

# Looking Beyond Perpetuity

## Customizing a Private Foundation

A foundation represents a powerful commitment to do charitable good. Our research provides guidance—

*For potential donors on:*

- Comparing the benefits of a foundation with those of other charitable alternatives
- Establishing a family philanthropic legacy without compromising personal lifestyle

*For directors and trustees on:*

- Identifying asset-allocation and gifting policies that best match charitable objectives
- Determining whether “perpetuity” is a realistic goal
- Managing the trade-offs among asset growth and the amount and stability of distributions

**This research paper is one in a series produced by Bernstein's Wealth Management Group on issues of particular significance to investors of means and their professional advisors.**

*Bernstein does not provide tax or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.*

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## Significant Research Conclusions

Private foundations have long been a major force in American philanthropy. For donors, they represent a meaningful pledge to philanthropic causes for years to come. And for the directors or trustees charged with fiduciary duties, foundations require great responsibility, since the assets and gifts supporting the charitable vision must be managed with care and prudence.

In the first part of this study, we address the personal planning issues donors and their advisors face when deciding whether to establish or to continue funding a foundation. Though a foundation's major appeal is often in its intangible benefits—particularly the opportunity to establish a familial charitable legacy that spans generations—there are key economic issues to consider as well. Our research indicates:

- **The tax-advantaged environment of a foundation should create substantially more wealth for charity than direct annual gifts.** We estimate the after-cost premium can be as high as 50% for donors who give a low-basis stock (the benefit of tax-free diversification and growth). The size of the advantage suggests that most smaller foundations—those with asset levels of \$1 million or less—can be successful even if their costs are above average.
- **The effect of making an irrevocable philanthropic gift on a prospective donor's other long-term goals and wealth-transfer plans can and should be quantified, after factoring in tax benefits.** The tax-deduction limitations on foundation gifts are more stringent than on gifts to public charities, but the difference may be irrelevant for many high-income donors.

Directors and trustees with responsibility for ongoing foundation management should make asset-allocation and payout decisions based on a strong understanding of the capital markets and in-depth knowledge of the short- and long-term charitable objectives of the foundation. In this area, our research indicates:

- **An equity-tilted portfolio that distributes the 5% annual minimum payout has, we estimate, less than an even chance of maintaining its real value over 20 years (a success rate slightly lower than the long-term historical record and far below more recent results).** Foundation managers are making perpetuity an even tougher bogey by paying out, on average, close to two percentage points *more* than the minimum—a hurdle that even the most aggressive asset allocations will have a hard time beating.
- **Although the above statistics may seem disheartening, perpetuity is not what every foundation donor is looking for—and is almost never the *only* goal.** We provide a framework to help foundation managers craft allocation and distribution policies that represent the most appropriate balance among current gift amounts, long-term asset growth, payout stability, and the prevailing market environment.



## 1. THE APPEAL OF A PRIVATE FOUNDATION

Charitable giving is a key objective for many individuals of means. It offers the personal satisfaction that comes with participating in an important cause, while also providing a financial benefit to the donor. In 2004 alone, charitable giving in the United States totaled an estimated \$250 billion.<sup>1</sup> There are many ways to give: Donors can give directly to charity, either during their lifetimes or at death, or they can gift through special tax-advantaged vehicles, including certain trusts and private foundations. These vehicles may offer a variety of benefits over making direct gifts—such as a large up-front income-tax deduction, a tax-advantaged environment to grow the gifted assets, an efficient vehicle for portfolio diversification, and a mechanism for leveraging multi-generational giving.

### Foundations as a Primary Giving Vehicle

Determining which philanthropic strategy is right for a given donor depends on his unique

circumstances and objectives. (See *Display 1* for a comparison of the salient characteristics of a broad sample of charitable strategies.)<sup>2</sup> For example, a donor with the dual goals of establishing a regular income stream and leaving a charitable legacy may find a charitable remainder trust (CRT) of interest, particularly if he owns large amounts of low-basis stock, which can be diversified inside the trust with capital-gains taxes deferred. On the other hand, for a donor who's interested in transferring wealth to heirs free of gift/estate tax—and who'd like to begin gifts to charity *now*—a charitable lead trust (CLT) may be appropriate.

Other donors may choose to establish vehicles for the sole benefit of charity. For them, giving through a private foundation<sup>3</sup> or other structured-giving vehicles such as a donor-advised fund (DAF) or a supporting organization (SO) may make the most sense. These vehicles are virtually free of income and capital-gains taxes and provide the donor with an immediate tax deduction up to the full value of the gift, even though the assets can be distributed to charity over a very long time.<sup>4</sup>

DISPLAY 1

#### Structured-giving alternatives to direct charitable gifts: a representative sample

Vehicle	When Charity Receives Gift	Tax-Free Environment?	Personal Income-Tax Deduction	Other Key Benefits
<b>Private Foundation</b>	Beginning now, over time	Yes*	Based on entire gift	Control and multi-generational legacy
<b>Public Charities</b> (Donor-Advised Funds, Supporting Orgs.)	Beginning now, over time	Yes	Based on entire gift	Ease of administration
<b>Charitable Remainder Trust (CRT)</b>	At expiration of CRT	Yes, but distributions are taxed	Depends on expected charitable remainder	Income stream to donor
<b>Charitable Lead Trust (CLT)<sup>†</sup></b>	Beginning now, over time	No <sup>‡</sup>	No	Potential tax-free transfer to heirs
<b>Charitable Gift Annuity (CGA)</b>	Now, but typically held in reserve	Yes, but distributions are taxed	Depends on expected charitable remainder	Income stream to donor

\* There is an excise tax of 1–2% per year on net investment income.

<sup>†</sup> Assumes a non-grantor CLT

<sup>‡</sup> Trust receives tax deduction each year equal to the lesser of the payment to charity or the taxable income.

1 Giving USA Foundation™ AAFRC Trust for Philanthropy/Giving USA 2005 reports giving from four major sources: individual living donors (\$187.9 billion), bequests by individuals (\$19.8 billion), foundations (\$28.8 billion), and corporations (\$12.0 billion).

2 See Appendix table (pages 24–25) and Glossary (pages 29–32) for a detailed description of the major philanthropic vehicles, including gifts to public charities and trusts.

3 Unless otherwise noted, references are to private non-operating foundations described in Section 509(a) of the Internal Revenue Code of 1986, as amended.

4 Various limitations apply to the size of the personal tax deduction a donor can use to offset income for each of these structured-giving strategies; the same tax benefits apply to donors subject to the alternative minimum tax. Bernstein is not a legal or tax advisor; prospective donors considering charitable or other gifting vehicles should consult these professionals.

Both foundations and DAFs are widely used; in deciding between them, a donor needs to consider the greater longevity and donor control typical of a foundation compared with a DAF's less restrictive requirements. Tax deductions on DAFs can be more favorable, for example, and the administrative regulations are far less onerous (see "A Closer Look," page 8, on the major requirements foundations must satisfy). Further, donors can generally give as much or as little as they wish—versus the minimum 5% annual distribution required of foundations.<sup>5</sup> And as pooled vehicles, DAFs can be cost-effective structured-giving vehicles for as little as \$10,000.

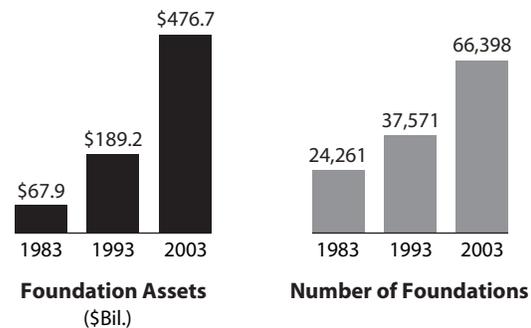
On the other hand, foundations allow the donor full control over the grant-making and investment decisions relating to the charitable assets (legally, DAF donors may recommend—but cannot dictate—how their grants are spent, and the investment options may be more limited). Further, foundations are one of the few charitable vehicles generally designed to last for many generations—potentially into perpetuity. And putting the family nameplate on a long-term philanthropic enterprise may well tip the scales in favor of a foundation.

Many individuals have found it so: As of year-end 2003, the number of U.S. private foundations in existence had grown to some 66,000, holding assets that approached \$477 billion—up sevenfold over the prior couple of decades (*Display 2*). And while DAFs and SOs have also grown significantly, foundations hold much more in assets. Though names like Rockefeller, Ford, and Gates may be the most storied among foundations, the IRS reported that as of year-end 2001 (the latest year for which these data are available), fully two-thirds of all U.S. foundations contained assets of less than \$1 million.

