THE ROLE OF FIDUCIARIES
MANAGING OTHER PEOPLE’S MONEY
Getting to grips with a challenging topic

In this edition we look at issues of ethics and trust in financial services.

It shouldn’t be controversial because the principle is simple – anyone who manages someone else’s money, oversees another’s hard-earned wealth or advises how money should be invested, should put that person’s interests first. This is the essence of a fiduciary’s role.

This is because the law imposes strict liability on a fiduciary. This means liability is determined without regard to fault as one of the elements usually required to determine ‘guilt’ in a commercial context. Strict liability means that the law considers it appropriate to impose this level of liability on those who create a risk which may harm another person even if the harm, when caused, was unintentional or innocent.

The philosophy behind the principle is that when there is creation of risk that is accepted as reasonable and socially desirable, a higher degree of care should be enforced or, to put it another way, it is considered appropriate to shift the burden of inevitable losses that occur in a modern and technological society to those who are best able to (and should) bear them.

Why this should be so was eloquently stated in an Australian High Court judgment, which said it is because in a fiduciary relationship, one person, in a position of vulnerability, justifiably vests confidence, good faith, reliance, and trust in another whose aid, advice or protection is sought.

In recent years, increasing legislative and regulatory attention has been paid to the protection of consumers. It was in 2011 that South Africa saw the first fully-fledged piece of consumer legislation come into effect under the Consumer Protection Act (CPA). In the same year, National Treasury published a policy document entitled A safer financial sector to serve South Africa better.
and thus insufficient for the financial sector. However, the concept of a fiduciary continues to be controversial because it is argued that there is still no absolute definition nor a certain way to describe the different kinds of relationships to which it can be applied – and because fiduciary principles may be applied in a variety of legal contexts. In some contexts it is easier to see why a fiduciary relationship should be obvious and needed, in other contexts less so.

One reason postulated as to why difficulties continue to surround the concept of a fiduciary is because it seems impossible to contain “the ephemeral and shifting notions of loyalty, good faith and trust”. Add to this the fast-paced and ever-changing complexities of the modern financial world and products coupled with the changing nature of relationships. We no longer have “traditional” relationships, markets, banking models or the simplicity of financial transactions of bygone eras. We now have layers of relationships, products and few geographical boundaries, which make it difficult for even the professional to keep track of clients’ best interests.

John Kay describes in Other People’s Money the changing ethos of the old-fashioned partnership of traders risking their own capital to what has now become the transfer of both risks and rewards from the partners to shareholders.

Similarly, the article in this edition by Jonathan Mort describes how, in the pension-fund context, in the evolution from defined benefit funds to defined contribution funds to umbrella funds, the relationships between fund, employer, employee, investment manager and adviser have changed and in some scenarios become more distant. This, together with the transfer of risks and rewards, raises important questions about how fiduciary relationships are to be determined in law or dealt with in terms of legislation or regulation and whether what is currently in place is sufficient and appropriate.

TREATING CUSTOMERS FAIRLY

While not law, the Financial Services Board’s (FSB’s) Treating Customers Fairly (TCF) framework is considered “fiduciary law” when it comes to thinking about the relationships between financial institutions and the customers they serve. Being a regulatory framework using a principle- and an outcome-based approach, it contains only six outcomes, yet there has been much debate on their applicability to and the accountability of financial firms for these outcomes when they do not have direct contact with retail customers. But the FSB has made it clear: “Firms should not be able to shirk TCF accountability purely because they do not have any direct interaction or contractual relationship with the retail customer.”

As more and more TCF-aligned regulatory proposals are pushed out, for example the draft default regulations issued by National Treasury, pushback is evident from many sources. Admittedly there are difficulties working out the nature of relationships and finding solutions tailored to individual circumstances. The draft regulations require that passive investment options be considered, which can but may not always be the appropriate option for every person. There are therefore huge fiduciary implications for those responsible for deciding default options.

The FSB has also issued a draft discussion document on what is termed the Retail Distribution Review (RDR). Like TCF, the primary objective of the RDR draft discussion document is the fairer treatment of customers and the achievement of better outcomes. Unlike TCF’s limited number of six outcomes, RDR contains a total of 55 specific proposals, all part of the development towards legislative and regulatory change which looks after investors’ interests. RDR also speaks the language of building consumer confidence and trust and having standards of professionalism in financial advice and intermediary services.

