



BNY MELLON WEALTH MANAGEMENT

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The Importance of Early Investment Discussions in Charitable Remainder Trusts

Charitable remainder trusts (CRTs) continue to be an important option for donors when fulfilling their charitable intentions. The split-interest nature of a charitable remainder trust ensures a benefit over the long term for both the non-profit and its beneficiaries.

Often, however, situations arise where there is a donor misunderstanding or simply a difference in expectations between donors and non-profits about a number of items, including how the trust investments will perform, the potential level of remainder assets to the non-profits, and the annual tax implications to the beneficiaries.

We believe it is important to address these potential differences during initial discussions with donors. Failing to do so could lead to difficult conversations over the duration of the trust's existence.

We recommend taking the following steps during initial donor conversations prior to completion of a CRT gift in order to ensure that both the donor and the non-profit are in agreement on appropriate expectations surrounding performance and taxation, as well as how exactly the trust will be managed.

	<p>Encourage Donor Input Early in Discussions</p> <ul style="list-style-type: none"> – Define the donor's goals/objectives – Identify tax considerations/requirements – Clarify investment decision-making roles
	<p>Set Realistic Expectations</p> <ul style="list-style-type: none"> – Use forward-looking capital market projections – Review market value expectations – Address potential investment misperceptions
	<p>Involve an Investment Professional</p> <ul style="list-style-type: none"> – Include an investment professional early in the process – Have direct conversation with donor – Provide illustration of future trust returns/values

Encourage Donor Input Early in Discussions

Defining Goals and Objectives

To prevent difficult conversations from arising later, have a clear discussion about the donor's ultimate goals and objectives. Why is he or she setting up the trust and what ultimately is the long-term objective? The donor's objective could be leaving a targeted remainder amount to the non-profit, maximizing income distributions to beneficiaries or simply a blend of both. Clearly, understanding the donor's objective is important, as this objective should be used as a critical input into the investment decision-making process, and can also provide a precise benchmark that can be revisited in follow-up conversations.

Identifying Tax Considerations

In addition to receiving a tax deduction, a donor or separate beneficiary may also desire tax-friendly treatment of distributions from a trust. Given that the taxation of trusts is based upon a four-tiered system that distributes highest-taxed income first, it is important to have the tax discussion with the donor prior to the funding of the trust, so that he or she can understand and anticipate what future taxation of payments could potentially look like.

We have seen numerous instances where donors and/or beneficiaries were anticipating mostly tax-free income, but had never clearly communicated that to the development professional early in the process. This could lead to donor disappointment upon receipt of the Form K-1, if the trust was not invested to prioritize tax efficiency, and require a difficult discussion between the donor and non-profit on taxation expectations. It is important to educate the donor and understand his or her tax expectations, as tax requirements can impact the investment decision-making and rebalancing process.

Clarifying Investment Decision-Making Role

We encourage initial input from donors on goals and objectives of the trust and want to make sure donors are comfortable with the ultimate investment strategy implemented. It is important, however, not to allow the donor to believe he or she can drive the investment decision-making process after the trust is created. Since the donor no longer controls the asset that funded the trust, the donor should not direct specific asset allocation decisions or the use of specific investment vehicles within the trust. Rather, we firmly believe it is the role of the investment manager to understand donor objectives, as well as the objectives of the remainder institution, and to use that information to craft an appropriate long-term asset allocation policy for the trust.

We recommend ongoing updates and communication with donors, as donor or beneficiary circumstances often change, which could warrant a fresh look at asset allocation. However, changes to investment strategy should never be directed solely by the donor or income beneficiary. More often than we would expect, non-profits find themselves in difficult conversations years after a trust was created because this concept was not clearly articulated during initial discussions, and therefore donors mistakenly felt they could control the investment decision-making of the trust.