But a private foundation is not right for everyone; in the first part of this research study, we assess

DISPLAY 2

**Foundations have captured investors' interest—whether measured by assets or presence in the marketplace**



Source: The Foundation Center

how valuable its tax advantages are to the potential donor, how much the donor might reasonably be able to gift, and how quickly she can expect those assets to grow for charity's benefit over time.

### Benefits to the Donor

Since a gift to establish a foundation is irrevocable, the donor must be comfortable with her answers to a number of questions before committing funds:

- What will the true cost of the gift be after the tax savings?
- What effect will the gift have on her personal spending, intergenerational wealth-transfer goals, or both?
- How great a benefit can she expect her favorite charity to realize?
- How much will it cost to run the foundation?

A foundation will allow the donor to reduce her taxable income and, if she gifts a low-cost-basis asset, virtually eliminate capital-gains tax when the asset is diversified. Further, gifting removes the principal amount from the donor's taxable estate, as well as any future appreciation

<sup>5</sup> The IRS is currently considering a proposal to impose the same 5% minimum distribution that is required of private foundations on donor-advised funds; further, some donor-advised funds may impose minimum distributions unrelated to any federal requirement.

## DISPLAY 3

**What donors give, and to which organizations, can make a substantial difference in their tax benefits**

### Income-Tax Deduction Summary\*

	Give Cash	Give Publicly Marketable Stock	Give Closely Held Stock, Real Estate
<b>Public Charity</b>			
Max. Deduction Limitations	Market Value 50% of AGI†	Market Value 30% of AGI	Market Value 30% of AGI
<b>Private Foundation</b>			
Max. Deduction Limitations	Market Value 30% of AGI	Market Value 20% of AGI	Cost Basis 20% of AGI

\* Assumes the shares are held for more than one year. In addition, on carry-forward deductions, see footnote to top of Display 4.

† Adjusted gross income

it realizes. All of these benefits can reduce the out-of-pocket cost of a donor's gift substantially; however, not all the benefits are fully realizable by every donor. For instance, the income-tax rules are least favorable for gifts to private foundations, so potential donors need to know the tax savings they are getting—and what they are leaving on the table—before funding. In general, the income-tax deduction allowed depends on the size of the gift relative to the donor's adjusted gross income (AGI), and the asset gifted (cash, stock, or real estate, for example). *Display 3* outlines the rules for gifts to private foundations and to public charities (whether the gifts are made through structured vehicles or given directly).

By way of example, the top of *Display 4* quantifies the cost to the donor of a \$1 million gift of zero-basis publicly traded stock after all tax savings, assuming he'll earn a total of \$5 million in AGI over the next five years. We assume that if the donor didn't gift he'd diversify his position anyway, paying capital-gains tax at a federal/state blended rate of 20%.

As for his income-tax savings, his \$1 million gift represents 20% of his AGI—which falls within the deduction limitation for a publicly traded stock

## DISPLAY 4

**Comparing economic savings to a donor: Foundations versus public charities**

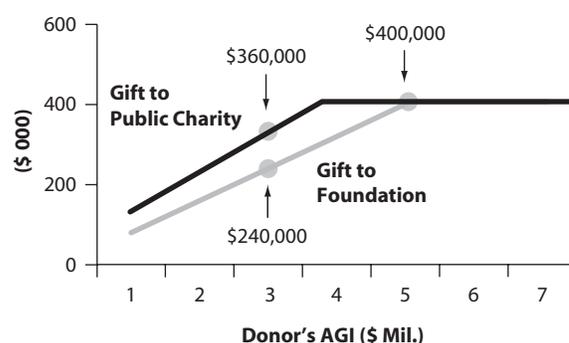
### Estimating the Effective Cost of a Charitable Gift

A donor will earn \$5 million in adjusted gross income over the next five years and will gift \$1 million in publicly marketable low-basis stock to a private foundation

	Personal Wealth
Contribution to Foundation	\$(1 Mil.)
Income-Tax Savings (40% Tax Rate)*	\$400K
Capital-Gains Tax Savings (20% Tax Rate)	\$200K
Effective After-Tax Cost of \$1 Mil. Charitable Gift	\$(400K)

\* Since the \$1 mil. gift is only 20% of AGI, the foundation donor can use the full allowable charitable deduction over a five-year period. Depending on the year in which the gift is made, certain phaseouts of charitable deductions may apply. Please consult your tax advisor.

### Analysis of Ordinary-Income-Tax Savings from a \$1 Mil. Charitable Gift of Low-Basis Stock\*



\* Assumes AGI is taxable at ordinary blended rates of 40%. Stock is assumed to have \$0 basis. On the phaseout of itemized deductions, see footnote 6 below.

gifted to a foundation—so he'll be able to deduct the full \$1 million gift from his income over time.<sup>6</sup> At a blended ordinary-income-tax rate of 40%, he'll realize a tax savings of \$400,000. Further, by gifting instead of holding on to and diversifying the zero-basis stock, the donor avoids a \$200,000 capital-gains tax.<sup>7</sup> In total, the donor has taken \$600,000 off his tax bill—making the effective cost of his gift only \$400,000. In this case, he'd have done no better by gifting to a public charity despite their more liberal deduction allowances.<sup>8</sup> As shown in the bottom chart in the display, for any donor with an AGI as high as \$5 million, the tax savings from

<sup>6</sup> For simplicity, we have ignored the phaseout of itemized deductions (which in most cases reduces such deductions by 3% of the difference between a taxpayer's AGI and \$145,950 in 2005). Although this phaseout is currently scheduled to disappear gradually, it can significantly limit the value of charitable deductions for donors with extremely high AGIs. Bernstein is not a tax or legal advisor; potential donors should seek tax and legal advice.

<sup>7</sup> Ignoring the small excise tax (see first footnote to Display 1).

<sup>8</sup> Gifting to a public charity would have allowed the donor to realize the deduction sooner, but the total deduction would have been the same over the five-year period.

a \$1 million gift to either a foundation or a public charity would be the same.

A donor with an AGI of \$3 million who wants to make a \$1 million gift would still erase her potential \$200,000 capital-gains tax bill. But as for ordinary-income-tax savings, her gift is 33% of AGI, far higher than the 20% allowance for gifts to foundations but only slightly higher than

the 30% allowance for public charities. Applying the limitations to a 40% tax rate translates into a \$240,000 tax savings on a gift to a foundation, but \$360,000 if the vehicle is a public charity. So on economic grounds, she'd be better off choosing a public charity over a foundation.

There are additional subtleties that pertain to donors in special situations (which can often

### A CLOSER LOOK | Rules Foundation Donors Should Know

A private foundation is a tax-exempt organization established and operated exclusively for charitable purposes. Foundations are overseen by directors and trustees, often comprising the donor, family members, friends, and/or advisors. These fiduciaries are responsible for investing the foundation's assets, distributing grants, and ensuring compliance with the relevant rules and regulations. Since private foundations are typically controlled by an individual or family, they are subject to much greater regulation than public charities. In order for private foundations to maintain their tax-exempt status, they must adhere to the following federal rules:

- *Minimum 5% annual payout*—Each year, the foundation is required to pay out at least 5% of the market value of the foundation's assets. The 5% may include most administrative expenses connected with the day-to-day operation of the foundation (but not the cost of any professional money management).
- *IRS Form 990-PF*—The foundation must file a publicly available federal income-tax return, which discloses information about the foundation's contributors, finances, and grants; this information is now available online to any interested party at no cost.

- *Tax on net investment income*—Although widely considered income-tax-free, private foundations do face a small excise tax on "net investment income," which includes taxable bond income, rents, dividends, and capital gains net of applicable deductions. At 1–2%, this tax is small, but it can be relevant nonetheless, particularly in years when diversifying low-basis assets.
- *Operating rules*—Compliance and administrative regulations are complex, and failure to abide by them can result in stiff penalties. For example, there are severe sanctions for violating rules prohibiting "self-dealing" (in most cases, transacting business with the donor's family) and owning "jeopardy investments," which can include any investment deemed to violate the "prudent investor" tests relative to the objectives of the foundation.\*

See the Glossary, pages 29–32, for details on these and other federal regulations affecting foundations. Further, Congress is currently considering several proposals designed to increase oversight of all tax-exempt organizations, private foundations among them.†

\* In addition, the Uniform Management of Institutional Funds Act, which applies to not-for-profit corporations in many jurisdictions, is currently being revised to include rules derived largely from the Uniform Prudent Investor Act. That act governs charitable trusts in many jurisdictions and requires investing as a "prudent investor" would, using reasonable care, skill, caution, and diversification.

