

**AUSTRALIAN PRUDENTIAL
REGULATION AUTHORITY**

**SUPERANNUATION CIRCULAR
NO. II.D.1**

**MANAGING INVESTMENTS
AND
INVESTMENT CHOICE**

APRIL 1999

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IMPENDING CHANGES

The 1998 Budget and the Assistant Treasurer’ s press release of 28 May 1998 foreshadowed changes covering the transfer of the responsibility for the regulation for certain small funds (currently known as excluded superannuation funds) to the Australian Taxation Office and the tightening of existing investment rules covering all superannuation funds.

These impending changes may impact on the information contained in this Circular and trustees should seek current information on the arrangements and how they apply to each entity’ s circumstances.

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Objective

1. The aim of this circular is to provide guidance on trustees' responsibilities for managing fund investments and beneficiary choice of investment strategies under the *Superannuation Industry (Supervision) Act 1993* ("SIS").
2. This circular replaces Superannuation Circular II.D.1. "Investment Strategies and Beneficiary Investment Choice" which was released by the former Insurance and Superannuation Commission in December 1995.

Introduction

3. Under SIS, trustees are solely responsible and directly accountable for the prudential management of their members' benefits. It is the trustees' duty to make, implement and document decisions about investing fund assets and to carefully monitor the performance of those assets.
4. Trustees' responsibilities when making investment decisions include formulating and implementing an investment strategy or strategies. This important duty is codified in SIS as a covenant (an obligation of the trustee). The intent is to protect member's retirement benefits by minimising the risk associated with reckless, ad hoc or unco-ordinated investments and to ensure investments are made in accordance with the sole purpose and investment provisions of SIS (refer paragraphs 47 to 48).
5. In following this approach to investment management trustees would be expected to implement a due diligence process that promotes considered and responsible decision making, and protects trustees from action by members in the event of unsuccessful investments.

The investment covenant

Section 52 and Regulation 4.09(2)

6. The covenants of section 52 are fundamental to the duties and obligations of trustees. They are included or, if not included, deemed to be included in the governing rules of all regulated superannuation funds, approved deposit funds and pooled superannuation trusts (collectively referred to as "funds" in this circular).

7. The investment covenant under section 52(2)(f) specifically covers the trustee's responsibility to formulate and give effect to an investment strategy that has regard to the whole of the fund's circumstances including (but not limited to):

- the risk involved in making, holding and realising investments, as well as the likely return from the investments having regard to fund objectives and expected cash flow requirements;
- the composition of the fund's investments as a whole including the extent to which the investments are or are not diversified and the associated risks;
- the liquidity of the fund's investments having regard to its expected cash flow requirements; and
- the ability of the fund to discharge its existing and prospective liabilities.

8. The investment strategy covenant is complemented by the other covenants in section 52, which require amongst other things, the trustee:

- to act honestly;
- to exercise the degree of skill, care and diligence of an ordinary prudent person dealing with the property of another for whom the person felt morally bound to provide;
- to perform and exercise its duties and powers in the best interest of the beneficiaries; and
- not to do anything which would prevent the proper performance and exercise of its functions and powers.

Investment objectives

Section 52(2)(f) and Regulations Part 2

9. Implicit in the investment covenant and the fund disclosure requirements is the requirement for trustees to formulate and document an investment objective for the fund (or for each subplan).

10. The investment objectives indicate the desired investment outcome for the fund (or for each subplan). The objectives should be documented and capable of being clearly communicated to assist interested parties in understanding the investment approach of the fund. Objectives should be measurable, for example by means of comparison to a performance benchmark or a desired level of return. The following examples illustrate approaches that may be taken in the formulation of investment objectives:

- to obtain a rate of return matching or exceeding, by a specified amount, a benchmark (eg. the All Ordinaries Accumulation Index or CPI) over a specified period (eg. 5 years);
- to provide real long term (at least 5 years) capital growth of at least 5% compounded and a level of income no less than 2% from a balanced portfolio;
- to seek to maximise tax effective returns by the use of imputation credits from a range of Australian equities.