Setting Realistic Expectations

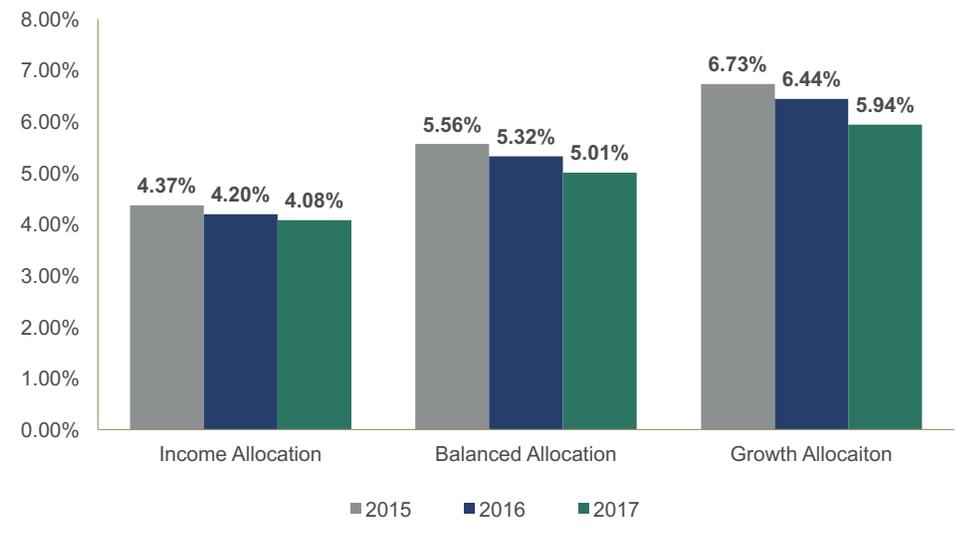
Use Forward-Looking Projections

It is important to set realistic expectations surrounding the current market environment and expected trust performance, both as part of early conversations and periodically as conditions change. The current bull market is entering its ninth year. It is quite common for donors to extrapolate recent performance and assume the strong investment return environment we have witnessed will continue indefinitely into the future. History tells us, however, that eventually this bull market — like all others — will end. When it does, investment returns will be lower than what we have become accustomed to during this strong market run.

BNY Mellon Wealth Management publishes detailed capital market assumptions that can help provide a framework for non-profits to aid in setting expectations for donors, with additional guidance from investment officers. As market conditions continually change, these assumptions are adjusted. Decreased expected returns in equities and the expected rising-rate environment in fixed income have contributed to decreased long-term return expectations. For example, BNY Mellon's forward-looking, annualized expected-return assumption

for a fully diversified growth portfolio is now approximately 5.9%, down significantly from the expected return of 6.7% for the same portfolio back in 2014 (see Exhibit 1). As markets change, so should future expectations of trust performance. Donors and non-profits can both benefit from introducing realistic expectations early into conversations.

Exhibit 1. BNY Mellon Wealth Management Capital Market Assumptions



Review Market Value Expectations

Donors want to see the value of the trust grow over time to benefit the non-profit institution. Unfortunately, in a lower-return environment, growth of trust principal value may be difficult to achieve. To increase in value, a trust must generate an investment return that more than offsets both annual beneficiary payments and fees. Assuming the minimum payout of 5% for a trust and a 1% annual fee, that is a 6% annual performance hurdle the investment portfolio must exceed in order for a trust’s market value to grow. Unless additional risk is assumed, it is possible that charitable remainder trusts will experience either lack of principal growth or principal erosion over the next 10 years. As declining market values lead to reduced trust payments for unitrust income beneficiaries, donors may become discouraged and call into question the merits of the investment/asset allocation decision-making. Therefore, it is very important to set realistic investment return expectations for the trust. To see material principal growth in a trust, the portfolio would need to earn annual returns upwards of 7% per year. We view this as an unlikely outcome, especially given market valuations and the expected upward path of interest rates.

