

Issuing New Gift Annuities in an Uncertain Environment



By Terrell H. Price

We were recently asked by a client if it still makes sense to issue gift annuities given the present environment and its perceived risks. Understanding that gift annuities are guaranteed obligations of the issuing charity, are the downside liabilities simply too great at the present time? To address that question, we thought we would dust off an article we wrote just two years ago when we discussed the same subject during a similarly difficult period.

As most readers know, the American Council on Gift Annuities' (ACGA) schedule of suggested maximum gift annuity rates has traditionally been based on quite conservative assumptions. Here is a quick review of those basic assumptions which have remained steady over time:

- The residuum realized by the charity upon termination of an annuity is assumed to be 50 percent of the initial gift value.
- Life expectancies are based on the Annuity 2000 Mortality Tables for females with a two-year setback in age.

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Equity Expectations: What Might the Future Hold?



By Maxwell R. Pray, CFA

As oil prices continue to rise, hovering around \$100 per barrel as of this writing, we are paying almost \$4.50 per gallon for premium gasoline. I wonder about my lunch plans...should I bring leftovers from home or go to McDonald's and order off the \$1 menu? This situation poses an even bigger question for us as investors: Is the spike in oil and gasoline prices temporary, or is something structural changing?

In our "investment world," we consider high energy prices to be a negative factor—just one of many such variables we evaluate amidst the constant flow of information available to us every day in our research and investment efforts. Other negative factors, which must be integrated into our investment outlook, include difficult federal and state budget imbalances at home, as well as recent international events such as the effects of the earthquake and tsunami in Japan, the European debt crisis, and upheaval in the Middle East and North Africa.

Despite these headwinds, some significant economic factors provide a positive outlook for investments. We see this particularly in quarterly earnings reports from 2010 and the first quarter of 2011. In one sampling of Clifford Swan stocks, first quarter 2011 revenues grew on a year-over-year basis at 11%, with earnings growth much higher than normally expected during a recovery

period. In addition, as companies become more confident in the recovery and anticipate future growth, hiring will increase and continue the trend of declining unemployment rates.

Continuing low interest rates also provide businesses the opportunity to borrow at affordable levels with more flexibility to invest in future growth. In one reflection on interest rates, 5-year U.S. Treasury notes came close to a 1% yield in November 2010—the lowest rate since the 1950's. Even as these rates may trend up going forward, we believe conditions are positive for equities.

Given that the last decade has tried the patience of investors, with two bear markets and a rebound in both cases, why do we think equity returns will be better in the next 10 years? Practically speaking, increased returns of even 1% per year have an impact over the course of a decade; compounding 1% over 10 years would provide an additional \$170,000 on a \$1 million dollar portfolio. In order to achieve this, of course, one must identify companies that will grow, and then remain disciplined to buy their stocks at the right price.

In the context of what happens around us, we continue to invest in companies that have low debt, produce solid returns on invested capital, achieve good earnings and cash flow growth, and have experienced management teams. We do not try to catch the next high-flying stock. We believe that, as Ben Graham indicated in his famous quote, "In the short run the market is a voting machine, but in the long run it is a weighing machine."

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By Peter J. Boyle, CFA, CIC

As we continue to grow and expand our investment counseling practice, we recently seized an opportunity to add Kevin J. Cavanaugh to our professional ranks. Though he traveled over 5,000 miles from Ireland to join Clifford Swan, Kevin is actually returning to his Los Angeles roots.

Prior to his stint in Ireland, Kevin spent many years in the investment businesses at CMB Investment Counselors, Cramblit & Carney, and Palladian Capital Management. While with these firms, Kevin worked with high net worth individuals and family groups, endowments, foundations and corporate retirement plans. He also performed fundamental research on equity and fixed income securities and served as the Chief Investment Officer while with Palladian Capital. It was through these prior organizations that we first developed a relationship with Kevin.

