



**TIME FOR CHANGE: CHARITY
INVESTMENT AND MODERN
PORTFOLIO THEORY**

Harvey P Dale and Michael Gwinnell

Reprinted from *The Charity Law & Practice Review*

Volume 3, 1995/96, Issue 2

Published by Key Haven Publications PLC,
7 Crescent Stables, 139 Upper Richmond Road
London SW15 2TN Tel: (0181) 780 2522

TIME FOR CHANGE: CHARITY INVESTMENT AND MODERN PORTFOLIO THEORY

Harvey P Dale¹ and Michael Gwinnell²

Introduction

The rate of dissemination of the results of academic research in investment through to adoption by practitioners has been accelerating. Approaches that in the 1970s took 20 years from research, through development, adoption in the US, to adoption in the UK, now move across the Atlantic almost instantaneously. Leading investment banks employ high-powered mathematicians with PhD's to keep at the leading edge of developments in derivatives, program trading and other investment strategies. Fund managers apply the results as a matter of course, and the principles of international diversification and the use of index funds are well understood. However, charity investment is an area where the UK has been particularly slow to adopt the results of developments in the US, which is due to the restraints of the Trustee Investments Act 1961 and the reluctance of the Charity Commissioners to recognise current practice and approve new techniques, as well as a tradition of undue conservatism among charity trustees and their professional advisers.

¹ Harvey P Dale, Professor of Law, Director, Program on Philanthropy and the Law, New York University Law School, Second Floor, 110 West 3rd Street, New York, NY 10012, USA Tel: (+1 212) 998 6161, Fax: (+1 212) 995 3149.

² Michael Gwinnell, Adviser, APS Advisory Services Limited, 17 Savile Row, London W1X 1AE Tel: (0171) 434 9761, Fax: (0171) 434 9754.

Acknowledgements: The authors thank Professor Etroy Dimson (London Business School) and Tom Dumont (Barrister of Lincoln's Inn) for their helpful comments on this article. The authors accept full responsibility for any remaining errors.

It is relevant that the first act of the recently formed Trust Law Committee³ has been to set up a working party under the Chairmanship of Professor David Hayton⁴ to examine the issues where it is felt that reform is urgently required, namely powers of investment, delegation of such powers and other matters related to investment. The Committee is concerned with the reform of private trust law as much as that of charitable trusts, but the principles of prudent investment are the same. The working party is expected to report early in 1996, has the support of the Law Commission, and will be lobbying for an early legislative response.

It therefore seems timely to review the implications of modern portfolio theory for charity investment, comparing the current state of law and practice in relation to charity investment in the UK with that in the US, as codified in the recently published US Uniform Prudent Investor Act.⁵ The latter is based on Restatement Third, Trusts (Prudent Investor Rule),⁶ which drew heavily on the recommendations of a seminal study by Bevis Longstreth.⁷ We conclude by summarising various issues arising from the Charity Commissioners' current policy, and make some suggestions as to ways round the constraints until the law and practice are modified.

The following counter-intuitive implications of modern portfolio theory for investment of charitable funds will be discussed:

- investment in low risk assets can be imprudent
- there is no such thing as a speculative investment per se — nor is there such a thing as a prudent investment per se
- spending capital can be more prudent than investing for income

³ Secretary: Michael Jacobs, Nicholson Graham & Jones, 25-31 Moorgate, London EC2R 6AR; Tel (0171) 628 9161, Fax (0171) 638 3102.

⁴ Professor David Hayton, School of Law, King's College, Strand, London WC2R 2LS
Tel (0171) 836 5454, Fax (0171) 873 2465.

⁵ Approved August 1994 by the National Conference of Commissioners on Uniform State Laws, 676 North St Clair Street, Suite 1700, Chicago, Illinois 60611, USA
Tel (312) 915 0195.

⁶ Restatement of the Law Third, Trusts, Prudent Investor Rule, The American Law Institute, Publishers, St Paul, Minnesota, 1992 (hereinafter "Restatement Third").

⁷ Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule*, Oxford University Press, New York, 1986 (hereinafter "Longstreth").

- spending all the income may be imprudent
- you are probably better off in an index fund than hiring an active asset manager
- derivatives provide powerful and low cost ways of reducing investment risk
- when rebalancing a portfolio you should sell the winners and buy the losers

We also show that for a charity in practice there are no material constraints on asset allocation imposed by the Trustee Investments Act. Our message is important: the invested assets of the top 2000 UK charities exceed £20 billion. An increase of just 1 per cent per annum in investment return (if this could be achieved through more efficient portfolio management without significantly increased risk⁸) would result in an additional £200 million a year being available for charitable purposes.

Modern Portfolio Theory and its Implications

One of the most famous maxims in the financial and business world is "there is no such thing as a free lunch". Applied to investment, this reflects many of the lessons of modern portfolio theory and its empirical support through research on market efficiency, the relation between risk and return, the importance of diversification, and the dominance of asset allocation in determining investment performance. While the theory is relevant to the differing investment needs of charities with short or medium term investment goals, its most powerful implications are for the investments of endowed charities and grant-making trusts. Their very long time horizons mean that they can afford to accept the volatility of short term returns that is inescapable if long-term returns are to be maximised. For such charities, over-investing in low risk assets is imprudent, since the latter are unlikely to provide a high enough return to allow a reasonable level of expenditure to be maintained in real terms in perpetuity.

Charity trustees need to think in terms of sustainable spending rates and accept that a more aggressive asset mix may be desirable to maximise long term spending. The concept of total return needs to be understood, along with the impact of

⁸ Such an increase could probably be achieved through a combination of more efficient investment portfolios and cost reductions from eschewing active management, with the former being more feasible for smaller charities and the latter for larger ones. In any event, we suggest that many charities are too conservative in their asset mix and as long term investors could comfortably tolerate a modest increase in risk.

inflation, before appropriate investment and spending decisions can be made. Spending only (or all) income, restricting the kinds of assets in which investments may be made, and proscribing the use of derivatives can result in inefficient portfolios and are thus imprudent.

Restrictions on the use of certain asset classes (such as foreign equities or venture capital) increase the risk of the overall portfolio, and are thus imprudent. The fees and transaction costs of active management can outweigh the benefits, active management is certainly riskier than investing in an index fund, and may thus be imprudent.

There are numerous excellent texts on modern portfolio theory aimed at a reader without advanced mathematics (for example, Elton/Gruber or Bodie/Kane/Marcus— see Select Bibliography). The most approachable summaries are Richard Brealey's book⁹ and in Appendix A of Longstreth.¹⁰ There is no universally accepted theory of investment: there is a number of different models that sometimes conflict. Nevertheless, common conclusions can be drawn, and the empirical evidence provides strong support for them.

Efficient Markets

The most important conclusion is that securities markets are highly efficient, in the sense that prices reflect available information and respond rapidly to new information as soon as it becomes available. This is supported by studies indicating that professional investment managers do not consistently outperform appropriate benchmarks. Although a small number may be genuinely superior, the average investment manager underperforms the market by a significant margin, and there is general agreement that it is exceedingly hard to identify any consistency in the performance of fund managers. This is why many large institutions have adopted passive investment strategies whereby they hold a fund that seeks to replicate the returns on a market-representative index, thus minimising both transaction costs and management fees. Given the difficulty in selecting superior investment managers, a passive strategy may thus be preferable.

⁹ Richard A Brealey, *An Introduction to Risk and Return from Common Stocks*, The MIT Press, Cambridge, Massachusetts, Second Edition, 1983.

