Charitable Annuities and Shrinking Reserves

BY K. GENE CHRISTIAN

Timing is everything. You've heard that adage before. These past 10 years have been both a golden era for organizations that issued charitable annuities and, simultaneously, one of the scariest periods to manage the annuity reserve fund. What has happened to make that so?

As everyone knows, the equity markets grew at a blistering pace through most of the late '80s and all through the '90s. On average, the Standard & Poor's 500 Index increased by a compounded annual rate of return of 18.2 percent each year during the '90s — unprecedented in our nation's history — while steadily falling long-term interest rates gave a boost to bond prices. This resulted in dramatic gains for long-term investors.

However, during this same period, stock dividends dropped from an average of 3.5 percent down to just over 1 percent, while CD, bond, treasury and money market rates began moving toward 40-year lows.

The result? Donors with significant stock positions and donors living on Social Security and CDs became quite interested in high-paying, fixed-rate charitable annuities. Many organizations have reported great success during the past 10 years writing more gift annuities at larger funding amounts than ever before. That's good news!

Unfortunately, many of those same organizations didn't become successful in their gift annuity efforts until near the end of the equity boom. Stop and consider your organization's situation. How many annuities did your organization write between 1987-1992, versus the same period 10 years later (1997-2002)?

Today those same organizations are facing a sobering reality. Not only did their gift annuity reserve fund miss the most dramatic stock market increase in U.S. history, that same reserve fund very likely *did* experience the most significant stock market decrease since the Great Depression. Why?

Because unwittingly staff, finance committees and financial institutions followed planned giving policy that dictated a significant portion of the gift annuity reserve fund be invested in equity positions. Again, consider your own organization's situation. What do your planned giving policy and your donor disclosure forms say about gift annuity reserve investments?

So the stock market fell 43 percent during a three-year period between 2000-2002 — the same time many charitable organizations were beginning to experience real success in securing new gift annuity commitments. Timing is everything.

Case Study

Consider the following case: Mega Charity has a national presence and has become extremely well known for current giving programs that include gift clubs, banquets, regional retreats, grant writing and so forth. About eight years ago, they decided to jump on the planned giving band wagon.

So they hired a PG director, established a working budget, put together some marketing material, secured a gift annuity license and got started. From 1998-2000 they "booked" five gift annuities totaling $368,500 in face value.

The donors were all older (a good thing, they surmised) with payout rates ranging from 8.5-11.4 percent. However, in aggregate, the actuarial life expectancy of the annuity donors was 10.25 years. (NOTE: This doesn't include any upward adjustment for the additional longevity gift annuity donors seem to possess.)

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Storytelling

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I came to the conclusion that these two professions have a lot in common. They both require a repertoire of stories; an understanding of your audience so you can choose the right story; the ability to observe and respond to audience feedback; and the desire to arrive at a greater understanding and, hopefully, appreciation of your audience.

If you're not practicing narrative philanthropy, then you may be missing out on one of the most effective "power tools" you can have in your fund-raiser's tool kit — the power of story. ◆

Norma Cameron manages the planned giving program at the University of Manitoba in Winnipeg. ncamero@ms.umanitoba.ca

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Since Mega Charity was fairly new to planned giving, and weren't yet sophisticated on issues involving risk analysis (see Brian Clontz's and Donald Behan's extraordinarily well-written article in the January-March 2004 issue of *The Journal of Gift Planning*), they simply established an account at the local bank and turned the money over for management. The bank's portfolio design was a fairly standard 60/40 equity to income split. In other words, the "lion's share" of their gift annuity reserve fund was invested in low-cost, high-quality equity mutual fund(s). So what's been the result?

Today, because of the aforementioned steep downturn in the equity markets, coupled with the unusually high mandatory annuity payout amounts, Mega Charity has only $207,000 remaining in its reserve fund — nearly a 44 percent reduction from the funding amount.

As a result, it is statistically probable* that Mega Charity will exhaust its gift annuity reserve fund and ultimately be required to dip into its other general assets in order to make the annuity payment obligations.

In the final analysis, in order for Mega Charity to stop further capital erosion in its reserve fund, the fund would have to earn 15.25 percent on average each year on its remaining $207,000 in order to make $31,500 in annual annuity payments. Of course, that likely will not happen.

So, to "combat" this eventuality, should Mega Charity now put even more money into equity positions hoping to "catch up," or do they go the conservative route and put it all in bonds? A conundrum to be sure!

Again, timing is everything. Most charitable organizations have become highly focused on harvesting the windfall associated with gift annuities, giving little attention to the underlying investment strategy in their annuity reserve funds. Even the larger, more sophisticated planned giving operations are quietly contending with serious underfunding issues related to their gift annuity reserves today.

So, what could Mega Charity have done differently in the beginning? Or more importantly, what can they do now to "right the ship"? I suggest there are two steps to consider.

First, a deep and detailed assessment must be done to determine what risks might exist today, particularly with the "block" of annuities that were written during a six-year period, 1997-2002.

Second, and more importantly for the future, every charitable organization that is issuing gift annuities must stop and carefully consider its current gift annuity reserve fund investment policy.