† The current proposals include periodic review by the IRS, increased penalties for engaging in prohibited transactions, and more detailed reporting to the IRS. These proposals are designed to curb abuses rather than change the structure or objectives of tax-exempt organizations. See U.S. Senate Committee on Finance, October 22, 2004 Memorandum ("Treasury Inspector General for Tax Administration Report"); U.S. Senate Committee on Finance, June 22, 2004, hearing ("Charity Oversight and Reform"); and Joint Committee on Taxation, January 27, 2005, report ("Option to Improve Tax Compliance and Reform Tax Expenditures"). Also note that the states may impose additional regulatory or reporting requirements.

be the impetus for establishing a foundation). For example, consider a donor thinking about funding a foundation with low-basis stock from a private business he's in the midst of selling. If the business owner sells for cash, he may be better off funding the foundation *before* the sale, trading off the lower income-tax deduction on closely held stock in return for shielding the capital gains.<sup>9</sup> If he's selling it for publicly marketable stock and has a high enough AGI, he may be well advised to fund the foundation *after* the sale of the business. The best strategy in any situation like this depends on the particulars of the deal and needs to be customized to each donor.

Issues like these only scratch the surface, which is why professional tax and legal advice is so important in deciding on a philanthropic strategy. But we'd encourage anyone considering a foundation to remember that:

- Gifts to a public charity can result in greater tax savings than gifts to private foundations—but only for a donor whose charitable gift represents a significant percentage of his AGI.
- A donor who wishes to establish a foundation but is unable to capture the full value of a tax deduction might consider funding the foundation over time, sized to his projected AGI.
- Though gifts of cash may allow for greater deductions than gifts of stock, gifting low-basis stock (or other assets) can be more advantageous, since the donor can avoid meaningful capital-gains tax.

## How Much Can the Donor Afford to Give?

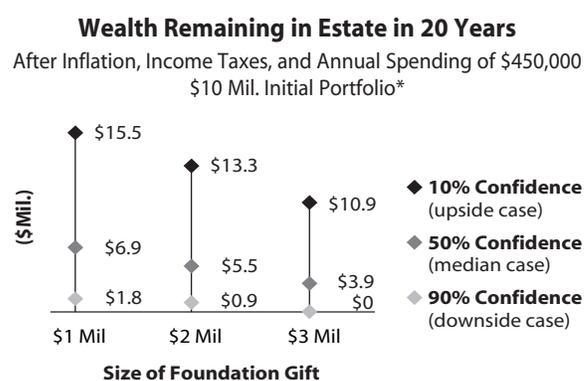
For most individual donors, taxes are only one part of the equation: They also want to be confident that their gifts will make a charitable impact without derailing their ability to meet other financial goals. If their gift is to a structured vehicle like a foundation and hence irrevocable, the need for caution is so much the greater. In a previous research

study on intergenerational wealth transfer,<sup>10</sup> we introduced the concept of “gifting capacity”—an estimation of how much grantors can comfortably give in today's dollars and still meet their personal wealth goals. In quantifying these estimates, we use our proprietary Wealth Forecasting Analysis, which combines information about the donor's individual circumstances with our projections of capital-markets returns and volatility. The output arrays potential wealth outcomes for the donor, arranged by probability of occurrence and based on 10,000 market scenarios generated by our model, ranging from superior to dismal.

For example, consider a philanthropist with \$10 million of liquid net worth in a balanced stock/bond portfolio who spends \$450,000 each year (grown with inflation). We're assuming he'll earn \$1 million in after-tax income in each of the next three years (as well as any income his portfolio generates), after which he plans to retire. He'd like to fund a foundation—but he's concerned about reducing the legacy to his children or even failing to meet his own future spending needs. How much can he gift?

### DISPLAY 5

***A donor wishes to leave a sizable estate to his family—how much can he also gift to a foundation?***



\* Donor assumed to earn \$1 million per year in income over the first three years of this analysis. Portfolio is invested in 60% stocks/40% bonds. Stocks are globally diversified: 35% U.S. Value, 35% U.S. Growth, 25% Developed International, and 5% Emerging Markets. Bonds are intermediate-term diversified municipals. Spending is adjusted for inflation. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33–35, for further details.

<sup>9</sup> Business owners may also consider making gifts to public charities such as donor-advised funds and supporting organizations, which may provide larger tax deductions. For our research on pre-transaction planning, *The Art Before the Deal: Maximizing Personal Wealth When Selling a Business*, please contact your Bernstein Advisor or visit [www.bernstein.com](http://www.bernstein.com).

<sup>10</sup> Please contact your Bernstein Advisor or visit [www.bernstein.com](http://www.bernstein.com) for our research publication *Keeping It in the Family: Planning for Efficient Wealth Transfer*.

*Display 5* (previous page) presents estimates for the philanthropist's wealth 20 years hence, after taxes, spending, and inflation, assuming that today he commits gifts to a foundation that range from \$1 million to \$3 million.<sup>11</sup> We can show our projections at virtually any level of probability; here we display an upside case, which represents the best 10% of results the donor is likely to experience; the median case; and the downside (90% of the scenarios will have outcomes of at least this much).

A gift as large as \$3 million would severely pressure the philanthropist's own wealth should the markets turn out to be poor; indeed, we see a 10% chance that the philanthropist would run out of money over the 20-year period. Of course, the safety factor is higher at lower gifting levels. In the downside case, we'd expect a legacy of \$1.8 million with a \$1 million foundation gift—but half that legacy if the gift is twice as big. The "right" foundation gift will depend on how risk-averse the donor is and how he trades off family wealth-transfer goals in relation to charitable goals. For serious foundation donors, quantifying solid estimates of the effect of one's charitable gifts on personal and intergenerational wealth goals is not just possible but a virtual necessity. (See also "A Closer Look" on combining foundations with CRTs or CLATs to meet multiple financial goals, page 12.)

### Benefits to Charity: Gift/Cost Analysis

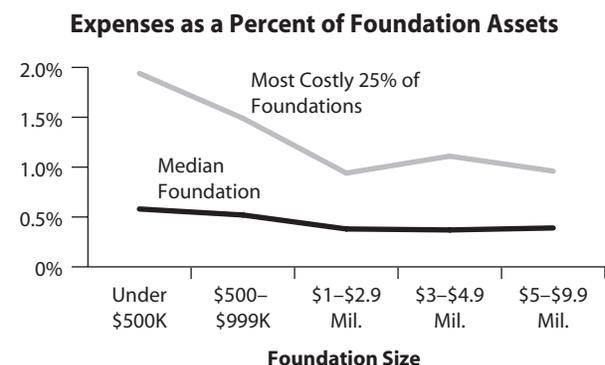
For those donors who are comfortable parting with some of their wealth, able to benefit from a charitable tax deduction, and attracted to the idea of a charitable legacy and family control, foundations may indeed be the right philanthropic vehicle. But we commented earlier that most foundations are relatively small (see page 6). Given their costs, is it likely that these smaller foundations will be viable?

To answer the question in purely financial terms, a foundation is successful if it produces more wealth for charity than annual gifting from a taxable portfolio, after distributions and after factoring in the foundation's additional expenses.<sup>12</sup> So the first order of business is to explore how much foundations actually cost to operate—particularly at lower asset levels, where the expenses are likely to be the highest as a percentage of the assets.

Based on cost survey data from the Association of Small Foundations, the median private-foundation expense ratio was about 0.5% of assets in 2004.<sup>13</sup> Interestingly, the median varied little by size of the foundation: It was 0.6% for foundations with \$500,000 or less, versus about 0.4% for asset sizes ranging from \$1 million to \$10 million<sup>14</sup> (*Display 6*). But prospective foundation donors should be aware that costs in the foundation landscape are skewed: Some foundations carried disproportionately high costs—particularly those with smaller asset sizes. When we looked at the top 25% of foundations by cost, for example, the expenses for those with \$500,000 or less were about 2%. But even past the \$1 million mark, costs were still at about 1%—double the median.

DISPLAY 6

**Foundation costs vary—but are often reasonable, even at smaller asset levels**



Source: Association of Small Foundations (2004 survey)

<sup>11</sup> Including the benefit of income-tax deductions

<sup>12</sup> The same analysis could be performed for any of the structured-giving vehicles that qualify as public charities (such as donor-advised funds and supporting organizations), since they also offer a tax-free environment and entail operating and administrative expenses.