11. The whole of a fund's circumstances must be considered in formulating the investment objective/s. These include the membership profile (eg. members' age and expectations, compulsory or voluntary membership), benefit structure (eg. defined benefit or accumulation fund), tax position, fund size and the likelihood of future support by employer-sponsors. Such factors affect the diversity and liquidity requirements of fund investments.

12. Trustees may seek professional advice in preparing objectives, however, this does not, in any way, reduce their responsibilities or obligations. Any professional advice received should be documented.

Formulating investment strategies

Section 52

13. The investment covenant prescribes that a trustee must formulate an investment strategy. An investment strategy is a plan for making, holding and realising fund assets consistent with the investment objectives adopted for the fund (or for each subplan).

14. Trustees may seek help to formulate investment strategies, however the responsibility remains with the trustees who should document any advice received and their consideration of it.

15. Members and employers of standard employer sponsored funds can express their views concerning investment strategies through their trustee representatives or through the fund's policy committee, as applicable (refer to Superannuation Circulars III.A.2 "Trustee Arrangements - Superannuation Funds other than Public Offer Funds" and III.A.3 "Trustee Arrangements - Public Offer Superannuation Funds").

16. Trustees must be able to demonstrate through trustee minutes, other documentation (eg. reports from investment advisers) and the actual wording of

the strategy that they have considered, at a minimum, the specific issues that must be taken into account under the investment covenant (refer paragraph 7).

17. When documenting such considerations, trustees should address any:

- statutory limitation or constraints on investments eg. the SIS sole purpose test and other investment requirements (refer paragraphs 47 to 48);
- non-statutory limitations or constraints on investments that are included in the fund's governing rules eg. ethical or environmental issues;
- reports obtained from experts; and
- possible trustee/director conflicts of interest and how these are dealt with in regard to specific investments eg. directorships, controlling influences etc.

18. There may be occasions where a trustee having taken into account all of the necessary considerations (including the need for diversification) invests all assets of a fund in a single asset class or even a single asset. This would be unusual given contemporary risk and portfolio management theories, which emphasise the risk of the entire portfolio rather than each investment in isolation.

Fund's circumstances

Section 52(g)

19. The whole of the fund's circumstances must be taken into account when formulating the investment strategy for the fund (or subplan). This includes the circumstances referred to in paragraph 11 and any need to maintain the real value of the capital of the trust or investment returns.

20. The circumstances may require a reserving policy, which may smooth investment returns to members. Where reserves are held, a strategy must be formulated to manage these reserves. The strategy must be consistent with the fund's investment strategy and its capacity to discharge its actual and contingent liabilities as and when they fall due (refer to paragraph 62).

Risk and return

Regulation 13.15A

21. Risk is the chance of loss on an investment. In this context, risk is usually measured by reference to the volatility of returns. Trustees must, in formulating an investment strategy, be able to identify, measure and manage the risks associated with particular investments or types of investments. As risks are subject to factors such as market changes, new products, new risk management

techniques and legislative changes, trustees are obligated to continuously monitor, assess and review the fund's investment objectives, strategies and performance. Different risks are normally associated with different assets and asset classes with the result that the level of exposure to particular assets or asset classes may need to be adjusted from time to time. The principal risks fund investments are exposed to include:

- market risk (the possibility of loss resulting from changes in market conditions eg. share prices, inflation, currency rates or interest rates);
- operational risk (the possibility that assets cannot be safely held or that administration systems may be inadequate to properly identify ownership);
- liquidity risk (the possibility of capital loss or losses arising from delays in converting an investment into cash, changes in the marketability of the investment); and
- credit risk (the possibility that a counter party to a transaction might fail).

22. There is a strong correlation between risk and return. In setting the fund's investment strategy trustees must determine the acceptable level of possible risks and volatility of returns bearing in mind all the circumstances of the fund.

23. Trustees may use derivatives to minimise risk by protecting assets against changes in the market (hedging). Derivatives must not be used to speculate. Any derivative use must be specified in the investment strategy and the required risk management statements (RMS) prepared and/or obtained from relevant parties eg. PSTs (refer Superannuation Circular No II.D.7 and Addendum "Derivatives"). The RMS covers the controls over derivative use and the process for assessing compliance with those controls.

