Cyprus Trusts - The Risks of Diversification

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Of growing importance to investors since the stock market retreats of 2000-2003 and 2007-2009 has been the re-evaluation of the question of what constitutes effective risk management. It seems that some important aspects of investment theory have failed to deliver the expected outcomes. When too many investors began to diversify into alternative investments, such as commodities, the result was that these asset classes lost their diversifying quality. When the supposedly conservative allocation of 60/40 between US equities and bonds turned into the 2007 downturn, it lost about 30% of its value[1]. When the very best of actuaries' minds are trained on steering the world's largest pension funds there are still perennial reports of unsustainable pension deficits.[2]

Within this environment, the Cypriot trustee managing a trust fund of portfolio investments has to navigate a path that serves the best interests of the trust. Of particular importance is the question of how to demonstrate that the portfolio has been constructed prudently and appositely.

From the outset, it is essential to recognise the settlor's *ad personam* right to choose the trustee. Whether that person is a layman, solicitor-trustee or trust company, equitable law respects the settlor's decision. In turn, the trustee must apply himself to the task in an ordinary manner but bringing to bear conscientiously the skills and talents he has; documenting all of his actions carefully along the way. The chosen trustee must understand why he has made, retained or divested the investments. He has to be aware of the principle of diversifying out of hazardous assets in order to reduce the risk of capital loss whether or not this is an appropriate course of action for the trust. He should keep dealing costs low, not trade the portfolio speculatively and seek independent specialist advice that is apposite. He must decide whether such advice ought to be followed and finally be ready to apply to the court for directions even if it is only to ask to be allowed to resign!

Cyprus Trust Law

For the Cypriot trust we begin with a look at the sources of law. Cyprus law expressly adopted English common law up to 1960, although it is always subordinate to the more superior constitutional, international treaty and statute laws. A trust instrument would be recognised provided it is constructed in accordance with English common law (up to 1960) or the law governing Cyprus International Trusts (enacted in 1992). In addition, there is the law governing trustees namely Cyprus Trustees Law CAP 193 which is virtually identical to the English Trustee Act 1925.

Evidently then, Cyprus has missed out on English statutory developments in the form of the Trustee Investment Act 1961 and Trustee Act 2000 (TA 2000). This is interesting because these provisions placed important investment concepts of common law jurisprudence on a statutory footing[3]. The standard investment criteria of s4 TA 2000 mandates the regular review of the suitability of the investments of a portfolio and the need for diversification so far as the circumstances lend themselves to the same. The statute further stipulates taking proper advice, from a person qualified to give it, as regards a particular investment, save where a trustee concludes this would be unnecessary or inappropriate.

The standard investment criteria could arguably be regarded as guidance for exercising the statutory duty of care when making investments that is applicable to Cyprus International Trusts to wit:

> "The trustee may vary the investment or retain it in its original state, as long as he exercises the diligence and the prudence which a reasonable person would be expected to exercise when he makes investments."[4]

What is also clear is that diversification and taking expert advice are not mandatory under the standard investment criteria but in any case should always be considered and the deliberations documented.

The Non-diversified Portfolio

For the lay trustee who receives no compensation for accepting[5] and holding office, who cannot resign on a whim, the simplest and least time consuming investment strategy would be to avoid hazardous and speculative investments entirely. In Cyprus, hazardous and speculative mean securities other than government bonds and freehold mortgages. CAP 193 Clause 4[6] refers to this class as Authorised Investments granting the trustee the unfettered power to invest in them[7].

By only investing in government bonds and matching the maturity dates of those selected to estimates of when beneficial interests would or could fall in, the trustee would reasonably expect to preserve the nominal capital value of the trust fund[8]. This exercise of matching assets (the trust fund) with liabilities (the beneficial interests) ought to keep in mind contingencies that may arise; for example, the maintenance of minors. It is also important not to lose sight of the potential downside risk in the event of mismatching when the liabilities fall due. This is known as duration risk. The price of a bond that has ten years to run is still sensitive to changes in interest rates. Any early divestment of it could give rise to an unexpected loss (or profit) depending on the direction of the change. With this approach therefore it may be

essential to hold a bond until maturity. In many countries there is a wide selection of maturity dates available making it possible to select different maturities and to manage the matching process effectively.