<sup>13</sup> This excludes any investment-management expenses that may be incurred or onetime "start-up" expenses. (An Association of Small Foundations 2004 member survey found that the median start-up expense was a little more than \$5,000.)

<sup>14</sup> These data indicate that even at lower asset sizes, private foundations can be competitive with alternatives such as donor-advised funds. For example, an analysis of the five largest commercial donor-advised funds reveals that the median operating and administrative costs are approximately 0.74% for funds with \$1 million in assets and 0.86% for funds with \$500,000. One relatively new factor in the cost equation for foundations that may have made them more competitive is the emergence of third-party "turnkey" foundation administrators. Given recent advances in technology, these administrators appear to be able to deliver comprehensive lower-cost administration for foundations with limited donor involvement.

We used our Wealth Forecasting Analysis to compare our estimates of the wealth transferred to charity after 20 years using:

- Typical- and high-cost foundations (0.5% and 1.5% annual expense ratios, respectively); and
- Direct gifts from two taxable portfolios, one holding a single stock, the other a diversified mix of stocks.

In each of these cases, we assumed the median outcome for an initial \$1 million portfolio and annual gifts of 5% of market value. *Display 7* depicts our projections of the total amount available to charity—combining in each case the cumulative amount gifted over the 20 years and any assets still remaining in the charitable portfolio, all adjusted for inflation.

We estimate that annually gifting a publicly traded low-basis stock (with average volatility and yield) from a taxable portfolio would result in total wealth to charity of about \$1.4 million in today's dollars. Annual gifting from a diversified portfolio would leave the charity with a projected \$1.8 million—the extra wealth representing the benefit of long-term diversification over 20 years. If, instead, \$1 million of low-basis stock were gifted to a foundation and reinvested in diversified stocks, we project that the combination of diversification and tax-free growth would translate into \$700,000 more wealth than annual gifts from a single-stock portfolio—a 50% premium.

However, if foundation expenses were as high as 1.5%, the extra wealth generated for charity versus direct annual gifting would be greatly reduced. For a donor with a low-basis stock, the tax-advantaged diversification and growth benefits

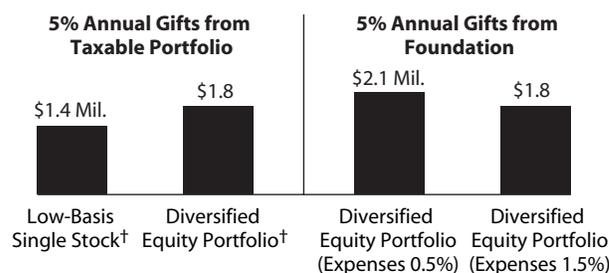
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DISPLAY 7

***Will a foundation's tax-advantaged environment justify its cost? In most cases, yes.***

**Median Inflation-Adjusted Wealth to Charity**

Total Gifted and Remaining Assets: Year 20  
\$1 Mil. Initial Portfolio\*



\* At 10% level of confidence, value from low-basis single-stock portfolio is \$4.6 mil., \$3.3 mil. from a diversified equity portfolio, \$4.0 mil. from a foundation with a 0.5% expense ratio, and \$3.4 mil. from a foundation with a 1.5% expense ratio. At 90% level of confidence, values are \$0.6 mil., \$1.1 mil., \$1.2 mil., and \$1.0 mil., respectively. Throughout this study, foundation forecasts are based on a Bernstein model that factors in an excise tax of approximately 1–2% of net investment income.

† Single stock is a stock with average volatility and dividend yield. Diversified stocks comprise 35% U.S. Value, 35% U.S. Growth, 25% Developed International, and 5% Emerging Markets.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33–35, for further details.

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would, we estimate, be enough to beat annual gifting by \$400,000 (\$1.8 million versus \$1.4 million, the fourth and first bars in the display).<sup>15</sup> But for a donor without a low-basis position, the foundation's benefit would be limited to its tax-free growth—which we would expect to be nullified by the high expenses. So in general, donors with assets that could benefit from both diversification and tax-free compounding will likely find that foundations—even those with asset levels of \$1 million or less and above-average expenses—can create substantially more wealth for charity than direct giving. This type of analysis can and should be applied to all structured-giving alternatives, including donor-advised funds and other public charities.

<sup>15</sup> Remember that we're dealing with the median case here; for upside potential—though by definition it's unlikely to be realized—single stocks have no rival. See *The Envious Dilemma—Concentrated Stock: Hold, Sell, or Hedge?*, page 3, available through your Bernstein Advisor or on [www.bernstein.com](http://www.bernstein.com).

## A CLOSER LOOK | Combining CRTs and CLATs with Private Foundations

We have discussed the benefits of stand-alone charitable remainder trusts and charitable lead annuity trusts (CRTs and CLATs) in past publications (see particularly *Unlocking the Investment Potential of Charitable Remainder Trusts* and *Keeping It in the Family*); certain donors may find using these vehicles in conjunction with a foundation beneficial.

### Satisfying Diversification, Income, and Philanthropic Goals

For example, a donor who would like to diversify low-basis stock and give to charity, but would also like to create an income stream for himself and his spouse, can utilize a CRT—making a private foundation the remainder beneficiary of the trust. While this shifts the donor's charitable gifting into the future, it generates current cash flow.

If the donor opts for such a strategy, he can set up the CRT for his lifetime; for his or his spouse's lifetime, whichever is longer; or for a certain term (not exceeding 20 years). The term selected can be customized based on how much cash flow he's looking for and when he wants his foundation to receive the assets. The shorter the trust term, the less he personally benefits and the quicker the foundation receives the

assets, and vice versa. This joint CRT/foundation strategy also allows the donor to diversify a low-basis stock inside the CRT without the 1–2% excise tax levied on a private foundation.

### A CLAT/Foundation Pairing

When a CLAT is paired with a private foundation, the foundation is the lead beneficiary of the trust, with the donor's children usually the remainder beneficiary.\* This strategy would provide a constant funding source for the donor's private foundation, as well as the potential to pass wealth to the donor's children free of any gift or estate tax, as long as the trust assets outperform the IRS hurdle rate.† The hurdle rate, based on bond yields, is low (less than 5%) as of this writing in August 2005—making now a propitious time to set up a CLAT and potentially reduce the estate-tax burden on the grantor's heirs.

Combining private foundations with trusts can yield benefits for donors with both charitable and other wealth-transfer goals; our Wealth Forecasting Analysis can help quantify the trade-offs. However, such combinations raise complex issues; it's key that donors interested in this strategy receive detailed tax and legal advice.

\* We're assuming a non-grantor CLAT.

† The hurdle rate for CLATs and certain other trusts is the Section 7520 rate, named after the section of the Internal Revenue Code authorizing its use. We assume in this analysis that any CLAT is "zeroed out." If a trust is zeroed out, the present value of its annuity stream, discounted by the Section 7520 rate when the trust was established, equals the grantor's original contribution. The entire remainder, if any, of a zeroed-out trust can be transferred free of gift or estate taxes.

### The Appeal of a Foundation

In setting up a foundation, donors are often motivated more by a desire to establish a family philanthropic legacy than by purely monetary factors. But the economics for both the donor and for charity must be fully understood to help ensure that one's charitable dollars are best used. For charity, the tax-advantaged environment of a foundation can yield substantially more wealth than direct giving; over 20 years, we estimate the increment can reach as high as 50% in typical markets, depending on the assets contributed. Further, despite what some might think, foundations need not be huge to produce a large charitable benefit, even after considering their potential for high costs.

## 2. FOUNDATION MANAGEMENT

Assuming a foundation has been established, we turn now to the multifaceted challenge of setting investment and payout policies that are consistent with the donor's charitable vision. That task is handled by the foundation's trustees or directors, who may include the donor himself, selected family members, or a team of outside professional advisors. And these days, in a tougher capital-markets environment, the importance of making the right decisions is magnified. Foundation managers, with fiduciary duties to exercise care and prudence in this regard, need a framework to ensure sound decision making.<sup>16</sup>

Often, the investment and giving policies are centered on the goal of having the assets last forever: In a 2004 survey by The Foundation Center, 69% of respondents articulated perpetuity as a goal. Whether or not foundation managers can expect to *achieve* this objective is a separate issue. Further, the intention to last forever (or at least for many generations) is often only one component of a donor's charitable mission. Many want to give as much as possible as soon as possible, or to give when the need is greatest, or to fund a *stable* flow of gifts. And, of course, all donors would like to meet their objectives with as little investment risk as possible.