¹⁰ 'The Lessons of Modern Portfolio Theory' by Edwin J Elton and Martin J Gruber.

Diversification

The second most important conclusion is that diversification of investments is necessary, because the market does not offer a higher return to compensate for the specific risk of a particular investment. One should not measure the riskiness of investments individually: it is their contribution to overall portfolio risk that is important.

The importance of diversification has been accepted for a long time. Modern portfolio theory has permitted the concept to be analysed mathematically. The riskiness¹¹ of a portfolio depends on two elements: the riskiness of each asset and the correlation of expected returns of each pair of assets. As the number of assets increases, the first element is quickly outweighed by the second. It is possible to divide the risk of each asset between the specific risk (attaching to the asset alone) and the market or factor risk (which measures the extent to which the asset's returns are sensitive to a common factor or factors). Because the specific risk can be diversified away, the market does not reward it.

The mathematics can be simplified by considering asset classes (i.e., sets of assets with similar characteristics) rather than individual assets. It can be shown that it is always possible to reduce the risk of an existing portfolio without reducing expected return by adding (perhaps a small proportion of) an investment in an asset class which is less than perfectly correlated with the existing portfolio. So without superior knowledge, all assets should be held in proportions reflecting their market weighting.

Asset Allocation

The third most important conclusion is that the strategic asset allocation decision, i.e., the proportion of assets to be held in different asset classes (such as UK equities, overseas equities, fixed interest securities, property), accounts for 80-90% of portfolio performance, with only the balance of 10-20% reflecting stock selection skills within asset classes.¹² There is also strong evidence that tactical asset allocation, i.e., varying the proportion in different asset classes from time to time, is unlikely to produce superior returns compared to a buy and hold strategy, although it would seem that maintaining a constant asset mix has produced superior returns over the last couple of decades. The latter requires periodic rebalancing, in effect selling the winners and reinvesting in the losers.

¹¹ Risk is generally measured in terms of variability of returns. Return here means total return, i.e., the combined effect of income and capital appreciation or depreciation, realised or unrealised.

¹² See for example Select Bibliography - Brinson.

Desirability of Foreign Exposure

Increasing the variety of asset classes reduces risk, and it is thus desirable to hold some overseas equities even if the investor is only concerned to meet domestic obligations. Foreign exposure introduces the question of currency risk: views differ on the merits of currency hedging for a long term investor.

In particular, emerging market investments, although in themselves highly volatile, produce returns that have a low correlation with mainstream asset classes and thus can provide important risk reduction to an overall portfolio, or enhance its expected return without increase in risk.

Risk is Inescapable

The appropriate trade-off between risk and return is the key decision of investment policy. This decision can only be made in light of the objectives, time horizon and risk tolerance of the investor. There is no such thing as a risk-free investment, except in the highly limited case where there is a known, fixed liability that can be provided for by an appropriate immunisation strategy (which involves the use of a portfolio of government securities that is insensitive to changes in interest rates). Except for short term requirements, cash equivalents (bank deposits or Treasury bills) are risky because the long term return is unpredictable, highly variable, and the principal value is not protected against inflation.

Even index-linked government securities are not risk free, since there is no guarantee that the spending needs of the institution will rise exactly in line with the retail price index, and eventually any index-linked security will mature, with complete uncertainty as to how it may then be re-invested. (The longest dated UK government index-linked security matures in 2030, which is as nothing compared to the perpetuity for which charitable trusts can endure!)

The Law of Conservation of Value

The value of an enterprise is not altered by its capital structure or dividend policy. Combining two enterprises will not increase their aggregate value unless the total cash flow they generate is enhanced. "Stripping" a gilt-edged stock into its constituent coupon and redemption payments (as will soon be possible) does not alter its overall value. In other words, the value of the whole pie does not depend on how it is sliced. These are generalisations which are broadly supported by

empirical evidence, if allowance is made for tax effects.¹³ Total return is what counts (i.e., the combined effect of income and capital appreciation or depreciation, realised or unrealised).

Sustainable Spending Rates

Since risk and return are related, the only way to gain a higher expected return is to accept increased risk. For a charity to be able to maintain its spending in real terms at the commonly accepted sustainable level of 4-5% of assets per annum requires a portfolio that is approximately 80% invested in equities. A higher rate of spend or lower proportion in equities entails a high probability of long term depletion of the real value of the institution's assets.¹⁴

Impact of Constraints

Constraints on asset mix — whether imposed by the Trustee Investments Act 1961 or a "permanent endowment" restriction on spending of capital — can make it impossible to achieve the optimal asset mix consistent with a realistic sustainable target spending rate. Conversely, the obligation to spend all income for charitable purposes (and limits on the power to accumulate) may prevent a proper reinvestment of income to enable the real value of an institution's assets to be maintained.

Long Run Returns

In the long run, the return on equity investments has greatly exceeded that on fixed interest securities. Historically, this so-called risk premium has averaged 6% per annum in the UK.¹⁵ Continuation of historic average returns would imply that over a 20 year period, £1,000 invested in gilts might grow to about £1,321 in real terms, whereas the same £1,000 invested in equities might grow to about £4,017 in real terms. Although there are some grounds for expecting the risk premium

¹³ Tax deductibility of interest compared with wholly or partially non-tax deductible dividends implies a government subsidy for debt finance which will increase the overall value of a debt-financed enterprise.

¹⁴ See for example, *Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix*, Council on Foundations, Washington DC, 1995.

¹⁵ From 1919-1994 the arithmetic average real return on UK equities was 10.3% pa and that on gilts 2.8% pa. However, the averages over rolling 10 year periods were 7.2% and 1.4%. Source BZW Equity-Gilt Study.

to be lower than this in future, it is generally agreed that it should continue to be significantly positive. Of course, the variability of equity returns is also much greater than those on fixed interest securities, so that in the short term the risk of loss is much greater. For a long term investor, such as an endowed charity, there is a clear case for a high proportion of equity investment. Failure to adopt an appropriate level of risk exposes the charity to the danger of long term depletion of its real asset base, and is thus imprudent.

Derivatives are Useful to Reduce or Manage Risk

Derivatives comprise a broad class of instruments that includes forwards, futures, swaps, and options. Because of their highly leveraged nature, they offer immense scope for taking a short term view with little capital, and it is indeed the interest of short term view takers that helps provide the huge liquidity and variety of derivative instruments. Certain highly publicised examples of losses incurred through the use of derivatives have given them an undeserved reputation.

In fact, derivatives provide powerful means to reduce or manage risk, enabling portfolio adjustments to be carried out far more quickly and cheaply than through trading securities. They enable foreign currency exposure to be managed efficiently, and also permit the synthesis of desired assets in a highly cost-effective manner.¹⁶ The use of derivatives in low risk arbitrage enables the investment manager to exploit pricing anomalies while avoiding market or interest rate risk.

Options can also provide important hedging tools and are not necessarily inappropriate for conservative investors. Certain dynamic investment strategies, such as portfolio insurance, are equivalent to options. The apparatus of option pricing models enables such strategies to be efficiently implemented.

Derivatives are more closely akin to insurance than to gambling (which is the association in the minds of many people). Just as buying insurance is a prudent act, so can be the provision of insurance by an appropriately capitalised and skilled organisation.