If the organization is going to invest a portion of its gift annuity reserve fund in equity positions, careful analysis must be done regarding what equity strategy is most suitable. Because payout requirements are high and static, the most important goal in equity investing for a gift annuity program must be to minimize the potential for significant capital loss.

I've personally become an advocate for strategies that 1) index and 2) write covered calls against their index investments. The details of how writing covered calls works is beyond the scope of this article, however the results are worthy to point out. During the last 15 years where we have experienced tremendous market swings, this strategy has resulted in overall investment returns commensurate with the stock market, but with significantly less volatility and down-market exposure.

Positive Results

For many, the notion of using option strategies as part of their gift annuity reserve program would be akin to buying pork belly futures. It just sounds speculative. However, objective data suggests otherwise. For example, the Gateway Fund, ticker symbol GATEX, might warrant consideration because it is an over-the-counter mutual fund that every organization can easily purchase. Get a Gateway prospectus and talk with someone in your area, or on your investment committee, about the appropriateness of this strategy in your situation.

Alternatively, there may be a professional in your area that provides a similar investment strategy. W.R. Ericksen & Associates LLC is a Pacific Northwest firm that is building a strong presence in the investment community by managing investments using these strategies. So I asked the folks at W.R. Ericksen & Associates to provide a back-test on the performance of a covered call program verses a plain investment in the S&P 500 index during the past 15 years.

Keep in mind as you review the following results that the S&P 500 index outperforms the majority of actively managed mutual funds every year. So, if your organi-

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Understand institutional priorities, both in campaign and out, especially when conceiving marketing ideas. Try to stick to the priorities that have been established when you are working with donors, especially those who want to designate their gifts for something you don't want or need. Make an effort to educate your donors about the current funding priorities and gauge their level of interest. If there's only interest in their pet project, then have one more conversation with finance or your director of advancement before accepting the gift.

Remember that these are future gifts, so try to designate them as broadly as possible with the fewest restrictions. Ask yourself, "Will the program be viable in the future?" If there is a restriction, try to use language like "with a preference for" and insert an escape clause that will save your organization from going to court in order to be able to use the funds. Most donors will understand the need for flexibility.

Document what you set up with donors for future gifts. Neither you nor your CFO may be there when this gift terminates, so put it in writing. Consider using an inter-

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zation had the equity portion of its gift annuity reserve invested in anything other than an S&P 500 index fund during the last 15 years, your reserve fund likely underperformed the index results noted below.

The first chart (A) shows a 15-year back-test of a covered call program along with the results of the S&P 500 index. The second chart (B) shows the decline each fund suffered in the recent bear market.

The CBOE S&P 500 BuyWrite Index℠ (BXM℠) is designed to represent a proposed hypothetical buy-write strategy. Like many passive indexes, the BXM Index does not take into account significant factors such as transaction costs and taxes and, because of factors such as these, many or most investors should be expected to underperform passive indexes. For more information, visit www.cboe.com.

Because a covered call writing program would have avoided the dramatic losses that occurred during the recent, prolonged down market, the gift annuity reserve fund would have been "protected," thereby ensuring payments to annuity donors for a much longer period of time.

Covered call writing discounts the art of investing (which again produces poorer results than the benchmark at least 70 percent of the time) and is rather formulaic and mathematics driven. In other words, the results noted above are not anomalies that are apt to change during the next 15 years. As long as the formulas are followed, these returns should be replicable indefinitely.

The mathematics behind the covered call writing on the S&P Index virtually ensure a) increased performance in a down market, b) better-than-market performance in a flat market and c) meaningful participation in an up market.

CHART A

Covered Call Program vs. S&P 500 Index Performance: June 1988 – Dec 2003

	Annualized Returns	Annualized Standard Deviation
Covered Call Program	12.50 %	9.9 %
S&P 500 Index	12.20 %	14.7 %

CHART B

Covered Call Program vs. S&P 500 Index Total Return: Jan 2000 – Dec 2002

	Total Return
Covered Call Program	-11.10 %
S&P 500 Index	-43.10 %

Conclusion

Virtually all charitable organizations need to rethink the equity exposure they have in their gift annuity reserve funds. While dramatic and prolonged, market downturns like we experienced during the three-year period 2000-2002 may not occur again for 25 years (it was the mid-70s previous to 2000-2002), clearly this recent period has taught us all that the staff/committees/institutions who superintend over gift annuity reserve funds must more completely understand the risks associated with equity investing in an environment where high, mandatory payouts are required.

In the final analysis, adjustments are likely warranted in most every gift annuity reserve fund that maintains equity exposure, regardless of past or future market performance. ◆

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* Based on projected annual investment returns of 5 percent (fund exhausted in 9th year), 7.5 percent (fund exhausted in 10th year) and 10 percent (fund exhausted in 12th year).

K. Gene Christian is a principal in the company Charitable Estate Planning Northwest (CEPN), a full-service planned giving consulting company based in Portland, Oregon. Gene is past president of the Northwest Planned Giving Roundtable and a current member of *Planned Giving Mentor's* National Board of Consultants. gene@cepn.intranets.com

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