Importantly, it tackles one of the most significant aspects of a fiduciary’s role head on – that of not having conflicting interests. It also contains proposals on fees and charges, which focus on another aspect of a fiduciary’s responsibility in respect of profit-making.

BALANCING GOVERNANCE AND PROFIT

Goverance is not cheap. Pushback or reaction to such proposals is indicative of the inherent tension between profit maximisation and actions and decisions that are supposed to be taken in the best interest of clients in the furthest of their outcomes and objectives.

While not attempting to resolve this tension here, consideration should be given to thinking that profit and clients’ interests are linked and can flow from one to the other.

As Anet Ahern and Mark Cliff’s article demonstrates, good stewards deliver better results when judged by self-imposed standards. In other words, fiduciary liability and commercial success are not mutually exclusive.

Both TCF and RDR look to making the financial industry responsible for outcomes. All of these initiatives are important and their connection to the role of the fiduciary, to the average investor and their financial outcome is exactly why the dots have to be joined, making Colin Habberton’s article and his contribution of a conceptual model so valuable.

To understand why there is such concern around outcomes, look no further than Akerlof and Shiller’s recent book Phishing for Phools: The Economics of Manipulation and Deception. While written in an engaging and entertaining way, these economists make no bones about the “phishing for phools” that goes on in many industries, the pursuit of profits that drives the manipulation and deception of the public and the profound implications this has for undesirable outcomes. They say that while innovation may lead to many things that enrich our lives, it comes with strong incentives for manipulation and deception.

This links perfectly with Jim Ware’s views as he points out some rather uncomfortable truths about greed in his article. He also makes a strong case for a new paradigm of give and take.

Should you be up for some enlightened entertainment on these serious issues, watch John Oliver’s feature relating his first-hand experience of fiduciary responsibility (or absence thereof) in the context of retirement advice and investing: http://bit.ly/2StqEWx. Finally, while it may not be possible to force ethics and trust, and despite whatever challenges there are seen to be, it is time to face up to what may be required to make the financial sector a trusted place.
The importance of stewardship

Research has shown that managers who are good stewards of their investors’ capital tend to deliver superior performance over time and tend to be around for longer.

A 2011 Morningstar study of its Stewardship Grades for mutual funds showed that good stewards delivered better fund performance and higher rates of survivorship relative to mediocre or poor stewards. Simply put, good stewards give their investors better returns.

In The Clash of Cultures: Investment vs Speculation, US investor and founder of The Vanguard Group, John C. Bogle, argued that the best stewards of investor assets can be measured by looking at a group of 15 standards. These standards reflect the degree to which fund managers balance the interests of investors in their funds with the interests of the shareholders of the companies managing the funds. While Bogle was writing based on US experience, many principles are as relevant for investors in South Africa.

**Standard 1: Management fees and operating expense ratios**
The fees should be reasonable, reconciling the conflict between managers who seek to maximise fees and investors who benefit by minimising them. Since lower expense ratios lead to higher returns, the reasonability of these costs is a clear indication of a culture of stewardship.

**Standard 2: Portfolio turnover**
There is an inverse relationship between a fund’s turnover and its returns: higher turnover correlates with lower returns. Managers who have lower rates of turnover are thus better stewards than those who have higher rates of turnover.

**Standard 3: Equity diversification**
Fund managers can get high stewardship marks if they offer mutual funds that are broadly diversified and designed for holding in the long term. Diversified funds reduce risks, which is in the interests of their investors.

**Standard 4: Marketing orientation**
A manager’s range of choice in the funds it offers is a powerful reflection of its emphasis on stewardship versus salesmanship. The manager who chooses solid, diversified funds that largely reflect the stock market as a whole is more of a steward – as opposed to the manager who offers narrow, specialised funds whose popularity blows back and forth with the market winds. Managers with the strongest discipline against pandering to the public taste for the hottest new investment ideas reflect the highest stewardship.

**Standard 5: Advertising**
Spending massive sums to promote fund growth suggests that salesmanship is in the driver’s seat. This is particularly relevant for managers who manage a large number of assets, as there is considerable evidence to show that building fund assets above a certain size impinges on the manager’s ability to create superior performance.

**Standard 6: Upfront fees**
Generally speaking, management companies who pay upfront fees usually do so to compensate a salesperson for placing investors in their funds. Such fees are a drag on investor returns. Funds without upfront fees demonstrate a higher degree of stewardship.