¹⁶ For example, an investment in a particular foreign equity class, such as the Standard & Poor's (S&P) 500 index (an index which measures the return on approximately the top 70% by value of US listed equities), can be created by investing cash in short term assets and taking out a swap whereunder the investor receives (or pays if negative) the total return on the S&P 500 index and pays a short term interest return (plus or minus an agreed margin). Such a combination produces returns equivalent to direct investment in the 500 constituents of the S&P index, without any of the attendant costs of custody, investment management, reinvestment of dividends or withholding taxes. The margin paid to the counterparty represents its fee essentially for carrying out such tasks, or their equivalent. The counterparty typically will lay off its own exposure through other swaps, index futures, etc.

No Such Thing as a Speculative Investment

The use of the word "speculative" is more pejorative than analytical. It tends to confuse more than to illuminate. There is no workable test for determining whether an investment is "speculative". The label is inconsistent with some of the most important teachings of modern portfolio theory, e.g., that no investment can be judged in isolation, and that diversification — even into more volatile securities — tends to reduce overall portfolio risk. It should be abjured by all careful thinkers. But just as there is no such thing as a speculative investment per se, so there is no such thing as a prudent investment per se.

Current Status of the Law in the United States¹⁷

The law on investments of charities in the United States is in a state of flux. It has been generally recognized that older legal enunciations of prudent investment standards are outdated and harmful. A 1986 landmark study, by Bevis Longstreth,¹⁸ strongly recommended reconsideration of the anachronistic rule.¹⁹ This suggestion was accepted and led to the 1992 publication of a modern version: the Restatement of the Law Third, Trusts, Prudent Investor Rule.²⁰ The principal standard in the new Restatement Third is stated as follows:

"The trustee is under a duty . . . to invest and manage the funds of the trust as a prudent investor would

"This 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

¹⁷ This portion of the article derives from an earlier article, Harvey P Dale, 'Nonprofit Directors and Officers — Duties and Liabilities for Investment Decisions', (see Select Bibliography - Dale). That article, written for a US legal audience, contains more details and citations than thought useful here, but the substance of the relevant parts of it has been brought up to date in this article.

¹⁸ Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* (see Select Bibliography - Longstreth).

¹⁹ Longstreth, at p 158.

²⁰ See Select Bibliography - Restatement Third. The Restatements of Law, in the United States, are promulgated by the American Law Institute, an independent charitable organization. Because they are written by distinguished Reporters, with the participation of highly-qualified legal experts in the field, they have great influence, both on courts and legislatures, but are not positive law. Note that the "Prudent Investor Rule" is now gender neutral.

trust portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."²¹

The emphasis is on the portfolio as a whole; no particular types of investments are viewed as being "good" or "bad" in isolation.²² The trustee is to act as a prudent investor would in managing his or her *own* property.²³ Although some current statutes and regulations reflect, to a greater or lesser extent, the Restatement Third's acceptance of modern portfolio theory and investment management, much remains to be done to bring the law up to date.

The federal system in the United States allocates to the states primary jurisdiction over the activities of charities. Most typically, the state Attorney General is the official with supervisory authority, often exercised through an Assistant Attorney General in charge of a Charities Bureau. There are no Charity Commissioners in the United States — at least, none having anything like the role and powers of the Charity Commissioners in England and Wales.

The federal government does have certain important, albeit limited, jurisdiction over charities. For historical reasons, it is exercised principally by the Internal Revenue Service, through the office of the Assistant Commissioner for Employee Plans and Exempt Organizations. It is well understood by the IRS that this an oversight responsibility and does not involve the more-typical IRS function of revenue raising.

²¹ Restatement Third, § 227, at p 8.

²² As the Reporter's Comments clarify, "[s]pecific investments or techniques are not per se prudent or imprudent". Restatement Third, § 227(f)(2), Comment f, at p 24. Thus, the following are all permissible and potentially quite prudent, in the context of an overall portfolio strategy: trading in options, investing in domestic and foreign equities, buying real estate or second mortgages, engaging in venture capital transactions, holding oil or gas interests, investing in commodities and foreign currency and derivatives, and writing puts, calls, or other options. The Official Comments state that "there is no arbitrary barrier to the competent use, in proper roles and circumstances, of options and futures transactions or of programs for investing in foreign markets, real estate, or unestablished enterprises". Restatement Third, Comment k, at pp 42-43.

²³ This has been held to be a more flexible standard than one which treats the trustee as managing assets of *another* person. See, e.g., *In re Conservatorship of Estate of Martin*, 228 Neb 103, 421 NW 2d 463 (Neb 1988), in which the court referred to the latter rule as "a higher standard." It has also been described as a "*far more constraining test*." Jeffrey N Gordon, 'The Puzzling Survival of the Constrained Prudent Man Rule', Appendix B, Longstreth, at p 198 (emphasis added).

State Law Standards

An increasing number of states have responded to the modern view of prudent investing, but in many states it will be useful for legislation to be adopted to accomplish this result fully.²⁴ Professor John Langbein, of the Yale Law School, has completed drafting a Uniform Prudent Investor Act under the auspices of the National Conference of Commissioners on Uniform State Laws.²⁵ The Act was formally promulgated in 1994. Section 2 of the Act reads in part as follows:

"(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

* * *

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act]."

Confirming this last message, the official comments to section 2 state:

"Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent. . . . The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility — in this case, inflation risk — that had not been anticipated. . . . The premise of subsection 2(e) is that trust beneficiaries are better protected by the Act's emphasis on close attention

²⁴ Much can be done, even without legislation, by Attorneys General in the United States or by the Charity Commissioners in England and Wales. A statement of practice, sympathetic to the modern prudent investor rule, would be of great help in creating a climate in which more efficient and flexible investment processes could flourish.

²⁵ See note 5 above. Although the Act "is centrally concerned with the investment responsibilities arising under the private gratuitous trust, . . . the prudent investor rule also bears on charitable and pension trusts" *Id.*, Prefatory Note.

to risk/return objectives as prescribed in section 2(b) than in attempts to identify categories of investment that are per se prudent or imprudent.

"The Act impliedly disavows the emphasis in older law on avoiding 'speculative' or 'risky' investments. Low levels of risk may be appropriate in some trust settings but inappropriate in others."

As of 23rd August, 1995, the Uniform Prudent Investor Act had been adopted in six states.²⁶ Several other states have also acted to adopt the more modern standard, albeit with legislative language that does not track the Uniform Prudent Investor Act.²⁷ For example, in 1993, a New York State advisory committee recommended the adoption of the modern Rule by legislation.²⁸ The resulting new law²⁹ went into effect 1st January, 1995. It provides, inter alia, that a charitable trustee is authorized "to invest in any type of investment . . . since no particular investment is inherently prudent or imprudent for purposes of the prudent investor standard".³⁰ In summary, as of the Summer of 1995, about 14 states have legislatively adopted the modern standard in one form or another. A substantial number of other states are expected to follow suit within the next few years.

Although United States law generally imposes different (and higher) duties of care and loyalty upon trustees of charitable trusts than upon directors of charitable corporations,³¹ it appears that this difference has not generally mattered in cases

²⁶ The states are California, Colorado, New Mexico, Oklahoma, Utah, and Washington. Telephone conversation with Ms Katie Robinson, National Conference of Commissioners on Uniform State Laws.

²⁷ Delaware Code Ann., title 12, § 3302; Georgia Code Ann. § 53-8-2; Minnesota Stat. § 501B.10(1); Tennessee Code Ann. § 35-3-117. Illinois adopted the new Prudent Investor Rule, in an earlier draft format, in September 1991, effective 1st January, 1992. Illinois PA 87-715 (1991), codified at 17 Ill. Rev Stat 1675, 1675.1, and 2103. Virginia also enacted it in 1992. Va. Code Ann. § 26-45.1. Florida adopted such legislation in 1993. Florida Laws, ch 93-257, amending Florida Stat. § 518.11 and adding § 518.112.