In summary then, the simplest kind of risk management without Modern Portfolio Theory's (MPT) diversification would take the follow form:

- The allocation of assets would be limited to triple A rated sovereign bonds and interest bearing bank deposits[9] in the reference currency of the beneficial interests;
- The selection of bonds would match maturities to the likely falling in of beneficial interests over the time horizon; and
- The capital held in interest bearing bank deposits would be kept to a minimum.

In this way the trustee gets a high level of visibility and assurance of outcome. English Trust law regards English sovereign bonds as very safe notwithstanding the *quasi* default on the War Loan issue after the First World War[10]. They are not considered to be hazardous or speculative. An independent actuary or stockbroker who understands them well and possesses the requisite expertise would be able to guide the lay trustee through the process of building such a portfolio.

Admittedly the level of returns may be low, even unimpressive, but ordinary prudence looks for and emphasises capital preservation seeing the requisite level of investment returns as dependant upon the circumstances of the trust. The demands about reasonable investment performance tend to be focused on the paid trust professionals or trustees who have agreed to them with the settlor.[11]

Diversification

Now of course there is nothing stopping the professional trustee from agreeing to a trust instrument that eschews all hazardous and speculative securities. There could though still be a danger that the professional trustee would be criticised for failing to preserve the capital value in real terms i.e. after adjusting for the effects of inflation. Conventional bonds are not designed as a hedge against inflation. The professional's best means of defence in this case would be to include inflation linked government bonds and/or equities in a diversified portfolio[12]. This is not the diversification of 'never put your eggs in one basket' fame which refers to the risk of default or bankruptcy. Instead it is the aforementioned MPT and its extensions. It is fundamentally about risk reduction as measured by standard deviation through the combination in a portfolio of two or more different assets whose prices move in a different direction upon the occurrence of a specific event. For example, the prices of government bonds and equities tend to move in different directions when investors become more or less risk-averse. When these assets' standard deviations and expected returns are slotted into the form of an equation and probabilities of outcomes layered in, the theory optimises risk and reward. So for a given level of risk, it is possible to determine the appropriate mix of assets in order to maximise the return.

Several problems have arisen, however, of which the two that follow are critical: firstly, versions of the model using standard probability distributions have underestimated the number of significant pull backs in equities over time; and, secondly, it pays little heed to the importance of entering the market at points representing good value when compared with empirical data. This is of greatest importance to equities but also applies to government bonds that are beyond the time horizon.

The importance of fundamental value is that when the equities' market flies higher and higher, bubbling away from good value as measured in historical terms, the risk of an 'Icarus moment' grows ever closer. It is no wonder that trust law over the years has wisely coined the terms hazardous and speculative as a way of describing such properties. When these moments occur they can do incredible and lasting damage to capital value as occurred in the 2000 and 2007 bear markets. As already mentioned the 2007-2009 downturn was reported to have produced a 30% fall in value for the US 60/40 equity/bond mix. Now this kind of drop would get made up over time if such time were available to the trustee but the arithmetic of compounding makes the climb back up much harder and longer than the drop. Consider the follow simple arithmetic:

- A fall in value of 50% - a 100% increase is required to make good;
- A fall in value of 33% - a 50% increase is required to make good;
- Three years of returns of 10% followed by a loss of 30% produces a loss of 7%.

An alternative school of thought designed to deal with MPT's profound weakness (over the short term at least) is known as value investing. Its two central tenants are: avoid deep losses and buy low/sell high. As a system it is more easily understood and arguably produces better results than MPT. Warren Buffet the remarkable chairman of Berkshire Hatherway who needs no introduction put it this way:

> "We love owning common stocks (equities) – if they can be purchased at attractive prices. Unless, however, we see a very high probability of at least 10% pre-tax returns, we will sit on the sidelines.....But occasionally successful investing requires inactivity."

> "Rule 1 is never lose money, rule 2 is never forget rule 1."

