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Matter of Trusts - Working Effectively with Your Trustee

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The investment management of trusts affects cemetery and funeral home operations through the interplay of several factors, including income, cash flow and tax consequences. Using case studies, a financial analyst and fund trustee explores some key issues and offers strategies for addressing them.

Matter of Trusts

Working Effectively with Your Trustee

by Marcia Williams

Suppose in mid-1993 you had an account from which you wanted to receive income. You invested in a 10-year Treasury note which was yielding about 6 percent. So, for each $100,000 invested, you received $6,000 in annual income.

At the bond's maturity in mid-2003, you looked to reinvest and found that a comparable bond was offering only a 3.5 percent yield. This will produce $3,500 per year in income, a decrease of more than 40 percent in raw dollars and an even greater decrease in purchasing power when the impact of inflation over those 10 years is taken into account.

Marcia Williams

By structuring the account for maximum current income in 1993, you placed it fully at the mercy of interest rates at the time of maturity. With only bonds for investments, the account included no element to provide growth to support the income level over time.

This is not simply an academic issue. This is a real concern, as any of you with endowment care trusts know. Over that same 10-year period, the cost of maintaining your property did not decline by 40 percent. This example illustrates the practical importance of the investment management of cemetery and funeral trusts. Let's look at some other situations.

CASE STUDY 1: MAUSOLEUM PROJECT. You decide to embark on a mausoleum construction project, establishing a trust to handle the funds from preconstruction sales. Your endowment care trust is running smoothly. Should the trustee invest this new fund in the same way the endowment care fund is invested?

Issue: All trusts are not created equal.

Strategy: Trustee and owner must recognize the subtle differences among the various types of trusts and how the trustee's decisions impact the owners' operation of their facility. See Table I (page 2) for a summary of the key characteristics of four trust types.

In this example, the key difference between the two trusts is that the endowment care account is expected to exist in perpetuity whereas the preconstruction account will exist only through construction of the project. Because the time horizons are vastly different, the two funds require different investment approaches. (See "Trust's Purpose Will Affect How Its Funds Are Invested" on page 3 for a discussion of the investment mix for different types of funds.)

CASE STUDY 2: LIQUIDITY NEEDED. You have an audit performed and find that your merchandise trust needs to distribute 30 percent of assets since those contracts have been fulfilled, yet the funds have not been withdrawn. The account has approximately 5 percent in money market funds, meaning that to make the distribution, the account will need to sell an additional 25 percent of its holdings.

Issue: The need to maintain an appropriate cash level in the trusts.

Trustee and owner must recognize the subtle differences among the various types of trusts and how the trustee's decisions impact the owners' operation of their facility.

Strategy: Anticipate and communicate. While a trustee can target a cash level, given the type of trust and its expected needs, it cannot anticipate the unexpected. Once you become aware that a large distribution will be needed, it is important to communicate this to the trustee. During that discussion, you can discuss the advantages and disadvantages of various alternatives. For example, it is possible to:

• Sell some holdings in anticipation of the distribution.

• Make the distribution over time, thereby smoothing the effects of taxes and any impact on the portfolio.

• Make the distribution at a later date to allow for a more orderly sale of holdings.

• Sell at one time if the ramifications to the structure of the portfolio and the tax consequences are not problematic.

In this case, you and the trustee each have part of the picture. The decisions each of you makes affects the other, so it is crucial to discuss the alternatives before acting.

CASE STUDY 3: MULTIPLE TRUSTS. You operate six properties with 20 trusts, varying in size from a $50,000 funeral

TABLE I

TYPE OF TRUST	TIME HORIZON	DISTRIBUTIONS	COMMENTS
Endowment care	Perpetual	Income only	
Preconstruction	Finite—life of project	As construction completed	
Preneed merchandise	Long-term	At fulfillment or cancellation of contract	Property owner bears risk if funds are not sufficient for services and merchandise.*
Preneed funeral	Long-term	At fulfillment or cancellation of contract	Contract holder bears risk if funds are not sufficient for services and merchandise.*

* *May vary state-to-state depending on local laws. Our comments address the general situation.*

home merchandise trust for a property not actively selling preneed to a $2 million endowment cemetery care account.

Issue: The complexity of keeping up with 20 trusts.

Strategy: You and the trustee should determine a comprehensive plan to address the needs of the various trusts. This starts with the portion of funds in each type of trust allocated to bonds, stocks, cash and other sectors. Then, those allocations must be implemented with specific investments—individual stocks and bonds or mutual funds.

In the most streamlined form, the trustee may select a set of mutual funds to use across accounts of every size. A slightly more involved strategy is to use mutual funds for the accounts below a given size and individual investments for the larger accounts. Both of these are valid approaches; the choice is really a matter of individual preference.

The simpler approach of using a selection of funds for all accounts, regardless of size, can be particularly efficient when a legislative change mandates that each location maintain both pre- and post-change trusts.

