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Planned Giving News—Fall 1999

CHANGING DONOR EXPECTATIONS

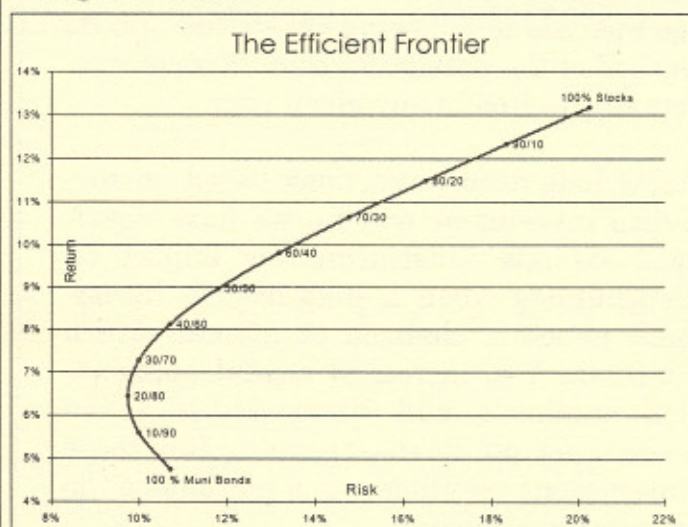
Earlier this year, we discussed many of the issues needing review before converting older NIM-CRUTS to standard unitrusts. Most organizations seem to have completed that process and are well along the legal path to conversion. With year end just a few months away, we suspect the time will soon be here when those NIMCRUTS will be flipped and a different investment strategy will be required as we enter the year 2000. Some considerations include:

- Donor education – the concept of total return
- Risk tolerance of the donor
- Expected duration and distributions of the trust
- Tax considerations

DONOR EDUCATION/RISK TOLERANCE

For many donors, understanding NIM-CRUT distributions has been a fairly simple and comfortable concept. In recent years of low interest rates, bond interest and stock dividends flowed into the trust and then flowed right back out to the donor – no more, no less. This was easy to understand and often consistent with an older generation's investment experience of CD's, bank savings accounts, and high-yielding utility stocks. Such investments have stable, fixed-percentage payouts that are easily understood and change very slowly from year to year.

By flipping to a standard unitrust, a much more complex list of considerations must be understood by the donor. Annual distributions will now be tied to total return— income *and* change in market value of the assets—which will be more volatile than simple interest and dividend flows. The total return of a portfolio will now play a more important role each year if donor distributions are expected to grow over time. Donors need to clearly understand the long-term benefits of portfolio growth. But at the same time, they must also be instructed regarding the increased volatility they may experience in portfolio value as well as their annual distribution. Simple illustrations such as the *Efficient Frontier* might be useful.



Over the long term, a balanced portfolio of stocks and bonds can manage risk while achieving a reasonable return.

DURATION AND DISTRIBUTIONS

As with any portfolio, the expected life of the trust is critical in establishing an appropriate allocation of investment assets. Investing for total return with greater equity exposure usually increases the volatility of expected distributions in any single year. The top chart on page 3 represents the historical return each year since 1930 for a blended portfolio consisting of ½ stocks and ½ municipal bonds.

But it can be clearly demonstrated that results over longer periods of time produce statistically less volatile returns, as demonstrated in the bottom chart. This chart uses the same data since 1930 but reflects average 5-year rolling returns. Notice how the results are much more stable and less volatile. Thus in constructing portfolios, a reasonable time expectation must be factored into the equation.

The year after a NIMCRUT is flipped, beneficiary distributions will no longer be limited by the amount and type of income received. In many cases, that distribution is likely to increase quite a bit over recent payouts of portfolio income. We expect most donors will be pleased. But they should be cautioned not to expect the same percentage increase in following years, and also be warned of the possibility that payouts may actually decline in any given year.

Using long-term projections based on historical investment results, we have developed exhibits illustrating the impact on distributions when a high-income investment policy is changed to a total return approach. Yes, increased capital appreciation emphasis will likely improve the donor's *overall lifetime* payout. But those expectations are subject to a reasonable life expectancy horizon.