For MPT then the problem has not only been about several of the questionable assumptions it makes[13] but the fact that it answers the wrong question. Investors and especially trustees have to know how to avoid deep losses and make reasonable investment returns. Moreover this point is not lost among serious financial professionals other than Buffet. A recent Barclays Equity Gilt Study[14] looked back at equities' lost decade up to 2008 attributing their palpable chagrin "to the extreme overvaluation of equities at the start of the decade".

Expert Advice

While Cyprus does not have a statutory rule the leading legal authority[15] is clear that the trustee must take specialist advice if the circumstances warrant it. The first demand is to find apposite advice. So the verification of title is for a lawyer, matching assets with liabilities is the task of an actuary, accountant or stockbroker, depending on complexity, and valuing property and businesses is in the hands of surveyors and accountants respectively.

As regards the crucial question of independence it is important to recall that the common law gauges the standard against the ordinary businessman (Victorian). Not the ordinary entrepreneur, ordinary tycoon or ordinary car dealer; nor for that matter the ordinary househusband or houseboy. Such an individual would never seek expert advice from a professional acting for the other side of a financial transaction (but it does happen). The message then is to be able to show, not only that advice has been taken from the apposite professional, but one who is evidently independent upon giving said advice[16].

Finally there is the matter of advice from financial advisors be they banks, licensed individuals, etc. The reader may by now be aware that very little mention has been made about alternative investments, mutual funds, unit trusts etc. Instead the focus has been on direct investment into bonds and equities (on an execution basis). With the exception of Exchange Traded Funds composed of these two classes, there is less visibility of outcome when investing indirectly in bonds and equities. In addition there are higher charges and the bid/offer system, while negotiable for larger investments, should be singled out for special concern. It is notable that this system, while far from ubiquitous, is more prevalent in Europe than in the USA. John Authers[17], writing about the sector overall, suggests that there is legitimate cause for concern because of the risk of conflict between the interests of financial institutions and their clients. The institutions' inclinations to give priority to

the accumulation of assets and to reward managers accordingly are linked to the tendency of managers to judge themselves by comparison with one another. Authers argues that managers, not wishing to lose clients, aim to avoid relative under performance propagating the herd mentality and bubbles. There are other similar concerns for trustees apropos of hedge funds.[18]

Indeed as an observation for trustees about the world as a whole and not only when common man meets sophisticated institution, the prudent trustee should possess the kind of insight on offer via a brief journey back in time to Plato's antiquity. In a dialogue of the same name, Gorgias is actively found out by Socrates who wishes to understand his method of teaching known as rhetoric. It transpires that the art of persuasive speech was nothing more or less than a systematic method of eliciting power over others and freedom for oneself. This is not to imply that all financial advice available to trustees is based upon rhetoric. However, trustees must seek out Gorgias so to speak and evaluate prudently whether his interests are aligned with theirs.

Summary

In the run up to the English Trustee Act 2000 a British Law Commissioner wrote:

> The old picture of the family trust with an avuncular trustee who had lots of spare time to devote to the running of the trust and a range of trustee investments that consisted only of government stocks and mortgages, is long dead. The modern trustee needs professional help to steer the trust properly through the thicket of modern investment practice and to ensure that it is properly managed to secure the best return for the beneficiaries or purposes of the trust."

It is not intended to quote the commissioner out of context so let it remain anonymous. However one of the intentions of this article is to act as a counterpoint to the argument that MPT managed by professional trustees was the logical and only way forward.

On the contrary, it is the settlor's pride and pleasure to choose his trustees whose job is first and foremost to preserve the capital value of the trust fund. This can be done efficiently and systematically without MPT's diversification but the returns when compared with the long run achievements of equities are likely to be unexciting. Greater stress in achieving reasonable performance may be placed upon the shoulders of professional trustees, subject as always to the terms of the trust.

In addition, the world's best known and wealthiest investor has shone a light on the priorities that the ordinarily prudent investor must follow. As an independent illustration of Buffet's argument, a recent article in the Cyprus Mail[19] claimed that for the first time on record wealthy women with more than GBP500,000 to invest, living in Great Britain, outnumber the men. The reason? The ladies being risk averse and prone to greater longevity had avoided deep losses and picked up more of the benefit of compound interest over time. Could it be that the art of steering through the thicket of modern investment practice may be to go round it altogether.