**Standard 7: Investor stability**
The longer the holding period in a fund, the better the long-term returns that investor is likely to earn, and vice versa. The shorter the holding period, the more the investors are trying to time markets. If funds are heavily focused on stewardship, they are likely to have lower redemption rates. This benefits the investor in two ways. Firstly, they are not at the mercy of the perils of market timing. Secondly, they are invested in funds where the manager is less focused on having to buy or sell assets based on fund flows rather than on asset valuations.
collective insight

Standard 8: Limitations on fund size
Promoted aggressively, funds with apparently superior performance draw large amounts of capital. These funds eventually become too large, their investible universe shrinks and their ability to recover the glory of their earlier days vanishes. In letting funds grow beyond the ability to manage them with distinction, salesmanship clearly takes centre stage. Steps and stated intentions to a limitation on fund size is an indication of stewardship.

Standard 9: Experience and stability
Managers (and management teams) with longer experience – who’ve worked through a few market cycles; can clearly articulate their philosophy and strategy; and display a culture of stewardship – should be supported, especially if they can demonstrate that they tend to focus on the long term.

Standard 10: Insider ownership
Managers who are significantly invested in the funds that they manage “eat their own cooking”. There is a significant alignment of interests between the decisions of the managers and the long-term returns of the funds that they manage. Such managers are aware that the decisions they make in managing the funds will have a direct impact on their own long-term returns and will thus act as stewards of the fund’s capital.

Standard 11: Organisation of manager
When business interests supersede professional interests, stewardship suffers.
Bogle scores managers’ stewardship credentials highest where the managers themselves own the management company and lowest where the management company is publicly listed and traded.

Standard 12: Composition of boards
The true independence of the independent directors of management companies cannot be measured, but Bogle favours directors with long tenures of service who charge reasonable fees.

Standard 13: Board leadership
The chairman of the management company leads the board, sets the agenda and is, or is supposed to be, in charge of fund governance. On the other hand the chief executive runs the management company. These positions should be separated, giving the board clear authority over management. Higher stewardship points are scored where this is the case.

Standard 14: Regulatory issues
Bogle gives higher stewardship points for managers with a clean regulatory slate and no points to managers who have faced significant regulatory problems.

South African investors have significant information at their disposal to determine the degree to which a unit trust management company embraces the standards of stewardship.

South African unit trusts have several standards in place regarding the compulsory public disclosure of fees and costs that make these comparable and measureable in terms of stewardship – for example TIC (Total Investment Charges) and EAC (Effective Annual Cost).

While not readily disclosed, intermediaries and institutional unit trust investors frequently examine portfolio turnover. In terms of equity diversification, investors can examine portfolios on a quarterly basis on the Association for Savings and Investment South Africa (ASISA) website. In addition, the ASISA fund classification and Collective Investment Schemes Control Act (CISCA) rules go a long way towards preventing over-concentration.

Information about the range of funds each management company offers is freely available to investors. We have a diverse set of management companies in SA, but the Financial Services Board (FSB) is becoming stricter about opening funds without a strong business plan.

If investors want to assess the level of advertising, just walk through an airport! However, Bogle’s reference to size has not been conclusively proven in our market.

Upfront charges by management companies have all but become a thing of the past – management companies have largely abandoned the practice.

As far as investor stability is concerned, this information is not readily available, but suffice to say that churn remains high in general. When it comes to fund size, the information is readily available and, in selected cases, we have seen soft- and hard-close practices being implemented. However, coupling a fund capping with the low stability of investors can be very risky for existing investors and the business.

Investment team information is usually readily disclosed by management companies and this will enable investors to make an assessment. Whether these professionals invest in their own funds is a question regularly asked by intermediaries and institutional unit trust investors.

Management company shareholding and listing status are readily available to investors, and board members can also be examined. Separation of duties and non-executive roles can be assessed. The King III code also reinforces the separation of leadership, roles and stewardship in general.

Details of regulatory non-compliance are published on the FSB website. In this way investors can assess whether a company is generally compliant or not.

Generally speaking, South African investors have significant information at their disposal to determine the degree to which a unit trust management company embraces the standards of stewardship. Increasingly, regulators and industry bodies are striving for an even higher level of disclosure in order to empower investors and advisers to make an informed assessment based on the criteria that matter to them.

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Mark Cliff, a certified financial planner, is the marketing manager for PSG Asset Management.
Understanding fiduciary responsibility

When it comes to the management of others’ finances, fiduciary responsibility cannot be underestimated.