Diversification

24. Diversification of investments is useful to distribute and control risk, and minimises the variability of investment returns. It involves spreading investments over a number of individual assets, asset classes (ie. shares, property, fixed interest, cash, international equities) countries or investment managers. Further diversification can be achieved by spreading investments within each asset class such as investing in commercial and residential property, long and short term fixed interest investments etc. The desirable level of diversification and the manner in which it is achieved will depend on the size and circumstances of the fund. The value of effective diversification should not be ignored, as it generally will result in a lower overall level of risk to achieve a desired return.

Liquidity and cash flow

Section 52(2)(f)(iii) and Regulation 4.09(2)(c)

25. The fund's liquidity and cash flow, particularly its capacity to pay expenses, tax and benefits when they become due is an essential consideration for trustees' investment decisions. When formulating strategies, trustees should consider:

- the desired liquidity;
- the required amount of investment in cash or in assets readily convertible to cash;
- the expected timing of investment income and member contributions; and
- any actual or contingent expenditure eg. taxation, member exits etc.

26. To maintain the necessary liquidity, trustees may wish to establish specific investment parameters eg. limiting equity exposure to the "top 50 equities" as these are generally liquid.

Expressing investment strategies

Section 52(2)(h), Regulations Divisions 2.4, 2.6 and Part 4.

27. It is important for interested parties (such as members and prospective members, APRA and auditors) to be able to easily understand a fund's investment strategy so that they can assess the potential investment performance and management of the fund.

Asset allocation ranges

28. One widely used method of expressing an investment strategy is to set formal asset allocation ranges. While this is not the only approach, APRA encourages its use. It involves the setting of formal asset allocation ranges (minimum and maximum exposure permitted for each asset class) with an associated benchmark for each asset class.

29. **An example** - The fund objective is to return, on average over a five year period, at least 2% above the Consumer Price Index and have a negative return no more than once every five years. The associated investment strategy to achieve this objective might be to invest in a balanced portfolio exposed to all major domestic asset classes as follows:

Asset Class	Range	Benchmark
• cash	0% - 20%	10%;
• fixed interest	20% - 40%	25%;
• Australian equities	50% - 70%	50%; and
• listed or unlisted property trusts	10% - 30%	15%.

30. SIS requires that investment information must be provided to prospective members or unit holders and to members or unit holders at least annually. These requirements are regulated by the Australian Securities and Investments Commission (“ASIC”) who can be contacted on 1300 300 630 or at www.asic.gov.au.

Implementing investment strategies

Sections 10, 52(2)(f), 102, 116, 122, 123, 124, 125 and 126

31. The investment covenant prescribes that a trustee must formulate and give effect to an investment strategy. Giving effect to (or implementing) the strategy is thus a separate process from formulating the strategy. Implementation of the strategy involves considerations such as the quantum of fund assets, the expertise of the trustees, the availability of appropriate advice, administrative capabilities and the costs of managing investments. It may involve direct investment, indirect investment (eg. through collective investments), using investment managers or a combination of these approaches.

32. Regardless of the approach taken, trustees must ensure that the fund’s ownership of the investments is assured. Generally this means that assets are held in the name of the fund trustee. However, a trustee may enter a contract with a custodian to perform custodial functions in relation to any of the fund’s assets. Where assets are held in the name of custodians, the trustee’s (and therefore the fund’s) interests need to be effectively assured through the contractual agreement with the custodian (refer paragraphs 35 to 38 for the rules relating to the engagement of custodians).

Investment managers

Sections 10, 116, 120, 124, 125 and 126

33. Where trustees delegate the investment management function, they must ensure proper selection processes have been undertaken and their due diligence examinations should be documented. An appointment of an investment manager must be in writing (also known as an investment mandate). The investment mandate should clearly specify the function to be delegated and address issues such as the required investment parameters or constraints, performance standards and benchmarks, regular reporting processes, fees and charges, termination clauses, ownership of books and records, dispute resolution procedures and indemnification conditions. SIS makes it impossible for the agreement between the trustee and the investment manager to exempt the investment manager from liability for negligence or to limit that liability. The trustee is obliged to ensure that the mandate enables the trustee to seek information from the investment manager at any time.

