Maintaining an endowment fund capable of providing for a cemetery's upkeep long after all the lots are sold is a perpetual problem. And in nearly all cases, out-of-date state laws regulating cemetery trust funds make the problem much worse, says this investment advisor. In this two-part article, he explains the situation and proposes a remedy.

# Cemetery Care Funds and Total Return Investing: A Problem and A Solution

**by Shale P. Lapping**

The importance of a cemetery care fund to the long-term maintenance of a cemetery cannot be disputed. Our landscape is littered with long-forgotten cemeteries, neglected and abandoned because they had no care funds or because the care funds they did have were woefully inadequate. One of our primary goals as an industry should be to try to ensure that the money put aside in these funds will enable today's cemeteries to remain cared for in the future.

*Shale Lapping*

This article approaches the issue from an investment standpoint and analyzes how the current statutes regulating the vast majority of this country's care funds impact the investment of those funds. Specifically, I will explain why regulatory changes are needed if cemeteries are to unlock the investment potential of their care funds and enable them to fulfill their long-term purpose.

Many cemeterians consider their care funds from the standpoint of the amount of current income the funds can provide. In many instances, that amount is not enough. Certainly cash flow considerations are a reality for many cemeterians, but the changes proposed in this article are designed not to increase the level of permitted distributions, but rather to provide for a sustainable level of distributions that help satisfy the care funds' long-term objectives.

## Growing The Fund

While there are a number different approaches that can be used to estimate the size a care fund needs to be in order to properly maintain a cemetery over the long term, assuming a proper level of maintenance and taking into account the impact of inflation, there is no question that the amount will be substantial, both on an absolute level and in relation to the size of a cemetery's current care fund. The calculation of exactly how much funding is necessary per acre makes for interesting discussion but is not relevant in the broad scheme of things. If we were to survey all cemetery care funds, we would likely find that very few are currently of a proper size in relation to their cemetery's life cycle.

How then can this problem be addressed? There are only three alternatives: increase contributions, decrease distributions or increase investment returns. Since none of these approaches are contradictory, ideally all three should be pursued. As a practical matter, however, there are competitive factors as well as cash flow constraints that often prevent a cemetery from altering its current contribution and distribution policy. The remaining option is to increase investment returns.

While cemeterians cannot control the broad market forces that affect their return on investments through the years, many would be able to increase their long-term rates of return if they were simply free to pursue the same investment strategies as other funds with long-term goals. Unfortunately, current regulations stand in the way.

## Long-Term vs. Short-Term

The problem can best be understood by examining some of the basic trade-offs that affect all types of endowment funds, as well as obstacles relatively unique to cemetery care funds. All endowment funds face long-term vs. short-term trade-offs. They need distributions to support current operations, yet they also need their funds to grow to offset inflation and provide adequate distributions in the future. Unfortunately, every dollar withdrawn today is one less dollar available for reinvestment and fund growth. In other words, all else being equal, the more money withdrawn today, the less money available for future withdrawals.

This point was analyzed in a study by the Council on Foundations examining the impact of various distribution rates over a 45-year period, from 1950 through 1994, using actual investment returns. The findings dramatically highlight the effect of current distributions on future earnings. A fund with a 5.5 percent distribution rate would have generated an inflation-adjusted growth rate of 25.4 percent, while a fund with a 6.5 percent distribution rate would have experienced an 18.8 percent *loss*, again adjusted for inflation.

The fund with the higher distribution rate would have paid out more dollars early on, but due to the growth in the fund with the lower distribution rate, by the final year of the analysis the fund with the lower distribution rate would have distributed 29 percent more money. The difference in total payout would have been even more dramatic if the study had continued. Bottom line: It pays to be patient.

There is no way to avoid this trade-off between short-term distributions and long-term growth; it is a reality for all endowment funds. While there are many ways of trying to balance the two, a simple or "neutral"

approach is to set the rate of distributions so that enough earnings will remain in the fund to offset inflation. While this means there will be no real, i.e., inflation-adjusted growth, at least there will be no erosion due to inflation.

In terms of this issue, cemeteries are in essentially the same position as every other endowment fund in the country—with one exception. Virtually all other endowments are tax-exempt, but unless they are nonprofit, cemeteries are subject to capital gains taxes on care funds. That means for-profit cemeteries need to set distribution rates to allow for enough growth to cover capital gains taxes as well as to offset inflation.

