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Planned Giving News—Spring 2000

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## Measuring Investment Results

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**H**ow does one respond to a well intentioned trustee who asks, "How are our deferred gifts performing?" Can an experience level whose sole observations have been of the endowment portfolio provide adequate preparation to successfully evaluate results achieved by Charitable Remainder Trusts, Pooled Income Funds, or Gift Annuity Pools? We have learned over the years that the two assignments have profound differences. If trustees are not educated on those differences, judgements and erroneous conclusions could be devastating to an otherwise successful program.

### ENDOWMENTS SERVE ONE MASTER

That is to say, the institution itself enjoys the use of annual distributions to support programs and also benefits from the perpetual nature of the corpus. With implementation of the widely accepted Total Investment Return Approach, institutions establish spending policies that operate independently of investment policy. The manager(s) are free to invest for maximum return consistent with the institution's policy and the terms of the Uniform Prudent Investor Act.

Supervision of endowment management is usually by a committee of the board and perhaps a consultant who collectively react to the varied perspective of the committee's members based on personal experience. As we all know, membership of these groups changes and the group's biases change reflecting current conditions and respond sometimes to cur-

rent investment fads. The end result is usually performance-sensitive expectations, frequent adjustments and occasional disruptions.

### DEFERRED GIFTS SERVE SPLIT INTERESTS

Deferred gifts in contrast are somewhat schizophrenic. The institution (as trustee—not owner!) is charged with protecting the interests of all participants, both current beneficiaries and remaindermen, in a balanced manner.

The institution certainly has an interest in the remainder value, but it usually also has a keen interest in satisfying the donor and beneficiary's interest as well. This motive goes beyond fiduciary principles. It is good public relations. Fundraising is critically dependent upon a satisfied and supportive constituency. It is not uncommon for an institution to put extraordinary attention on satisfying the expectations of the income beneficiary. This practice is good for donor relations, and it responds to the fiduciary principles governing management of split interest trusts.

While it may not appear to be so on the surface, many trustees will take the position that a satisfied beneficiary is good for the institution, and its interests are protected in a larger sense that goes beyond the specific trust. Managing split interest trusts represents a fundamental difference from endowment management and is critically important to understand when evaluating the success of the trust investment effort.

*(Continued on page 4)*

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# Valuing Pooled Income Fund Income Interests

Many charities hold pooled income funds with limited assets and only a few participants, many of whom are unhappy with the level of income being distributed to them. Faced with the prospect of continuing to administer a fund that is not appealing to the charity's donor base and is not expected to attract additional gifts, these charities often explore options that would allow them to close the fund. Generally, the beneficiary could relinquish all rights to further payments from the income fund with, or without, compensation from the charity.

## DETERMINE THE PRESENT VALUE

When exploring the alternatives, a value must be placed on the expected future payments to the beneficiaries. Known as a present value, it is a hypothetical amount that, if invested, would be sufficient to satisfy all future beneficiary distributions that would have been paid if the fund was not closed. In addition to estimating the amounts that would have been paid the beneficiaries and the duration of these pay-

ments, an estimate is required of the investment income that would be earned by this hypothetical amount.

The amount paid to the beneficiaries of a pooled income fund depends on the distributable income earned by the fund, which is often only the interest and dividends earned by the fund's investments. The duration of the payments depends on a life expectancy. The income earned by the fund could consist of only distributable income such as interest and dividends, or include the reinvestment of non-distributable income such as capital gains.

The schedule below shows the present values associated with various (1) future beneficiary distributions expressed as an annual percent of \$1,000 in trust principal held (*distributable returns*), (2) life expectancies (*duration*), and (3) fund investment returns (*discount rate*). The schedule contains three levels of distributions (5%, 6%, 7%) for each investment return alternative.

### Present Values of Distributions per \$1,000 Principal

Distribution per \$1,000	Investment Alternative #1			Investment Alternative #2		
	\$50	\$60	\$70	\$50	\$60	\$70
Discount Rate	5%	6%	7%	10%	10%	10%
<i>Duration (years)</i>						
5	220	258	293	195	234	273
10	392	449	500	314	377	439
15	525	591	647	386	464	541
20	630	696	750	431	517	603
25	711	774	824	458	549	641
30	775	832	875	474	569	664
35	824	<b>876</b>	912	484	<b>581</b>	678
40	863	908	938	490	588	687

### INVESTMENT RETURN ASSUMPTIONS

One investment return alternative assumes that the fund's rate of return is equal to the amount distributed, expressed as a percent of the principal value held by the beneficiary. This is appropriate for a pooled income fund that is invested to earn the highest amount of currently distributable income. Where distributable income is interest and dividends, this type of fund is invested entirely in fixed income investments.