²⁸ EPTL-SCPA Legislative Advisory Committee, Third Report: 'The Proposed Prudent Investor Act in New York' (March 22nd 1993).

²⁹ New York Estates, Powers & Trusts Law § 11-2.3.

³⁰ Id. § 11-2.3(4)(A).

³¹ See, e.g., Daniel L Kurtz, *Board Liability: Guide for Nonprofit Directors* pp 22-24 (1988).

applying the prudent investor rule.³² Thus, the Restatement Third takes the view that, even though the rule is phrased as applicable to trustees, "funds held for investment by a charitable corporation . . . are to be invested in accordance with the prudent investor rule of § 227".³³ The Prefatory Note to the Uniform Prudent Investor Act agrees:

"Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations."

Federal Standards

The federal standards for prudent investing appear in the Internal Revenue Code of 1986 (as amended) ("IRC"), the Employee Retirement Income Security Act of 1974³⁴ ("ERISA") (as amended), and regulations and other precedents interpreting them.

The principal tax provision — IRC § 4944 — affects only "private foundations"³⁵ and was originally enacted in 1969. It imposes penalty excise taxes on any private foundation, and its management, for investing "in such a manner as to jeopardize the carrying out of any of its exempt purposes." Although the statute contains no

³² There is language to the contrary in *Lynch v Redfield*, 9 Cal. App 3d 293, 88 Cal. Rptr 86 (1970), which applies a trust standard. As one author correctly observed, however, "[g]iven the facts of that case . . . it is unlikely that any different result would have been reached whatever standard was employed". Daniel L Kurtz, *Board Liability: Guide for Nonprofit Directors* p 24 (1988) (footnote omitted).

³³ Restatement Third, § 389, Comment *b* at p 190. Another leading commentator has stated that "[t]he modern paradigm of prudence applies to all fiduciaries who are subject to some version of the prudent man rule, whether under ERISA, the private foundation provisions of the Code, UMIFA, other state statutes, or the common law". Longstreth, at p 7.

³⁴ Pub L 93-406, Sept. 2, 1974, 88 Stat. 829, codified in various sections of the United States Code.

³⁵ The term is defined in IRC § 509, but the definition is quite complex because it operates by subtraction and by extensive cross references. Generally, a private foundation is a charity which engages in grant making activities and is not broadly supported by the public. Those interested in more detail may consult Bruce R Hopkins, *The Law of Tax-Exempt Organizations* part III, pp 353-545 (6th ed. 1992).

definition of a jeopardizing investment, the Treasury regulations,³⁶ adopted in 1972, do. They start by declaring that "an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence" In elaborating on that standard, the regulations are a bit schizophrenic:

"In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation . . . However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of 'puts' and 'calls', and 'straddles', the purchase of warrants, and selling short."

From a current perspective, more than two decades after the adoption of that regulation, it seems somewhat inconsistent internally. The good news includes measuring performance by total return, linking risk with reward, acceptance of focus on the portfolio as a whole, and refusal to treat any particular investment as a per se violation. The bad news includes applying the standard "on an investment by investment basis", and identifying certain specific types of investment as requiring close scrutiny.

More recent and more enlightened is the standard adopted by the relevant ERISA regulations, allowing the trustee to make:

"a determination . . . that the particular investment or investment course of action is reasonably designed, as part of the portfolio . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action" ³⁷

³⁶ Treas Reg. § 53.4944-1(a)(2)(i).

³⁷ 29 C.F.R. §§ 2550.404a-1(b)(2)(i). These regulations are promulgated under 29 U.S.C. § 1104(a)(1), entitled "Fiduciary duties".

Here there is no investment-by-investment judgment; the portfolio is always appraised as a whole. The total-return concept is embraced, and risk is properly linked with reward. Furthermore, no particular type of investment is singled out for greater concern than any other.

There have been several recent indications of growing acceptance of the modern prudent investor standard by the US Internal Revenue Service, but they are somewhat technical and thus have been omitted from this article.³⁸

Concluding Comments on US Law

There is both good news and bad news in the modern prudent-investor standard. The good news is the freeing of portfolios from outmoded and irrational constraints, thus allowing a much more flexible approach to investment management, with (hopefully) increased opportunities for prudent improvement of total returns. The bad news is that no particular investment's "prudence" is to be judged in isolation, so the trustees (or directors, etc.) are compelled to examine and think about the overall portfolio, rather than finding safety in simplistic selection of specific *types* of investments with little or no strategic thought or later supervision. Thus:

"The key to this approach is process. Prudence is to be found principally in the process by which investment strategies are developed, adopted, implemented, and monitored in light of the purposes for which funds are held, invested, and deployed. Prudence is demonstrated by the process through which risk is managed, rather than by the definition of specific risks that are imprudent".³⁹

It should be emphasized that, under the new Prudent Investor Rule, directors and trustees cannot find protection merely by putting all of the charity's assets into certificates of deposit or US Treasury obligations. Not only is no investment, taken alone, *per se imprudent*, but no investment, taken alone, is *per se*

³⁸ They deal with the treatment of certain interest-rate swaps, derivatives, and short sale transactions for purposes of the tax on unrelated business taxable income. Interested readers can find further discussion of these in Dale, at 4-10 - 4-12. See also Rev Rul 95-8, 1995-4 IRB. 1 (short sale gains not subject to tax as unrelated business income).

³⁹ Longstreth, at p 7.

prudent.⁴⁰ To highlight this point, a recent article in *Foundation News* — a publication of the US Council on Foundations — is provocatively entitled, *Investing in US Securities is a Violation of Your Fiduciary Duty*.⁴¹ In the second article in their series, the authors state that "[u]nder the mistaken illusion of seemingly satisfying their fiduciary duties, far too many foundation directors and trustees have been . . . making investment decisions that are too conservative".⁴²

Proper analysis of risk and return profiles, in the context of an overall portfolio, is not an easy exercise. Yet the modern prudent investor rule requires just that of the guardians of charitable assets. Here there is a further item of good news: although the older view also constrained trustees etc. from delegating their responsibilities, there has also been a growth in the flexibility of that standard. The Uniform Management of Institutional Funds Act of 1972 ("UMIFA") authorized such delegation.⁴³ UMIFA has been adopted in some form in many states.⁴⁴ As a result of the widespread adoption of UMIFA, a broad survey of fiduciaries concluded:

"Delegation of investment authority, a major legal stumbling block before statutory and regulatory reforms over the last fifteen years, is both widespread and apparently unproblematic for the great majority of

⁴⁰ As the Official Comments to the Restatement Third point out, "All investments, even the nominally excepted short-term US Treasury securities, and all investment strategies involve some risk in the comprehensive sense of possible loss of real, inflation-adjusted value." Restatement Third, Comment e, at p 18. Bevis Longstreth, emphasizing the critical role of process, says: "Even the most aggressive and unconventional investment should meet that standard [of prudence] if arrived at through a sound process, while the most conservative and traditional one may not measure up if a sound process is lacking". Longstreth, at p 7.

⁴¹ John A Edie & Lowell S Smith, 'Investing in US Securities is a Violation of Your Fiduciary Duty', *Foundation News*, Nov/Dec 1993, at pp 24-30. Mr Edie is Vice President and General Counsel of the Council on Foundations. Mr Smith is Managing Director of the Private Banking Division of Morgan Guaranty Trust Company of New York.

