposes are points (a) and (b). Both of these considerations go to the heart of portfolio concepts: (a) because diversification is the means by which a portfolio achieves its stability, (b) because portfolio diversification can only be made in light of the current holdings of the trust fund. These provisions, when considered in conjunction with s 13M of the Act (which we have referred to above), tend to support the conclusion that portfolio theory is a legitimate trustee investment strategy. Presumably, point (c) would also be relied on by a trustee who employed portfolio techniques, since one of the advantages of portfolio theory is that it allows a prudent investor to secure the maintenance of real value of her fund. In short, the provision gives trustees sufficient hints to support the conclusion that portfolio management is authorised by the Act, and ought to assist a court in any challenge to portfolio techniques.

However, the Act may not go far enough in sending the right signals to the courts. It would have been preferable if the legislation had specifically stated that the trustee when making investments could have regard to the relationship of that investment to other investments in the investment package. This would have made the compatibility of portfolio strategies and investment management more obvious. A good example is the *Third Restatement* which mandates a portfolio approach:

> **S 227 General Standard of Prudent Investment—**[The prudence standard] requires the exercise of reasonable care, skill, and caution, and is to be applied to investments *not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy*, which should incorporate risk and return objectives reasonably suited to the trust. (emphasis added)

Consider also s 52(2)(f) of the recently enacted Commonwealth statute, the *Superannuation Industry (Supervision) Act* ('SIS'). That provision requires superannuation trustees:

> (f) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:
>
> (i) the risk involved in making, holding, and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements;
>
> (ii) the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity being exposed to risks from inadequate diversification;
>
> (iii) the liquidity of the entity's investments having regard to its expected cash flow requirements;

> (iv) the ability of the entity to discharge existing and prospective liabilities ...

Another example is the suggestion of American writer, TD Johnston, that legislation should empower a trustee '[to] consider not only the individual merits of the investment but the merits of the investment as part of a portfolio of investments.'[117] An express statement to this effect would satisfy any concerned trustee that portfolio management strategies had statutory imprimatur and would be readily defensible before a court. As it is, the New Zealand legislation fails to do this explicitly. Thus, it may be incumbent on any trustee who follows a portfolio style of trust investment to justify that style as a prudent investment strategy in terms of s 13M, and, having done that, convince the court that the losses sustained by the trust fund were not lost through imprudence.

Is Failure to Adopt Portfolio Theory Imprudent Behaviour?

If, despite the deficiencies in the legislation which we have identified, we assume that portfolio theory is consistent with the new legal regime ushered in by the 1988 amendments, a crucial question for trustees of large funds must be whether failure to adopt portfolio theory strategies will amount to imprudent behaviour.[118] In its Discussion Paper, the Working Party stated:[119]

> [W]e do not suggest that every fund manager must embark on a scheme of portfolio management, irrespective of the size and the particular needs of the fund concerned. Nor do we assert that techniques of portfolio management have as yet been as extensively developed in New Zealand as appears to have been the case in the USA, though we have no reason to doubt that the necessary expertise is becoming more readily available here, and that market forces would soon encourage financial institutions and other qualified persons to provide such services to trustees if portfolio management strategies were to become an accepted or required aspect of trustee investment practices.

This would seem to indicate that the Working Party did not feel that it was yet correct to hold all trustees to portfolio management techniques. However, that opinion was expressed in 1985, and since that date New Zealand's financial services sector has rapidly grown more sophisticated. This in turn affects our

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117 Above n 51 p 528. Other examples are to be found in legislation enacted in a number of US states in recent times and which are set out in the Reporter's notes to s 227 in the *Third Restatement* above n 4 pp 60ff.

118 Another question, which I do not propose to deal with at length here, is: if there is an obligation on trustees to adopt portfolio strategies, are there particular versions which must be adopted? We have noted earlier that if the efficient market hypothesis (see discussion in text accompanying notes 21-31 above) is held to be true then active management strategies will only be justifiable where the extra research and transactional costs are outweighed by the extra return expectations that such strategies would produce. For more on this, see: Halbach above n 8 pp 1165-1166 (and proposition (d) on p 1166 in particular). It should be noted that s 227(c)(3) of the *Third Restatement* states that trustees should 'incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.' Halbach, above n 8 p 1174, observes that this cost consciousness requirement ought to see trustees 'take account of market efficiency information and concepts ... [and] compare investigation expenses and other transaction costs ... [though] efforts also were made throughout to avoid suggesting that active management strategies are impermissible.' Section 13E of the New Zealand Act does not mention cost consciousness as one of the considerations that a trustee can have regard to in exercising investment powers. However, s 13E is not exhaustive and cost consciousness may be a factor that courts would imply as being of relevance.

