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Implications for the Fiduciary Responsibilities of Investment Fund
Trustees**

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SOCIALLY RESPONSIBLE INVESTMENT IN MARKET DOWNTURNS

Implications for the Fiduciary Responsibilities of Investment Fund Trustees

*Richard Copp, Michael L Kremmer and Eduardo Roca**

In the past, socially responsible investment (SRI) has been justified largely by empirical evidence showing SRI returns to be broadly similar to returns on conventional (non-SRI) investments. There are exceptions, however, and in any case this empirical evidence is based on returns in normal economic times. The extent to which it applies in recessions such as the recent global financial crisis (GFC) has so far been unclear. Our empirical analysis shows that, before the GFC, SRIs internationally yielded even higher risk-adjusted returns than conventional investments, although SRIs in Australia significantly under-performed compared with conventional investments in terms of risk-adjusted returns. Since the GFC, both in Australia and worldwide, SRIs have significantly under-performed against conventional investments in terms of risk-adjusted returns. These results confirm that traditional investment fund trustees and managers risk breaching their fiduciary duties if they invest in SRIs during times of economic downturn, perhaps suggesting a need for statutory reform if SRI is to be encouraged within the investment community. Reform could include the introduction of a business judgment rule, greater disclosure for SRI, a statutory indemnity for trustees investing in SRIs, and tax breaks and subsidies.

Socially Responsible Investment?

Although any precise definition varies between countries,¹ socially responsible investment (SRI) can broadly be defined as the process of selecting or managing investments, not with the aim of maximising investor returns for given risk *per se*, but rather that of optimising these parameters subject to social, environmental and ethical (SEE) constraints. Social constraints include seeking to foster human capital (for example, education and training, workplace health and safety) and enhancing worker rights.

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¹ See, for example, Oxford Business Knowledge (2007), p 5.

Environmental constraints include goals of minimising pollution and the carbon footprint, conservation of non-renewable resources (such as oil) and preservation of valued flora and fauna and the ecosystems they support. Ethical constraints encompass objectives to eradicate human rights abuses (for example, the use of child or ‘sweatshop’ labour, forced prostitution or pornography); product testing on animals; or to withdraw any perceived tacit support for oppressive political regimes.²

At the point at which investments are selected for inclusion in the SRI portfolio, assets are typically screened to determine the extent to which they are consistent with the SEE constraints of the fund manager. Three types of screening process are typically employed in practice around the world: positive, passive and negative screening. Positive screening involves the fund manager establishing set criteria for evaluating whether the asset complies with its SEE objectives, and allowing particular investments ‘in’ to the portfolio if they meet these criteria. Passive screening involves individual portfolio managers passively investing in portfolios whose composition mirrors particular SRI share indices and whose objectives align with those of the fund (for example, the fund manager may invest in the Dow Jones Sustainability Index or the Dow Jones Islamic Market Index). Negative screening involves the application of SEE criteria to exclude from the portfolio particular assets that fail to meet the criteria.³

Growth in SRI Worldwide

The level and value of SRI globally have grown substantially over the past three decades, and SRI is now actively being promoted at the global level by such organisations as the World Business Council and the United Nations through its Principles for Responsible Investment, and its Environmental Program–Financial Institutions Initiative. In North America, SRI assets are worth US\$2.71 trillion⁴ for the United States and C\$503 billion (US\$471 billion)⁵ for Canada. The largest SRI market in Europe is the United Kingdom, valued at €781 billion (US\$1.17 trillion).⁶ In Asia, Japan is the leading market, with up to ¥840 billion (US\$7.3 billion)⁷ worth of SRI assets. Finally, total assets invested in Australia’s SRI markets are valued at

² Oxford Business Knowledge (2007), p 4.

³ Oxford Business Knowledge (2007), pp 6–7. In addition to the placement of funds in investments that are screened for social, ethical and environmental (SEE) considerations, SRI may also include activities such as shareholder activism, which involves actions by shareholders to improve the SEE performance of companies, and community-based investing, which consists of direct investments in projects that benefit specific communities or constituencies – see Ethical Investment Association of Australia (2004) for discussion of this issue). The focus of this article is on the first type of activity.

⁴ Social Investment Forum: United States (2007).

⁵ See Canada’s Social Investment Organisation (2006).

⁶ European Social Investment Forum (2006).

⁷ Social Investment Forum: Japan (2007).

A\$19.4 billion (US\$17.3 billion).⁸ The interest in and support for SRI has also generated the creation of specific share indices such as the Dow Jones Sustainable Index (DJSI) and London's FTSE4GOOD index, as well as specialised research houses such as Morningstar and the Sustainable Investment Research Institute (SIRIS).