Upon arrival at an airport recently, a border control official who was checking my passport asked me, ‘What’s your profession?’ My response: “I’m a fiduciary.” His reply: “What’s that?”

I began to wonder if he knew the people who manage and oversee his pension fund savings. I didn’t even try to answer the question in full, and told him that I sit on investment boards. He seemed satisfied with that.

Given the many flaws of governance we read about in the news on a very frequent basis, the well-documented principal–agency problem is becoming prevalent. It’s everywhere – many people act as an agent for somebody else (the principal), sometimes without even knowing it.

The principal relies (in many cases with no other choice) on an agent. And often, principals do not have the same information as the agents they interact with. However, the agent should not benefit from their informational advantage. Any compensation should be agreed upon with the principal and should not result in a conflict of interest.

The issue of agency can be a minor and trivial issue, but also a major one. For example: a doctor operating on a patient. The information asymmetry between doctor and patient makes it almost impossible to put both parties on equal footing. In effect, patients have no choice but to trust the medical professional.

The same holds true in financial services. The public entrusts its life savings, pension money and any other assets – sometimes as collateral for a loan – to a financial services company to be taken care of in line with the client’s characteristics and needs.

The client hasn’t got much choice: try operating in modern society without a bank and savings account!

Given the trust the clients (knowingly or unknowingly) have to place in a financial services firm, the duty of the firm towards these clients becomes fiduciary in nature (fiduciary stemming from the Latin word fidere, meaning “to trust”), which is often considered to be the highest standard of care.

The combination of information asymmetry, highly important financial matters and the absence of the possibility for completely waterproof control measures makes trust the most important ingredient for the proper functioning of financial markets. Especially given the complexity of today’s financial products and the time lag between financial and investment decisions and the realisation of financial outcomes.

Indeed, why would anybody allow somebody else to manage financial matters if there is no trust?

Fiduciary duty then means, everything else being constant, a duty to place the client’s interests before the firm’s. This is a difficult challenge, given the many pressures financial services firms are facing. However, it is also a noble duty: you are being trusted to handle other people’s financial affairs – one of the most important elements in their lives!

This doesn’t mean a firm should give up profits. Let’s consider a pension fund.

A pension board oversees the pension fund and serves as representation for the pension fund members.

This is like an empty bucket, which is filled over time through a scheme (government, employer or personal). The pension fund’s aim is to take these contributions and invest them profitably, risk- and cost-effectively, and then pay out to members during retirement.

A pension board oversees the pension fund and serves as representation for the fund’s members. Board members are to act without conflict of interest. The board has a fiduciary responsibility towards members to ensure that the pension fund is doing the right thing, has robust processes and management and so on.

Given the size and complexity of claims on the one hand, and investments on the other, this board must be highly sophisticated to be effective in overseeing the management of claims and investments, as new risks that can impact the value of the investments emerge very frequently.

It’s a basic premise that people working for the pension fund themselves would also want their money to be invested in such a way that their retirement claims are going to be honored.

One should be able to trust fiduciaries – this is a question of values, culture, incentives and integrity. It is also about being honest about what a fiduciary adds to a board and what not, and about professional skills and knowledge.

Of course, this profile cannot come cheap – if it did, you have to ask what the role, the integrity and the skill of the fiduciary are really all about. Therefore, the public wants to see evidence – proof that the fiduciary has integrity, proof that they have gained their skills in the form of appropriate credentials, and proof that the fiduciary has an understanding of risk.

Remember that in financial services, much like in the medical profession, unnecessary, unknown and unmanaged risks can creep in and every mistake can have huge consequences for the patient (or client).

In order to manage these risks, many financial firms will have a code of conduct regulating their behaviour towards clients and others. And while this is a useful and necessary tool to have, it is important to understand how this tool is applied in incentive systems, management audits, human resource processes and sanctioning. Firms have to provide proof that this code of conduct is also adhered to when board appointments are made.

Fulfilling a fiduciary duty is real work, which requires appropriate compensation. Different levels of quality and intensity of work will be compensated accordingly, so will a heightened level of care and diligence. As in all business situations, ask: “Am I getting enough bang for my buck?”

And does that fiduciary’s work cover what an investor, plan member, beneficiary, owner really requires? This includes proven integrity, financial professionalism, tacit knowledge of complex and ever-changing financial matters, relevant skills, dedication and the avoidance of (even the appearance of) conflicts of interest.