⁴² John A Edie & Lowell S Smith, 'Let Go of Your Old Investment Assumptions', *Foundation News*, Jan/Feb 1994, at p 38.

⁴³ UMIFA § 5.

⁴⁴ It has been adopted by 38 of the 50 states and by the District of Columbia. In New York, for example, UMIFA § 5 was adopted, almost but not quite word for word, as N-PCL § 514(a). That subsection requires, however, that any such investment contract be terminable at the will of the "governing board at any time, without penalty, upon not more than sixty days' notice".

fiduciaries . . . A significant proportion of those . . . fiduciaries have retained consultants to assist in selecting investment managers."⁴⁵

The Restatement Third carries this flexibility forward,⁴⁶ as does the Uniform Prudent Investor Act.⁴⁷ Indeed, a comment to the latter Act concludes that "[t]he trend of [recent] legislation . . . has been strongly hostile to the nondelegation rule".⁴⁸ In many cases, the best — and perhaps the only — way to fulfil the trustees' and directors' duties will be via prudent delegation to sophisticated investment managers.⁴⁹ It will sometimes be wise to get advice about how best to choose such counsel, and it will always be wise to consider carefully the impact of the fees and costs of such counsel on the total investment return of the charity.

Under the modern rule, investment yields are not to be measured by income as opposed to capital appreciation. The *total return* from the portfolio — income less expenses, plus unrealized appreciation in value of assets, less unrealized losses in value of assets — is the focus. Thus, the Restatement Third, in mentioning the "return objectives" of a trustee,⁵⁰ is intended to refer "to total return, including capital appreciation and gain as well as trust accounting income",⁵¹ and the

⁴⁵ Longstreth, at p 154.

⁴⁶ See Restatement Third, § 171.

⁴⁷ Uniform Prudent Investor Act § 9(a) provides that "[a] trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances".

⁴⁸ Uniform Prudent Investor Act § 9, Comment.

⁴⁹ Trustees have great flexibility in delegation, subject to the duty of prudence. Restatement Third, § 171. The official comments add that "[a] trustee's discretionary authority in the matter of delegation may be abused by imprudent *failure* to delegate as well as by making an imprudent decision to delegate." *Id.* at p 141 (emphasis added). They state, further, that "the trustee has power, and may sometimes have a duty, to delegate . . ." *Id.* at p 38 (emphasis added). See also *id.* at pp 6, 16. In *Johnson v Johnson*, 212 N.J. Super. 368, 515 A 2d 255 (1986), the Attorney General asserted, and the court seriously analysed, the claim that the trustees of a \$100 million charitable foundation should be surcharged for failing to appoint proper investment advisors. The court ultimately held that no such liability should accrue because of other facts, including the receipt of sophisticated investment advice from a large broker-dealer.

⁵⁰ See Restatement Third, § 227, quoted *supra*, at p 7.

⁵¹ Restatement Third, § 227, Comment *e*, at p 18.

Uniform Prudent Investor Act explicitly requires the trustee to consider "the expected total return from income and appreciation of capital".⁵²

It follows that a charity should generally be authorized to fund its operations without regard to whether such outlays are paid from income or from capital. Thus, UMIFA provides:

"The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair market value of the assets of an endowment fund over the historic dollar value of the fund as is prudent"⁵³

Of course, the creator of a charitable trust may explicitly and consciously restrict the trustee to expending only income. In general, this would be unwise,⁵⁴ and quite often such language is inserted into trusts without any clear understanding of its impact.⁵⁵ If, however, it is determined that such an income-only restriction is intended and is applicable, the trustee may not disregard it.⁵⁶

In the United States, large foundations, and perhaps also a few large universities, appear to be doing a fairly good job of investment management. With those exceptions, most US nonprofit organizations — whether smaller foundations or non-grantmaking entities of *any* size — seem to be doing a mediocre or poor job. This mismanagement (or under-management) loses funds which otherwise could be used

⁵² Uniform Prudent Investor Act § 2(c)(5).

⁵³ UMIFA § 2.

⁵⁴ Not only does such a provision constrain the trustee's investment discretion because of the need to generate "income", but it can pervert the ultimate goals of the trust. Consider, for example, the long-range impact on a charitable trust of investing in wasting assets or junk bonds, which produce high levels of current "income" at the cost of ultimate loss of trust corpus. In general, investments can be so selected as to tilt returns towards or away from "income" as well as "principal", making such restrictions partially illusory as well as tending to introduce distortions into investment decisions.

⁵⁵ Special considerations apply when a trust has two or more beneficiaries, particularly if their respective interests are ordered chronologically, as in the case of a life interest followed by a remainder interest. It is beyond the scope of this article to analyse these considerations, but much consideration has been given to the issues in some of the literature cited herein.

⁵⁶ Thus, "only when beneficial rights do not turn on a distinction between income and principal is the trustee allowed to focus on total return . . . without regard to the income component of that return." Restatement Third, § 227, Comment *i*, at p 35.

to promote the missions of the nonprofit institutions. Much more is lost to charity through such under-management than through losses from excessively-risky investments. The modern prudent-investor standard will increase the flexibility of and options for prudent management of charitable funds. It will *also* increase the duties of those charged with responsibility for investing.

Current State of English Law & Practice

There is brief coverage in the standard UK text books on the law of charities on the subject of investment powers and duties, while there are some general references in texts on the law of trusts. Debra Morris has recently surveyed some contemporary issues, and there is clear if simplified coverage in John Harrison's book *Managing Charitable Investments* (see Select Bibliography). Michael Harbottle's detailed survey of the law *Investing Charity Funds* was not available until this article was about to go to press. The Charity Commissioners' publications are discussed in the following section.

General Principles of Trust Law

The Prudent Man Rule Under English Law

Even where the trust instrument confers the investment powers of a beneficial owner, the trustees have a duty to act prudently. The authorities state that speculative investment is not permitted, quoting Lord Watson in *Re Whiteley*⁵⁷ that there is a "duty to avoid all such [permitted] investments ... as are attended with hazard". However, "the onus ... of proving that the investment was altogether too hazardous ... lies upon the [beneficiaries]" as stated by Parker J in *Shaw v Cates*.⁵⁸ The English version of the prudent investor rule was formulated by Lindley LJ in *Re Whiteley*, *Whiteley v Learoyd*:⁵⁹

"The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty is rather 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."

⁵⁷ [1887] 12 App Cas at 733.

⁵⁸ [1909] 1 Ch 389 at 395.

⁵⁹ [1886] 33 Ch D 347 at 355.

For modern formulations of the duty of trustees there are two cases relating to private trusts, and one to a charitable trust. In *Nestle v National Westminster Bank plc*, in the judgment of Dillon LJ⁶⁰ in the Court of Appeal, he quotes the above words and then goes on to say:

"This principle remains applicable however wide, or even unlimited, the scope of the investment clause in a trust instrument may be. Trustees should not be reckless with trust money."

However, he then brings us to the present by saying:

"But what the prudent man should do at any time depends on the economic and financial conditions of that time — not on what judges of the past, however eminent, have held to be the prudent course in the conditions of 50 or 100 years before ... when investment conditions were very different."

On the question of risk versus return, we have the words of Sir Robert Megarry V-C in *Cowan v Scargill*.⁶¹ The power of investment

"must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment."

This makes it clear that total return is to be considered, but does not deal explicitly with the need for diversification. Since the Trustee Investments Act 1961 came into force a trustee has been required by section 6(1)(a) to have regard in the exercise of his powers of investment

"to the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust ..."