To determine whether objectives are viable, we review history and our market forecasts to help answer questions such as:

- What are the odds that a given foundation will keep pace with inflation?
- What's the effect of higher giving on the chance of achieving perpetuity? On the share of gifts managed by current- versus later-generation family members?
- How will a stable annual gifting stream affect a foundation's longevity?

- How much investment risk is needed to best meet the donor's goals?

With answers to these questions, foundation managers are better equipped to match long-term investment and spending policies to the donor's stated wishes. Those wishes and a strategy designed to meet them can be codified in a written investment policy statement to help ensure clarity for years to come (see "A Closer Look," page 20).

### The Odds of Lasting Forever: History Versus Projections

It's particularly critical today to be conversant with these dynamic tensions—ironically because they've been *dormant* over the last two decades. In the 20 years ending 2004, the heady markets of the 1980s and 1990s dominated returns, trumping the ensuing crash of the early 2000s. The result (*Display 8*, next page) was that foundations with virtually any allocation earned enough return to cover the 5% annual minimum distribution and inflation.

A foundation portfolio completely allocated to bonds (five-year Treasuries), traditionally not a growth-oriented asset, would have benefited from the sharp decline in interest rates over the 20 years and compounded at 8.4% annually. After subtracting the minimum 5% payout and the 3% inflation rate, the portfolio would still have almost half a percentage point in annualized real return left to grow in the foundation.<sup>17</sup> A classic 60% stock/40% bond mix would have seen the inflation-adjusted value of the portfolio grow 3.6% per year after paying out the required distribution. Looked at another way, a foundation allocated in those proportions could have supported a spending rate of 8.6% annually without damaging its value. It's no wonder that many commentators at the time disparaged a 5% payout as stingy.<sup>18</sup>

<sup>16</sup> Foundation managers generally are expected to invest the assets as a "prudent investor" would; see first footnote to "A Closer Look: Rules Foundation Donors Should Know," page 8.

<sup>17</sup> Payouts can include most operating and administrative expenses; unless otherwise indicated, in this study we assume that these expenses are included in, rather than incremental to, the payout levels given. The costs associated with an outside investment manager cannot be included in the payout.

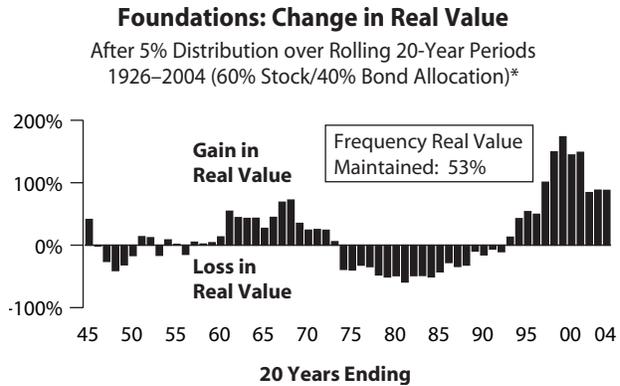
<sup>18</sup> See, for example, Perry Mehrling, "Spending Policies for Foundations: The Case for Increased Grants Payout," National Network of Grantmakers, 1999.

But if we look at how a 60/40 allocation (close to today’s typical foundation portfolio) fared across a very broad swath of history—all the 20-year periods dating back to 1926 (when reliable data began), rolled annually through 2004—we see how unusual the recent past was (*Display 9*). What’s most striking about the 60 such periods we captured is how unpredictable maintaining inflation-adjusted value has been for foundations, assuming the minimum 5% payout rate, even over long time periods. The effect of the roaring 1980s and 1990s is clear on the right side of the chart; but that period was counterbalanced by a long stretch of real losses in the 1960s and 1970s. Before that, there was little consistency in results, making the odds of pacing inflation over the full time period little better than even (53%).

In *Display 10*, we expand on these results by varying the two key levers that determine a foundation’s asset value: the asset mix and the payout rate. In the top chart, we quantify the frequency with which different allocation and payout combinations would have maintained a foundation’s inflation-adjusted value. We’ve already seen that historical results on this score have been mediocre; the data in *Display 10* reinforce the difficulty of pacing inflation, even for the most aggressive allocations. A foundation that made the minimum 5% payout and invested in an all-equity portfolio would have

DISPLAY 9

**Almost eight decades of history suggest that perpetuity is a tough hurdle...**



\* Stocks are represented by the S&P 500, bonds by long-term government bonds through 1962 and by five-year Treasuries thereafter.  
Source: Bureau of Labor Statistics; Center for Research in Securities Prices; Compustat; Federal Reserve; Roger G. Ibbotson and Rex A. Sinquefeld, "Stocks, Bonds, Bills, and Inflation: Year by Year Historical Returns," University of Chicago Press *Journal of Business* (January 1976); and Bernstein

increased its success rate by only 10 percentage points versus a 60/40 portfolio (while experiencing more volatility along the way). And with a higher payout rate of 7%, the frequency drops fairly dramatically across all the allocations.

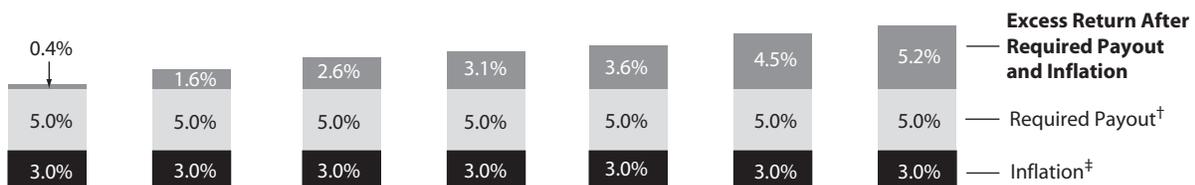
In the bottom chart, we quantify an easier bogey: a foundation simply maintaining its initial nominal value over 20-year periods. Foundation managers might take heart that the frequency of retaining initial values was in fact high. For

DISPLAY 8

**The long bull market dominated the last 20 years; for private foundations, it was hard not to preserve capital value even after payouts**

**Results by Asset Allocation: 1985–2004**

0%	20%	40%	50%	60%	80%	100%	Stocks
100%	80%	60%	50%	40%	20%	0%	Bonds
8.4%	9.6%	10.6%	11.1%	11.6%	12.5%	13.2%	<b>Annualized Return*</b>



\* Total annualized return calculated using blended index returns for stocks and bonds. Stocks are represented by the S&P 500, bonds by five-year Treasuries.

<sup>†</sup> In accordance with Internal Revenue Code Section 4942

<sup>‡</sup> The compound inflation rate for 1985–2004 was 3.0%.

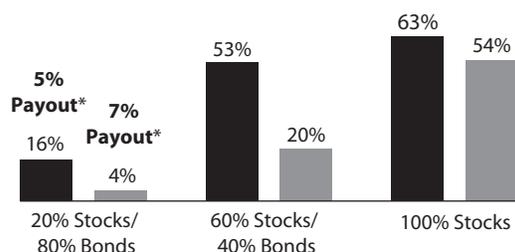
Source: Bureau of Labor Statistics, Compustat, Lehman Brothers, and Bernstein

DISPLAY 10

**...and tougher if the stock component is reduced  
and/or the payout level raised**

### Frequency of Maintaining Inflation-Adjusted Value After Distribution

Rolling 20-Year Periods 1926–2004

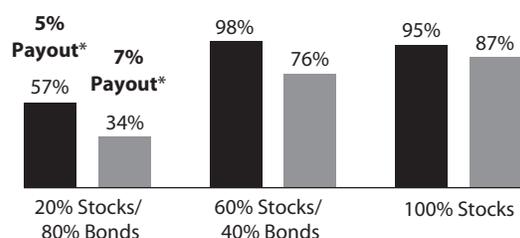


\* Giving level is calculated as a percentage of annual assets. Stocks are represented by the S&P 500, bonds by long-term government bonds through 1962 and by five-year Treasuries thereafter.

Source: Bureau of Labor Statistics; Center for Research in Securities Prices; Compustat; Federal Reserve; Roger G. Ibbotson and Rex A. Sinquefeld, "Stocks, Bonds, Bills, and Inflation: Year by Year Historical Returns," University of Chicago Press *Journal of Business* (January 1976); and Bernstein

### Frequency of Maintaining Nominal Value After Distribution

Rolling 20-Year Periods 1926–2004



\* See footnote above.

Source: See above.

example, even with a 7% payout and a 60/40 balance rather than an all-stock allocation, the odds of maintaining nominal value were 76%; going to all equities brought the odds up to nearly nine in 10. On the other hand, a foundation that only maintained its nominal value over these 20-year periods would be worth 55 cents on the dollar relative to its initial value. The charitable impact of a \$1 gift would be cut virtually in half.

