Managing Charitable Gift Annuity Reserves

The importance of asset allocation as well as non-investment considerations

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KEY POINTS

- Gift annuity reserves can be invested in a variety of different manners based on the specific needs of the organization
- There are also many non-investment variables that must be taken into account when managing gift annuity assets

When considering the management of charitable gift annuity (CGA) reserves, there are several considerations that must be made. While on its surface, the question of how to manage the CGA assets would seem to be remarkably easy and one of pure asset allocation. The New York State Insurance Department, for example, applies the Prudent Investor Standard to gift annuity reserves.

There are however, many non-investment variables that must be taken into account when managing gift annuity assets. The complexity of non-investment issues vary from the relatively straightforward, such as social screening, to the more complex issues such as beneficiary concentration with a donor who has extended life expectancy and whose residuum is designated to fund a special project at a specified dollar threshold.

Understanding the basics of a charitable gift annuity

The setting of an investment policy for a CGA pool should start with an understanding of the basics of a gift annuity. The American Council on Gift Annuities (ACGA) suggests a set of payout rates that are designed to return a 50% residuum to the issuing charity. The ACGA uses customized mortality assumptions that take into account the extended life expectancy that many charitable annuity beneficiaries experience relative to the general population. The ACGA assumes a 1% administration/investment management fee. It is assumed that all of the donor's initial gift goes into the CGA pool to support the payments to annuitants.

Perhaps the most challenging input to the suggested payout rate calculation is the return assumption. The ACGA uses a relatively straightforward asset allocation when determining a growth rate for CGA assets. The ACGA's asset allocation model is set at a 40% weight for equities, a 55% weight to the yield on the 10-year U.S. Treasury Bond, and a 5% allocation to cash. The yield on the 10-year Treasury Bond varies and cannot be invested in directly, but the yield is used as an input when calculating the assumed rate of return. The equity return assumption is 8% and the other two rates of return are based on observations from the fixed income markets. The ACGA's calculated return assumption as of December 31, 2016 is 4.25%. The ACGA uses this allocation as it believes the 40% equity/55% fixed income/5% cash allocation used in the derivation of its rate schedule is a reasonable allocation that is achievable by virtually all charities. In the past, investment restrictions in states such as California made a 40% equity allocation difficult or impossible, depending upon the mix of contracts in a particular charity's program.

Charities often assume that the ACGA's payout rate model is the recommended asset allocation for a charity's CGA reserves. However, this is merely an allocation that the ACGA assumes that most charities can attain depending on the investment restrictions in their particular state. It is critically important that charities and their investment advisors select an asset allocation that is appropriate for the unique circumstances and preferences of the institution and its gift annuity program. For some institutions, it might be appropriate to invest the gift annuity assets more aggressively, while for other institutions it can be equally appropriate to invest in a more conservative allocation.

Determining asset allocation

Charities should consider the following factors in selecting an asset allocation for a charity's gift annuity assets:

- *The desired expected investment return and associated targeted residuum*
- *The risk tolerance of the institution*
- *The desired variability in the asset to liability ratio*
- *The effective payout rate of the program*
- *The ability to deposit funds to bring reserve accounts up to state required minimums*
- *The availability of liquid unrestricted assets to make payments on any contracts that might run out of money*

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- *The value of the existing pool of gift annuity assets and the dollar amounts of annuity payments that must be made pursuant to those contracts*
- *The expertise of its staff or advisors to create, access, and manage well-diversified investment portfolios at reasonable costs*
- *Whether most gift annuity contracts have unrestricted or restricted gift purposes*
- *The existence of an institutional assessment against each annuity to build a reserve for making payments on contracts that run out of money*

While not intended to be an exhaustive list, this does account for many of the factors that should be considered when thinking about how to invest CGA assets.

For many institutions who issue gift annuities, the liability and assets of the gift annuity pools are relatively small compared to the overall unrestricted assets of the institution. In those types of cases, institutions will generally adopt investment philosophies and allocations similar to endowment assets. However, endowments with significant exposure to private markets, hedge funds, or other illiquid holdings generally favor more liquid holdings in their CGA pools.

For institutions with smaller endowments and relatively larger gift annuity reserves, it may make sense for an organization to be more conservative in the gift annuity pool. Institutions may decide that it makes sense to reinsure the larger or more at-risk contracts. Reinsurance decisions can be made on a case by case basis rather than having to make a decision on the CGA pool as a whole. Reinsurance is typically done by buying a commercial annuity that matches the payout for a specific beneficiary.

In conclusion, gift annuity reserves can be invested in a variety of different manners and while many institutions invest their CGA assets in a similar manner, there is no single solution. Each organization must consider their own circumstances when thinking about how to invest the assets given to them. Ongoing monitoring and evaluation is also important as new gifts are brought into the pool and older gifts mature.

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David develops customized investment portfolios for his clients based on their unique parameters for risk, return, liquidity, and other factors. After taking the time to listen to his client's objectives and to understand any tax, legal, and personal considerations, David then structures a well-diversified portfolio in keeping with each client's asset allocation program. David holds a master's degree in Finance from Northeastern University and a bachelor's degree in Economics from the University of North Carolina at Chapel Hill.

CS14533 Rev. 1/2017