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 And in nearly all cases, out-of-date state laws regulating cemetery trust funds make the problem much worse, says this investment advisor.

How State Regulations Hurt Cemetery Care Funds and How They Could Help

by Shale P. Lapping

(Editor's note: In part 1, the author explained total return investing and the long-term vs. short-term trade-offs endowment fund managers face. In part 2, he explains why the prohibition by most states on total return investing by cemeteries homes hurts their endowment funds, and offers suggestions for changing those regulations.

Generating 5 percent distributable income, inflation proofing the fund and maintaining a balanced portfolio is not as easy as it may at first seem. But wait. There's more. We are just getting to the crux of the problem. In the case of cemeteries, under the governing statutes in most states, distributions are limited to income, i.e., dividends and income. Therefore, even if we were to assume that 5 percent represented a prudent level of distributions, that 5 percent would have to be raised from income, a daunting task under most market environments.

As of the end of 2002, even with interest rates at 40-year lows, the interest rate on 10-year Treasuries was 3.85 percent, compared to a yield on the S&P 500 of just 1.81 percent. Then there's the NASDAQ, which had a year-end yield of just 0.11 percent. These differences are dramatic. If one were starting with a fully liquid portfolio in this environment, an investor would not be able to generate a 5 percent yield even if the fund invested 100 percent in bonds!

Simply stated, here is the difficulty: Stocks generate a higher total return than bonds, but bonds generate a higher level of income (interest) than stocks (dividends). If income generation is a primary focus, then income becomes the dominant factor in selecting an asset allocation. The consequences are disheartening.

Even if one were to assume a 7 percent yield on bonds and a 3 percent yield on

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stocks (a combination that we have not witnessed for a number of years), one would still need an asset allocation of 50 percent bonds to reach the 5 percent income target, resulting in a full 15 percent less in stocks than what is needed to produce a targeted rate of return sufficient to offset inflation.

In this case the fund is experiencing the classic growth vs. income trade-off, i.e., the more income you need, the less total return you can get. The care fund simply cannot afford to increase its investment in stocks. The care fund ends up buying income at the cost of total return; a self-defeating strategy based on an artificial (legally imposed) trade-off basically unique to cemeteries.

Bear in mind that this is not a short-term phenomenon. Stock dividends (as a percentage of a stock's market value) have been decreasing for many years. While this trend may reverse, it is far from certain. Throughout the bull market of the 1990s yields fell precipitously, with many of the best performing stocks (not just the tech darlings such as Microsoft, Intel and Cisco, but also certain stalwarts such as Berkshire Hathaway) paying no dividends.

Care funds that could only distribute income and that needed even a moderate amount of income were effectively locked out of a broad segment of the stock market, resulting in a decrease in true diversification and a further increase in risk.

On the other hand, care funds that did purchase these stocks and reaped returns on the order of 20 percent to 30 percent annually in the form of principal appreciation did not benefit at all from the increase in the fund's market value in terms of increased distributions.

As can be seen by examining recent market conditions, the problem is not just an under-allocation to stocks, but a heavy reliance on the current interest rate environment. When rates are low, cemeteries can experience a double whammy. Not only are they less likely to generate a sufficient total return due to an under-allocation to stocks, but even a high bond allocation may not generate enough income. In these cases, there may be nothing a cemetery can do to increase income, other than to increase the maturity or decrease the quality of the fixed-income portfolio, thereby significantly increasing risk, and even that may not be enough.

The bottom line is that an income-oriented distribution approach places cemeteries at the mercy of a company's dividend policy and market interest rates, regardless of how well the stock and bond markets may be performing overall.

The Problem

Two points are clear. First, statutes that prohibit a total return investment approach and limit distributions to income create perverse incentives for the structure of an investment program and undermine the goal of long-term growth in a care fund. If a cemetery has a significant need for current income, this mechanism results in an asset allocation skewed away from where it should be in a long-term endowment fund.

Second, a prohibition on a total investment approach, while once relatively common, is now a relic from a bygone era and is essentially limited to the cemetery business. In the institutional arena, these types of restrictions are virtually nonexistent. The literally trillions of dollars that comprise this country's pension funds—public, private, defined benefit, defined contribution—are all managed on a total return basis. The

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model law that governs endowments and foundations and has been adopted in the overwhelming majority of states provides for total return investing.

More specific data can be found in the report titled "2001 Investment Performance and Practices of Community Foundations," compiled by the Council on Foundations. In that report, only 4 percent of the foundations surveyed indicated they spend all of their current income as their primary spending formula.

In the case of individual trusts, where the clear demarcation between principal and income was once a hallmark of state trust law, things are also changing. Within the last couple of years, Delaware, New York and Missouri have all passed laws allowing trustees to convert traditional trusts that distinguish between principal and income into "total return unitrusts" that essentially eliminate the distinction. Even the IRS is considering revising its definition of trust income to allow for total performance portfolios. An income-oriented distribution policy is rapidly on its way to becoming extinct—except for cemetery care funds. This is not a badge of distinction for the industry.

Cemetery care funds must confront two trade-offs: the long-term vs. short-term trade-off and the growth vs. income trade-off. The big difference is the first trade-off is grounded in reality, the second is not. The statutory mechanism that regulates most cemetery trust funds and provides for an artificial distinction between principal and income is both outdated and out of step. In fact, it is counterproductive, undermining the very goals of these statutes.

While these provisions may have been well intended when they were enacted with the goal of ensuring the protection of the care funds over the long-term, and in keeping with the prevailing views regarding trust fund investments and accounting, that time has long since passed. There is simply no valid investment reason to continue this type of approach, and as described in this article, there are a number of good reasons to eliminate it.