These principles are restated by Sir Donald Nicholls V-C in *Harries v Church Commissioners for England*⁶² where he says that charity trustees

"[should seek] the maximum return, whether by way of income or capital growth, which is consistent with commercial prudence ... having due

⁶⁰ [1994] 1 All ER 118 at 126.

⁶¹ [1984] 2 All ER 750 at 760, [1985] Ch 270 at 287.

⁶² [1992] 1 WLR 1241 at 1246.

regard to the need to diversify, the need to balance income against capital growth, and the need to balance risk against return."

The Rule Against Excessive Accumulation⁶³

"Accumulation" here means the addition of income to capital under a direction or power in a trust instrument. Under section 164 Law of Property Act 1925 (as amended by the Perpetuities and Accumulations Act 1964) accumulation may not exceed 21 years from the date of death of the settlor or 21 years from the date of the making of the disposition. Income need not be spent in the year of receipt, so long as it is spent shortly thereafter, but such a retention does not constitute accumulation. Further, where a company is the settlor, the rule does not apply.⁶⁴ The rule does not apply in Scotland or Northern Ireland, nor to charitable companies.

The Charity Commissioners take the view that charity trustees have a primary duty to apply all the income of a charity in furtherance of its objects. Accumulation is permissible if the power exists, so long as properly exercised. In practice, if the power is absent or has lapsed, they do not object to purposeful accumulation, i.e. either there is a specific project in mind or it is to cover projected future deficits or to act as a general reserve where the need is justifiable.⁶⁵

For income to be exempt from tax under section 505 ICTA 1988 it must be applied for charitable purposes only. However, "if the income is reinvested ... and held, as invested, as part of the funds of the charity" it is being applied for charitable purposes, as stated in the judgment of Oliver LJ in *IRC v The Helen Slater Charitable Trust*.⁶⁶

The Trustee Investments Act 1961

When the Trustee Investments Act 1961 ("TIA") was passed, it was welcomed as providing much needed flexibility compared with the narrow restrictions of the Trustee Act 1925. It added to the investment powers of all trusts created before 3rd August 1961, but cannot reduce them. It does not affect the investment powers of a trust created on or after that date, unless the trust instrument requires

⁶³ See Select Bibliography - Law Commission 133.

⁶⁴ *Re Dodwell & Company Limited's Trust* [1979] Ch 301.

⁶⁵ Annual Report 1992 para 98; expanded at Charity Law Association meeting, 14th June 1994.

⁶⁶ 55 TC 230 at 250.

trust funds "to be invested in any investment for the time being authorised by law for the investment of trust funds" (or similar words), or is silent on investment powers.

However, the TIA does impose a duty on *all* trustees when exercising their powers of investment to have regard "to the need for diversification ... insofar as is appropriate to the circumstances of the trust" (section 6(1)(a)) and to consider "the suitability of investments of a particular description" and "the suitability of a particular investment as one of such description".

There has been a lot of criticism of the TIA's restrictions on trusts which do not have wider investment powers and it is true the rules are cumbersome and outdated. However, some of the criticisms are misguided,⁶⁷ since it is possible to get round the restrictions in various ways (see below).

The implications of the TIA restrictions are clearly described in a Charity Commission leaflet⁶⁸ and will not be summarised here. Suffice to say that the TIA requires funds to be divided into two parts⁶⁹ (narrower range and wider range) and specifies the permissible investments for each range and the advice required before they can be purchased or retained. The investment philosophy underlying such division and the focus on a list of permissible investments is outdated. However, the basic principles of asset allocation can be encompassed within the universal TIA requirements for diversification and suitability.

Charities and the Applicability of Trust Law

Trust law applies to charities constituted as trusts or as unincorporated associations (whose property has to be held by trustees on behalf of the association) but not to charitable companies. The definition of "charity trustees" in the Charities Act 1993 (section 97(1)) does not make the directors or members of charitable companies trustees for the purpose of trust law. It is generally accepted that a charitable corporation is the beneficial owner of its assets for the charitable purposes contained in its constitution and does not act as a trustee of its assets, except insofar as they may be subject to special trusts (i.e., restrictions on the

⁶⁷ For example, the Deregulation Task Force Charities and Voluntary Organisations working group estimated in 1994 that charities were up to £450 million per annum worse off because of TIA restrictions on investment in equities since 1963.

⁶⁸ *Trustee Investments Act 1961: A Guide* CC32 February 1995.

⁶⁹ The initial division was 50:50. In 1995, this was altered to 25:75 for charitable trusts as a result of intense lobbying by the charity sector during the passage of the 1992 Charities Bill.

purposes for which they may be expended). Charitable companies have unrestricted investment powers and the unrestricted ability to alter their memorandum of association by special resolution (except the objects clause) if their investment powers are restricted by the memorandum. Companies may enter into any transaction for the benefit of the company, subject to the control of the members.⁷⁰ Directors of a non-charitable company are not required to avoid speculative investments so long as they act with ordinary care and prudence.⁷¹ However, a charitable company is not established for profit and in this respect is similar to a trust. It can thus be reasonably argued that the fiduciary duties of directors of a charitable company are akin to those of trustees. The Charity Commissioners take this view, since they consider speculative investment to be unsuitable for any charity, however constituted.

Permanent Endowment

A charity has a permanent endowment if it holds property subject to a restriction on its being expended for the purposes of the charity. Often, the restriction is that only income may be expended. This inhibits effective investment management, since it ignores both the concept of total return and the impact of inflation.

Tax Constraints for Charities

The Finance Act 1986 introduced anti-avoidance provisions which were re-enacted as sections 505 and 506 and Schedule 20 Income & Corporation Taxes Act 1988. The rules are complex, and can impose loss of tax relief on income and chargeable gains if the charity incurs non-qualifying expenditure. Non-qualifying investments and loans are treated as non-qualifying expenditure. The definition of qualifying investments is set out in Schedule 20. It includes all TIA authorised investments (except mortgages), most kinds of stock exchange investments, common investment funds and unit trusts. Other investments, including unquoted shares, derivatives, and loans are qualifying investments if made for the benefit of the charity and not for the avoidance of tax. A claim has to be made, and the onus is on the charity to satisfy the Inland Revenue.

It is not suggested that a prudent investment policy is likely to result in failure of the qualifying investment tests. However, the need to document the purpose of investments not falling within the automatically qualifying list and to make a claim for relief from tax has to be borne in mind when implementing a policy which includes such investments.

⁷⁰ *Burland v Earle* [1902] AC 83.

⁷¹ *Sheffield and South Yorkshire Building Society v Aizlewood* [1890] Ch D 412.

Policy of the Charity Commissioners for England and Wales

The Charity Commissioners have published several leaflets describing the law in simple terms. The basic document is *Investment of Charitable Funds: Basic Principles* (CC14)⁷² with further information provided in *Common Investment Funds & Common Deposit Funds* (CC15).⁷³ They have also produced a guide to the TIA (referred to above).

A more technical description of the policy of the Charity Commissioners is set out in Volume 3 of their *Decisions*,⁷⁴ 4. 'Schemes Conferring Wider Powers of Investment' and '5. Schemes Conferring Powers of Amendment'. The latter is relevant, in that any general power of amendment granted by a Scheme that extends to varying the trustees' powers of investment will be subject to the Charity Commissioners' prior written approval of the specific change in investment powers.