This massive growth in SRI is being fuelled by the increasing involvement of large institutional investors such as pension and mutual funds, and other traditional financial services providers. The involvement of these financial institutions and institutional investors is a response to the changing expectations about how corporations and businesses should behave in relation to their social and environmental impacts.

Intuitively, incorporating extra-financial factors is likely to change the risk–return profile of any portfolio, relative to one that is traditionally managed according to the 'minimax' principle (minimising risk and maximising returns). However, much of the available empirical evidence to date shows that SRI does not, at least internationally, generally involve any sacrifice in the level of funds' risk-adjusted returns – a fact that is not lost on proponents of SRI. Yet this empirical evidence relates to periods before the recent global financial crisis (GFC). Anecdotal evidence suggests that the period since the GFC has seen significantly lower investment returns and higher investment risks.

This raises two issues: (1) whether SRI has performed as well as conventional investments since the GFC; and (2) whether initial clamour for the reform of financial legislation to address the causes and consequences of the crisis was justified.

Relevance of Investment Trustees' Fiduciary Duties

Historically, one of the most contentious legal issues surrounding SRI has been whether, by investing in SRIs, traditional trustees and fund managers of investment portfolios breach their fiduciary responsibilities by failing to maximise returns and minimise risk.

For the purposes of this paper, a 'traditional' trustee is one whose trust was settled at least 20 years ago, and whose trust deed does not explicitly contemplate investment in SRI. These 'traditional' trustees comprise many of the large investment funds in commercial practice today. As a consequence of the wording in its 'traditional' trust deed, the trustee of a 'traditional' fund may not, as a matter of trust law, have the legal power to invest in SRIs.⁹ For example, in superannuation funds where investment choice is offered to members, it is currently common for the fund trustee to offer an SRI option, and members are able to choose whether all or some of their superannuation savings are invested in SRI. This is despite the fact that

⁸ Responsible Investment Association Australasia (2007).

⁹ It would not help such a traditional trustee if it fully disclosed to its investors the risks of SRIs in a recession or if some beneficiaries actively chose to invest in an SRI option offered to them by the trustee, if that trustee did not have the power to invest in SRIs in the first place. We are grateful to an anonymous referee for highlighting this issue.

the fund may not have a legal power to invest in SRI in the first place. It is these ‘traditional’ investment trustees and trust funds that provide the focus of this paper.¹⁰ The apparent reluctance of traditional fund trustees and managers to invest in SRIs, presumably to avoid any such breaches, has been cited as one of the main obstacles to growth in the SRI sector.¹¹

There are two main schools of thought in relation to whether investment in SRIs causes traditional investment trustees and fund managers to breach their fiduciary duties. One school of thought argues that, other things being equal, such trustees and fund managers risk breaching their fiduciary duties if they invest in SRIs because returns may well be sacrificed in the pursuit of SRI.¹² This school of thought implicitly assumes that SRI investments underperform conventional (non-SRI) investments in terms of risk/return. A second main school of thought in defence of SRI draws on the findings of the existing empirical evidence that SRI does not involve any sacrifice in the level of fund returns, and contends that *ipso facto* traditional trustees and fund managers cannot be in breach of their fiduciary duties by investing in SRIs.¹³

This article seeks to examine the risk–return performance of SRI relative to conventional (non-SRI) investments both before and since the GFC. It looks at whether trustees and managers of traditional investment funds breach their fiduciary duties by investing in SRIs, and whether – and in what ways – the law may be in need of legislative reform. The article necessarily spans two paradigms – financial economics and law – and to some extent may appear to be two stories in one. This is unavoidable, given the interdisciplinary nature of the topic.

SRI Performance Before the GFC

The empirical evidence on SRI performance is mixed. Most existing studies report that, globally, SRI performed equally as well as conventional funds before the GFC. For instance, according to most studies, there were generally no statistically significant differences between the investment performances of SRI and conventional (non-SRI) investment funds in Australia (although this finding is sensitive to the time period studied),¹⁴ in

¹⁰ In contrast, a recently settled, stand-alone trust fund whose trust deed explicitly permitted its trustee to invest in SRIs would not have this problem; this is beyond the main ambit of the paper.

¹¹ See, for instance, Lane (2006), pp 33–34; Kinder (2006), p 32.

¹² For example, see Langbein (2007), pp 1077–78; Langbein and Posner (1980), pp 98, 108, 110.

¹³ Kinder (2006).

