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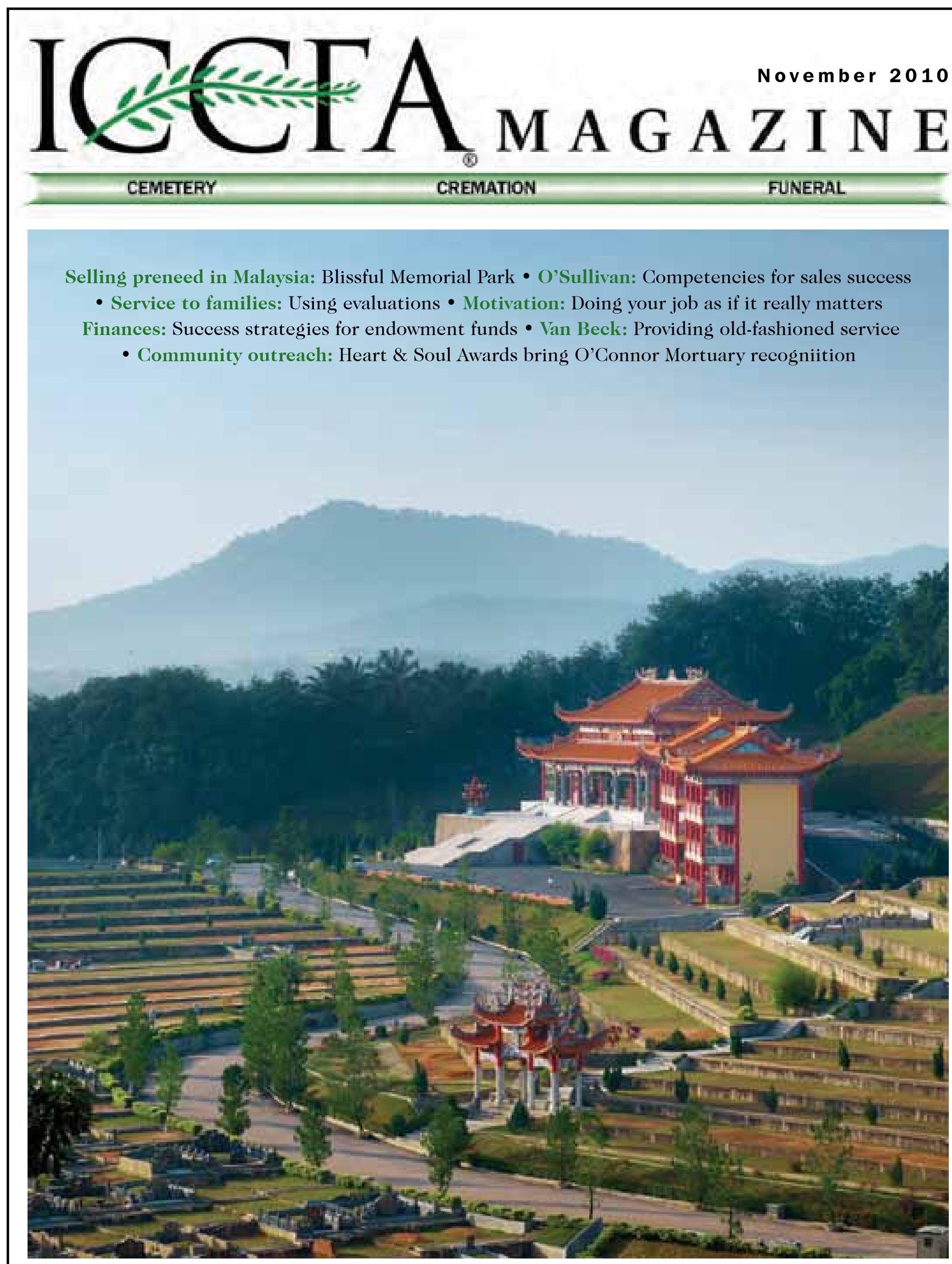
Success strategies for endowment funds *as seen in ...*