## Total Return Investing

The second trade-off, however, is even more critical, and it is here that the difference between cemetery care funds and other endowment funds becomes even more apparent. Virtually all other endowment funds (e.g., family foundations, community foundations, college endowments, hospital endowments) use a "total return" model for investing, as authorized in the Uniform Management of Institutional Funds Act. This authorization is no accident.

One of the principal purposes of this act, first promulgated in 1971 and since adopted by virtually all states, was to encourage the managers of charitable funds to invest with the goal of maximizing the fund's *total* return, rather than making investments offering high current yields but little potential for appreciation. "Total return" refers to principal appreciation plus the income (interest or dividends) that a portfolio generates. In other words, under a total return approach, it makes no difference whether the investment return comes in the form of appreciation or income.

Because of their need to generate a sufficient rate of return to meet both their long-term (growth to offset inflation) and short-term (distribution for current operating purposes) needs, most endowments are drawn to a stock-oriented portfolio. An allocation of 65 percent stocks and 35 percent bonds could be considered typical. The reason is fairly straightforward: Stocks tend to produce a much higher return than bonds, albeit with a much higher level of volatility. This volatility, however, is not a problem, as investors with a long-term time horizon have the advantage of being able to endure short-term fluctuations in order to pursue higher returns over the long term.

For example, consider the returns on stocks from 1926 to 2002. During that period, large capitalization U.S. stocks produced an average annual return of 10.71 percent, and small capitalization stocks performed slightly better. In comparison, intermediate-term U.S. government bonds produced an annual return of 5.34 percent. Even if we reduced quality and lengthened maturity, and replaced the intermediate government bonds with long-term corporate bonds, the average return would rise only to 5.77 percent.

Keep in mind that this data takes into account 2000-2002, which has produced horrific returns for the stock market, while bonds have experienced a protracted bull market. Despite these recent trends, when the long-term numbers are considered, stocks have still out-performed bonds by a margin of almost 2-1.

In making their asset allocation decisions, most endowments assess the historic returns of the overall market and aim for a prudent level of diversification, taking into account the particular risk profile of their investment committees as well as their distribution needs. One factor that they do not normally consider, however, is income, interest and dividends.

What is interesting is the relationship among the targeted distribution rate, total return rate and asset allocation. Assuming the fund needs to generate enough growth to offset inflation and that inflation is treated as a constant regardless of the fund's distribution needs, the higher the distribution rate the higher the targeted total return.

Based on historical returns, stocks are expected to produce a much higher total rate of return than bonds. Therefore, the higher the targeted total return, the higher the fund's allocation to stocks. In other words, the greater an endowment's distribution needs, the greater the endowment's stock allocation needs to be. This reasoning is a normal part of an endowment fund's asset allocation strategy.

## Distribution Levels

The next question is what level of distributions do these endowments target? Or, more important, what level should they target? This issue has been the source of considerable discussion and study, using both index returns and actual portfolio returns, in the foundation community in recent years. The vast majority of the studies have concluded that 5 percent (including investment expenses) is an appropriate distribution target, assuming an allocation of 65 percent stocks and 35 percent bonds, if the fund wants to be reasonably assured of a growth rate that will offset inflation.

Would this figure work for cemeteries? Consider a slightly more lenient approach—assume the 5 percent represents pure distributions to the cemetery for operations. Add on 0.5 percent for investment-related expenses (probably a low figure). Also assume an inflation rate of 2.75 percent (again, probably a low figure against a long-term average of 3 percent).

The total is now 8.25 percent, without factoring in any payment for capital gains taxes and without assuming any real increase in the value of the fund. Coincidentally, this figure is exactly what a portfolio allocated 65 percent to stocks and 35 percent to bonds would produce, assuming a rate of return of 10 percent on stocks and 5.5 percent on bonds.

Few investors would have thought twice about using those assumptions at the height of the bull market, and may have even laughed at how "conservative" they were. Given the current state of both the stock and bond markets, however, these expected rates, which are necessary in order to generate a moderate level of distributions and arguably inflation-proof the care fund, now appear much more sobering. For the near term, it would probably be aggressive to assume higher rates of return.

Based on this scenario, the wisdom of trying to target a distribution rate in excess of 5 percent becomes dubious, at best. Even at this level, the impact that a 5 percent distribution figure has on a fund's asset allocation is significant. Historically, the only asset class that has been capable of producing a return of 5 percent plus inflation has been stocks. Examined in isolation, every dollar invested in bonds will almost certainly fail to achieve the fund's long-term return objective. These statements represent reality, and need to be taken into account.

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