This happened with some Ohio trusts in October 1999. The trusts existing before the law's enactment became closed to new contributions, which were to be made only to trusts established after the law took effect. This led immediately to "paired" trusts, one much smaller than the other, with similar objectives. With a target asset allocation and mutual funds or other investments that can be scaled across account sizes, two accounts can be invested the same way. Table II (page 3) gives one set of possible allocations.

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CASE STUDY 4: ACQUIRED TRUSTS.

You've acquired a new property and therefore its trusts. The holdings in those trusts are very different from the target investments which you and the trustee have agreed on.

Issue: Getting from here to there.

Strategy: The trustee must recognize that dealing with this type of transition means taking a long-term view, putting a plan in place and then following it and monitoring the results.

My firm had a situation like this with a trust which held primarily limited partnerships acquired by a prior trustee when they were in vogue. The strategy we had in place did not include any limited partnerships, but we were constrained from selling them by two factors.

First, there was not an active market for partnerships. Second, some of them showed substantial losses; if we were to sell them all at one time, the losses generated could have caused the trust to be underfunded, possibly drawing the attention of state regulators.

Taking a long-term view, we simply chipped away at the trusts' limited partnership holdings. First, we sold those for which we could get prices that would not create too much loss. We then continued to scout resources for selling them, working with a number of secondary market makers to sell the balance of these limited partnerships.

The process took several years, but the investments in that endowment care trust now are aligned with the target worked out with the owner.

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Through these examples we have seen how investment decisions for cemetery and funeral trusts can be made to enhance the operation of the facility and simplify life for the owner.

This can be done through candid discussion of parameters for investments and any unusual activity which may be anticipated, deliberate structures for the various types

TABLE II

ASSET CLASS	FUNDS*	PRENEED FUNERAL ALLOCATION	PRENEED MERCHANDISE ALLOCATION	ENDOWMENT CARE ALLOCATION	PRE-CONSTRUCTION CONSTRUCTION ALLOCATION
Money market fund	Federated prime obligations	5 percent	5 percent	5 percent	100 percent
Indexed stocks	Vanguard Index 500	10 percent	20 percent	10 percent	—
Managed US stocks	Clipper	10 percent	20 percent	15 percent	—
Intermediate bonds	Vanguard GHMA	50 percent	35 percent	50 percent	—
Short-term bonds	Federated ultrashort	25 percent	20 percent	20 percent	—

** These are the funds used to calculate the performance figures referenced in the article. Past performance is not an indicator of future performance.*

What a Trust Is For Will Affect How its Funds Are Invested

Table II provides a summary of portfolio structure for the various trusts a funeral home or cemetery might have. The guidelines listed serve as a starting point for structuring the portfolios. There will be variations for different owners due to their different situations. Let's look in detail at the similarities and differences among these.

• **Endowment (perpetual) care:** This targets 25 percent in stocks, 70 percent in bonds and 5 percent in money market funds. The bonds are there to provide current income and the stocks to provide the opportunity for growth in the fund. This is one way to counterbalance the problem illustrated at the opening of the main article with the 10-year Treasury note investment.

Looking at this portfolio mix over the 10 years ending in June 2003, one finds that it returned an annualized 8.7 percent. This figure includes income and gains on holdings. Despite the fact that it includes a tough bear market, its worst one-year return was down only 0.7 percent and the best return was up over 23 percent.

• **Preneed merchandise:** This targets 40 percent in stocks, 55 percent in bonds and 5 percent in money market funds. We include a higher allocation to stocks in these trusts since they are not restricted to disbursements of income only. Moreover, these are similar to defined-benefit retirement plans in that the property owner bears the risk if the funds are not sufficient to pay the obligations.

With the higher allocation to stocks, this mix has returned 9.8 percent annualized over the 10 years ending in June 2003. The higher allocation to stocks also led to a worst year return of -5.7 percent and a best year return of over 27 percent.

• **Preneed funeral:** This targets 20 percent in stocks, 75 percent in bonds and 5 percent in money market funds. We allocate less to stocks in this category of trust since the assets belong to the contract holder. Thus, that person bears the risk if the amount is insufficient to pay for the services subscribed, and he/she reaps the benefit if the account grows larger than needed to pay for the services.

Over the 10 years ending in June 2003, this mix has returned 8.3 percent annualized with the smallest annual return -0.5 percent and the best return 22.3 percent.

—Marcia Williams

of trusts and selection of investment vehicles to span trusts of different sizes.

Marcia Williams, CFA (chartered financial analyst), is founder and president of Independence Trust Co., Franklin, Tennessee. She served as director of the global Financial Analysts Federation and as president of the Nashville Society of Financial Analysts. Her work has been published in the Tennessee Society of CPAs Journal, Nashville Business Journal, CFA Digest, and International Society of Financial Analysts Digest. She can be reached at (615) 591-0044.