While in Ireland, Kevin started a small investment counseling firm, studied philosophy and gained unique perspectives on life and the investment markets. Kevin reminds us all about the value and responsibilities of our profession with his following thoughts:

In times of increased economic uncertainty, where can one find perspective? In my opinion, that is a primary role of the traditional investment counselor. Like a field general, the investment counselor is trained to help devise and implement policy, to think and act strategically and attend to the tactical possibilities. A good investment counselor needs more than intelligence and probability calculation. A valuable counselor has the responsibility to know how to read the signs of the times.

It is this commitment to the value of the investment counselor that fueled my enthusiasm about the opportunity to join the firm. I am delighted to be part of the team and look forward to interesting times ahead.

At Clifford Swan, Kevin will aid both our counseling and research efforts. Please join us in welcoming our newest member of the Clifford Swan family. ♦

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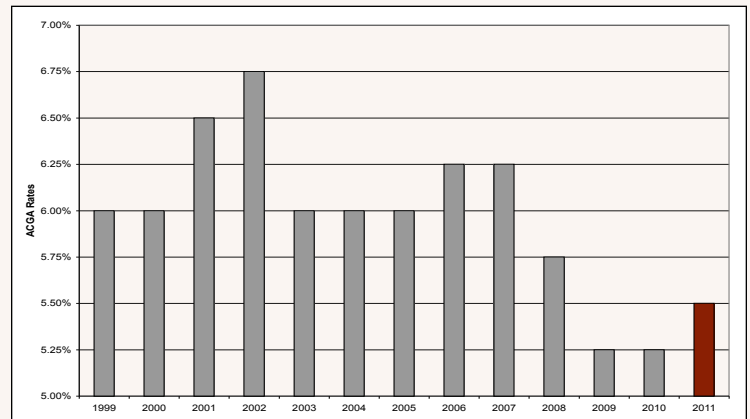
- The recommended annuity rates also incorporate projections for increasing life expectancies over time.
- Annual expenses for investment and administration remain at one percent of the fair market value of gift annuity reserves.

Recently, however, a small change in the Council's thinking produced a very slight increase in its suggested charitable gift annuity rates. For example, two years ago, when suggested annuity rates were at all-time lows, the ACGA suggested a rate of 5.3 percent for a 65-year-old donor. Today, that rate is 5.5 percent. For a 75-year-old donor, the previously suggested rate was 6.3 versus today's rate of 6.4 percent. Similarly, an 80-year-old donor's rate has moved from 7.1 percent then, to 7.2 percent today.

Although any increase in annuity rates increases a charity's liability, these increases are very small. And, they remain significantly lower compared to suggested rates from just three or four years ago (see the following chart).

Single-Life Donor Rates	2007	2009	2011
65 Year Old	6.0%	5.3%	5.5%
75 Year Old	7.1%	6.3%	6.4%
80 Year Old	8.0%	7.1%	7.2%

A slightly more significant change is represented by the annual investment return on gift annuity reserves presently assumed by the ACGA. The assumption increased from 5.25 percent, before annual expenses, to 5.50 percent. The historical progression of this assumption is reflected in the following graph.



To better understand the present investment risks a charity might take when investing newly established gifts, let's take a look at the specific investment presumptions needed to produce the new 5.5 percent anticipated target return. As it has for years, the ACGA assumes a long-term portfolio asset allocation as follows:

ACGA Long-Term Allocation Assumption	
Stocks	40%
10-Year Treasury Bonds	55%
Cash	5%

With this asset mix favoring high-quality bonds and cash, one can infer the investment results needed to produce an overall portfolio return of 5.5 percent. Specifically, the big future risk in today's investment environment is in determining what annualized return should be expected of stocks. One way to analyze the situation is to use currently available rates for both cash and 10-year Treasuries and then solve for the return required of stocks.

In today's marketplace, we find cash investments returning 1.0 to 1.3 percent, while 10-year Treasuries can yield 3.4 percent to maturity. These rates are slightly higher than those available two years ago. Given these realities, stocks must deliver an average annual return of 8.9 percent in order for the overall portfolio to provide a 5.5 percent return, as shown in the following table.