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A recent analysis of global investment practice published by the United Nations titled *Fiduciary Duty in the 21st Century* provides the following prescription:

Fiduciary duties exist to ensure that those who manage other people's money act in the interests of beneficiaries, rather than serving their own interests. The most important of these duties are:

- **Loyalty:** Fiduciaries should act in good faith in the interests of their beneficiaries, should impartially balance the conflicting interests of different beneficiaries, should avoid conflicts of interest and should not act for the benefit of themselves or a third party.
- **Prudence:** Fiduciaries should act with due care, skill and diligence, investing as an ‘ordinary prudent person’ would do.

The problem is though that an ordinary, prudent person does not necessarily have the skill to navigate the complexities of financial markets and instruments they invest in, despite their best care and due diligence.

Quite understandably, trustees serving on pension fund boards look to delegate responsibility to professional investors such as asset managers and consultants who have the required skill. But when it comes to the fiduciary duty of trustees, is delegation enough to ensure that investment decisions are made responsibly?

**Reducing complexity**

This year marks the 10th anniversary since the launch of the UN Principles for Responsible Investment (PRI). In acknowledgment of the limitations of financial markets to adequately address socioeconomic inequalities, negative environmental impact, corporate governance failures and systemic risk, the PRI seeks to promote the importance of environmental, social and governance (ESG) factors in investment practice.

Aside from the ethical perspective of such a paradigm, the rational argument for “responsible investing” is that it enhances the analysis of investments, risk assessment and potential for medium to long-term investment return (UNPRI, 2015). In effect, the PRI calls for institutional investors to include ESG considerations in their investment decision-making and their market participation.

As detailed in the table, ESG considerations are wide-ranging and, in themselves, complex. However, the recent memory of MTN’s Nigerian challenges, the collapse of African Bank and the after-effects of the Marikana tragedy highlight the importance of these issues and their impact on financial markets, returns and what should be considered when making decisions about other people’s money.

### ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) DEFINITIONS

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<tr>
<th>CONCEPTS</th>
<th>DEFINITION</th>
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<tr>
<td><strong>Environment</strong></td>
<td>Examples of environmental issues include: Biodiversity loss, greenhouse gas emissions, climate change impacts, renewable energy, energy efficiency, resource depletion, chemical pollution, waste management, depletion of fresh water, ocean acidification, stratospheric ozone depletion, changes in land use as well as nitrogen and phosphorus cycles.</td>
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<tr>
<td><strong>Social</strong></td>
<td>Examples of social issues include: Activities in conflict zones, distribution of fair-trade products, health and access to medicine, workplace health safety and quality, HIV/AIDS, labour standards in the supply chain, child labour, slavery, relations with local communities, human capital management, employee relations, diversity, controversial weapons and freedom of association.</td>
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<tr>
<td><strong>Governance</strong></td>
<td>Examples of governance issues include: Executive benefits and compensation, bribery and corruption, shareholder rights, business ethics, board diversity, board structure, independent directors, risk management, whistle-blowing schemes, stakeholder dialogue, lobbying and disclosure. This category may also include business strategy issues, both the impact business strategies on the environment and society, and their implementation.</td>
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**SOURCE:** UN Principles for Responsible Investment (2015)

**Connecting the dots**

The conceptual model on page 28 attempts to address the complexity institutional investors face in their investment decision-making processes.

Fundamentally, it assumes a value chain perspective of the investment process regarding the capital flows from contributors to asset owners, such as pension funds, and onto asset managers. It follows the deployment of that capital to assets such as operating companies and traces the return on capital from the activities of those assets back to the eventual beneficiaries of institutional investors.
2. Commercial domain
From a company or asset perspective, as the destination for investment, the primary aim is to deliver value to shareholders, i.e. sustainable financial returns to those institutional investors. Value is materialised through revenue and returns generated through the activities in the communities in which they operate, in conjunction with various stakeholders impacting their performance. As these activities are carried out, certain social and environmental effects on communities in which companies operate may be realised that could have material impact on risk and return.

3. Analytical domain
Institutional investors and companies understand each other’s aims and analyse performance through a common language of quantitative reporting such as annual financial statements (AFS) that measure return and risk. Integrated Reporting (IR), Sustainability Reporting (SR) and the Global Reporting Initiative (GRI) have inspired the addition of non-financial information into company reporting, including qualitative metrics relating to ESG criteria. The more information that can be delivered through appropriate metrics, the greater the degree of disclosure that becomes possible, enhancing the transparency of investment practice.