## Improving the Allocation of the Average Foundation

While it's tempting to look to the last 20 years, we think foundation managers should expect an investment environment much closer to the long-term experience. But most foundations aren't being managed to that standard. The latest data suggest that, on average, foundations have chosen an allocation close to a medium-risk 60/40 balance, with a payout ratio in the neighborhood of 6½%, *excluding* operating and administrative expenses—or just about 7% in all (*Display 11*, next page).<sup>19</sup>

With 10-year Treasury yields slightly above 4% at this writing, and our expectations for equity returns in the high single digits, it's hard to envision a foundation earning in excess of the minimum 5% *after* inflation required to preserve its real value while maintaining appropriate risk control. There are only a few things a foundation manager targeting longevity can do: change to a more aggressive allocation, reduce the annual giving amount and expenses, or revisit the importance of perpetuity as a defining goal.

As to allocation, our primary observation is that improvements to the investment mix can be made—and in this case without meaningfully increasing portfolio risk. We'd eliminate the cash component—which creates a drag on returns—increase foreign stocks (from both the developed and emerging markets) to about 20% of the portfolio for greater return potential and portfolio diversification, and increase the real-estate investment trusts (REITs) to 10%—another diversifying asset.<sup>20</sup> These changes aren't dramatic but nonetheless can be important in trying to tilt the odds in the foundation's favor long term.

However, for the one-fourth of all foundation portfolios holding large single-stock concentrations—a surprisingly high percentage, given the natural environment foundations provide for diversification—we would recommend more significant change. For foundations in that category,

<sup>19</sup> Allocation is as of year-end 2004, payout as of year-end 2003.

<sup>20</sup> Our analysis assumes that the REITs in the foundation's allocation are structured to prevent the characterization of income as "unrelated business taxable income" (UBTI; see Appendix, page 31), which would be subject to income tax. Consult your legal advisor regarding the nature of any particular REIT and whether it will generate UBTI.

DISPLAY 11

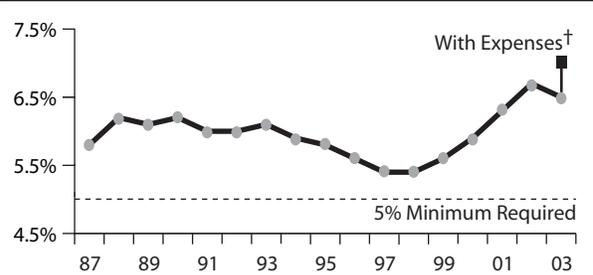
**Today's average foundation isn't allocated optimally for perpetuity and is paying out at too high a rate**

**Allocation of Average Foundation (2004)**

Asset Class	Average Weight
U.S. Stocks	51%
Foreign Stocks	6
Bonds	24
Cash	11
Real Estate	4
Alternative Assets	4

Source: Association of Small Foundations  
 A Commonfund survey found that donor undiversified stock represented a significant component in many foundations. In about one out of every four foundations, this concentrated stock position represented an average of 40% of the equity component, adding substantially to the risk profile of those foundations.

**Foundation Charitable Giving Rate\***



\* Excepting 2003, represents only amount of charitable gifts made by foundations; excludes certain operating and administrative expenses and other items that can be used to meet a foundation's minimum required distribution  
 † Median expense ratio of private foundations from 2004 Association of Small Foundations survey  
 Source: Association of Small Foundations, The Foundation Center, and Bernstein

we'd typically advise diversifying at least some of that concentrated stock position.

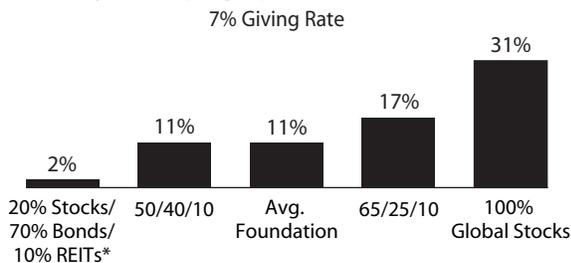
All in all, if we modestly raised the risk level of an approximately 60/40 portfolio to a more diversified mix of 65% global equities, 25% bonds, and 10% REITs, we estimate that the assets would grow faster, leaving more to charity and—assuming a low payout rate—increasing the chance of achieving perpetuity. But at today's fully loaded distribution of about 7%, we believe the odds of pacing inflation long term wouldn't be dramatically increased (*Display 12*).

Using our Wealth Forecasting Analysis, we estimate only an 11% probability of today's average foundation pacing inflation for 20 years at its current 7% payout rate (using market indexes rather than factoring in any potential premium from active management). Making the allocations more efficient by adding a little risk raises the odds another six percentage points—a measurable albeit modest difference. With an allocation wholly to global diversified stocks, we project a three out of 10 chance of "staying whole": not inspiring, although far better than the odds we'd give for the lower-risk mixes.<sup>21</sup>

DISPLAY 12

**Assembling a more efficient asset mix helps—but not much, particularly with foundations distributing 7% on average**

**Probability of Keeping Up with Inflation for 20 Years**



\* Stocks are globally diversified: 35% U.S. Value, 35% U.S. Growth, 25% Developed International, and 5% Emerging Markets. Bonds are 100% intermediate-duration taxable bonds, REITs are represented by the National Association of Real Estate Investment Trusts (NAREIT) Index. For allocation of average foundation, see Display 11.  
 Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33–35, for further details.

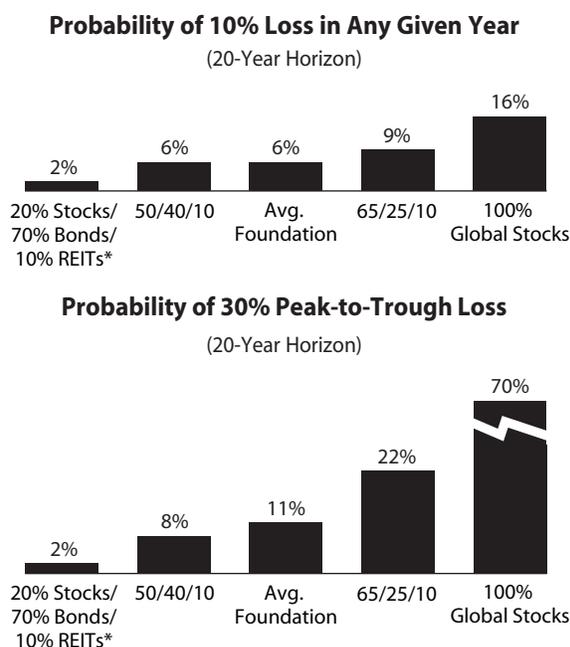
*Display 13* presents the other side of the coin of increased allocation risk: increased portfolio fluctuations. We show our estimated odds of each of the mixes in *Display 12* experiencing a 10% annual loss in any given year and the probability that the allocation would register a 30% peak-to-trough loss, two frequently used touchstones for risk.

The 65/25/10 portfolio increases volatility versus today's average foundation: marginally in the case of a 10% loss, more significantly for the 30% loss bogey. These losses may well be recouped over the 20-year period—and we'd expect only a one out of five chance that such an allocation would result in a 30% loss. However, for a global-equity

21 For a detailed analysis of probability levels, see the Appendix, page 26.

DISPLAY 13

### Assessing portfolio risk: Stocks increase volatility as well as expected returns



\* See footnote to Display 12 on asset composition.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33–35, for further details.

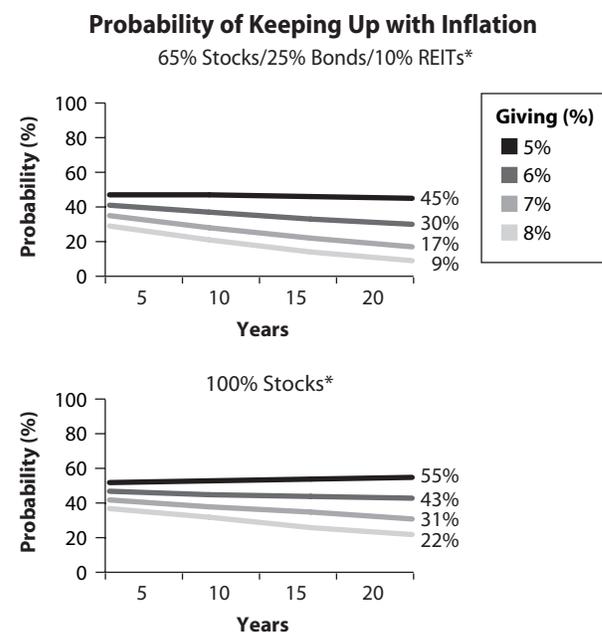
portfolio, that probability goes up to an estimated seven out of 10. Foundation managers may decide to accept risk of that magnitude in exchange for the likelihood of better returns, but many will find the stepped-up volatility a mismatch with the donor's goals.