A Solution

Before we examine an alternative statutory approach, two caveats are in order. First, a total return approach should not be adopted for the purpose of allowing cemeteries to increase their rate of distributions from their care funds. An increase in distributions, in and of itself, would be counterproductive. Second, a total return approach is not intended to encourage cemeteries to adopt an all-stock portfolio. Such an allocation would probably be imprudent.

The alternative approach is simply intended to enable cemeteries to adopt both distribution and investment policies in keeping with the manner in which the vast majority of this country's long-term institutional funds—endowment funds in particular—are already invested, and have been for some time. Specifically, cemeterians should be free to select an asset allocation for their care funds based on traditional investment considerations of risk and return, without having to cloud the picture by taking income generation into account.

The approach being outlined is not without precedent in the cemetery business. While the vast majority of state care fund laws still distinguish between income and appreciation, some have been modified in recent years and moved away from this distinction. Tennessee and Indiana now allow for some version of total return investing. While these provisions are not necessarily model statutes, they do represent a movement in the right direction. In addition, Missouri is also in the process of adopting a regulation that would apply the state's newly enacted unitrust provision to cemetery care funds.

It is not the intention of this article to propose the specifics of a model statute, but an ideal care fund statute should:

• **Enable the cemetery to structure its investment program on a total return basis.** There should be no benefit, per se, in generating income rather than principal appreciation.

• **Allow for a regular pattern of distributions** each year, regardless of market conditions.

• **Outline a clear distribution mechanism** that is simple for the cemetery to administer and simple for the regulators to enforce.

• **Provide for a cap on distributions to ensure the growth of the fund.** While there is no cap in the statutes that govern other endowments and foundations, that is because none is needed, since many of these entities have consciously chosen to spend down their funds and pursue a limited rather than a perpetual life. This option is not available to a cemetery care fund. The one benefit of the current regulatory approach limiting distributions to income is that it provides some type of a cap on distributions. If this cap is eliminated, it should be replaced with something else.

• **Provide for broad investment discretion,** along the lines of the investment provisions in the Uniform Management of Institutional Funds Act or the Prudent Investor Act. The statute should not dictate the particulars of an investment program.

A sample statutory provision might authorize cemeteries to withdraw from their care funds on some regular basis, e.g., in monthly or quarterly installments, an amount not to exceed 5 percent of the market value of the fund as of the close of the previous calendar year. In order to avoid significant fluctuations in distributions based on the fluctuations in market value, the year-end value could be changed to an average of the ending market value over the past 12 or 20 quarters, on a rolling basis. This type of formula is customarily used in the endowment and foundation field.

In keeping with the need to control all distributions, the provision also should include expenses, and in the interest of political reality the cap would probably need to be raised slightly to accommodate this additional cost. This provision would then provide cemeteries with a strong incentive to run their programs on a cost-efficient basis. The only distributions to be excluded from the formula would be taxes, which are beyond the control of the cemetery.

The Benefits

In addition to addressing the specific concerns set forth in this article, the guidelines outlined above are based on reality, since they would tie care fund distributions to the market value of the fund. Any other approach, such as the prevalent income-oriented approach, which essentially ignores the market value of the fund for distribution purposes, is fanciful. The purchasing power of a cemetery care fund is properly measured by its current market value, not its current yield. In order for distributions to grow, the value of the fund needs to grow.

The proposed approach aligns the cemetery's short-term cash flow needs with the true objectives of the care fund, which is to ensure that there is enough money to provide for the maintenance of the cemetery over the long term.

The proposed approach also would allow cemeteries to budget for a specific amount of distributions for the fiscal year. This would be a big change from being dependent upon the timing of coupon payments and dividend distributions, and having cash flow affected by the sale or maturity of individual income-producing securities.

The most important benefit of the proposed approach is that there is no down side, not in terms of administration or investment. There is simply inertia to overcome. Some states have already moved in this direction. The more that do so, the easier it will become for the rest to change. The starting point is to recognize the problems and then educate people—especially regulators and legislators—about the proper solution.

Conclusion

Unlike exempting cemetery care funds from taxation, which would literally take an act of Congress to amend the tax code, care fund regulation is handled at the state level through legislation specific to the cemetery business. While many cemeteries historically have been reluctant to propose care-fund legislation for fear of opening a Pandora's box, the alternative is to allow a wholly unsatisfactory statutory regime to remain in place. The longer we wait the more pressing the problem becomes.

If cemetery care funds are to be able to meet their long-term objectives, they need to be free to adopt an asset allocation that stands a reasonably good chance of producing returns that at least keep pace with inflation. The best way to provide this freedom is by replacing an income-oriented distribution approach with a total return approach.

It is important to recognize that the goal of such legislation is not to confer any special privileges on cemetery care funds, but simply to place them on the same footing as all other endowment funds in this country. When examined in this light, state cemetery associations should feel comfortable in raising the issue with state regulatory agencies with the goal of securing an agreed-upon legislative proposal.

Given that the proposed regulatory change could easily result in many cemeteries increasing their stock exposure, the timing of this article might seem strange, coming on the heels of a prolonged and severe bear market. Cemetery care funds, however, are long-term entities, and those individuals that oversee these funds need to have a long-term perspective.

Throughout the bull market of the 1990s, many cemeteries were under-invested in stocks and lost the opportunity for valuable appreciation because of the current statutes and their income-oriented distribution requirements. A change in the law could enable cemeteries to better position their care funds by the time the next bull market comes around.

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