4. Ethical-legal domain
In South Africa, institutional investors and the companies they invest in are subject to similar legal and governance structures. King III recognises the impact that companies can have on wider stakeholder groups and communities and should assume the responsibility of corporate citizenship.

In alignment with King III, the PRI and CRISA provide normative frameworks promoting the importance of ESG criteria into investment decision-making. Corporate Responsibility (CR) underpinned by principles like the UN’s Global Compact (GC) and Sustainable Development Goals (SDGs) provide a common set of objectives to guide decision-makers who are looking to incorporate responsible business practices into their operations. Legal structures set the rules of the game regarding the allocation, deployment and return on capital mediated by various regulations and respective regulatory institutions.

ESG as a common language
Although these horizons are presented in concentric circles in the model, their “proximity horizon” may differ depending on the relative importance or urgency regarding how a particular ESG factor may affect the interests of investors (or activities of companies as their investments) and consequently their respective decision-making processes.

ESG provides a conceptual framework to understand the risk, return, responsibilities and objectives of institutional investors on the one hand, and companies on the other.

Colin Habberton is CEO of PayProp Capital, a risk management solution provider to the residential property sector in South Africa.
Defining stewardship and the fiduciary

In this age of consumer protection and rights, the investment manager needs to know the extent of their obligations.

...carve-outs", for conduct that the DOL believes should not give rise to a fiduciary relationship.

A five-point test previously used to determine what constituted fiduciary investment advice was considered appropriate for the primary type of retirement savings arrangement at that time, being the employer-sponsored defined benefit pension plan.

The new proposals, which extend the fiduciary obligation, are aimed at the growth of individual account plans where there is member investment choice in defined contribution savings arrangements.

Where do we in South Africa lie in this spectrum? The Financial Advisory and Intermediary Services Act (the FAIS Act) imposes extensive duties and responsibilities on investment advisers and intermediaries. Do those duties and responsibilities effectively codify the fiduciary obligation? If not, should there be an additional, over-arching fiduciary obligation as proposed by Kay? Or is the UK approach more appropriate?

At the outset it is important to acknowledge that, as in the US, the context in SA is that the retirement savings market is becoming predominantly a retail market: most occupational savings are by nature into defined contribution (DC) funds, and much of this entails some form of member investment choice.

With the accelerating migration to umbrella funds and the likely preservation of retirement savings, this growth in the retail market will only increase. As it is, the retail retirement savings market is understood to be significantly larger than the institutional market.

While understanding the context may be helpful in considering the role of a fiduciary, it is best to begin with what the correct understanding of the fiduciary duty is.

The vagueness of the description “to act in the best interests of the beneficiary”, while true, is not very helpful. It is better to understand when a fiduciary duty arises, which to use the test in the seminal case of Phillips v Fieldstone African (Pty) Ltd 1 All SA 150 (SCA), depends on the circumstances as there is no fixed list of fiduciary duties.
While at common law it seems that a fiduciary duty is owed by an investment manager or adviser to their client, this has been amended by the provisions of the FAIS Act and the FI Act.

In that case the Supreme Court of Appeal helpfully said that a fiduciary duty exists in circumstances where:
- There is scope for the exercise of some discretion or power.
- The discretion or power can be used unilaterally to affect the beneficiary’s legal or practical interest.
- There is a vulnerability of the beneficiary to how that discretion or power is exercised.

There are two crucial aspects to this test: the power of one person to act in relation to another person, and the vulnerability of that other person to how that power is exercised. Both aspects will determine the extent of the fiduciary duty. At common law at least, there seems little doubt that an investment manager or adviser owes a fiduciary duty to their client.

Two easy examples illustrate this in the pension fund context: in a defined benefit (DB) occupational fund with no balance of cost obligation to support the funding of the benefit promise, the beneficiaries are enormously vulnerable to poor investment decision-making by the trustees. By contrast, in a member investment choice retirement annuity fund, where membership is voluntary and there is no exit penalty, there is far less vulnerability of the member, in general terms, than in the DB occupational fund example.

However, once the fiduciary duty is established, the courts will apply it strictly. Hence the strict rules about secret profits and conflicts of interests.

How does all this help with answering the questions posed above? Before this is considered, it must be noted that the Financial Institutions (Protection of Funds) Act (the FI Act), is also relevant.