¹⁴ Bauer et al (2006) showed that, while SRI and conventional investments performed similarly in terms of risk-adjusted returns over the 11-year period 1992–2003, this was sensitive to the time period tested – for example, during the period 1992–96, SRIs significantly under-performed conventional investments, but matched conventional investments during the period 1996–2003.

the United States,¹⁵ in the United Kingdom¹⁶, between SRI and conventional funds from the United States, the United Kingdom and Germany¹⁷, or between such funds in the United Kingdom, Germany, Sweden and the Netherlands.¹⁸ Other studies, however, report that the risk-adjusted returns on SRIs – over different time periods – on average exceed those on conventional investments in the United States,¹⁹ as well as in Canada, France, Germany, Italy, the Netherlands, Spain, Switzerland and the United Kingdom.²⁰ Then again, there is some evidence that the risk-adjusted returns on conventional investments on average exceed those of SRIs in continental Europe and the Asia-Pacific region.²¹

Given the range of these empirical findings, it is hardly surprising that competing legal views have emerged concerning whether trustees and managers of traditional investment funds breach their fiduciary duties by investing in SRIs. Other things being equal, it is more difficult to argue against SRI if it yields risk-adjusted returns that are at least as high as those on conventional investments.

Since there is no clear conclusion within the existing literature with regard to SRI performance, we conducted our own investigation of SRI performance using the Dow Jones Sustainable Investment Indices and share price index data from Thomson Datastream performance over the 15-year period 1 July 1994 to 29 May 2009. We undertook the investigation for the period before the GFC – March 1994 to 31 July 2007; since the GFC – 1 August 2007 to 29 May 2009; and for the combined periods. For the period before the GFC (1 March 1994 to 31 July 2007), the results of our empirical analysis show that SRI internationally performed better than conventional investments in terms of risk-adjusted returns (see Table 1).

However, in terms of investment just in Australia, our results reveal that, before the GFC, SRIs significantly under-performed conventional (non-SRI) investments in terms of total risk-adjusted returns (see Table 2).

At the very least, these results suggest that even before the GFC, investment fund trustees and managers would have been well advised to carefully consider precisely where in Australia they placed their investors' funds.

¹⁵ Diltz (1995); Guerard (1997); Sauer (1997); Gregory et al (1997); Bauer et al (2005); Hamilton et al (1993); Statman (2000); Goldreyer et al (1999); Renneboog et al (2007); Renneboog et al (2008).

¹⁶ Gregory et al (1997); Renneboog et al (2007).

¹⁷ Bauer et al. (2005).

¹⁸ Kreander et al (2005).

¹⁹ Chong et al (2006); Hong and Kacperczyk (2009).

²⁰ Hong and Kacperczyk (2009).

²¹ Renneboog et al (2007, 2008).

Table 1: Pre-GFC investment performance of SRI vs conventional funds internationally (1 March 1994 to 31 July 2007)

Pre-GFC	SRI internationally (%)	Conventional (non-SRI) investments internationally (%)
Average investment return (% pa)	9.0	7.65
Total risk-adjusted return (% pa)	0.58	0.55

Note: The figures presented are the annualised results of calculations performed on the daily returns series. The total risk-adjusted returns is calculated by dividing the average annualised return by the annualized standard deviation – the daily standard deviation multiplied by the square root of the number of trading days in the year. The statistical difference between the total risk-adjusted returns of SRI and Non-SRI Securities is tested using an F-test for the null hypothesis that the variances of the two daily returns series have been drawn from a single population; that they are equal. In this case the null hypothesis was rejected at the 1 per cent level of significance.

Table 2: Pre-GFC investment performance of SRI vs conventional funds in Australia (1 March 1994 to 31 July 2007)

Pre-GFC	SRI in Australia (%)	Conventional (Non-SRI) Investments in Australia (%)
Average investment return (%pa)	9.35	11.69
Total risk-adjusted return (% pa)	0.56	0.94

Note: The figures presented are the annualised results of calculations performed on the daily returns series. The total risk-adjusted returns is calculated by dividing the average annualised return by the annualized standard deviation – the daily standard deviation multiplied by the square root of the number of trading days in the year. The statistical difference between the total risk-adjusted returns of SRI and non-SRI securities is tested using an F-test for the null hypothesis that the variances of the two daily returns series have been drawn from a single population; that they are equal. In this case the null hypothesis was rejected at the 1 per cent level of significance.

Do These Findings Still Hold During the Global Financial Crisis?

