CLIFFORD ASSOCIATES

INVESTMENT COUNSELORS SINCE 1915

Planned Giving News—Summer 2002

CRT Investment Policy Review

The last three years have been challenging to all investors including Charitable Remainder Trusts. The split interest nature of these entities make them perhaps more vulnerable to emotional, reactionary changes than an institution's endowment pool.Trustee voices express concern about the declining value of remainder interests and income beneficiaries question why Standard Unitrusts, Net income Unitrusts, and Pooled Income Funds distributions are lower than in earlier years. Is it appropriate to change the individually adopted investment policies?

First, let's stand back and look at the general economic situation. The US economy is strengthening after inventory reductions, substantial layoffs, and a dramatic lowering of interest rates by the Federal Reserve. With the exception of the high technology (dot.com) sector, growth is slowly but surely resuming. Our trading partners are likewise showing signs of resumption in economic growth. The US dollar has weakened which makes our exports more attractive. Of concern are the reported cases of fraudulent accounting, reduced consumer confidence, and the possibility of new terrorist threats.

The standards set by the Uniform Prudent Investor Act (UPIA) help protect the value of stock investments during this period of declining prices. Compliance with the Act has never been more important. In a nutshell, quality products and services, seasoned management, sound finances and a high degree of liquidity and stability characterize appropriate investments. Some might label these companies as conservative. This is precisely the type of holdings these trusts should invest in and are required by the UPIA. Damage done to (dot. com) investors should not be the experience in these trusts.

Investor fatigue makes calls for reducing or eliminating stock allocations common at this time in the investment cycle. This is where the trust's investment policy preserves the long-term view and reduces the likelihood of buying high and selling low. Market timing is a futile exercise and has never proved to be consistently successful. A useful distinction between investment policy and portfolio adjustment is strategy vs. tactics. Our strategies are based on the long view that incorporates both bull and bear cycle results in our planning and estimates. Investment policy (strategy) is not intended to change with temporary shifts in market sentiment. Beneficiary circumstances, however, may suggest a review of the adopted policy. Development professionals should be alert and able to distinguish between those conditions that may impact the policy as opposed to emotional concerns about the current environment. Your investment advisor should be of help in analyzing and responding to those questions in this time of stress.

Jim Fox

The Mechanics of Present Value Calculations

Charitable remainder trusts, charitable lead trusts, pooled income funds, and charitable gift annuities create an obligation to make periodic payments to a beneficiary over the time period specified by the trust or gift annuity agreement. The amount of the beneficiary payments may be fixed as in an annuity trust and charitable gift annuity, or based on a percentage (payout rate) of the trust's periodic market value as in a standard unitrust. In addition, the beneficiary payments may be based on the income received by the trust or fund as in a net income unitrust and pooled income fund.

For all but gift annuities, the beneficiary distribution obligation exists only to the extent that the trust is able to make the required payments. If the trust is depleted by the beneficiary payments, the beneficiary distributions cease. The beneficiary distribution requirement of a charitable gift annuity is a general obligation of the issuing organization and the beneficiary payments must be made as long as the issuing charity has assets from which the payments can be made.

Present value calculations are used to determine the current value of the beneficiary distribution obligation that involves future payments over what may be a person's life. A present value is a hypothetical amount that if invested to earn a specified return (**rate**) and from which certain payments are made (**pmt**) would result in a target future value (**fv**) after the anticipated time period (**nper**). A common method used for this calculation is the present value formula offered by many electronic spreadsheet software applications, which is explained below:

PV (RATE,NPER,PMT,FV,TYPE)

PV CALCUATION FORMULA: RATE

The present value formula **rate** variable is the annual discount rate, which is the expected investment return, divided by the number of compounding periods per year. The number of compounding periods per year is the number of beneficiary payments per year since the expected investment income is adjusted after each withdrawal of funds (see the **nper** section below).

PV CALCUATION FORMULA: NPER

The present value formula **nper** variable is the total number of compounding periods. A compounding period is the time period after which the projected investment income is assumed to be reinvested into the hypothetical fund. For purposes of determining the present value of a beneficiary payment obligation, the number of compounding periods is the same as the number of beneficiary distributions since the projected investment income is adjusted after each withdrawal. A quarterly payment frequency with a ten-year duration represents forty payments (payment frequency times number of years). The frequency of the payments is assumed to be uniform; if the beneficiary payments begin as quarterly payments, they must remain quarterly payments for the duration.

The investment income earned since the prior beneficiary distribution is added to the hypothetical fund at the same time the current beneficiary distribution is removed from the fund. This updated fund balance is carried to the next beneficiary payment date when the process begins again.