34. An investment manager must be a body corporate and must not be a disqualified person. Broadly, a body corporate may be disqualified from being an investment manager as a result of insolvency, being wound up or where the body corporate knows or has reasonable grounds to suspect that a disqualified person is acting as a responsible officer. A responsible officer is a director, secretary or an executive officer of the body corporate. For further information refer to Superannuation Circulars III.A.2 “Trustee Arrangements - Superannuation Funds other than Public Offer Funds” and III.A.3 “Trustee Arrangements - Public Offer Superannuation Funds”.

Custodians

Sections 122, 123, 126A and Regulation 13.19

35. Trustees may also choose to use custodians for services ranging from clearing, settlement and safekeeping of assets to investment administration and reporting to the trustees or investment managers.

36. Like all delegations to service providers, proper selection processes and agreements must be in place. Custodians (other than for excluded funds) must be a body corporate and must not be disqualified persons (refer paragraph 34). The custodian must hold net tangible assets or an approved guarantee for an amount not less than five million dollars, or the total value of the net tangible assets of the custodian and the approved guarantee must not be less than five million dollars.

37. An investment manager cannot appoint a custodian without the written consent of the trustee. Custodians should be appointed under a contractual agreement which sets out, at a minimum the delegated functions, investment parameters, performance standards and benchmarks, regular reporting processes, fees and charges, termination clauses, ownership of books and records, ownership of assets, rules for appointment of any sub-custodian, dispute resolution and indemnification conditions. The trustee should ensure that the agreement with the custodian (which will be either between the custodian and the trustee or the custodian and the investment manager) enables the trustee to seek information from the custodian at any time.

38. All delegated functions remain the responsibility of the trustee and adequate reporting and controls must be in place.

Monitoring

39. Trustees must monitor investments, strategies, objectives and supporting systems to ensure compliance with legislative and contractual requirements and to minimise risk, including the risk of fraud or mismanagement. Monitoring must take into account any actual or proposed changes to the fund and to external conditions. This may include:

- proposed and actual legislative amendments which may impact on the fund, such as choice of fund, goods and services tax (GST) and business tax reform;
- a sudden unexpected growth of membership or change in membership profile due to corporate restructures;
- changes to the economic climate and the status of specific markets;
- changes arising from financial market developments, such as the introduction of the Euro;
- systemic influences such as the Y2K problem; and
- changes to service providers.

40. Once such factors are identified the appropriate response will depend on the circumstances but may include re-balancing the investment portfolio, altering the investment strategy, reporting to members or reviewing business continuation plans.

41. All fund investments must be regularly monitored and reviewed to ensure that the investments remain consistent with the investment strategy, objective and

performance benchmarks. The amount, complexity and type of investments will govern the frequency and style of monitoring needed eg. hourly, daily, weekly; computerised or manual monitoring etc. It is recommended that reviews should be undertaken at least every six months.

42. If asset ranges are specified, investments must be regularly reviewed to ensure they are maintained within the pre-determined asset ranges ie. that they are adjusted as necessary in the light of market movements.

43. Procedures should be in place to adequately monitor direct investments in particular assets (eg. property or equities). This includes monitoring of performance to ensure that the investments remain relevant and appropriate, the receipt and recording of income and obtaining proper valuations.

44. Trustees should also ensure that procedures are in place to adequately monitor indirect investments (eg. collective investments such as pooled superannuation trusts, unit trusts, life policies, etc). This includes monitoring of performance to ensure that the investments remain relevant and appropriate, and the receipt of regular and timely transaction reports.

45. Consistent with the initial formulation and implementation of investment decisions, trustees must document the review and monitoring process and any resulting actions.

46. Where trustees have delegated the investment management or custodial function (in whole or part), sufficient information and reports must be available to trustees to enable informed decisions to be made. The reporting mechanism should form part of the written agreements and include frequency, performance benchmarks and compliance issues. The activities of investment managers and custodians should also be monitored to ensure they can continue to meet their obligations.

