
CLIFFORD ASSOCIATES

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Setting Investment Policy

In an earlier newsletter (Fall 2000) we discussed benchmarking investment returns and pointed out significant differences between endowments and deferred gifts. Investment policy must respond to the split-interest nature of life income arrangements. How does a professional manager approach the challenge of maximizing returns for two competing interests?

In addition to considering trust peculiarities, the manager is required by the Uniform Prudent Investor Act (UPIA) to respond to external issues such as general economic conditions, inflation or deflation, other resources of the beneficiaries, needs for liquidity and an assets special value to one or more of the beneficiaries. These complexities, coupled with specific trust requirements, make the investment policy a vital determinant of future investment success.

At Clifford Associates, we believe it is critical to first understand the nature of each trust. What factors are most likely to influence a well-reasoned investment plan?

1. Type of arrangement – nature of income
2. Duration – expected life
3. Taxability – net return payout
4. Regulatory obligation – compliance with UPIA

The starting point is understanding how income is determined based upon the trust requirements and establishing a potential investment criteria that will provide no less than the income contemplated by the donor and the accepting trustee. We then evaluate how the manager might produce income in a tax efficient way, utilizing the 4 tier income process in a way that minimizes the beneficiaries' personal tax liability. (See our Fall 1998 newsletter article titled "*Setting Investment Policy*")

After determining what is needed to meet the income level mutually agreed to by the donor and trustee, we consider how to protect the purchasing power of the remainder interest. Additionally, it will be necessary to evaluate the impact any growth strategy might have on future income determination. For example, a standard unitrust might be structured to produce long-term capital gains with

(Continued on page 4)

Financial Planning Vs. Financial Statements

Charitable remainder trusts transfer funds to a charitable organization at some time in the future, usually upon the termination of the life income interests. For *financial planning* purposes, the charitable organization wants to know the current value of (1) what they will eventually receive from the trust and (2) the amount that will be paid to the income beneficiaries over the life of the trust. For *financial statement* purposes, charitable organizations holding a remainder interest in the charitable remainder trust and serving as trustee must report the market value of the trust's assets on their balance sheet offset by an income interest liability and remainder interest fund balance.

Present value calculations are used to determine the current value of the income and remainder interests for both financial planning analyses and financial statement presentations. The present value of the income interest is an amount that if held today and invested to earn a total return equal to the discount rate, would be sufficient to make the required payments to the life income beneficiaries over their life expectancy. The present value of the remainder interest is an amount, that if held today and invested to earn a total return equal to the discount rate over the life expectancy of the life income beneficiaries, would equal the funds expected to be transferred to the charitable organization upon the trust's termination.

Different methods are used to calculate these present values for financial plan-

ning and financial statement purposes due to the point-in-time nature of financial statements. Although appropriate for financial planning purposes, an income interest present value calculation based on expected increases in the amount paid the beneficiaries due to anticipated growth in a unitrust's value is inappropriate for financial statement presentations. If beneficiary payments are inflated because of growth in the unitrust's market value, then the amount eventually going to the charitable remainder organization must also be inflated. When combined, the present values of the income and remainder interests calculated in this manner could exceed the current market value of the unitrust assets. However, financial statements reflect present values of income and remainder interests *as they relate to the current trust market value* since balance sheet assets must equal liabilities plus fund balances. In addition, this method could also result in an income interest present value that itself exceeds the current market value of the trust's assets despite the fact that the obligation to make the income beneficiary payments exists only to the extent that there are sufficient funds held in the trust.

For example, a unitrust with an initial value of \$100,000 and a 7% payout rate that is expected to grow by 3% per year over 10 years produces the following annual payments and ending values:

Year	Payment	Ending Value
1	7,000	103,000
2	7,210	106,090
3	7,426	109,273
4	7,649	112,551
5	7,879	115,927
6	8,115	119,405
7	8,358	122,987
8	8,609	126,677
9	8,867	130,477
10	9,133	134,392

The present value of the above payments (income interest), using a 7% discount rate, is \$55,444 and the present value of the year-10 ending value (remainder interest) is \$68,318. Combining these income and remainder interests results in \$123,762, which is 24% greater than the \$100,000 current market value.

Regardless of the method used, a discount rate and life expectancy must be chosen for the present value calculation. Below is a comparison of present values of \$1,000 based on various discount rates and life expectancies:

<u>Life Expectancies (number of years)</u>					
Discount Rates	8	9	10	11	12
5%			613.91		
6%			558.39		
7%	582.01	543.93	508.35	475.09	444.01
8%			463.19		
9%			422.41		

A given percentage change in either the discount rate or life expectancy produces approximately the same percentage change in the resulting present value. For instance, a 50% increase in the discount rate (6% to 9%) produces a 24% change in the present value (558.39 to 422.41). A 50% increase in the life expectancy (8 to 12 years) also produces a 24% change in the present value (582.01 to 444.01). However, among viable alternatives, the percentage difference in potential discount rates will always be greater than the percentage difference in possible life expectancies. Therefore, great care should be taken in determining the appropriate discount rate.

Risk-free and *reasonable* are terms often used in the determination of a discount rate. *Risk-free* is used to describe the expected investment return earned from no (or extremely low) risk investments while *reasonable* is used to describe the expected return from a diversified investment portfolio invested for long-term total return with a prudent market risk. In most cases, discount rate alternatives fall in the range of 4% to 8%.


On the following page is a comparison of three life expectancy tables. The 80CNSMT table, which is based on the 1980 US census, was used to calculate charitable deductions for gifts to charitable remainder trusts from May 1989 to June 1999. The 90CM table, which is based on the 1990 US census, is used to calculate charitable deductions for gifts to charitable remainder trusts after June 1999. The third table (NVSR) was published in the February 7, 2001 *National Vital Statistics Report* from the Centers for Disease Control and Prevention. It is based on (1) final mortality statistics for

(Continued on page 4)

("Financial Planning ..." continued from page 3)

<u>Age</u>	<u>80CNSMT</u>	<u>90CM</u>	<u>NVSR</u>
Birth	73.9	75.4	76.7
10	65.1	66.3	67.4
20	55.5	56.6	57.7
30	46.1	47.2	48.2
40	36.8	38.0	38.8
50	27.9	29.0	29.8
60	20.0	20.9	21.5
70	13.3	14.0	14.3
80	8.0	8.4	8.6
90	4.4	4.5	4.7
100	2.7	2.5	2.6

1998, (2) July 1, 1998 population estimates prepared by the US Bureau of the Census, and (3) data from the Medicare program prepared by the health Care Financing Administration.


It is understandable that life expectancies have increased with each projection taking into account the effect on life spans of improving health and medical care. However, the change is fairly small as evidenced by the table where the average change in life expectancies between the 80CNSMT and 90CM tables, and between the NVSR and 90CM tables, is less than 1 year or about 2.5% of the expected remaining years. 

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("Setting Investment Policy" continued from page 1)

minimal taxable income. This approach, over the long term, might greatly benefit both income and remainder interest. However, volatile stock market valuations might create a temporarily depressed market value at the annual valuation date when payments are calculated.

As a trust nears maturity, because of the beneficiary's failing health or normal life expectancy estimates, market volatility must be reduced. Fixed income investments might be selected with the duration of the portfolio matching the life expectancy of the beneficiary.

In the final stages of planning, development officers offer valuable insight into donor and income beneficiary needs, expectations, experience, biases, and other financial resources. A final policy for each trust is established with the concurrence of the portfolio manager and institution. This investment road map improves the chances of superior results for all parties. Naturally, as circumstances change, review and perhaps modification of the investment policy is appropriate. 

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