ICCFA MAGAZINE

November 2010

CEMETERY CREMATION FUNERAL

Selling preneed in Malaysia: Blissful Memorial Park • **O'Sullivan:** Competencies for sales success • **Service to families:** Using evaluations • **Motivation:** Doing your job as if it really matters
Finances: Success strategies for endowment funds • **Van Beck:** Providing old-fashioned service • **Community outreach:** Heart & Soul Awards bring O'Connor Mortuary recogniition

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ICCFA Magazine Author Spotlight

➤Williams, a chartered financial analyst, is founder, CEO and president of Independence Trust Co., a federally chartered trust company based in Franklin, Tennessee which works with cemetery and funeral trusts across the country as trustee and investment manager.

➤She sits on the City of Franklin pension and investment board, has served as a director of the global Financial Analysts Federation and as president of the Nashville Society of Financial Analysts.

➤She serves on the Government and Legal Affairs sub-committee of ICCFA and has served as supplier representative to the board of the Cemetery Association of Tennessee. Her work has been published in the ICCFA Magazine, Tennessee Society of CPA's Journal and the Nashville Business Journal.

***Author's note:** Special thanks to Marshall L. Bartlett, senior vice president of investments at Independence Trust, for his assistance on this article.*

If scrupulously following your state's endowment fund regulations isn't enough to make sure your cemetery will have enough money far, far into the future, what else do you need to do?

Success strategies for endowment funds

In the August-September 2009 issue of ICCFA Magazine, Daniel Isard wrote a thought-provoking article making the case that an endowment care trust which meets its regulatory funding requirements may still not be adequately funded on a business basis and urging cemetery owners to consider this issue in their planning. This article discusses some strategies to consider in addressing this potential issue.

In particular, we will look at:

• Considering the investment structure of the endowment care trust, including the allocation between stocks and bonds and the nature of the specific investments within those sectors.

• Seeking legislative changes to allow total return trusts, rather than ones which pay out only income.

• Reserving funds, either in trust or in a non-trust account, in addition to those which regulators require to be trusted.

Note that we have made simplifying assumptions in our illustrations and rounded off numbers to make the presentation more user-friendly.

Investment structure

In his article, Isard considers a representative cemetery with 32,000 interments once fully subscribed and estimates that it would take $440,000 annually to maintain the property. In current dollars, if your trust generates income of 2 percent, you would need to have $22 million, or $687.50 per grave site, in the trust account in order to generate this level of income.

That is for today; it gets worse as time goes on. If the trust is invested in only bonds, certificates of deposit and other fixed-income securities, in just a few years of even modest levels of inflation, the income it generates will not be sufficient to maintain the property.

Investment structure: Return assumptions

Consider some different interest rate scenarios and how much money would be needed to generate $440,000 in income under each, as indicated in Table 1.

Clearly, the size of the trust required to generate that income level is highly sensitive to the interest rate. Even an increase from 2 percent to 3 percent reduces the size of the trust required by a third. An increase from 2 percent to 4 percent halves the size of the trust required.

TABLE 1

Interest rate	Total trust size	Trust assets per grave site
2 percent	$22,000,000	$690
3 percent	$14,700,000	$460
4 percent	$11,000,000	$345
5 percent	$ 8,800,000	$275
6 percent	$ 7,300,000	$230

Even in our current extremely low interest rate environment, you can earn 3 percent on a 10-year government bond and incrementally more on a government agency or corporate bond.

Hold this thought for the next section, where we consider possible legislative changes which could make a 4 percent or 5 percent rate a possibility.

Investment structure: Asset mix assumptions

If this endowment trust is invested only in bonds, certificates of deposit and other fixed-income investments, it would not be expected to grow over time. If it stays the same size, the income generated by it cannot be expected to keep pace with even a modest level of inflation.

But consider what happens if you change the mix of assets. In Table 2 (on page 38) we look at estimates of the income generated and also the growth of the principal value from owning only stocks, owning only bonds and owning two possible mixes of those assets.