Other investment requirements

Sections 62, 65, 66, 67, 71, 109, Regulations 13.14 and 13.15A

47. In addition to trustees' responsibility to formulate and give effect to an investment strategy, trustees must comply with other SIS investment rules. These include the general prohibitions on borrowing, lending to members, placing charges over fund assets (except in relation to certain derivatives contracts), requiring investments to be made on an arm's length basis, restrictions on holdings of in-house assets and acquisition of assets from

members. These investment issues are discussed in Superannuation Circulars II.D.2 to II.D.7.

48. Regulated superannuation fund investments must also be consistent with the sole purpose test of section 62 of SIS. This provides that trustees must ensure that fund investments are maintained solely for the purposes listed. These include the provision of benefits to members on their retirement, reaching a specified age and/or upon death. Regulated superannuation funds may also provide benefits relating to termination or cessation of employment due to ill-health or death (refer Superannuation Circular III.A.4 “The Sole Purpose Test”).

Investment choice

Sections 52(4), 58 and Regulation 4.02

49. Trustees may decide to offer investment choice to members or unit holders (beneficiaries) by giving them a choice of two or more investment strategies within the one fund. (This is distinct from the announced Government intention to allow members to choose a superannuation fund into which contributions made on their behalf by their employer are to be paid.)

50. Where investment choice is offered, members can select from the available range of investment strategies to produce a tailor-made portfolio that meets their individual needs. Trustees are not responsible for the actual strategy/ies a member may adopt provided all the requirements for choice of strategies are complied with (refer paragraphs 53 to 59) and each investment strategy offered has been properly formulated and implemented (see paragraphs 13 to 38).

51. The trustee’s decision to offer a range of strategies will depend on the individual circumstances of the fund, fund membership (eg. taking into account the differing investment requirements of members), costs and administration capabilities.

52. When offering choice, trustees must be satisfied on an ongoing basis that the administrative capabilities of the fund and/or service providers are able to cope with the complexity that may be created by the range of choices offered. Failure of systems has created significant problems in the past, administrative capabilities must be able to be substantiated to external auditors and APRA.

Beneficiary information and directions

Regulation 4.02

53. If investment choice is provided, trustees must give each beneficiary or each member of the class of beneficiaries:

- a choice of two or more strategies from which a strategy or combination of strategies may be chosen;
- the investment objectives of each strategy offered;
- all information the trustee reasonably believes a person would reasonably need for the purpose of understanding the effect of, and any risk involved in, each of those strategies; and
- full information about the range of directions that can be given and the circumstances in which they can be changed eg. switching fees, period of notice.

54. After the above points have been complied with, the direction from the beneficiary, or class of beneficiary, must specify:

- which strategy or combination of strategies is to be followed; and
- where applicable, matters relating to the choice of strategy eg. the level of exposure to each chosen strategy.

55. The investment choice provisions do not allow members to choose individual investments unless they are offered as a strategy in their own right. The only exception may be in relation to certain small fund circumstances as outlined in paragraphs 64 to 66.

Subsequent directions

Regulation 4.02(5)

56. Subsequent directions about investment strategy choices (eg. switching between investment strategies) may only be given by beneficiaries if:

- the beneficiary (or each member of the class of beneficiaries) is given all information the trustee reasonably believes a person would reasonably need for the purpose of understanding the effect of, and any risk involved in, the subsequent direction (including any fees or charges); and
- the direction relates to the strategy to be followed in relation to the investment of the interest in the fund of the beneficiary (or class of beneficiaries).

Default strategy

Section 16, Regulations 4.02(3) and 4.02(4)

57. Where investment choice is given to standard employer-sponsored members (ie. employee members whose employer contributes on their behalf, or has temporarily ceased to contribute, to a fund wholly or partly pursuant to an arrangement between the employer and the trustee of the fund), trustees must identify a default strategy that will be adopted if no direction is given. This default strategy need not be identified if it is a condition of membership for the beneficiary to choose a strategy or combination of strategies.