Our findings so far are in line with the mixed SRI performance reported in the existing literature. These results are, however, based on returns in relatively ‘normal’ economic times. The extent to which it applies during recessions such as the recent GFC has to date remained unclear. In an effort to overcome this gap in the evidence, we examined the investment performance of SRIs and conventional investments, in terms of risk-adjusted returns, during the period since the GFC (ie 1 August 2007 to 29 May 2009). Our empirical analysis shows that, since the GFC, SRIs worldwide have

significantly under-performed conventional investments worldwide in terms of total risk-adjusted returns (see Table 3).

Notwithstanding the findings presented so far, it may be argued that investors in SRI would take a longer-term view of performance, since such non-financial considerations involved in SRI as environmental, social and governance (ESG) issues impact more on the long-term value of businesses.²² We therefore analysed the performance of SRI *vis-à-vis* conventional investments for the full sample period – that is, 1 March 1994 to 29 May 2009. We examined the systematic risk²³ of SRI *vis-à-vis* conventional investments during all market downturns, including the GFC, across the full sample period.²⁴ We undertook the examination based on the market model with GARCH²⁵ specification.²⁶ The results of our analysis show that the systematic risk of SRI during market downturns over the full period increased more than that of conventional investments, worldwide.²⁷

²² See, for instance, UN Principles for Responsible Investment (2007) and CSR Europe, Deloitte, Euronext (2003) for a discussion of the impact of ESG factors on investment.

²³ Systematic risk is that component of total risk which is associated with the movements in the economic system; it is termed ‘undiversifiable’ risk because it represents that element of total risk that cannot efficiently be diversified away. For further discussion, see Brooks et al (1998).

²⁴ The previous market downturns tested were for the periods 7 January 1994 to 9 December 1994; 28 December 2001 to 14 March 2003; and 19 October 2007 to 6 March 2009 (the GFC as experienced by Australian equity markets). The world equity markets also experienced downturns in the periods 7 January 1994 to 2 December 1994; 8 September 2000 to 4 April 2003; and 8 June 2007 to 29 May 2009 (the GFC, as experienced by world equity markets, but dominated by the reaction on US stockmarkets).

²⁵ Generalised Autoregressive Conditional Heteroskedasticity (GARCH) models. For more detail, see Bollerslev (1986); Glosten et al (1993); Nelson (1991).

²⁶ We estimate the following model where the first equation is the familiar market model to which has been added a dummy variable which is indicative of periods in which the market is falling and the second equation models the time variation in the error term in the mean equation. Note that the market here, with a beta of 1, is used to represent conventional investment.

$$R_{i,t} = \mu + \beta R_{m,t} + \omega(R_{m,t-1}) + \varepsilon_{i,t} \quad .$$

$$\sigma_{\varepsilon_{i,t}}^2 = \alpha + \gamma \varepsilon_{i,t-1}^2 + \delta \sigma_{\varepsilon_{i,t-1}}^2$$

The relevant empirical results for the mean equation for SRI internationally were

$$R_{i,t} = 0.0 + 0.992R_{m,t} + 0.043(R_{m,t-1})$$

$$t - stat \quad (1.01) \quad (87.92) \quad (2.73) \quad .$$

which indicate that as the market falls there is a statistically significant increase in systematic risk of SRI internationally. The mean equations of the market model were estimated with t-distributed GARCH errors, which conventional tests indicate are free from autocorrelation in both the first and second moments, ensuring the validity of the t-statistics given in the brackets.

²⁷ Since the risk of SRIs increased and SRI returns fell, it can be inferred that market risk-adjusted returns on SRIs declined on average.

Table 3: Post-GFC Investment Performance of SRI vs Conventional Funds Internationally (1 August 2007 to 29 May 2009)

Pre-GFC	SRI internationally (%)	Conventional (non-SRI) investments internationally (%)
Average investment return (% pa)	-32.71	-30.21
Total risk-adjusted return (% pa)	-1.51	-1.30

Note: The figures presented are the annualised results of calculations performed on the daily returns series. The total risk-adjusted returns is calculated by dividing the average annualised return by the annualized standard deviation – the daily standard deviation multiplied by the square root of the number of trading days in the year. The statistical difference between the total risk-adjusted returns of SRI and non-SRI securities is tested using a F-test for the null hypothesis that the variances of the two daily returns series have been drawn from a single population; that they are equal. In this case the null hypothesis was rejected at the 0.047 level of significance.

Additionally, as can be seen in Table 4, we also find that, in the Australian context, SRI under-performed conventional investments over the full period, based on total risk-adjusted returns.