Compare owning only bonds to a blended portfolio obtained by adding just a 20 percent allocation to stocks, an asset class which offers the opportunity, if not the guarantee, of growth over time.

Annual income is slightly lower ($1,000/year), but at the end of only five years, the principal value of the portfolio is expected to have grown enough ($66,700) to more than offset this lower income. These differences can be seen graphically in charts 1 and 2 (on page 38).

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TABLE 2

Percent stocks	Percent bonds	Expected income yield	Expected growth of principal	Annual income per $1 million	Value of $1 million in 5 years*
100%	0%	2.4%	6.4%	$24,000	$1,363,700
0%	100%	2.9%	0% **	$29,000	$1,000,000
20%	80%	2.8% ***	1.3%	$28,000	$1,066,700
50%	50%	2.7%	3.2%	$27,000	$1,170,600

* This assumes that the income has been paid out.
** Based on 20-year S&P 500 returns through December 31, 2009, and current income levels.
*** Based on August 2010 10-year U.S. Treasury note.

CHART 1: Growth of principal over time

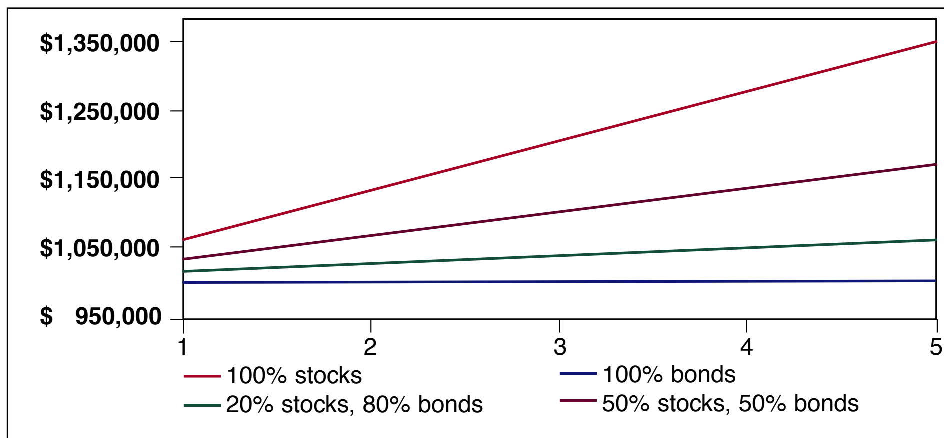

CHART 2: Expected annual income

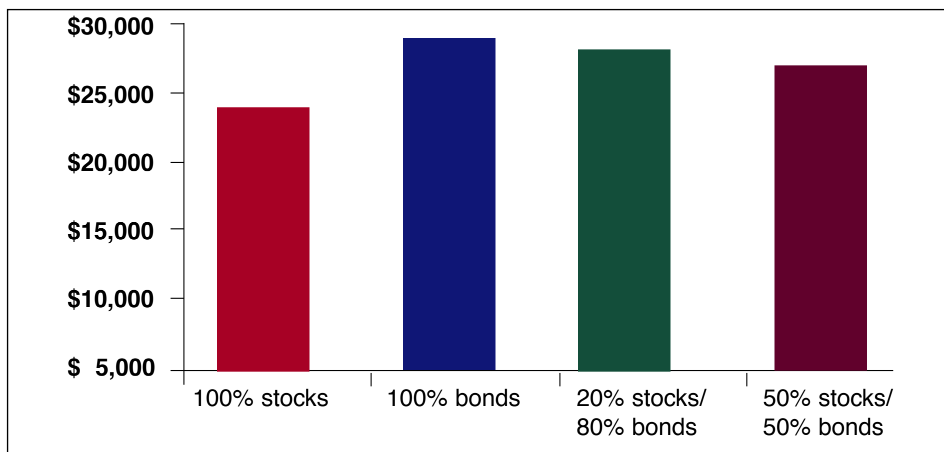

TABLE 3

	Trust	Non-trust
Convenience	Very. Just send additional funds to existing trust.	Requires a new account be established and monitored.
Creditors	Protected from claims of creditors	Part of general corporate assets and subject to creditors' claims.
Flexibility	Subject to all regulatory restrictions.	Maximum flexibility. No regulatory restrictions.
Investments	Subject to trust requirements and restrictions.	Unrestricted.
Taxes	Taxed as own entity. $5/gravesite offset for income protects up to $160,000 in annual trust income.	Taxed as part of general corporate assets.