### It's Mostly About Payouts

As important as allocation is, payout levels tend to be more so. *Display 14* compares the longevity implications of a 65/25/10 mix versus 100% global stocks for different payout levels. Overall, at payouts any higher than the minimum, the odds of "staying whole" for 20 years deteriorate quickly. With the 65/25/10 portfolio, going to even a 6% payout lowers our projected probability of holding real value from roughly even to 30%; the falloff is notable for an all-stock portfolio as well. The flip side is the improvement in longevity odds we'd project for both portfolios if today's average payout were the minimum 5% rather than 7%.

DISPLAY 14

### Foundation longevity is sensitive to every percentage-point increase in payout



\* See footnote to Display 12 on asset composition.

Giving level is calculated as a percentage of annual assets. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33–35, for further details.

### Looking Beyond Perpetuity: Different Perspectives on Foundation Giving

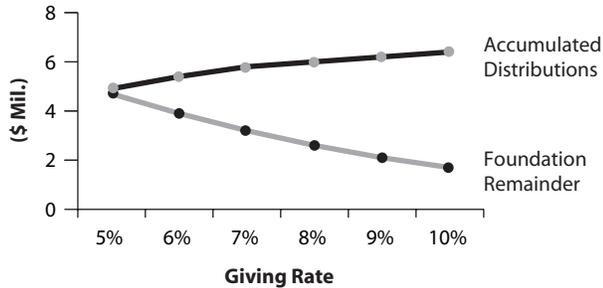
These results have significant implications for foundations aiming for perpetuity. They have special applicability for the many foundations whose charitable goals call for giving more than the minimum to charity—or as much as the donor or foundation manager believes the charity needs at any given time. For most of those foundations, perpetuity may not be a reasonable objective. In these cases, it's the responsibility of the foundation's leaders to consider adjusting the investment and giving policies—and indeed to think more broadly about perpetuity itself.

For example, consider *Display 15* (next page), which presents a perspective on managing a foundation that many foundation managers might find appropriate. The line chart at the top of the display compares the real value of the cumulative gifts versus the remainder after 20 years at varying payout rates, based on the median results from

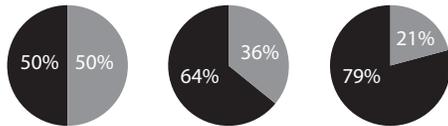
DISPLAY 15

**Who controls the lion's share of the gifting?****Median Inflation-Adjusted Values**

65/25/10 \$5 Mil. Initial Portfolio: Year 20\*

**Share of Charitable Giving**

20-Year Horizon\*

**Payout Rate:**

5%

7%

10%

■ Current Generation

■ Future Generations

\* See footnote to Display 12 for allocation details.

Giving level is calculated as a percentage of annual assets. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33–35, for further details.

our Wealth Forecasting Analysis for a 65/25/10 foundation established with \$5 million. There are no surprises here: As the payout rate goes up, so do the accumulated distributions to charity—at the cost of a declining remainder. Further, it's notable that although foundation value erodes, it's typically not a fast process—even at high payouts. Even after a double-digit payout for 20 years, we project that a foundation established with \$5 million would still have about \$2 million in inflation-adjusted value left to spend in the median case. Failing to achieve perpetuity doesn't usually mean a quick end to charitable gifting.

But the pie charts show how the payout/remainder relationships play out in a more personal way: They show who controls the gifting. Consider, for example, a foundation currently paying out 5% whose donor is an influential decision maker and has a life expectancy of 20 years. We project that

half the foundation's assets would be gifted under his aegis over the next two decades, with half left for disbursement by succeeding generations. At the current average 7% distribution, more of the money is given away faster; we estimate that almost two-thirds of the gifting would be in the hands of current decision makers. With a payout as high as 10%, the current decision makers would control virtually 80% of the charitable decisions. The higher the payout rate, the less say future generations will have about how the charitable funds are spent. That may suit the objectives of some donors, perhaps because they wish to exert major control over the foundation or because they want their favorite charities to receive more in the early years. However, if an objective is to have succeeding generations deeply involved in philanthropy, the foundation would either need to cut back on its payout or perhaps even receive additional gifts from the donor.

Thinking through and quantifying scenarios like these can be critical in setting goals, both at the time the foundation is established and after the donor is no longer involved. Further, these decisions are not set in stone: The gift may be irrevocable, but a foundation's allocation and payout rate can be modified at any time (subject to the required 5% minimum distribution), and more gifts can always be added.

**The Pros and Cons of Stable Giving**

For some foundations, disbursing a *stable* flow of gifts may be a key piece of the charitable vision. Indeed, we saw this phenomenon unfold in practice during the bear market of 2000–2002, when gifts from foundations in aggregate held at fairly stable levels despite the plummeting stock market. If that's a critical objective, simply spending a percentage of the foundation's assets each year won't work.

Some foundation managers might consider developing a giving policy that allows them to distribute, for example, *either* a set percentage of the asset value *or* the prior year's giving amount, whichever is greater. Adopting such a strategy

DISPLAY 16

**Trading off stable gifts for potentially declining foundation value:****\$5 Mil. Foundation Invested 65/25/10—Inflation-Adjusted Values: Year 20\***

	5% Every Year	Greater of 5% or Prior Year's Gift	7% Every Year	Greater of 7% or Prior Year's Gift
Probability of 20% Peak-to-Trough Decline in Distribution	98%	— <sup>†</sup>	98%	— <sup>†</sup>
Accumulated Gifts—Median Case	\$4.9 Mil.	\$5.5 Mil.	\$5.8 Mil.	\$6.7 Mil.
Probability of Maintaining Inflation-Adjusted Value	45%	39%	17%	8%
Remainder Value—Downside Case <sup>‡</sup>	\$2.6 Mil	\$1.6 Mil.	\$1.7 Mil.	\$0.0 Mil.

\* See footnote to Display 12 for allocation details.

† There is the possibility that the foundation will run out of money because of fixed spending in declining markets (see, for example, Display 17). Barring that eventuality, there is no chance that distributions will decline if a stable-gifting policy is adopted.

‡ The worst 10% of future market scenarios in Bernstein's estimation

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33–35, for further details.

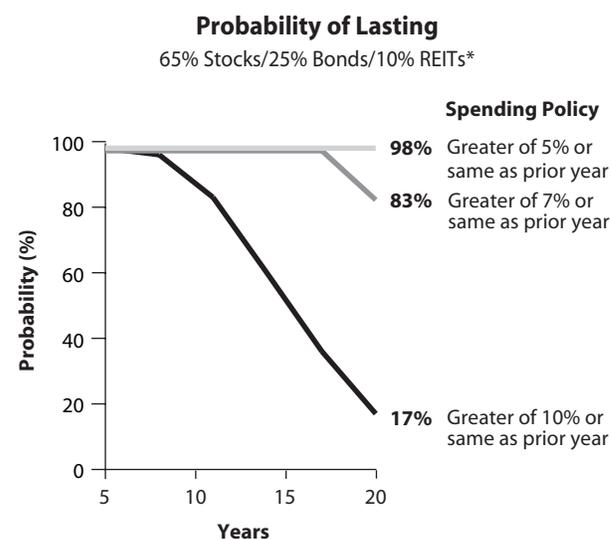
ensures that gifts do not decline in poor markets (though they can, of course, increase in good ones). The other side of this coin is that a stable-gifting strategy will cut into the asset base when times are tough, potentially exhausting the assets sooner than would otherwise be the case. *Display 16* quantifies the trade-offs of a stable-giving strategy versus simply gifting either 5% or 7% of the assets.

If stable giving is the chosen strategy, the spending is never reduced from year to year (unless the foundation runs out of money). We estimate that the inflation-adjusted value of the total amount gifted over 20 years will be \$600,000 to \$900,000 higher in the median case than spending a straight percentage of the assets. Of course, the chances of maintaining the foundation's real value will decline—since the foundation's principal will be used in poor markets to fund the gifts. Depending on the payout rate and the time period, the result could be the dissolution of the foundation. According to our estimates, the downside (defined as the worst 10% of results) is that by paying out either 7% or the prior year's payout (whichever is greater), the foundation runs out of money in 20 years.