An implicit restriction on investment policy to the TIA is contained in the model constitutions for a charitable trust and charitable unincorporated association published by the Charity Commissioners⁷⁵ which have no reference to powers of investment. The model constitution for a charitable company⁷⁶ is also silent on investment powers, which may reflect the Commissioners' view that the TIA applies to a charitable company (see below).

Critique of the Charity Commissioners' Current Policies

The omission of any reference to investment powers in the Charity Commissioners' current model constitutions is unhelpful, particularly as there is no warning in the accompanying commentary that the TIA restrictions will apply, as well as the Trustee Act 1925 limitations preventing delegation to a discretionary investment manager or use of nominees.

The leaflet *Investment of Charitable Funds: Basic Principles*⁷⁷ defines "trustees" as charity trustees, using a definition which implicitly includes the directors of a

⁷² Amplified in *Investing Charity Cash* (CC14(a)).

⁷³ CC15(a) lists those funds currently available.

⁷⁴ HMSO January 1995.

⁷⁵ GD2 and GD3, January 1995.

⁷⁶ GD1, January 1995.

⁷⁷ CC14 [hereinafter "CC14"].

charitable company. The leaflet *Trustee Investments Act 1961: A Guide* (CC32) defines "trust instrument" to include Memorandum and Articles of Association. In both cases it would seem to follow that the Charity Commissioners take the view that the TIA applies to charitable companies, when this is arguably not in fact the case (see above). In any event, if it does, in most cases the members can add unlimited investment powers by special resolution without reference to the Charity Commissioners.⁷⁸

CC14 sets out basic investment precepts with which it is in general unnecessary to quarrel. However, there is no recognition of the fundamental trade-off between risk and return, nor that all investment involves risk. The concept of total return is not addressed in the objectives section,⁷⁹ being mentioned in passing under "Investment Performance".⁸⁰ The suggested limitation of 5% in any one equity or fixed interest stock is rather sweeping⁸¹, as is the requirement for a discretionary investment manager not to deal in more than 5% of the total funds without written approval!⁸²

The section on 'Speculation'⁸³ is somewhat black and white and does not mention the need to consider individual investments within the overall portfolio, i.e., it outlaws individual "speculative" investments. It states baldly that "... futures, options, interest rate swaps and foreign currency deposits are not suitable for charitable funds".

The section on 'Common Investment Funds'⁸⁴ suggests that such funds investing solely in overseas equities are suitable for charities but states that "no more than 20% of a charity's investments should be invested in this way" without providing

⁷⁸ This may not be possible if the objects clause also contains the company's powers, since the objects clause of a charitable company cannot be altered without the consent of the Commissioners (section 64(2)(a) Charities Act 1993). We take the view that in section 64(2)(b) Charities Act 1993 the words "the manner in which property of the company may be used or applied" refer to charitable uses, not investment powers, although this is unclear.

⁷⁹ CC14 page 3 "Objectives of investing charitable funds".

⁸⁰ CC14 page 11.

⁸¹ CC14 page 9 "Diversification".

⁸² CC14 page 5 "Investment Policy".

⁸³ CC14 pages 9 to 11.

⁸⁴ CC14 pages 12 and 13.

a reason.⁸⁵ In fact, until May 1995 there was only one such Common Investment Fund generally available⁸⁶ and this is open only to Methodist charities!

The Charity Commissioners' views are expanded in Volume 3 of their *Decisions*.⁸⁷ This describes the purpose of charity investment to be:

"(1) the creation of sufficient income to enable the charity to carry out its purposes consistently year by year with due and proper consideration to future needs; and

(2) the maintenance and, if possible, enhancement of the value of the investment funds whilst they are retained."

This implicitly assumes that we are considering an endowed charity or foundation with perpetual life, perhaps with a restriction on the spending of capital. It does not address the many other cases where investments may constitute a reserve fund, or funds being raised for a particular goal, or the funds of a charity which in accordance with the donors' wishes may plan to spend itself out of existence. Nor does it address the concept of total return. There is no explicit reference to the need to balance risk and return, as laid down by Sir Robert Megarry V-C in *Cowan v Scargill* and Sir Donald Nicholls V-C in *Harries v Church Commissioners*.

CC Wider Powers then discusses the distinction between "investment" and "trading". This is a notoriously grey area where the Inland Revenue and the Courts have made fine distinctions and we will not attempt to review the cases here. Clearly many investments are purchased with a view to sale at a profit at some future date and are not expected to be held indefinitely to provide a growing source of income. The Inland Revenue have recognised this by permitting, for example, venture capital limited partnerships and investment trusts with limited lives to be treated as investment, not trading, vehicles. Zero-coupon bonds and treasury bills are discount instruments which produce no income but are clearly investments. The purchase of derivatives, currencies and commodities is not automatically speculative and is not trading if carried out with a view to diversification, hedging, or the creation of synthetic securities. The purchase and

⁸⁵ The average allocation to overseas equities by large, professionally managed unconstrained funds measured by WM was 25% in 1994 (Source: The WM Company: Charity Fund Annual Review 1994).

⁸⁶ Central Finance Board of the Methodist Church Overseas Fund; the Kleinwort Benson managed Chariguard Overseas Equity Fund is available to all English charities but was only approved in May 1995 after 4 years of discussion with the Charity Commission.

⁸⁷ See Select Bibliography - CC Wider Powers.

development of land for investment purposes is commonly carried out by pension funds through funding agreements with developers, and is not per se "trading" or "too speculative". The definition of an investment is far too narrow, and ignores the fact that the value of all investments depends on subjective views of risk and return.

The Charity Commissioners' policy on granting wider powers where these are constrained seems extremely narrow, although they explain in CC Wider Powers why they feel unable to give unrestricted powers, or wider powers without division, in all cases. Their suggested limits of £20 million for unrestricted powers and £1 million for wider powers without division seem far too high, and assume that the expense of the investment management structure will be too great below this level, which is not necessarily the case. However, their policy on appropriate narrower-range and wider-range investments is enlightened compared to the TIA restrictions.

The Charity Commissioners' policy of prohibitions on acquisition of foreign currency and investment in derivatives (except in very narrow circumstances) shows total disregard of the mechanics of managing a portfolio of foreign investments (which is likely to require the maintenance of foreign currency accounts) and the accepted practice of hedging global bond portfolios through the use of forward foreign currency transactions. They are plainly ignorant of the possibility of creating synthetic foreign equity index funds through the use of futures or swaps (which can be more cost effective than actual purchase of securities, by avoiding custody fees, withholding taxes, stamp taxes, etc.) The beneficial impact of investment in foreign equities in reducing portfolio risk is ignored.

Rather than attempting in CC14 to provide a simplistic pocket guide to investment management, a subject which is full of pitfalls for the unwary, it might be more helpful for the Charity Commissioners to recommend that all charity trustees should seek professional advice on investment policy (as distinct from specific investments, as already required by the TIA), and to suggest that only Common Investment Funds should be used by charities with less than, say, £100,000 to invest (unless the trustees have access to free professional advice). In this way, there would be no justification for the (in any event misguided) TIA restrictions, which could be swept away in their entirety.

Ways Round the Constraints in the Meantime

Until a UK equivalent of the Uniform Prudent Investor Act is enacted, which desirably would entirely supersede the TIA, charity trustees are obliged to find ways round the various constraints imposed by the TIA, the Charity Commissioners, and trust law. However, they are in a better position than other

trustees, whose only resort for variation of trusts is to the High Court and who cannot use Common Investment Funds.

First of all, the words of Dillon LJ in *Nestle v National Westminster Bank plc* quoted above should be noted: "... what the prudent man should do at any time depends on the economic and financial conditions of that time ...". For a trustee to adopt current best practice is therefore not only possible but desirable.