Table 4: Pre- and post-GFC combined investment performance of SRI vs conventional funds in Australia (1 March 1994 to 29 May 2009)

	SRI in Australia (%)	Conventional (non-SRI) investments in Australia (%)
Average investment return (% pa)	4.78	5.93
Total risk-adjusted return (% pa)	0.24	0.39

Note: The figures presented are the annualised results of calculations performed on the daily returns series. The total risk-adjusted returns is calculated by dividing the average annualised return by the annualized standard deviation – the daily standard deviation multiplied by the square root of the number of trading days in the year. The statistical difference between the total risk-adjusted returns of SRI and non-SRI securities is tested using an F-test for the null hypothesis that the variances of the two daily returns series have been drawn from a single population; that they are equal. In this case the null hypothesis was rejected at the 1 per cent level of significance in respect of the Australian securities and could not be rejected in respect of the international securities.

Overall, these results are crucial in informing, and bringing up-to-date evidence to bear on the scholarly debate about whether SRI breaches investment trustees' fiduciary duties.

Do Traditional Fund Trustees and Managers Breach Their Fiduciary Duties by Investing in SRI?

As noted earlier, two key positions are advanced in the literature on whether or not traditional fund trustees' and managers' fiduciary and statutory duties preclude them from investing in SRIs:

- 1 Trustees' and managers' fiduciary and statutory duties preclude SRI.
- 2 Trustees' and managers' fiduciary and statutory duties do not preclude SRI.

These propositions will be referred to throughout as View 1 and View 2. They are at the heart of a debate that has raged in SRI circles for almost 30 years. This debate has not been confined to scholarly circles; it has had wider practical implications for fund managers and trustees, who historically have been reluctant to invest in SRIs.²⁸

View 1

At the root of View 1 are the twin beliefs that a traditional investment trustee has a duty to maximise returns for a given risk level,²⁹ and that such a trustee breaches its fiduciary duties if it sacrifices adequate risk-adjusted returns because of non-financial goals (such as SRI).³⁰

Most OECD countries have legislation that specifies the fiduciary relationship between fund trustees or managers and investors.³¹ For example, in Australia section 52(2)(c) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) mandates that trustees must act in 'the best interests' of their members, which is generally interpreted to mean the members' best financial interests.³² Section 62 of the SIS Act states that trustees of superannuation funds regulated by the Act must ensure that their fund is maintained solely for the provision of benefits to members upon their retirement or death. Section 52(2)(b) of the Act requires the trustee to exercise 'the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide'. The definition of 'prudent' depends on contemporary views and practices,³³ and such legislation often applies to both fund trustees and managers.³⁴ Comparable legislative provisions exist in other OECD countries.³⁵

²⁸ Richardson (2007), p. 173; Lane (2006), pp. 33-34; and Kinder (2006), p. 32.

²⁹ Boasson et al (2004), p. 56; and Martin (2009), pp. 1, 2 and 18.

³⁰ Ali and Gold (2002), pp. 18, 31.

³¹ Oxford Business Knowledge (2007), p. 18.

³² Taylor and Donald (2007), p 8; Donald and Taylor (2008), p 49.

³³ Finn and Ziegler (1997); Taylor and Donald (2007), p 9; *Nestle v Westminster* [1993] 1 WLR 1260, per Dillon LJ at 1268.

³⁴ Richardson (2007), p 173.

³⁵ Oxford Business Knowledge (2007), p 19.

In light of such legislation, many fund trustees and managers fear the risk of lawsuits for breaches of their fiduciary or statutory duties if they invest in SRIs,³⁶ or at the least believe that there is less risk of lawsuits if they invest in conventional (non-SRI) investments.³⁷ One study found that 55 per cent of the largest mutual funds in the United States voted against all social and environmental proposals; that 15 per cent voted against nearly all such proposals; and that 30 per cent abstained from voting.³⁸ While some commentators believe that the risk of lawsuits as a result of traditional funds investing in SRIs may be more imaginary than real,³⁹ others point out that if SRI were truly costless, a much greater proportion of funds invested in SRIs could be expected in practice.⁴⁰ Nor are the fundamental problems solved by using a combination of traditional master trusts and SRI sub-trusts since, unless the objects of the master trust have been varied in accordance with a power of variation in the trust deed, the master trust is likely to be infected by the breach of duty.

Our empirical results confirm View 1 to the extent that, other things being equal, traditional investment fund trustees and managers do risk breaching their fiduciary duties if they invest in SRIs during economic downturns such as the recent GFC. This is because, since the advent of the GFC, SRIs have significantly under-performed conventional investments in terms of risk/return.

