Fundamental fiduciary truths

The concept of fiduciary duty may appear to offer a stable footing for investor relationships, but the ground is shifting. Keith L. Johnson offers a helping hand through the changes.
Fiduciary standards have historically evolved in response to societal change. Investment fiduciary relationships arise when control of assets is delegated to an agent who undertakes responsibility to manage those assets for the benefit of one or more third-party beneficiaries. This creates an inherent conflict of interest between the agents and beneficiaries. It also makes investment beneficiaries and society vulnerable to being taken advantage of by fiduciary agents.

Fiduciary duty is what protects both from abuse at the hands of the agents who exercise management control over delegated assets. Strict standards prevent abuse The vulnerability of beneficiaries (and society) is one reason why fiduciary standards for investment fiduciaries are stricter than those applied to corporate directors. Other reasons include:

- investment agents typically possess highly specialised expertise, which makes evaluation of the quality of their services by non-expert beneficiaries very difficult;
- fiduciary negligence or misconduct might not be evident until years later;
- in many jurisdictions, there is little transparency around fiduciary agents' actions, especially in regard to externalisation or deferral of risks and the effects of fees netted out of fund assets; and
- fiduciaries often have opportunities to generate near-term performance by externalising costs to future beneficiaries and society.

Fiduciary duty rules can vary across jurisdictions, but the nature of fiduciary relationships generally raises similar issues. This results in a fair degree of consistency around fundamental fiduciary principles (see box to the right).

Responding to change The application of fiduciary duties has been relatively stable during the past generation. However, fiduciary standards have historically been dynamic concepts that evolve in response to changes in societal circumstances and advances in knowledge. For example, during most of the 20th century, common law countries used lists of authorised investments that were intended to prevent fiduciaries from taking on too much risk. Under those standards, corporate stock was considered an imprudent investment for fiduciaries. That changed during the last quarter of the century in response to widespread acceptance of modern portfolio theory, as well as a better appreciation of the risks faced by beneficiaries when portfolios are filled with long-term fixed income securities during periods of inflation.

We now appear to be at a point where a similar transition in the application of fiduciary principles is occurring in response to relatively recent changes in knowledge and circumstances. These include:

- growing population numbers and rising living standards in the developing world, together placing mounting demands on our planet's resources;
- the unprecedented level of assets managed by institutional fiduciaries, making those fiduciaries systemically influential;
- fundamental investment theory assumptions being questioned after the financial crisis;
- the longer and more complex service provider chain between beneficiaries and investee companies, which dilutes the responsibility of each provider;
- the increasingly short-term outlook of investors, which makes it difficult for companies to pursue long-term strategies and renders future investment risks or opportunities largely irrelevant;
- the massive transfer of wealth between current generations, with decades of costs and risks being pushed into the future; and
- the effects of climate change precluding the continued use of many established business and investment practices.

This has not gone unnoticed. Fundamental fiduciary principles are receiving greater attention across jurisdictions. For instance, the UK Law Commission issued a report in June 2014 that encouraged fiduciaries to take a longer-term view of their responsibilities.

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The adoption of investor stewardship codes around the world is another consideration. Asset owners are developing new investment beliefs tied to sustainability and fiduciary duties, and the use of integrated reporting that recognises the influence of environmental, social and governance factors is growing.

In addition, risk management analyses are beginning to evaluate diversification across risk exposure buckets, rather than merely across asset classes. Sustainable accounting standards are being developed, while asset owners are collaborating to gain scale and effectiveness. On top of all this, a number of market benchmarks and index funds that address sustainability are now available.

These developments have changed what is required of fiduciaries to achieve the goals that underlie fundamental fiduciary principles. They are bringing increased focus on investment time horizons, intergenerational equity, the systemic effects of herding around broadly adopted practices, investor governance and stewardship, behavioural biases of decision makers and the integration of sustainability factors into investment analysis.

The ICGN guidance on fiduciary duty

ICGN has been a leader in providing guidance to help investment fiduciaries fulfill their responsibilities in the context of these changes. The ICGN Model Mandate and the ICGN Global Governance Principles both provide direction on implementation of fiduciary principles.

While they are intended for use within the context of local rules, these ICGN guidance documents provide valuable cross-jurisdictional insights into evolving practices for fiduciaries. Key guidance provisions include:

Prudence: “Institutional investors should be led by governing bodies and staff with the appropriate capacity and experience to oversee effectively and manage all relevant activities in the interests of beneficiaries or clients. Decision-makers along all parts of the investment chain should be appropriately resourced and meet relevant standards of experience and skill in matters subject to deliberation.”
ICGN Global Governance Principles, s.12.1

Risk Management: “As long-term owners which are exposed across asset classes, major institutional investors need to be aware of systemic risks to the value of their overall portfolio. . . There are three aspects to these risks that matter to the long-term owner: singular long-term risks within individual assets; risks with a combined impact across an asset owner’s portfolio; and economic impacts which come to bear across the financial system as a whole or over a long-term horizon.”
ICGN Model Mandate Initiative, s.1.0

Loyalty: “Institutional investors should have robust policies to clarify, minimize and help manage conflicts of interest to help ensure that they maintain focus on advancing beneficiary or client interests. In particular, policies should address how matters are handled when the interests of clients or beneficiaries diverge from each other.”
ICGN Global Governance Principles, s.13.1

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Impartiality: “In considering what time horizons are appropriate, institutional investors will need to consider the best interests of their clients and beneficiaries, and any issues of intergenerational fairness between them, as well as where the ultimate risk bearing lies.”
ICGN Global Governance Principles, s.11.4

Accountability: “Benchmarks for measuring success should be tailored to the needs and risk exposures of beneficiaries or clients, with reporting designed to provide them with an understanding of success toward meeting those needs and managing related risks, in addition (as relevant) to providing applicable market-relative performance numbers.”
ICGN Global Governance Principles, s.10.3

In conclusion, ICGN offers investors invaluable guidance on the governance practices needed to implement a contemporary ‘fit for purpose’ understanding of fiduciary principles in a rapidly changing world.

ABOUT THE AUTHOR

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