TAX CONSIDERATIONS

Restructuring the composition of a portfolio from a NIMCRUT to a Standard Unitrust may present a unique one-time opportunity to consider both present and future tax consequences. Pure investment considerations must be tempered in consideration of the tax burden such moves will place on the donor. In general, we favor minimizing Tier 1 income. Tier 1 tax rates, which include short-term capital gains, are double those of Tier 2 rates and result in twice as much tax paid by the donor. And although Tier 2 assets are preferable, they still carry a 20-percent tax burden. Careful selection of high-quality long-term growth stocks requiring minimal trading can help reduce Tier 2 income over a trust's life. (Please see our Summer 1998 issue for a discussion of the 4 Tiers.)

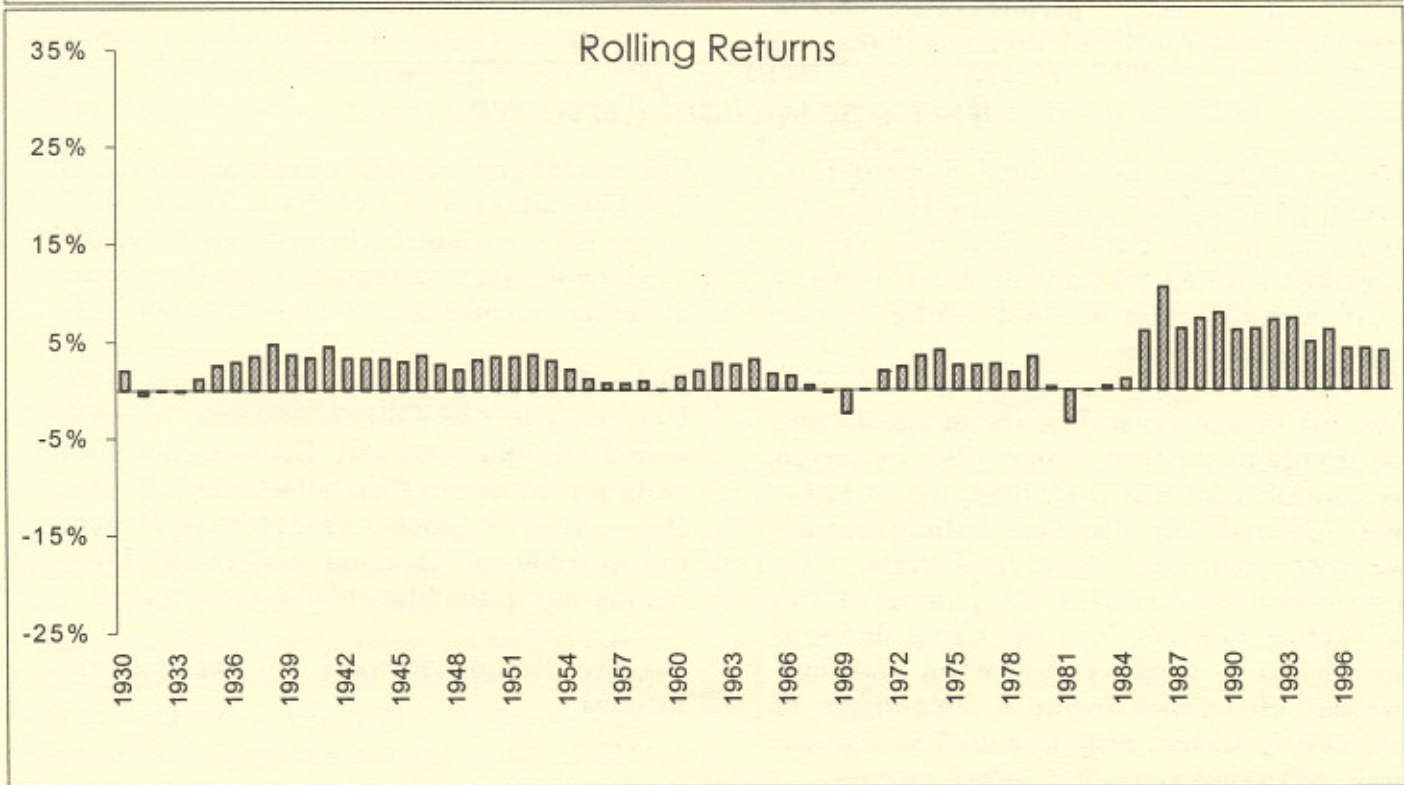
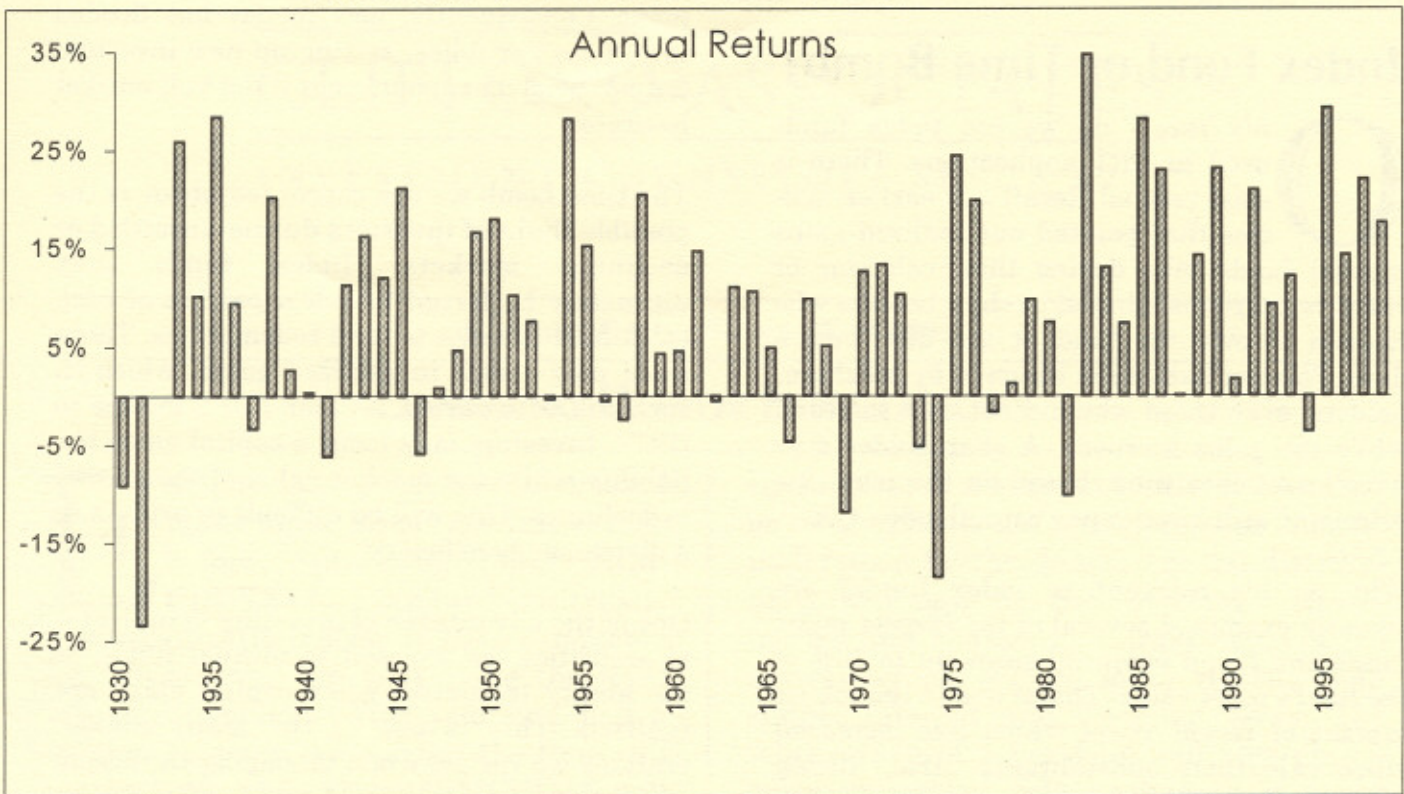
To help provide the necessary cash flow, Tier 3 municipal bonds with high coupons are often useful. And with careful planning even a principal cash reserve might be wise to allow sufficient Tier 4 tax-free distributions during the first few years following a flip, as trustees try to avoid triggering capital gains.