The FI Act provides:
- In section 2, that both a financial institution [which includes an insurer, a pension fund, a collective investment scheme, and a financial service provider (FSP) or representative under the FAIS Act], and its directors and employees, owe a duty of utmost good faith in relation to assets being invested; and may not make use of these assets in any way to gain directly or indirectly any improper advantage for the financial institution;
- In section 3, that a director or employee of a financial institution must declare any interest in any investment to be made;
- In section 4, a financial institution may only invest trust property through the vehicle agreed in its mandate.

These provisions include some aspects of the fiduciary duty (notably in respect of declaring conflicts of interest and owing a duty of utmost good faith), but not in others (such as the duty to account). The duties imposed would appear also not to extend to the underlying beneficiaries. But a contravention of these duties is punishable by significant criminal penalties under section 10 of the FI Act.

While the FAIS Act appears primarily to be concerned with the conduct of FSPs and representatives, the conflict of interest provisions are weaker than those espoused in the Fieldstone case. It is also not clearly stated whether or not a fiduciary duty is owed.

So while at common law it seems that a fiduciary duty is owed by an investment manager or adviser to their client, this has been amended by the provisions of the FAIS Act and the FI Act, which override the contractual arrangements.

But what is not clear is whether, in the pension fund context, the common law fiduciary duty is also owed by the fund’s investment manager or adviser to the members. It would also be helpful if there was clarity about how that common law fiduciary duty, if it applied, differed according to the type of fund: a DB fund/DC occupational fund with or without member investment choice/funds with members whose benefits are preserved by default/funds with pensioner liabilities or living annuity liabilities.

It is not helpful for the investment environment that there is no clarity on these issues. Most importantly, in this age of consumer protection and rights, the investment manager needs to know the extent of their obligations. This would then help to define what is meant by stewardship.

What is clear however is that a strengthening of the duties owed to members would also support the Treating Customers Fairly (TCF) initiative. TCF is very much part of the current reform process taking place in SA, and as this initiative was adopted from the UK, it will be interesting to see whether SA follows the route of the UK or US in regard to whether and how fiduciary duties and responsibilities should be subjected to reform or further codified.

Jonathan Mort is a specialist pension fund lawyer, and is a director of Jonathan Mort Inc, which he established in 2009.
A letter to asset managers

If the investment industry is to shed its rapacious reputation, a drastic shift in thinking is needed.

Most of us will agree that the investment industry’s reputation is in need of an extreme makeover. Robert Jones, chief investment officer of Systems Two Advisors, is also of this opinion and was bold enough to state it in his piece in the Spring 2016 edition of the Journal of Portfolio Management, titled Defending the Wall.

What caught my interest in Jones’s piece is this section: “No one needs to promote greed; it’s deeply ingrained in all of us. Wanting more than you need (aka greed) is, for better or worse, human nature. The simple fact is this: People who wanted more were more likely to survive and reproduce than people who were satisfied with what they had. Greed is in our genes.”

However, one could argue that if Jones’s goal is to improve our industry’s reputation, he is not helping. Defending greed doesn’t put us in a favourable light.

Jack Bogle, founder of The Vanguard Group, has shown us repeatedly that the average investor is better off with low-cost index funds, especially after fees.

But no, the long-only active level of profit wasn’t enough so then the really greedy folks got together and figured out an even better fee arrangement: two and 20. (Hedge fund managers typically charge 2% of total asset value as a management fee and an additional 20% of any profits earned.)

In May, The Economist ran a piece titled Hedge Funds haven’t Delivered on their Promise in which it quoted Warren Buffett: “There’s been far, far, far more money made by people on Wall Street through salesmanship abilities than through investment abilities.”

So, if we are to undo some of the damage done by Madoff, the Fidentia debacle and those nasty Wall Streeters, let’s show the world that we understand the new thinking. We’ve moved beyond the naiveté of MBA classes preaching about maximising shareholder value and economist Milton Friedman’s nails-on-blackboard quote: “The only purpose of a business is to make a profit.”

Value investor James Montier wrote: “It is quite staggering just how many bad ideas in economics appear to stem from Milton Friedman.” Montier calls the profit/shareholder maximising idea the “world’s dumbest”.

We have a choice. The investment industry can be a noble calling. But we have to shift from old to new thinking.

And while we’re on the topic of greed, hopefully we are all aware that Gordon Gekko was not the hero of the film Wall Street. Right?

(As Andrew Lo points out in his article The Gekko Effect, in one study of MBA students, over half the class thought he was.) The film Wall Street and the books Liar’s Poker and Bonfire of the Vanities wonderfully captured the ego and greed that ran through our industry in the 80s.

