

INVESTING PLANNED GIFTS IN MUTUAL FUNDS

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KASPICK & COMPANY has developed an investment approach that brings the benefits of broad asset class diversification—higher expected returns and reduced volatility—to charitable trusts. Through the years, two important principles have guided the firm's philosophy. First, our approach to portfolio management shifts the emphasis from security selection to asset allocation and portfolio construction. Research has shown that it is the portfolio design—that is, the asset allocation of the portfolio—that explains over 90% of the portfolio's returns. Our work focuses on how different mixes of asset classes affect the risk and return profile of the portfolio and of the beneficiary's payments.

Second, to implement our portfolio designs, we use low-cost, institutional quality mutual funds. Donors and prospective clients often ask us why we invest planned gift assets primarily in mutual funds. Often, those who ask believe that using mutual funds is more costly and will result in large tax liabilities. This is not necessarily true; moreover, there are many benefits to using mutual funds that donors and beneficiaries should consider.

Advantages of Mutual Funds

Perhaps the most significant benefit is that by investing trusts in carefully selected portfolios of mutual funds, we are able to **diversify them across asset classes, manager styles, and individual securities**. This level of diversification is difficult to achieve in separate accounts unless the accounts are very large. Portfolio diversification is important because it allows trusts to achieve higher returns at lower levels of risk. Our diversified portfolios also include asset classes designed to act as hedges against unanticipated deflation and inflation, which better protect beneficiary payments against these two extreme economic environments. This is the same approach used today by large endowments and pension plans. By using mutual funds, we

are able to diversify portfolios of all sizes, whereas to similarly diversify a separately invested account, one would likely need in excess of \$30 to \$40 million.

Using mutual funds allows KASPICK & COMPANY to **invest with the best managers** in each asset class. A separately invested account would be managed by one person and the portfolio would receive only that person's performance. We rarely find the best managers at the same firm. Few managers, for example, are expert at both high yield bonds and small cap stocks. Today, we use funds from many different fund families, including Vanguard, Morgan Stanley, Dimensional Fund Advisors, and Harbor. The only way to access many of the portfolio managers we have selected is through their mutual funds.

Mutual funds also provide **daily pricing and daily liquidity**. Portfolio assets can be invested immediately, and withdrawals can be made on any day. Assets remain fully invested at all times. Furthermore, because of this liquidity, rebalancing a portfolio or making changes can be done efficiently and quickly.

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Each trust is maintained in its own custody account, with its own auditable record of transactions. Custody costs are essentially eliminated and trust assets are never commingled. **Detailed statements** on a trust's asset allocation, performance, and portfolio transactions are available on any day, for any period.

The large asset base of most mutual funds generates economies of scale in investing and trading, which **reduces brokerage costs**. And mutual fund portfolio managers can use **more sophisticated asset management strategies** to add value relative to small individual accounts.

Misunderstandings About Mutual Fund Fees

Much of the criticism associated with using mutual funds to invest planned gift assets is directed at the

costs of funds, with the argument being that using funds is unavoidably more costly. However, with the right approach an investment strategy can be implemented at relatively low cost using mutual funds. KASPICK & COMPANY delivers a low-cost investment solution to planned giving programs.

In addition to selecting mutual funds with strong historical performance records and disciplined investment philosophies, KASPICK & COMPANY uses funds with low expense ratios. We never pay loads of any kind or invest in funds that charge 12b-1 fees. We use primarily institutional mutual funds that have lower fees than funds that are targeted at retail investors. Our Growth portfolio (71% stocks and 29% bonds) has a weighted average expense ratio of 0.53%. Based on information from Morningstar, the average mutual fund investor would pay 1.28% in expenses for a similarly diversified portfolio, before considering any loads that are common with retail funds.

Expense Ratio Comparison		
Objective	Kaspick & Co. Portfolios	Morningstar Averages
Aggressive Growth	0.56%	1.33%
Growth	0.53%	1.28%
Growth/Income	0.51%	1.23%
Income/Growth	0.46%	1.18%
Income	0.38%	1.11%
High Income	0.36%	1.09%

A separately invested account at a money management firm or brokerage house would typically incur layers of fees that in many cases would result in total fees that are higher than those incurred using carefully selected mutual funds. These include asset management fees, custody charges, and brokerage costs, which are often at retail levels.

Mutual Funds and Capital Gains

Another frequent criticism of mutual funds is that they distribute capital gains to investors, which are then taxable. Many investors in 2000 were confronted with the unpleasant reality that their mutual fund investments had experienced a decline in value for the year, and yet they were still required to pay taxes on short- and long-term capital gain distributions from those funds.

While it is true that a *taxable* investor should pay careful attention to potential capital gain distributions,

charitable remainder trusts do not pay taxes. Only the payments to the beneficiaries are taxed, based on the IRS's four-tier accounting rules. These rules specify that all ordinary income is distributed to the income beneficiary first. The remainder of a beneficiary's distribution is usually taxed as some sort of gain. The asset mix determines the level of ordinary income earned by the portfolio. We work hard to minimize short-term gains (since they are taxed at ordinary income rates), so that the remainder of the payout is distributed as long-term gain.

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Our investment process has always been sensitive to how it affects the tax character of beneficiary payments. Specifically, we influence their tax character in our selection of managers and how we trade portfolios. As part of our selection criteria, we look for funds that have low portfolio turnover and that are managed with tax considerations in mind, i.e., that will not distribute large short-term gains. We are in effect indifferent to the long-term gain distributions, since typically that tier has filled up as a result of the sale of the donated security. Receiving long-gain distributions from a mutual fund does not result in beneficiaries paying unnecessary taxes. Therefore, a fund that is "bad" for a tax-paying individual because it distributes significant long-term gains might still be a very good choice for a charitable remainder trust.

Summary

There are thousands upon thousands of mutual funds available today and many would be poor choices for our portfolios. By using mutual funds with good performance records, sound approaches, low expense ratios, and tax-efficient methods, KASPICK & COMPANY can offer the benefits of broad asset class and manager diversification in a cost-effective manner to charitable trust portfolios of all sizes. ■