WORTH THE EFFORT

By now, you have probably performed the analysis and shown your donors why it is worthwhile to make the change from a NIMCRUT to a standard unitrust. The next step is to teach the benefits of investing for total return. Your donors may need to be reminded to keep thinking of the long term. They may have to tolerate occasional yearly declines in income in exchange for greater total income received over their life times. In most cases, they can also enjoy the satisfaction of anticipating leaving a larger remaining value to your organization. For many donors, this is the important outcome that inspired their gift in the first place.

Terry Price

**Annual returns can be volatile, even for a balanced portfolio.
Encourage your donors to take a longer-term view.**



These charts compare annual and 5-year rolling returns for a hypothetical portfolio composed of 1/2 long-term municipal bonds and 1/2 stocks. Historical returns from 1930 through 1998 were used for this demonstration. The rolling returns show much less volatility than the annual returns.

Index Fund or Time Bomb?

Only rarely do we see index funds used in CRT applications. There is good reason! Recall our earlier articles that pointed out realized gains mutual funds take during their calendar or fiscal year are distributed to shareholders who happen to own the fund at the distribution date. This tax liability is incurred by *all* shareholders, even those who did not own the fund while the gains accrued. A shareholder may have losses in a fund, based on the purchase price, and still have to pay capital gains tax.

Why is this relevant to index funds? We recently examined several of the largest index funds and found potential gains up to 50% of the fund's asset value. This is due to the robust market of recent years which has increased stock valuations substantially. Also, during this bull market, performance-sensitive investors have convinced themselves that an

indexing approach may produce excellent results without the need for active management. Consequently, new money has flooded into these portfolios, setting up new investors for potential disappointment if the bull market hesitates.

The time bomb we are concerned about is the possible flight of investors during unsettled or declining markets. Index funds may ultimately be forced to sell a portion of each stock held in order to fund redemptions. Those sales may result in realized gains, which in turn will be reported as Tier 1 or 2 income to CRTs. Investors may incur a capital gains tax liability while the market value of their asset is declining. This will be difficult to explain to a distressed beneficiary.

One of the advantages of investing in individual securities, as opposed to mutual funds, is the ability to control when capital gains are realized. This is one of the many considerations we review when managing the assets of a charitable remainder trust. *Jim Fox*

Welcome Richard Cervanyk

We are delighted to welcome Richard Cervanyk, CPA to Clifford Associates. He recently joined us in our Denver office and will be working with Ken Dike and Jennifer Nolan in trust administration and accounting for our planned giving clients.

Richard brings several years of accounting experience to our firm. Since 1993, he served as Controller for VECO Drilling, Inc. in Lakewood, Colorado, an oil and gas drilling contractor with operations in several states. His responsibilities included all phases of the accounting function from preparing financial statements to treasury, budgeting and forecasting. His duties included supervision of accounting, human resources staff and preparation of income and sales-use tax returns.

Prior to joining VECO, Richard was a Senior Tax Consultant with Deloitte & Touche, LLP, a "big five" accounting firm. From 1989 until 1993, he served a variety of clients there in tax planning, consulting and compliance matters.

Richard is a graduate of Colorado State University in Fort Collins, Colorado where he served an internship with Deloitte Haskins & Sells, a predecessor firm to Deloitte & Touche. He received his Bachelor's degree in accounting in 1989 and became a Certified Public Accountant in the State of Colorado in 1990.

We are looking forward to working with Richard.

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