View 2

Proponents of View 2 contend that traditional fund trustees and managers do not breach their fiduciary or statutory duties if the investment is done prudently (assuming that SRI does not result in lower risk-adjusted returns than conventional investments), or if the trustee/manager exercises the requisite standard of care.⁴¹ Such supporters of SRI argue that it is the process by which the traditional fund trustee or manager considers alternative investments that should be the focus of the law on fiduciary duty, not the returns on investment; provided trustees and managers comply with their legal and equitable obligations, they cannot be held liable for breach of duty.

Surely all of these propositions beg questions, however. What is the prudent course of action, or the reasonable standard of care? What are trustees' or managers' legal and equitable obligations? Clearly View 2 will be correct if the costs of investing in SRIs are minimal.⁴² The problem arises when they are not.

³⁶ Lane (2006), pp 33–34.

³⁷ Dobris (2008), p 761.

³⁸ Williams and Conley (2005a), p 546n, cited in Williams and Conley (2005b), p 95n.

³⁹ Dobris (2008), pp. 760–61; Martin (2009), p 5.

⁴⁰ Cf O'Brien Hylton (1993), p 50.

⁴¹ Martin (2009), pp 7–8.

⁴² Hess (2007), p 28; O'Brien Hylton (1993), p 43; Richardson (2007), p 180.

Some SRI proponents contend that it could be a breach of traditional trustees' or managers' fiduciary and statutory duties not to consider SRI.⁴³ Others argue that this is likely to become the law in the foreseeable future.⁴⁴ In relation to the first argument, the legal position seems clear: currently, trustees must actively consider SRIs, along with conventional investments; this does not, however, mean that trustees must necessarily invest in SRIs. The second argument then collapses into the first – there is no reason to predict that the first argument may well become future law; it is already law.

Perhaps more fundamentally, some proponents of SRI assert that View 1 assumes (wrongly) that capital markets are efficient at processing information into investment pricing, and that it assumes the true systematic risk of an investment can be measured accurately, whereas in fact true measurement of risk remains elusive.⁴⁵ While capital markets may be inefficient at a point in time in processing information, they tend to be efficient over time at doing so; and while available techniques of assessing the systematic risk of an investment may be far from ideal, these techniques remain the best available and the most widely used in practice and academe.⁴⁶

Our empirical results contradict View 2 to the extent that, other things being equal, traditional investment fund trustees and managers do risk breaching their fiduciary duties if they invest in SRIs during economic downturns such as the present GFC. This is because, since the advent of the GFC, SRIs have significantly under-performed conventional investments in terms of risk/return.⁴⁷

Making Sense of the Existing Law and Financial Evidence

The extant law of trusts is reasonably clear, and much depends on the objectives set out in the relevant trust deed.⁴⁸ Other things being equal,

⁴³ Hess (2007), p 27.

⁴⁴ Strandberg (2005), p 31.

⁴⁵ O'Brien Hylton (1993), pp 50–51.

⁴⁶ See, for example, Copeland et al (2004).

⁴⁷ There is a third view in the literature: that that SRI does not breach traditional investment trustees' or managers' fiduciary or statutory duties, provided the risk-adjusted returns on SRIs are similar to those on conventional investments – see, for example, Hess (2007), p 29; or provided the objective of maximising returns is not disregarded or subordinated to non-financial objectives – see Ali and Gold (2002), p 18 and Richardson (2007), p 185. Such a view may, however, represent a category error in logic – see, for example, Copi and Cohen (2008). If SRIs by definition yield lower risk-adjusted returns than conventional (non-SRI) investments – and they do since the GFC, according to our empirical results – then adherents to this third view are simply and illogically defining away the fundamental problem. On this basis, such a third view is ultimately unhelpful as a means of furthering the debate, either at an empirical or a logical level.

⁴⁸ See collectively *Marshall v Discrimination Commissioner* (1996) AAT (ACT) 147 (18 June 1996); *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 68, per Gibbs CJ; and Finn (1989), p 32.

existing traditional (non-SRI) trusts cannot simply invest in SRIs if their deeds do not allow this. If they purport to do so, traditional fund trustees and managers do risk breaching their fiduciary or statutory duties:

- not to unconscionably exercise a power for a purpose not justified by the trust deed⁴⁹ or a statute (for example, invest in SRIs if the ability to do so is not permitted by the trust deed or legislation). Such an exercise is likely to constitute a fraud on a power;
- to act in the best interests of all beneficiaries, and not to pursue its own interests;⁵⁰
- to act in good faith, including not to misuse property held in a fiduciary capacity, or engage in conflicts of duty and interest⁵¹; and/or
- to treat beneficiaries of different classes fairly – for example, to not make decisions that advantage some beneficiaries or beneficiary classes at the expense of others, even if the trustee were to honestly believe they could be discriminated against.⁵²

While some commentators might glibly assert that the risks of lawsuits for breach of such duties are minimal,⁵³ they fail to point out that, unless the trust deed contains an explicit power of variation⁵⁴ (and many older trust deeds do not), such investment in SRIs could trigger a resettlement of the trust, with a concomitant substantial capital gains tax bill if the trust was settled after September 1985.⁵⁵ (While this would not occur if the trust is a tax-exempt charitable purpose trust, most investment trusts in this context are not.) It is this prospective pecuniary cost that is far more likely to precipitate a lawsuit than any umbrage about a breach of fiduciary responsibilities *per se*.