	Allocation	Return
Stocks	40%	8.9%
10-Year Treasury Bonds	55%	3.4%
Cash	5%	1.2%
Total Return		5.50%

However, with some minor adjustments to the return assumptions for bonds, the required growth from equities drops dramatically. If the yield on bonds increases from 3.4 to merely 4.0 percent, the requirement of stocks drops dramatically to 8.1 percent.

	Allocation	Return
Stocks	40%	8.1%
10-Year Treasury Bonds	55%	4.0%
Cash	5%	1.2%
Total Return		5.50%

And if we change the asset mix a bit, the required stock return improves yet again. Specifically, if we increase the stock allocation by 10 percent while simultaneously reducing bonds by 10 percent, the required stock return drops significantly as shown below.

	Allocation	Return
Stocks	50%	7.3%
10-Year Treasury Bonds	45%	4.0%
Cash	5%	1.2%
Total Return		5.50%

As investors, what conclusions might we draw from these analyses? While the simple numbers themselves seem fairly reasonable, are there other considerations? And if so, what are they?

We believe there are other factors which come to bear. Let's consider the general level of valuation we find in these asset classes at the present time. Treasury interest rates, to begin with, are at close to 50-year lows. And, although difficult to predict with great certainty in the near term, we believe interest rates on Treasuries, as well as on other high-quality bonds, are likely to trend higher rather than lower in the coming years. Even modest increases in the general level of interest rates would provide solid returns to support annuity cash flow distributions. Given these facts, is it likely one could expect a 4.0 percent return from a high-quality bond portfolio both today and in the future? In a word, yes.

How about stocks? The stock market is up 80-90 percent from its March, 2009 bottom. Should we expect more? This tends to be the area where most CFOs get nervous, especially when the recent volatility of the equity markets is so fresh in our minds. One is hard-pressed to forget daily sessions of stock market fluctuations exceeding 10 percent in 24 hours and to remain focused on a longer-term perspective.

And yet, along with an improving stock market since 2009, the economy has rebounded. Both corporate earnings and margins have improved significantly, balance sheets are stronger, GDP has returned to healthy levels, and unemployment has begun to fall while consumer spending has shown steady improvement.

There are certainly clear concerns about our near-term economic future. Fears such as inflation, government budgets and deficits, the federal debt, Mideast oil, home foreclosures, and the price of gasoline continue to dominate the news. However, we also had great concerns two years ago.

Remember the crash of the real estate market? How about the near collapse of the U. S. financial system, the Madoff scandal, TARP, massive federal stimulus

Even modest increases in the general level of interest rates would provide solid returns to support annuity cash flow distributions.

packages, and deflation? Yet, since then, we have survived without Lehman and Bear Stearns. We have yet to see any deflation. The housing market seems to have leveled off. Madoff is in jail. And through it all, stocks have managed to provide excellent returns with valuation metrics which remain quite reasonable.

So, putting it all together, should charities continue issuing gift annuities? Given the near-term economic uncertainties which lie ahead, the answer to our client's question is perhaps no easier today than it was in the spring of 2009. And yet, we do know some things for certain as we make that decision.

Investors will always face near-term risks and will likely always have concerns regarding an uncertain world. It's usually the nature of the concerns which change, not that they ever go away completely. However, for some of those same uncertain reasons, the attraction to donors of a charitable gift annuity remains high. Where else can a donor currently find a high-quality investment returning a steady, guaranteed 5.5 to 7.0 percent cash flow?

We also know the investment assumptions behind the ACGA's suggested rates remain very conservative. And when analyzed based on long-term historic data, the required investment returns seem reasonable. For example, the long-term history of the stock market suggests the odds of a 7.3 percent annualized return going forward are extremely high. Also, looking at 10-year rolling returns of 50/50 balanced portfolios suggests a similarly positive expectation. We hope that through this discussion we have provided our readers some practical considerations when gift opportunities present themselves in the near future. ♦

Equity *continued from page 1*

Rather than chase momentum created by current investment trends and emotional swings in the market, we invest in companies that have “weight” for the long term, much as one would if considering investment in a private business.