The second investment income alternative assumes that the fund's rate of return is 10% for all beneficiary distribution levels. This return could be considered the beneficiary's investment performance on personal assets invested for total return. The present values shown under this alternative are the initial amounts that the beneficiary would have to invest at 10% to be able to make all beneficiary distributions that would have been paid by the pooled income fund had it not been closed.

\$876 held in a pooled income fund that earned only distributable income at a rate of 6% would be sufficient to make beneficiary distributions for 35 years in a amount equal to 6% (\$600) for each \$1,000 held in the pooled income fund. If \$581 were invested to earn 10%, beneficiary distributions could be made for 35 years to a beneficiary in a amount equal to 6% (\$600) for each \$1,000 held in the pooled income fund.

### CHARITABLE CONTRIBUTION

The Internal Revenue Service has its own actuarial tables and method of calculating the present value of future beneficiary distributions from a pooled income fund. When valuing an income interest, a hypothetical charitable contribution is calculated as if a gift, equal to the market value of the principal held by the beneficiary, is being made by the beneficiary to the pooled income fund. This hypothetical charitable contribution is deducted from the current market value of the principal held by the beneficiary to determine the charitable contribution by the beneficiary who relinquishes all rights to future distributions from the pooled income fund.

Below is a table that sets forth the charitable contributions for gifts of pooled income fund income interests assuming various discount rates. The discount rate used to value charitable contributions for gifts to a pooled income fund is the fund's highest rate of return over the last three years.

A 60 year-old beneficiary would be entitled to a \$650 charitable contribution for each \$1,000 of trust principal held in a pooled income fund with a 6% rate of return. Since a donor can only deduct the value of a gift less anything received in return for the gift, this charitable contribution would have to be decreased by any payment that the charity might make in return for the relinquishment of the income interest.

The charity should seek legal advice when closing a pooled income fund. Federal and state law, and the pooled income fund trust document itself could affect the method by which, or ability to, close the fund.

*Ken Dike*

Age	Discount Rates		
	5%	6%	7%
50	712	765	805
55	656	711	754
60	594	650	695
65	527	583	629
70	457	510	555
75	385	434	477
80	313	356	395
85	245	282	315
90	186	215	243

*("Measuring..." continued from page 1)*

### **THE BENEFICIARY VALUES PAYOUT**

A beneficiary will judge performance based on variables relating to the payout pattern it produces. What is the level of payout compared to expectations? How variable is the payout stream? Its taxable characteristics may also be a consideration.

Total return measures do not work well in this environment. Other circumstances influence investment judgments. One consideration is the trust duration. Unlike a perpetual endowment that has no ending target, each deferred gift does! As beneficiaries age, fund management must, by definition, react to short term considerations. It is common, for example, for trusts that have a few years of expected life remaining, to match the asset maturity to that of the trust life expectancy. Maximum total return has absolutely no application here.

### **TRUST REQUIREMENTS MUST BE MET**

Trust requirements can define the character of income forcing managers to invest in high-income securities. On occasion, realizing capital gains is required to meet payout obligations independent of investment analysis and judgment.

Even gift annuity funds with stated dollar payout obligations might not invest for total return if regulatory constraints exist. In all types of planned giving vehicles, payout considerations impact investment policy and the resulting outcome.

Other factors also impact returns. The generally small size of individual trusts can limit investment options. Size also impacts trading and management costs, adversely affecting returns.

### **BALANCING BOTH INTERESTS**

How does a competent advisor react to these complex and conflicting considerations? First and foremost, the manager must understand the trust terms, the donor expectations, and the expected life span of the beneficiaries. Only then can a tailored investment policy be established that achieves the payout goals and protects the charitable remainder interest from erosion of purchasing power caused by future inflation. If that value can be enhanced without jeopardizing payout production, added value has been produced. In the final analysis, total return standards do not apply to a deferred gift program. Two measures, however, are critical: Are the donor and current beneficiaries satisfied; and is the remainder value meeting or exceeding the annual inflation adjustment?

In the final analysis, satisfied donors and beneficiaries measure investment success—not satisfied trustees or consultants. Clifford Associates investment counselors are available to assist you in helping trustees familiarize themselves with the important nuances of trust management.

*Jim Fox*

### **TIME IS RUNNING OUT...**

The deadline for reformation of existing NIMCRUTs to add a FLIP feature has been extended to June 30, 2000. If you are considering this option for your existing Net Income Unitrusts, you must take action soon. Call us for details.

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