There are two main solutions to this dilemma within the framework provided by existing law. One solution is for traditional funds not to invest in SRIs at all, but rather for new (SRI) funds to be settled whose trust deeds include clearly drafted, precise provisions explicitly permitting SRI.⁵⁶ For example, the deeds of new superannuation trusts could define ‘sole purpose’ to include SEE objectives. Alternatively, if settlors could overcome investor and government myopia, the objectives of SRI trusts could incorporate the pursuit of long-term, rather than short-term, risk-adjusted returns.

⁴⁹ See, for example, *Vatcher v Paull* [1915] AC 372 at 378.

⁵⁰ *Chan v Zacharia* (1984) 154 CLR 178 at 198, per Deane J.

⁵¹ See Finn (1977), Chs 15, 17, 21; *Keech v Sandford* (1726) Cas TK 61.

⁵² See Finn (1977), Ch 10, also pp. 60 *et seq* and the cases noted therein.

⁵³ Dobris (2008), pp 760–61; Martin (2009), p 5.

⁵⁴ *Chief Commissioner of Stamp Duties (NSW) v Buckle and Others* (High Court of Australia) (1998) 98 ATC 4097; 37 ATR 393.

⁵⁵ Australian Taxation Office (1999).

⁵⁶ Thornton (2008), pp 421–22.

Proponents of SRI claim that funds investing in SRI are better placed than traditional funds to withstand market downturns because their investors are prepared to focus on, among other things, long-term rather than short-term returns.⁵⁷ Having said this, there appears to be no empirical evidence that the value of long-term returns in SRI exceeds that of short-term returns in conventional, or non-SRI, investments.

If either of these alternatives were adopted, beneficiaries could not then complain if they earned lower risk-adjusted returns than they could in a traditional profit-maximising fund, since they would voluntarily and knowingly have assumed the risk of such lower returns. Further, there would be no need to wind up the traditional (non-SRI) trust, since this would be economically wasteful unless there was no longer a need or use for its continuance.

This solution – settling new SRI funds where there is no power of variation in existing traditional trust deeds – might offer little comfort to investors in traditional funds wishing to invest in SRIs. Yet investors in traditional funds could gravitate to the newer SRI funds if they really preferred them. Indeed, given the empirical evidence presented in this article, it would be a good test of such investors' true preferences ('revealed preferences' in economics⁵⁸), rather than what investors say they want.

A second solution might be that, provided the trust deed had an explicit power of variation, all beneficiaries in a traditional trust fund could, in accordance with the rule in *Saunders v Vautier*,⁵⁹ set aside or modify the trustee's and manager's duty to maximise risk-adjusted investment returns subject to ancillary or collateral SRIs.⁶⁰ If the trust deed does not contain an explicit power of variation, then this second solution is not applicable and investors in traditional funds wishing to invest in SRIs are left with the first.

Legislative Reform?

As it stands, extant trust law is hardly a ringing endorsement of the ability of traditional fund trustees to invest in SRI, and it would appear that developments in the law have not kept pace with apparent changes in social attitudes.⁶¹ At some point in the foreseeable future, the courts will need to confront and address the issues surrounding when a trust fund can invest substantially in SRIs.⁶² In the meantime, the preclusion from consideration by traditional fund trustees and managers of all but ancillary or collateral SRIs must seem to many an unnecessary inconvenience.

⁵⁷ See, for example, Gray (2009), pp 5,8, 10; Hess (2007), pp 29, 35; Taylor and Donald (2007), p 8.

⁵⁸ Koutsoyiannis (1983), p 28.

⁵⁹ *Saunders v Vautier* (1841) 41 ER 482; (1841) 4 Beav 115.

⁶⁰ Dobris (2008), p 793.

⁶¹ Luxton (1992), p 592.

⁶² O'Brien Hylton (1993), p 45.