When the beneficiary payments do not begin until some time in the future (deferred payments) two present value calculations

are required. The first calculation determines the present value of the beneficiary payments as of the date the payments begin (deferred present value). A second calculation is used to determine the current present value of the deferred present value. This is more fully explained in the **fv** section.

PV CALCUATION FORMULA: PMT

The present value formula **pmt** variable is the amount of each beneficiary payment. As with the payment frequency, this amount is assumed to be uniform throughout the duration. Agreements creating charitable remainder annuity trusts, charitable lead annuity trusts, and charitable gift annuities provide for fixed, uniform beneficiary payments. The beneficiary payments made by unitrusts and pooled income funds vary each year based on the trust's periodic market value or the investment income received.

Since the objective is to determine the present value of the beneficiary payment obligation *as it relates to the current market value of the trust or fund*, the **pmt** amount for standard unitrusts (no income limitation) is the payout rate multiplied by the current market value of the trust. The **pmt** amount for net income unitrusts, where the amount of the beneficiary distributions is the lesser of the investment income received by the trust and the payout rate applied to the trust's market value, is the lesser of (1) the discount **rate** and (2) the maximum payout rate, multiplied by the current market value of the trust. The **pmt** amount for pooled income funds, where the amount of the beneficiary distributions is based solely on the investment income received by the fund, is the discount **rate** multiplied by the trust's current market value.

PV CALCUATION FORMULA: FV

The present value formula **fv** variable is the expected future value and is only used when the beneficiary payments do not begin until some time in the future (deferred payments, see the previous **nper** section). Otherwise, either enter a zero for this variable or leave it blank.

Two present value calculations are required when the beneficiary payments begin at a future date. The objective of the first calculation is to determine the present value of the future beneficiary distributions as of the date the beneficiary distributions begin. This calculation is done using the procedures previously mentioned. The current market value is used when determining the amount of the beneficiary distribution (**pmt**) for unitrusts and pooled income funds. The number of compounding periods (**nper**) is the number of beneficiary payments from the time they actually begin through the trust's termination.

The value resulting from the first calculation is used as the future value (**fv**) in the second present value calculation. This second calculation uses the same discount rate (**rate**) as the first calculation. The number of periods is the number of payments that would have been made had the payments started on or before the current date and continued through the date that the payments actually begin (this is the beginning of the time period used in the first calculation). This approach makes the frequency of compounding periods uniform for the time periods before (calculation #1) and after (calculation #2) the date the beneficiary payments begin.

PV CALCUATION FORMULA: PMT

The present value formula **type** variable specifies whether, for compounding purposes, the beneficiary payments are made

(Continued on page 4)

("Present Value Calculations ..." continued from page 3)

at the end of a compounding period or at the beginning of a compounding period. If the payments are made at the end of the period, which they most always are, enter a 0 for this variable or leave it blank. If the payments are made at the beginning of the period enter a 1 for this variable.

PV CALCULATION: MARKET VALUE LIMITATION

For all but gift annuities, the beneficiary distribution obligation exists only to the extent that the trust is able to make the required payments. Therefore, the present value of the beneficiary distributions can be no greater than the current market value of the trust assets. Since the beneficiary distribution obligation of a charitable gift annuity is a general obligation of the issuing organization, the present value of the beneficiary distributions may exceed the current market value of the gift annuity fund.

NET PRESENT VALUE CALCULATOR WORKSHEET

Clifford provides its clients with an electronic spreadsheet with the raw data and default variables required to make these calculations as well as the calculation itself. The client is able to change any of the variables in order to meet any particular need they may have. In this manner, our clients can concentrate on the appropriateness of the underlying assumptions, such as the expected long-term total return used to define the discount rate, and leave the data acquisition and formula mechanics to us!

Ken Dike

Denver Office

In order to streamline client communication and better coordinate the various functions related to our planned giving effort, most of the planned giving functions previously shared between the Pasadena and Colorado offices are being consolidated in the Pasadena office. As Ken Dike has assumed overall responsibility for coordinating the firm's planned giving program and will be spending significantly more time in the Pasadena office, it is no longer necessary for our clients to send any materials to both offices. Please use the Pasadena office as the preferred mailing address.

We are constantly looking for ways to improve the quality of services we provide our clients and believe this change will improve our efficiency. If you need to contact Ken in the Colorado office, please use the contact information below.

200 South Los Robles Avenue, Suite 320
Pasadena, California
(626) 792-2228
(626) 792-2670 Fax

P.O. Box 2945
Evergreen, Colorado 80437-2945
(720) 746-1244
(720) 294-9896 Fax
kdike@clifford1915.com