➤ from page 36

Investment structure: Income opportunities

Table 2 and charts 1 and 2 are based on overall stock market returns. It is possible within the stock market sector to choose investments which deliver more of their return in dividends than the overall market.

Using the Dow Jones Select Dividend Index (whose members are evaluated in terms of their dividend payment) as a proxy for these, we find it has a dividend yield of 4.1 percent vs. only 2.4 percent for the broader stock market, as represented by the S&P 500.

By selecting dividend-paying stocks, one can produce more income than the overall stock market and more growth opportunity than the bond market. This allows for higher income from the equity portion of your portfolio.

Further, by using a mix of fixed-income investments—certificates of deposit, agency bonds, corporate bonds or funds—you can get higher interest income than from pure treasury bonds and notes.

Seeking legislative changes

To this point, our discussion has assumed that the regulatory structure only allows the withdrawal of income—dividends and interest. However, Tennessee regulations for cemetery endowment care trusts permit a total return-based withdrawal.

For instance, a Tennessee endowment care trust can elect, under certain circumstances, to withdraw up to 5 percent of the value of the trust at the prior year end, irrespective of whether it earned that much in interest, dividends, realized or unrealized capital gains. This means that in making investment elections, one can structure the portfolio for growth and income and not be constrained by the portion which comes from actual dividends and interest.

However, even under this structure, it is wise not to take out more than the trust is returning, since you want the principal value to grow over time.

Consider Table 2 to see the advantage. In the 50/50 stock/bond portfolio, you have a 5.9 percent expected annual return, 2.7 percent from dividends and interest and 3.2 percent from growth of principal.

If you are in a state which permits you to withdraw only net income, you can withdraw only 2.7 percent or $27,000 for a $1 million trust (ignoring expenses). In a

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total return or unitrust state, you could withdraw 5 percent or $50,000, or 85 percent more than the actual income generated. This is a significant benefit to the property being maintained by the earnings from the endowment trust.

A number of states have adopted a similar type of unitrust election for personal trusts. If your state does not permit this for endowment trusts, it may be worth talking to your state association about pursuing legislative changes to allow this option, particularly if your state is one which has made the change for personal trusts.

Reserving additional funds

The last strategy to consider is that of reserving funds in addition to those which are required by regulation, so that once your property is fully sold, the care trust has sufficient funds to maintain it. The additional funds can be reserved either in trust or outside of trust. Table 3 (on page 38) compares the two methods.

Conclusion

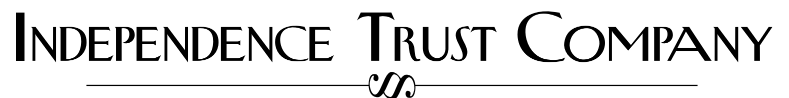
Realizing that the amount required by regulators to be put into an endowment care trust may not generate enough income to maintain that property once it is fully sold, we have considered several strategies to address this issue.

We saw that the allocation of investments in the trust can make a big difference on how much income it generates. Moreover, the nature of the particular investments can also make a substantive difference in the amount of income generated.

Beyond these investment strategies, you might want to seek legislation to permit disbursements based on a percentage of the trust assets, rather than being constrained by receipts of dividends and interest, since that can significantly enhance the amount of earnings which can be generated to support the property.

Finally, conservative cemeteries may wish to reserve additional funds to meet the future needs for funds to maintain the property. We compared the advantages and disadvantages of reserving those funds within the existing endowment care trust vs. outside of that vehicle.

This article is intended to raise and address general issues for consideration. Before acting on these matters, be sure to discuss the particulars of your property's situation with the appropriate legal, tax and trust advisors. ❑



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