But it doesn’t have to be that way. We have a choice. The investment industry can be a noble calling. But we have to shift from old to new thinking. So, what’s the new thinking?

The new thinking shows up in the works of scholars like Adam Grant and Fred Kiel. In simple terms it highlights the success of “generous/abundant” mindset over the old “greedy/scarcity” mindset that we learnt about in the dismal science. (Small wonder economics earned that title.) To be sure, many people still choose the greed/scarcity mindset but it is a choice.

A closer look at the new mindset

Adam Grant’s book, Give and Take, is a well-researched look at a new paradigm; it argues for the benefits of generosity. Grant’s goal is “to persuade you that we underestimate the success of givers… [and show] why givers dominate the top of the success ladder”. Many thought leaders, including Dan Pink, Dan Ariely, and Robert Sutton enthusiastically endorse Grant’s research.

For an industry struggling with rebuilding trust (visit edelman.com for more information), investment leaders would be wise to think carefully about this new paradigm. In the abovementioned book, one financial adviser credits his success to this strategy of generosity: “There’s no doubt that I’ve succeeded in business because I give to other people. When I’m head-to-head with another adviser to try and win business, people tell me this is why I win.”

And regarding the “old” notion above that people are largely greedy, a study by Shalom Schwartz, quoted in Give and Take, looked at values globally and found:

In all twelve countries, most people rate giving as their single most important value. They report caring more about giving than about power, achievement, excitement,
Of the investment CEOs polled, over half of them answered that they do not always put client interests first! A disturbing notion to contemplate.

So, my hope is that our industry will begin to explore this new mindset – abundant/generous – and come to see it as much more effective than the scarcity/greedy one. And accept that there is choice; we don’t have to be greedy. We can take a page from Maslow and move up the needs hierarchy – past security and survival – to self-actualisation: “The self only finds its actualization in giving itself to some higher goal outside oneself, in altruism and spirituality.”

Surely, given the intelligence and financial well-being of investment professionals, they are perfect candidates for pursuing self-actualisation. But collectively we must raise our sights above the lowest levels of the needs hierarchy!

It was refreshing to see Charles Ellis, one of the most respected names in our industry, agree with this view in the Financial Analysts Journal (July/August 2015 edition): “The best long-term benefit of active investing – and all its many benefits – is not just economic but also spiritual.”

Some of us are inclined – either by nature or nurture – to be more greedy (takers), while others are more generous (givers). Again, the key is: we have a choice.

Old thinkers, meet the millennials

Finally, on the topic of greed, I’ll add one more puzzle piece: the millennials. As Chip Espinoza, Mick Ukleja and Craig Rusch discuss in their book Managing the Millennials, this new generation – born between 1980 and 2000 – and found that they are much closer to the abundant/generous mindset than the scarcity/greedy mindset.

Consider these facts about the millennials:

1. Very attuned to social causes
2. Over 85% said that money is not a good measure of success
3. Over 60% expect their employer to contribute to their social causes
4. Over 60% would rather make $40,000 in a job they love, than $100,000 in one they think is boring

For investment professionals clinging to the old view, watch out. Millennials are coming at us like a bullet train. In less than 10 years, they will be over 75% of the workforce. And their values are much more in line with the new view. They have donated more time to charitable causes than Xers and baby boomers combined. They are very big on purpose, with many choosing to work with ESG and SRI funds.

The Gallup organisation characterises them in this way:

Boomers: My Paycheck
Millennials: My Purpose

Millennials don’t see money as the top value. So, if you don’t familiarise yourself with the new thinking of Grant, Kiel and others, you may be increasingly out of sync with public thinking in the future.

The Yin and Yang of it

In summary, let’s acknowledge the yin and yang of greed. Yes, we can all be greedy, especially when we’re fearful. “There won’t be enough, I’d better grab all I can get!” But we can also be generous, when we feel confident and secure. Grant argues that some of us are inclined – either by nature or nurture – to be more greedy (takers), while others are more generous (givers). Again, the key is: we have a choice.

Anyone reading this piece is bright enough and wealthy enough to choose “generous” as a mindset. Maslow and others see this choice as the natural evolution of human development. And certainly investment professionals who have a fiduciary responsibility to steward other people’s wealth should be deeply committed to this mindset.

James Ware (CFA) is the founder of Focus Consulting Group, a firm dedicated to helping investment leaders leverage their talent.