119 Above n 6 pp 21-22.

consideration of the issue.

At the outset, it has to be noted that most trustees of large funds will be investment companies and other professionals caught by s 13C. As we have seen, that section imposes a higher standard of prudence on those whose business (either in whole or in part) consists of trust investment management.[120] Thus, investment practices of such persons will have to meet the standards of the investment industry at least. Moreover, just as in other areas of liability law, it is likely that the courts will not be content to leave the determination of appropriate standards to investment practitioners alone and will set standards that will continually force professionals to keep abreast of contemporary changes in techniques, practices and theories. Trustees cannot ignore the new learning and continue to rely uncritically on old-fashioned approaches to investment.[121] This is particularly so where adherence to the traditional approach can be shown to be motivated by the desire to protect the trustee from liability to suit, instead of by concerns related to the securing of the optimal return on the trust fund for the beneficiaries. In short, to the extent that portfolio management has established itself as an orthodox theory of investment management with successful wide-spread application, persons caught by the provisions of s 13C may well be required to apply portfolio management strategies to funds under their control.

The only decision to have considered the 1988 amendments to date has been the High Court decision of Thomas J in *Jones v AMP Perpetual Trustee Company NZ Ltd*.[122] One of the arguments advanced by counsel for the plaintiff (superannuation) beneficiaries in that case was that a failure of the defendant to institute an investment strategy until over two years after the introduction of the legislation was a breach of the prudence principle.[123] Thomas J held that the defendant had not acted imprudently in respect of the investment of the superannuation funds. Further, he held that the failure to adopt an investment strategy was not a breach of the 1988 Act as the concept of 'investment strategy' only assumed significance in the formation of trust portfolios during the 1990s; it would not be appropriate to fault the defendant for a failure to do something which was not practice at the time the investment was made.[124] His Honour did, however, proceed to examine an investment strategy adopted in 1990 in light of the prudence principle, declaring it to be prudent. Implicit in all of this is an acceptance that as techniques such as formulated investment strategies become the norm, trustees will be required to adopt them and see them through. Likewise, as portfolio management of trust investments continues to establish itself on a firm footing, as it is currently, (professional) trustees will be required to adopt such strategies.

120 See the text accompanying n 97 above.

121 Similar sentiments are expressed by Langbein & Posner above n 26 p 30, though in a slightly different context.

122 Above n 33.

123 The basis of the argument was that by directing the court to take account of investment strategy in determining whether a trustee had acted prudently, s 13M(d) of the 1988 Act implicitly required trustees to adopt an investment strategy: above n 33 p 709.

124 Above n 33 p 710.

Reaction of the Investment Community to the New Legislation

It is clear that so far as the investment community is concerned the new legislation clearly establishes the legitimacy of portfolio theory as a method of prudent trustee investment. Many superannuation fund[125] managers' and trustee company brochures advise trustees of their duties to engage in portfolio management strategies now that the *Trustee Amendment Act* has been introduced.[126] Indeed, Russell Davis, General Manager of NZ Guardian Trust, and author of *A Guide to Trustee Investment Under A Prudent Person Approach*,[127] has stated that '[a]lthough our trustee investment laws have not been thoroughly tested by the courts they do appear to be working well in practice.'[128] Further, enquiries made by the author indicate that so far as many members of the investment community are concerned portfolio theory is consistent with the purposes of the 1988 amendments, and it is being used as the theoretical model for a significant amount of trust investment in New Zealand.