Let’s put some numbers to this philosophy. If we can buy a solid company (e.g. a business) for \$100, and earn \$8 per year, we think that would be a good investment. If we can take some of those earnings and reinvest \$5 in the business while pocketing \$3, then five years from now that \$100 investment could be worth \$127. While we grow that business at a modest 5% per year, by the end of year five we’ll be earning \$9.72 or more, pocketing \$3.65 in dividends and still reinvesting in the business. That sounds like a good game plan to us. Please refer to the table below which illustrates the numbers in detail.

In the above example we mention “pocketing” some of the investment earnings through collecting dividends. We continue to like companies that pay dividends to shareholders—a very

expand at a rapid clip, we like to see that company reinvest the earnings and cash flow rather than pay some of it out to shareholders. Conversely, for companies that are more mature, and are earning good returns, we like to see some of those returns come back to shareholders in the form of dividends (and/or stock buybacks).

In the earlier example, we outline an earnings growth rate of 5% for a single company. We can also estimate earnings from a broader viewpoint. Over longer periods of time, we expect companies to expand and grow at rates close to economic GDP rates of 2-3%, plus inflation of 2-3%, plus gains from operating efficiency of 1-2% and a dividend of 2-3%. Add those up and we can foresee returns of 7-11% over the next decade for equities. One key effort is finding those companies that are in it for the long run, and not just “out to get some votes” from the investing public in a momentum play.

Going forward, it is significant that even with uncertainty around political unrest in the Middle East and Africa, government debt (at all levels), and higher energy prices, companies are running very efficiently with

unemployment insurance are declining, with unemployment at 9% in April 2011, down from a peak of 10.1% in October 2009. As housing prices stabilize and the fear of job loss lessens, the consumer is beginning to spend more. Whether they’re buying a tube of toothpaste in the back country in Brazil, a car in India, a cell phone in China, opening a bank account in Indonesia, or flying from LAX to London, consumers support companies that produce great products. All of us, as consumers and investors, benefit from good returns on investments as they lead to better economic growth and also to positive returns in equity prices over time. ♦

	Year 1	Year 2	Year 3	Year 4	Year 5
Investment (Worth *BOY)	\$100.00	\$105.00	\$110.25	\$115.76	\$121.55
Earnings Growth	5%	5%	5%	5%	5%
Earnings	\$8.00	\$8.40	\$8.82	\$9.26	\$9.72
Earnings Yield	8%	8%	8%	8%	8%
Dividend	\$3.00	\$3.15	\$3.31	\$3.47	\$3.65
Dividend Yield	3%	3%	3%	3%	3%
Investment in Business	\$5.00	\$5.25	\$5.51	\$5.79	\$6.07
Cumulative Return (*EOY)	8.0%	16.4%	25.2%	34.5%	44.2%
Investment (Worth *EOY)	\$105.00	\$110.25	\$115.76	\$121.55	\$127.62

At the end of 5 years, the investor has collected \$16.58 in dividends and the company has invested \$27.62 back into the business, adding up to a total return of 44.2%. * B/EOY = Beginning/End Of Year

important source of investment return. In the example, we can see that, of the 44% return from the investment, about 17% of that return comes from dividends and 27% from growth in the investment. We also invest in companies that reinvest most or all of their earnings in the business and pay out small or no dividends. For example, if we invest in a smaller or younger company with more potential to

high margins. Emerging markets continue to grow, and consumers are spending. The driver for much of our growth is consumer spending, which makes up 60-70% of our economy as measured by a percentage of GDP. In the recovery from what some people call the Great Recession (2007-2009), the consumer has been more frugal than in recent recoveries due to the difficult housing and employment markets. New claims for

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