58. As part of the process for developing investment strategies, trustees must determine which of the strategies offered is the default strategy.

59. The default strategy need not be the same for all members, for example it may vary with the age of a member. Where a different default strategy is offered to different members, or classes of members, the trustee must, of course, fulfil its duty to treat all members fairly and equitably.

Distribution of investment earnings

Section 52(2)(g), 115, Regulations 5.01, 5.01A, 5.02 and 5.03

60. Generally, trustees determine amounts to be credited or debited to members at least once a year, taking into account investment returns less costs and any transfers to or from reserves. Trustees may also determine from time to time interim crediting rates to be paid upon a member's exit taking into account changes in the fund's investment performance.

61. Trustees must ensure that there is an adequate procedure to determine crediting rates which are fair and reasonable between all members and the various kinds of benefits. Returns that are fair and reasonable may not necessarily result in uniform investment returns for all members. This may be the case where member choice of strategies is offered and returns reflect the specific assets backing the particular investment strategy. Refer to Superannuation Circular I.C.1 "Minimum Benefit Standards" for further information concerning investment returns.

62. Reserves may be used to smooth returns where the governing rules of the fund do not prohibit the trustee from maintaining reserves. This enables the trustee to determine either a higher return to be distributed than actually received from the investments or increase the reserve and distribute a lower than actual return. Trustees must ensure that reserves are managed in a manner consistent with the investment strategies and the fund's ability to meet its liabilities.

Directions to trustees

Section 58

63. Trustees may seek advice or use the services of others. However, the governing rules of the fund must not permit trustees to be subject, in the exercise of any of the trustee's powers, to direction in relation to investments by any person. Exceptions to this general principle include:

- a court;
- the Australian Prudential Regulation Authority (APRA);
- the Australian Securities Investment Commission (ASIC);
- the Australian Taxation Office (ATO) in its role as a regulator under SIS (the Government has announced that the ATO will fulfil this role in respect to certain small funds on and after 1 July 1999);
- beneficiaries in respect of their choice of investment strategies (refer to paragraphs 49 to 59); and
- certain small funds in the circumstances detailed in paragraphs 64 to 66.

Small funds

Sections 52(2)(f), 52(4), 58, 59, Regulations 4.03, 4.04 and 4.09

64. Trustees of regulated superannuation funds with fewer than 5 members and some single beneficiary Approved Deposit Funds (ADFs - refer to paragraph 66) may also be subject to direction and exercise of trustee discretion by a person other than the trustee. This enables members and unit holders of these funds to have direct input on investment decisions (member directed investments).

65. Trustees of superannuation funds with fewer than 5 members are only bound by a direction from a member to purchase a specific investment where the governing rules permit the direction, the resulting investment is in accordance with the investment strategy for the fund and the investment does not conflict with SIS requirements.

66. An excluded ADF is one that has a single beneficiary and was established:

- before 1 July 1994; or
- on or after 1 July 1994 with an eligible termination payment of at least \$400,000

Statutory defence for loss or damage

Sections 52 and 55

67. Section 55(5) provides trustees who have acted properly with a statutory defence against an action for loss or damage suffered as a result of the trustee making an investment. This defence is available where the investment was made in accordance with an investment strategy formulated and implemented under the investment strategy covenant.

68. The existence of a statutory defence allows trustees to focus on the overall risk of the total investments, rather than the risk attached to each investment in isolation. This enables the trustee to invest fund assets according to the investment strategy in what might, when considered in isolation, appear to represent a rather risky investment (eg. some investments in venture capital projects).

69. Trustees should be aware that this defence is dependent on their discharging the burden of proof. This emphasises the importance for trustees to document their considerations and approaches to investment decisions.

Penalties

Sections 31, 32, 33 34, 52, 55, Regulation 4.02 and 4.09

70. Significant civil and/or criminal penalties may apply where trustees have contravened the operating standards concerning the formulation and implementation of investment strategies and beneficiary investment choice.

71. Trustees may also incur personal liability as a result of their actions if they are negligent in the exercise of the trustees' duties contained in the investment covenant.