Conclusion

Portfolio theory is one of the most popular and orthodox investment methodologies. Central to its operation is the view that investment decisions only have meaning when taken in light of the entire holdings of the investor; investment decisions cannot be made in isolation from a consideration of the portfolio as a whole. The reason for this is that a well-diversified portfolio, consisting of elements which do not react to similar economic events in the

125 The trustees of superannuation funds operate under the same strictures as private trustees: Section 8 of the *Superannuation Schemes Act* 1989 reads as follows:
8 Implied provisions as to investment of scheme money - The following provisions shall be implied in every trust deed of a registered superannuation scheme:
(a) That all money belonging to the scheme and available for investment shall be invested in accordance with the provisions of the *Trustee Act* 1956 as to the investment of trust funds; and (b) That, notwithstanding anything to the contrary in s 13D(1) of that Act, the trustees and any investment manager of the scheme shall, in exercising the power of investment, exercise the care, diligence, and skill required of that person by s 13B or s 13C of that Act, as is applicable.
For a discussion of exoneration clauses in the context of superannuation schemes see above n 97.

126 See, for example, *Developing Successful Investment Strategies: A Guide for Superannuation Trustees* put out by the Tower Corporation (no year), *Trustee Investment Under The Prudent Person Approach: Practical Implications for Trustees of Superannuation Funds and Their Professional Advisors* put out by CIGNA (no year), *Trustee Investment and the Public Trust Office* published by the Public Trust Office (no year), which states (p 1) 'The Trustee Act principally focuses on [*inter alia*] encouraging trustees to adopt a portfolio approach to investment'.
It is also interesting to note how clearly the investment community has appreciated the importance of seeing prudence as a conduct-regarding principle. Very many investment houses advise prospective clients that 'Prudence is gauged by the process through which investment strategies and tactics are developed, adopted, implemented, and monitored. Specific risks are not labelled imprudent, but rather prudence is demonstrated by the process through which risk is managed' (Tower, p 4). Similarly, the CIGNA guide states: 'The 'prudent person' rule is, moreover, primarily concerned with the trustee's conduct in making and selecting investments rather than the overall performance of the portfolio.' (p 5) While it is not usual in the US to set standards by reference to anything other than the substantive merit of the individual investments, there have been cases where the Court put store by the procedural care taken by the trustee in selecting the investments: see, for example, *Stark v United States Trust Company of New York* 445 F Supp 670 (1978) (SDNY) and *In re Morgan Guaranty Trust Co of NY* 396 NYS 2d 781 (1977). Cf *In Re Newhoff* 486 NYS 2d 956 (1985).

127 Above n 74.

128 407 *LawTalk* 19, 20 (7 February 1994).

same way, allows an investor to spread the variability of the funds without reducing the anticipated return on the fund.

The traditional legal regime surrounding investment powers of trustees creates significant obstacles in the path of those who would like to apply portfolio management theory to trust investment. In particular a set of rules, the investment rule, the legal list rule, the anti-netting rule, the impartiality rule and the anti-delegation rule all militate against the deployment of portfolio techniques in the context of trust investment. Any legislative attempt to construct a legal framework with which portfolio theory would be compatible needs to deal with these five rules. In addition, new legislation of this sort would need to overcome a number of other problems, such as judicial unfamiliarity, monitoring difficulties, and so on, before it could be truly effective.

New Zealand's *Trustee Amendment Act* 1988 is one of the first legislative attempts to construct legislation favourably disposed towards portfolio theory. The Act has abolished the legal list rule. However, its treatment of the anti-netting rule has been less than clear, and it has completely failed to consider the impartiality rule. Nor does it address issues such as delegation and advice in such a way as to indicate that the new environment is one which will be 'portfolio theory'-friendly. To some extent these deficiencies cast some confusion over the compatibility of portfolio theory with the Act. That said, s 13E of the Act does signal a legislative acceptance of portfolio theory and ought to be sufficient to communicate acceptance of the theory to courts. Whatever the doubts which one may have over this issue, the investment community in New Zealand has adopted portfolio management in the trust area, and, interestingly, it may well be that if the courts are convinced that the Act is really pro-portfolio, then trustees will have an obligation to make investment decisions in line with the tenets of portfolio theory.

The lesson to be learned from the New Zealand legislative experience is that legislators who wish to bring trust investment law into line with portfolio theory need to fully understand the relationship between the theory and the traditional rules of trust investment law. Moreover, they need to give full consideration to creating the right framework, sending the right signals to the legal community which will have the task ultimately of ensuring that the legal standards are understood by, and complied with by, the investment community. If legislation fails to do this it may only tend to mislead and confuse. This in turn may discourage the deployment of portfolio techniques to the detriment of the interests of the beneficiaries.