Careful drafting of the constitutions of new charities (and of the wording of wills and other dispositions) is clearly desirable to provide *ab initio* the widest possible investment powers and powers of amendment. In the case of existing charities with restricted powers, the amendment clause should be examined to see whether the trustees can extend their powers without resort to the Charity Commissioners for a Scheme or to the Court. If a Scheme is necessary, CC Wider Powers sets out the Charity Commissioners' current policy, which has been discussed above. Several charities have applied to the Court for wider powers,⁸⁸ but the expense (and need for Charity Commission approval) will rule this out in most cases.

However, as the Charity Commissioners point out in CC Wider Powers, the wide variety of Common Investment Funds, Authorised Unit Trusts, UCITS,⁸⁹ and Investment Trusts (with TIA status) currently available means that the TIA constraints need have little real effect on the implementation of investment policy. (Indeed, the capital growth of equities over the last 30 years has in many cases resulted in the wider range part becoming worth as much as 90% of the total.) The main problem is the cumbrous nature of the rules.

The whole of an undivided trust fund can be invested in special-range property (i.e., property in which trustees are specifically authorised to invest), including Common Investment Funds.⁹⁰ If a division has been made, particular points with regard to the narrower range (NR) restrictions (which are clearly made in CC32) are:

- trustees have complete discretion as to whether withdrawals are made from the NR part, the wider-range (WR) part or some combination of the two.⁹¹ If there is no restriction on

⁸⁸ *Trustees of the British Museum v AG* [1984] 1 All ER 337 and *Steel v Wellcome Custodian Trustees* [1988] 1 WLR 167.

⁸⁹ A collective investment scheme complying with the EU Directive on Undertakings for Collective Investment in Transferable Securities.

⁹⁰ CC32 page 10 "Can money be invested in special-range investments?" paragraph 36.

⁹¹ CC32 page 7 "Are there restrictions on withdrawals?" paragraph 23.

expenditure of capital, the NR part can thus be progressively reduced over time. (The NR/WR division is once for all, although new accruals from outside the fund have to be divided.)

- there is nothing to stop the NR part being invested in Common Investment Funds of any description.⁹²

The complaints of charity trustees and others about being forced to invest in government securities and the loss of purchasing power to charities that has resulted since 1961 because they could not invest more of their funds in equities are thus misguided. Indeed, a trustee who has not taken advantage of the power to invest some of the NR part in equity-based Common Investment Funds may be guilty of imprudence!⁹³

There are various devices that can also be used to reduce the capital in the NR part for charities with a permanent endowment, e.g., by investing in high coupon government stocks selling above par, which will convert capital into income.

Conclusions and Recommendations

We conclude that it is indeed time for change:

The current state of the law in the UK is woefully anachronistic and in need of legislative resuscitation. The Charity Commissioners are to be commended for their recent actions evidencing a willingness to allow more flexibility, albeit on a case-by-case basis. However, they should be more willing to take the lead in fostering best practice as part of their statutory remit to promote the effective use of charitable resources. The Charity Commissioners, more than any other group, should understand that much more is to be gained than might be lost by urging and encouraging more aggressive management of funds by UK charities. Unfortunately, it would seem that, like many others' with a legal background, their posture reflects an inadequate understanding of the discipline of managing investments. We believe that UK legal advisers and charity trustees generally need to become more informed on this subject, and should warn their clients and friends of the need to manage their assets better, in particular of the importance of asset allocation. Sweeping away the TIA restrictions (as with the transfer of securities from the Official Custodian for Charities) would remove an illusory safe harbour for charity trustees and force them to focus on the real issues of investment

⁹² See note 90 above.

⁹³ To be fair, only balanced (i.e., mixed equity and fixed income) Common Investment Funds were available from 1963-1986, when the first all-equity fund (Mercury Asset Management's Charishare) was launched.

management. Delegation should be the typical route — through carefully selected managers or via pooled investments — and charity trustees should worry about liability risks if they fail in their duties here.

Our specific recommendations are as follows:

- the Charity Commissioners should acknowledge their responsibility to be aware of the implications of modern portfolio theory and modify their policy appropriately
- English trust law should be updated to reflect current best investment practice
- the Trustee Investments Act 1961 should be replaced by a Prudent Investor Act along the lines of the US model
- the rule against excessive accumulations should be abolished for charitable trusts
- a new standard of spending should be authorised for charities, adapting the principles of permanent endowment to recognise the impact of inflation and the concept of total return, building on the principle of the US Uniform Management of Institutional Funds Act
- charity trustees are entitled to and should take account of current best investment practice in formulating investment policy, and use all methods at their disposal to get around current constraints.

Select Bibliography

- | | |
|-----------------------|---|
| BZW Equity-Gilt Study | <i>The BZW Equity-Gilt Study: Investment in the London Stock Market since 1918</i> , 40th edition, Barclays de Zoete Wedd Securities, London, 1995 |
| Bodie/Kane/Marcus | Zvi Bodie, Alex Kane and Alan J Marcus <i>Investments</i> , Second Edition, Richard D Irwin, Burr Ridge, Illinois, 1993 |
| Brealey | Richard A Brealey, <i>An Introduction to Risk and Return from Common Stocks</i> , Second Edition, The MIT Press, Cambridge, Massachusetts, 1983 |
| Brinson | Gary P Brinson, Brian D Singer and Gilbert L Beebower, 'Determinants of Portfolio Performance II: An Update', <i>Financial Analysts Journal</i> , May-June 1991 at p 40, and Gary P Brinson, Randolph Hood and Gilbert L Beebower, 'Determinants of Portfolio Performance', <i>Financial Analysts Journal</i> , July-August 1986 at p 34. |
| CC14 | <i>Investment of Charitable Funds: Basic Principles</i> (CC14), Charity Commissioners, November 1993 |
| CC32 | <i>Trustee Investments Act 1961: A Guide</i> (CC32) Charity Commissioners, February 1995 |
| CC Wider Powers | <i>Decisions of the Charity Commissioners</i> Volume 3 Section 4 'Schemes Conferring Wider Powers of Investment (1994)', HMSO January 1995 |
| Dale | Harvey P Dale, 'Nonprofit Directors and Officers Duties and Liabilities for Investment Decisions', 22nd NYU conference on Tax Planning for 501(c)(3) Organizations chapter 4 (1994) |
| Elton/Gruber | Edwin J Elton and Martin J Gruber, <i>Modern Portfolio Theory and Investment Analysis</i> , Fifth Edition, John Wiley & Sons, New York, 1995 |
| Harbottle | Michael Harbottle, <i>Investing Charity Funds</i> , Jordan Publishing Ltd, Bristol, 1995 |

- Harrison John Harrison, *Managing Charitable Investments*, ICSA Publishing, Hemel Hempstead, 1994
- Law Commission 133 The Law Commission Consultation Paper No 133, *The Law of Trusts - The Rules against Perpetuities and Excessive Accumulations*, HMSO 1993
- Levy Robert A Levy, 'The Prudent Investor Rule: Theories and Evidence', *Geo. Mason L Rev*, 1994
- Longstreth Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule*, Oxford University Press, New York, 1986
- Morris Debra Morris, 'Charity Investment in the UK: Some Contemporary Issues for the 1990s', *Web Journal of Current Legal Issues*/Blackstone Press 1995
- Restatement Third Restatement of the Law Third, Trusts, Prudent Investor Rule, The American Law Institute, Publishers, St Paul, Minnesota 1992