If there is a genuine widespread investment community preference for SRI on the part of beneficiaries of traditional funds who are frustrated at their inability under existing trust law to invest according to SEE criteria, then there would appear to be a compelling argument for setting in motion an agenda for future legislative reform. Much would depend on the nature of the legislative reform. Possible useful reform could encompass:

- express statutory authorisation for fund trustees and managers to consider and, if appropriate, engage in SRI. By way of analogy, in the United States, many state statutes allow company directors (themselves fiduciaries) to take account of a variety of stakeholder interests before acting to preserve shareholder wealth in a takeover bid;⁶³
- a business judgment rule,⁶⁴ which states in effect that traditional fund trustees or managers would not be liable if the interests of their investor beneficiaries were adversely impacted by circumstances beyond their control (such as the GFC). A business judgment rule already exists in Australia in section 180 of the *Corporations Act* (Cth), in relation to company directors' duty of care and diligence, and a similarly worded provision could be included in other legislation affecting investment trusts, such as the *State Trusts Acts* and the *SIS Act* (Cth);
- greater transparency, by requiring SRI disclosures⁶⁵ – for example, in a similar manner to that required under the Australian *Corporations Act* (Cth)⁶⁶ – and social accounting for investment trusts.⁶⁷ While these measures might be useful, they would not by themselves resolve the fundamental questions about SRI addressed earlier, and would need to be coupled with other measures;
- a statutory indemnity for fund trustees and managers in relation to beneficiaries' lawsuits for breach of fiduciary or statutory duty, or breach of contract;⁶⁸ and/or
- tax breaks or subsidies.⁶⁹ While a carefully thought-through system of taxes and subsidies might be beneficial and effective, this is ultimately a question for politicians and Treasury officials, not lawyers.

⁶³ Greenberg (2007), p 11.

⁶⁴ Greenberg (2007), p 10.

⁶⁵ Oxford Business Knowledge (2007), p 18.

⁶⁶ Oxford Business Knowledge (2007), pp 19, 23, 327.

⁶⁷ Richardson (2008), pp 290, 272–77.

⁶⁸ Cf Richardson (2008), p 282.

⁶⁹ Oxford Business Knowledge (2007), p 18; Richardson (2008), p 285.

Conclusion

Much of the literature on the legal implications of SRI is bedeviled by fallacious logic. A more clinical and less emotive evaluation of trust law shows that whether a traditional investment trustee's or fund manager's duties preclude SRI depends *ceteris paribus* on the objects of trust set out in the trust deed. Extant trust law does not support the first view – namely that traditional trustees' and fund managers' fiduciary duties preclude SRI – if the trust deed contains an express mandate to invest in SRI.

If existing investment fund trust deeds do not contain an express mandate to invest in SRI, beneficiary investors wishing to do so have a range of alternatives:

- 1 If there is a power of variation in the trust deed, they could amend the objects of the trust to encompass SRI.
- 2 If there is no power of variation in the trust deed, any variation in the trust purposes is likely to result in a resettlement of the trust, particularly in economic downturns, with adverse capital gains tax consequences if the trust was settled after September 1985. However, there is nothing to prevent prospective investors, even in a recession, from setting up a separate trust whose deed specifically provides for investment in SRIs.
- 3 Lobby for legislative change in an attempt to put the matter beyond doubt.

If SRI were accepted by the investment community as a societal objective, possible legislative reforms could include the introduction of a business judgment rule, greater disclosure for SRI, a statutory indemnity for trustees investing in SRIs, and tax breaks and subsidies to encourage SRI. In the meantime, avenues for further research into SRI are plentiful. Fruitful topic areas include:

- Are trusts an appropriate vehicle for investing in SRIs anyway?⁷⁰
- Assuming they are, when can beneficiaries be taken to have validly set aside a traditional investment trustee's or manager's duty to earn an appropriate full return?⁷¹
- When are lower returns in the pursuit of SRI objectives not a breach of the traditional investment trustee's duties? And when is not reducing risk for SRI purposes not a breach of the traditional investment trustee's duties?⁷²

⁷⁰ Thornton (2008), p 422.

⁷¹ Dobris (2008), p 794.

⁷² Dobris (2008), p 789.

- Does the aggregate value of long-term risk-adjusted returns exceed the aggregate value of short-term risk-adjusted returns, as some SRI aficionados claim?

The answers to these questions are likely to shape the direction of future debate on legal issues surrounding SRI. It is a debate that has already raged for almost 30 years. If scholars and researchers can, with some sense of urgency, glean answers to these questions, meaningful reform should (hopefully) be effected before another 30 years has elapsed. This should not be perceived as too sanguine or idealistic an aim. In terms of the type of community in which we wish to live, and the nature of investment in that community, the stakes should be recognised for what they are – ultimately very high, but definitely within reach.

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