Address Potential Investment Misperceptions

We often see issues arise when donors do not understand fundamental investment concepts. While investment sophistication has become more widespread in recent years as access to information has become easier, this trend has not necessarily reached every planned giving donor. A common misperception we have noticed in our conversations with donors is the belief that stocks always go up. The MSCI ACWI, a global equity market index, has declined in three of the last 10 single-year periods, despite the ongoing nine-year bull market. One of those declines, the stock market crash of 2008, led to a 42% decline in the index. We have also encountered donors who believe investing in bonds carries no risk. While bonds tend to exhibit less volatility than stocks in the aggregate, bonds are still subject to other risks, such as credit risk, default risk, interest rate risk and inflation risk.

Markets rise and fall, and all asset classes carry certain risks. While portfolio diversification can help to reduce these risks, it is important that donors recognize that a certain level of risk must be taken in order to generate investment return. To help uncover investment misperceptions, development officers may want to inquire directly about donors' prior investment experience or knowledge so any issues can be addressed. Correcting these misunderstandings early in the life of the trust can help prevent more work down the road, especially during periods of market disruptions.

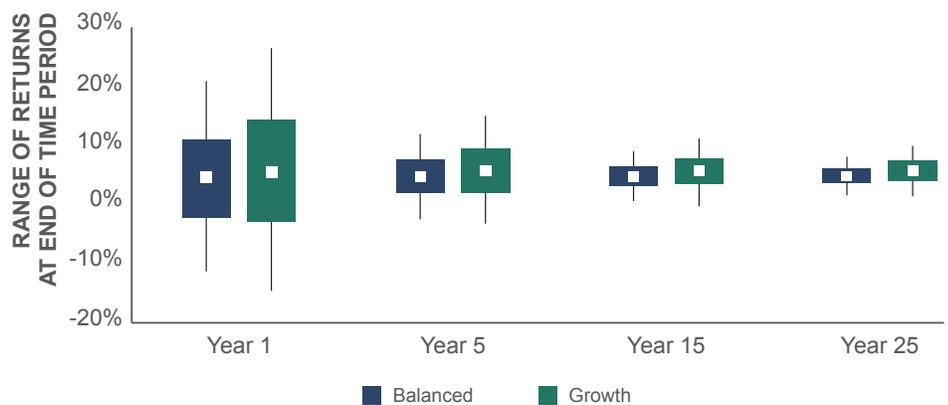
Involve a BNY Mellon Investment Professional

A useful approach not always adopted by our clients is to include a BNY Mellon investment officer in early conversations with donors. Having an experienced investment professional as part of the discussion can help clarify the investment strategy. Your investment officer can help the development team and the donor at the outset of a trust by presenting varying allocation options and their forward-looking implications, including potential returns and market values. After taking into consideration the donor's goals, the investment officer can provide suggested allocation strategies that may best align with the needs of the donor and the organization. These suggested allocations are then combined with BNY Mellon's capital market assumptions and run through a Monte Carlo simulation, which simulates thousands of potential future outcomes and summarizes those with the highest probability of occurring. The output of this analysis includes forward-looking projections of the allocation's impact on both future investment returns and remainder market values. To help illustrate the value of this exercise, two excerpts can be seen below:

Range of Returns Analysis

The "range of returns" analysis visually demonstrates expected investment returns for two different allocation strategies. This analysis can help inform a donor about the risk and return potential of various asset allocation strategies, including the impact of time horizon on the overall volatility of returns. Exhibit 2 is a comparison of a balanced asset allocation and growth asset allocation. This illustration of potential return outcomes can help set reasonable donor expectations.