So left to sum up it would seem that fellow trustees of all hues might keep in mind a simple system:

- There are known 'knowns' - these are the trust's time horizon and financial results of holding government bonds to maturity;
- Then there are known 'unknowns' – these are the financial results of holding hazardous investments such as equities;
- Finally there are the unknown 'unknowns' – these are the next generation of paradigms, fads and fashions of the bankers and financial intermediaries the results of which are unknown.

Needless to say under Rumsfeld's method[20] the trustee of a portfolio should coalesce around the 'knowns' and extend into 'known unknowns' depending on his ability and status. The reference to 'unknown unknowns' is merely intended to serve as a warning.

END NOTES:

1. Money Magazine, "Planning for a Bumpy Ride,", Walter Updegrave", 9 June 2010.

2. The British government recently announced it was shifting its inflation measurement from the Retail Price Index (RPI) to the Consumer Price Index (CPI) in an attempt to reduce these liabilities by stealth.

3. Another implication is that Cypriot trustees (other than those with express powers or governed by the law concerning collective investment schemes) continue to be barred from delegating the task of investment management.

4. Law 69/1992 Clause 8.2.

5. A person may decline to act as trustee.

6. As regards Cyprus International Trusts CAP 193 Clause 4 is superseded by Law 69/1992 Clause 8.

7. CAP 193 Clause 4 authorises freehold mortgages only where the trust instrument does not expressly prohibit them.

8. In many countries index linked government bonds are issued allowing the trustee to hedge against inflation.

9. Bank Deposits: these are not authorised investments as per CAP193 and care needs to be taken on two fronts. Be careful about banks which the authorities may allow to fail in the event of liquidity or solvency problems by minimising the amounts of capital lodged with such banks to amounts required to meet only day to day needs. The financial authorities have stepped in convincingly since the crash of Lehman but the risk of bank failure must never be forgotten, especially from those institutions paying interest rates temptingly above the going rate. Indeed, it was Mervyn King, the chairman of the Bank of England, who suggested post crisis that in the future, two categories of deposit might be a good idea providing clear differentiation between the deposits underwritten by the government, paying lower interest and a non-guaranteed account yielding a higher amount. Bank deposits must never been seen as risk-free and those outside of the category 'too big to fail' ought to be regarded as hazardous. Any losses from such a lesser bank may have to be made good. Of course where a trustee could show that a deposit was being retained at the express stipulation of the trust instrument, he might be able to make a legitimate argument in his defence.

10. The classification as safe of all sovereign bonds is not intended and is subject to a case by case assessment. The British War Loan's coupon was reduced to 3.5% from 5% in 1932.

11. See the Jersey and New Zealand cases of Midland Bank Trustee and Re Mulligan respectively.

12. It has more recently been accepted that profits and losses of individual securities may be offset, one against the other, provided they are part of a connected and coherent strategy.

13. For example, that all investors are rational and that no-one trades.

14. The Equity Gilt Study has been published continuously since 1956.

15. The rule in Speight v Gaunt ((1883) 9 App Cas. 1) was as follows: "…[As] a general rule a trustee sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own."

16. Another marker as to the qualitative side of the advice is found in CAP193 itself. Section 8 exonerates a trustee from breach of trust under certain conditions when lending trust funds backed by a mortgage representing up to two thirds of the valuation of property. These conditions are essentially that of independent advice from a surveyor or valuer and perhaps as necessary from an accountant or stockbroker. By implication the trustee has to get in a high level of assurance that his advisors know their subject.

17. Financial Times, The Long View, 17 January 2010 .

18. Buffet is reported to have once complained that the hedge fund scene was a compensation scheme dressed up as an industry.

19. "Cautious women outnumber wealthy men for the first time." was printed in the Cyprus Mail on 18 June 2010.

20. Donald Rumsfeld, Secretary of Defence of the USA, 2001-2006 once said: "There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. These are things we don't know we don't know."