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Investing Charitable Remainder Trusts

By Kathleen Gilmore

Charitable remainder trusts, charitable gift annuities, and pooled income funds serve multiple purposes for both charitable organizations and their donors. Many charities use these planned giving vehicles to significantly increase their donor base and support by opening more possibilities for a broader range of donor needs. Donors appreciate the extraordinary work that their gifts can make possible and recognize the significant tax benefits that can be derived from these estate-planning techniques. From an investment standpoint, these can be some of the more demanding gift vehicles to manage because of their technical complexity and the critical, continuous monitoring of investment portfolios to protect both income and remainder interests.

In the case of charitable trusts, each trust is unique, each donor specific in their objectives, each charity desirous of maximizing the gift when the trust matures. After 17 years of investing donor gift vehicles, we have yet to see two that are alike. The trustee is required to balance income, tax and philanthropic goals in a portfolio which is intended for long-term investment. These requirements, in turn, must be aligned with the Prudent Investor Act to meet the demands for proper diversification and donor objective-oriented (versus benchmark-oriented) investing. For these reasons, amongst others, we generally find investing trust portfolios in individual securities a superior approach to mutual fund investing for these same gift vehicles. Let us explain.

INCOME VERSUS GROWTH

Simply put, trust investments need to produce short

term, reliable payouts and long-term, stable growth. The Prudent Investor Act requires investment advisors to select securities that are appropriate to all interested parties. This balancing act must be maintained within the context of market dynamics, dictating the need for flexibility and control over the portfolio holdings. Mutual funds are generally invested by managers who grade their performance relative to a given benchmark – not to the objectives of an individual trust and the benefiting institution. For example, there are many mutual funds who touted their performance against the S&P during the recent bear market, but their investors still lost millions of dollars. Benchmarks certainly play an important role of allowing the investor to qualify performance within the market context, but we like to see them used as a high-level checkpoint rather than the determining focus of a portfolio's success. Without the discipline of investing to a quantifiable objective, trust advisors can be tempted to chase market momentum, losing site of the risk/return parameters defined by the trust. Mutual fund managers may be especially susceptible to this danger; Wall Street tends to reward the big numbers, so fund managers are incited to chase what's hot now. In addition, mutual funds must adhere to prospectus, not individual trust, objectives underscoring an approach that is, by necessity, less customized to and focused on unique trust goals.

In contrast, the flexibility provided by investing in individual securities may allow for more control of portfolio performance and focus on the trust objectives. Specific to equity investing, we believe fundamental research can identify leading companies which have done well in a variety of economic environments. A properly diversified

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portfolio of such quality stocks generally represents the long-term growth commitment desired by the charitable organization. Balancing this core portfolio with fixed income securities that are appropriate, reasonable income producers for donors provides stability in the ever-changing, shorter-term market environment.

DIVERSIFICATION

Proper diversification of the investment portfolio is another critical requirement of the Prudent Investor Act. Depending upon the size of a trust, we generally recommend portfolios with investments in 25-30 different companies across a variety of industry sectors. Assuming that investments in multiple mutual funds within a single portfolio will automatically result in proper diversification may be a source of false comfort. One of the disadvantages of investing in stock mutual funds is that you may not be aware of exactly where your investments are concentrated. While investors may try to diversify by holding a variety of funds with different investment styles, it often turns out that there is considerable overlap in their fund holdings. For example, in a recent review of a trust portfolio we did not manage, we discovered that one stock appeared in six of ten different funds within the portfolio. It's interesting to note that funds calling themselves growth, value, or capital appreciation funds all owned this stock.

TAX CONSIDERATIONS

In order to minimize the tax implications defined by the four-tier tax system applicable to charitable trusts, flexibility in portfolio security selection is critical. When mutual funds are used, the unpredictable realization of capital gains compromises the control required to take full advantage of tax saving opportunities. In addition, the structure and timing of mutual fund income flows is often counter-productive when designing a portfolio to benefit from the four-tier tax system. By contrast, a portfolio focused on avoiding first and second tier tax implications will likely be invested in quality municipal bonds individually selected

for best yield and rating characteristics in addition to separate stock holdings chosen with an eye to long-term appreciation and low portfolio turnover. This latter approach also has the potential to maximize the up-front charitable deduction (particularly when high-basis assets are used). Where taxes are concerned, investment control is the name of the game.

Most charitable trust donors are sophisticated investors with strong philanthropic interests. They recognize the benefits of using, what is itself, a sophisticated vehicle to meet their objectives. When determining the best choice for trust portfolio investments, we have explored how mutual funds and individual security holdings behave very differently from one another in ways which, we believe, favor individual securities as the preferred investment vehicle. It is important to note, however, that there are circumstances where mutual funds may be the better option. This is generally the case with smaller trusts where small individual equity positions would be too costly and owning separate fixed income securities would be impractical for liquidity and diversification concerns. For larger trusts, however, we strongly believe that investing uniquely tailored portfolios with individual holdings in quality companies is the best way to fully realize the interests of both donor *and* charity. Indeed, this philosophy applies to separately managed portfolios in general, and is one which A.M. Clifford stood by long before the idea of charitable trusts had been invented.



Prudent Investor Rule:

"A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution.

A trustee's investment and management decisions respecting individual assets and courses of actions must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust."

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