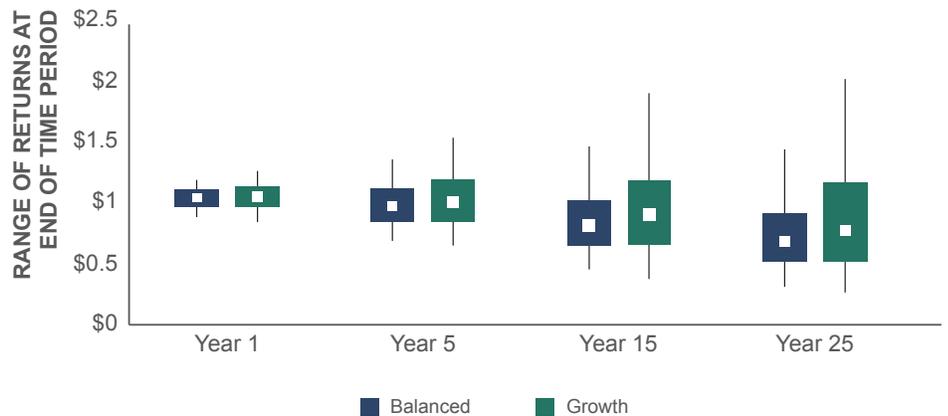
Exhibit 2. Range of Returns Analysis



Range of Assets Analysis

The “range of assets” analysis can project the probability of remainder values to charities over different time horizons. In Exhibit 3, two different allocation strategies for \$100,000 with a 5% annual payout trust are compared (growth vs. balanced asset allocation) over a one, five, 15 and 25 year time horizon. This analysis would not only take into account expected investment performance, but beneficiary outflows and fees. Notice the significantly larger potential remainder assets using a growth — as compared to balanced — investment strategy, particularly for longer-term trusts. Also notice that after payout and fees, the expected-case scenario (as depicted by the white boxes in Exhibit 3) results in a decline in market value from the initial funding amount using both the balanced and growth allocations.

Exhibit 3. Range of Assets Analysis



Conclusion

Having detailed discussions with donors about how a trust works is critical in the early stages of the trust formation process. It is equally important to use these conversations as an opportunity to set reasonable donor expectations about taxation of payments, future investment returns and potential remainder values that will be generated for the non-profit. Having these conversations prior to or at the funding of the trust can help prevent donor confusion and frustration well into the future. Ideally, the trust should set the stage for a long and beneficial mutual relationship between the non-profit and its donor.

About the Authors

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Lindsey is an Investment Officer for BNY Mellon Wealth Management's Charitable Solutions Group. In this role, she works directly with non-profit clients to address their investment management needs. Lindsey joined the firm in January of 2017.

Prior to that, Lindsey spent seven years at Langen McAllenney, a division of Janney Montgomery Scott, in Hartford, CT as a sell-side equity research analyst. In this role, she was responsible for research, analysis, and recommendations of publicly traded insurance companies. Lindsey also completed an MBA internship at State Street Global Advisors, in the Investment Solutions Group, where she was challenged with creating hedge fund replication strategies to capture alternative/exotic beta.

Lindsey received a Master's degree in Business Administration from Boston College and a Bachelor's degree from Fordham University. She is a 2018 CFA Level III exam candidate.

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Michael Daley is a senior investment officer for BNY Mellon Wealth Management's Charitable Solutions Group with over 15 years of investment management experience. Michael's not-for-profit clients include secondary schools, healthcare groups, colleges and universities, and religious organizations. Michael's extensive background and experience in investment management enables him to work directly with his clients to design, implement, and actively manage their investment portfolios. In addition, he provides counsel and advice on best practices regarding asset allocation, spending rates, investment policy, manager selection and performance evaluation.

Michael joined the firm in 2002. Prior to that, Michael worked as an earnings analyst at Thomson Financial/First Call in Boston. While at Thomson, Michael worked closely with sell side analysts across a wide range of brokerage firms to ensure and maintain the integrity of extensive earnings estimate databases.

Michael received a bachelor's degree with a major in finance from the University of Vermont and a master's degree of business administration from the University of Maryland. Michael is a CFA Charterholder and a member of the CFA Society Boston.



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