This may be fine for a foundation oriented primarily to funding intermediate-term charitable needs—but it's always important to know how long a foundation's assets can be expected to support a

stable-giving policy. For example, we estimate that over 20 years, a typical balanced foundation should have little problem supporting a stable-giving 5% strategy (*Display 17*). Indeed, with a 7% annual base gift, the odds are still high that the foundation will continue to exist. However, with a 10% payout bogey, the foundation would likely run out of money within 20 years. Even in that instance, though, if spending down the assets

DISPLAY 17

**The higher the stable-giving percentage, the shorter the foundation's effective life**

\*See footnote to Display 12 for allocation details.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33–35, for further details.

## A CLOSER LOOK | Establishing a Written Investment Policy Statement

A written investment policy statement is often used to articulate a private foundation's investment objectives and to set expectations for the long-term stewardship of its assets. The process of creating a written statement helps fiduciaries clarify the donor's purpose in creating the foundation—and improves the odds that the foundation's assets will continue to be managed over time with that purpose in mind. This is particularly important for foundations designed to span multiple generations.

Investment policy statements are typically separated into distinct sections, with the following areas covered at a minimum:

- Risk and return objectives
- Asset classes deemed acceptable (including any allocation to alternative asset classes such as hedge funds)
- The strategic asset allocation, the range of acceptable allocations, and rebalancing rules
- Investment and performance guidelines for investment managers, including the benchmarks they'll be measured against
- The payout policy

### Assessing Probabilities

Given the inherent uncertainties of the capital markets, fiduciaries may find it helpful if policy statements also assess the likelihood of foundations meeting their various objectives. For example, a statement could be crafted to include probability assessments of the foundation:

- Beating inflation
- Experiencing a given peak-to-trough drop in assets
- Experiencing a given annual drop in its payout level
- Running out of assets in a given time period
- Distributing a given amount in the current generation versus a given amount in the future

Meeting every goal with a high degree of probability may well be a challenge, but if fiduciaries had data like the above to work with, they could set parameters around key trade-offs: for instance, how much asset and payout stability they're willing to forgo in order to help assure longevity. The goal of incorporating this segment in the policy statement is simple: to help ensure that the foundation's investments have been calibrated to meet the donor's most important objectives.

is an option, data like these can help foundation managers make informed decisions about the payout rate.

### Matching Investment Policy to Charitable Goals

With clear objectives for current gifting and long-term asset preservation, foundation managers can create a tailored asset-allocation and gifting policy that best meets their charitable objectives.

*Display 18* schematically plots different allocation and giving-policy combinations by their ability to meet foundation goals. The importance placed on stable giving is on the horizontal axis, the importance of perpetuity on the vertical.

We'd make the following observations:

- If stability of asset value and giving are important goals, as well as a high current (as opposed to long-lasting) charitable impact, the donor might opt for a high and stable payout policy,

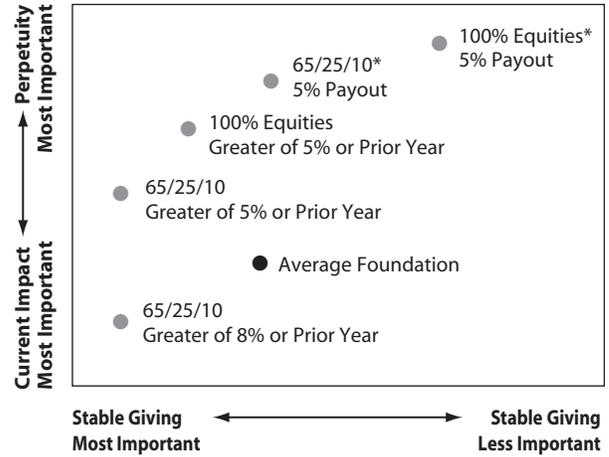
using perhaps a 65/25/10 allocation (see lower left of grid).

- If stable giving is less important and the donor is prioritizing perpetuity, a foundation might consider a far more aggressive 100% stock allocation and a lower payout (probably the minimum 5%; upper right of grid), as well as perhaps adding supplemental gifts over time.
- In between are various allocations tilted toward one of the goals; we show a few in the display as examples.

DISPLAY 18

**Fitting investment objectives to foundation goals**

**Spending vs. Longevity Trade-Offs**



\* See footnote to Display 12 for allocation details

**Foundation Management**

The two most critical levers in the hands of a foundation manager are the foundation’s payout ratio and asset mix. Overly influenced by the last great bull market, too many foundations may be assuming that a foundation may stay alive forever with a relatively balanced allocation despite a generous distribution. In fact, today’s markets are less friendly—but still amenable to efficiently allocated foundations designed to meet the donor’s charitable objectives. The essential trade-off is unavoidable: The more paid out (whether through increasing the distribution rate or establishing a stable-gifting strategy), the more foundation longevity is likely to be reduced. But the best combination of allocation, payout rate, risk level, and time horizon can still be determined for each donor through comprehensive quantitative analysis.



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# Appendix

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- **GIFTING SUMMARY: REPRESENTATIVE CHARITABLE VEHICLES**
- **DETAILED PROJECTIONS OF FOUNDATION LONGEVITY**
- **GLOSSARY**

## GIFTING SUMMARY: REPRESENTATIVE CHARITABLE VEHICLES\*

### Structured-Giving Vehicles Offered by Public Charities

	Overview	Tax-Deduction Limits	Donor Legal Control of Grants/ Investments
<b>Donor-Advised Funds</b>	Many different types; can be run by investment companies or community foundations and other nonprofit organizations; very little administrative burden on donor; generally cost-effective for small gifts	50% of AGI <sup>†</sup> for cash, 30% for long-term securities; most gifts valued at market value	Donor may recommend grants and investment strategy, but fund makes final decisions
<b>Supporting Organizations</b>	Often viewed as a hybrid between public charities and private foundations (see below); have their own legal identities (often associated with donors' names), but must be operated, supervised, or controlled by or in connection with one or more public charities; offer donor and his family significant influence but not legal control	50% of AGI for cash, 30% for long-term securities; most gifts valued at market value	Donor may recommend grants and investment strategy, but board makes final decisions

\* For additional commentary on each of the vehicles in this table, see the Glossary, pages 29–32.

† Adjusted gross income

‡ Depending on the method of qualification chosen, certain Type III supporting organizations must distribute substantially all of their income to or for the supported public charities.

### Private Foundations

	Overview	Tax-Deduction Limits	Donor Legal Control of Grants/ Investments
<b>Non-Operating Foundations</b>	Good fit for donors who desire maximum control over gifts and assets and wish to involve family deeply in philanthropy; donors must deal with administrative complexity and legal/regulatory scrutiny	Less favorable than for public charities: 30% of AGI for cash, 20% for long-term securities; gifts of public securities valued at fair market value; gifts of closely held/restricted stock and real estate valued at cost basis	Complete control of grants, investments, and the foundation's governing body
<b>Operating Foundations</b>	Operating foundations account for less than 10% of private foundations; suitable only for donors who wish to be directly involved in the active operation of their own charitable activities (running a museum, for example), as opposed to just grant making	Same as for public charities: 50% of AGI for cash, 30% for long-term securities; most gifts valued at market value	Complete control of grants, investments, and the foundation's governing body

§ Distributions made directly for the active conduct of exempt activities must equal 85% of the lesser of adjusted net income or 5% of assets not directly used for charitable activities. Additional distribution requirements may apply, depending on the method of qualification used by the foundation for income-tax-exempt status.

	<b>Administrative/ Compliance Burden</b>	<b>Costs</b>	<b>Minimum Payout to Charity</b>	<b>Donor Privacy</b>	<b>Excise Tax?</b>	<b>Family Involvement/ Succession</b>
	Minor; handled by fund	Generally no start-up costs; ongoing costs can vary significantly by fund	Generally none, but set by some funds	Names of individual donors can be kept confidential	No	Some funds encourage continuance of donors/ advisors to next generation; others do not
	Can be significant; however, some support services may be provided by the charities supported	Legal fees; start-up costs; ongoing costs vary, but can be significant	Generally none <sup>†</sup>	Varies by organization, but detailed public tax returns on grants, staff salaries, etc., may be required	No	Family may be involved and serve on board, but majority of board must be independent non-family trustees (often representatives from the public charities supported)

	<b>Administrative/ Compliance Burden</b>	<b>Costs</b>	<b>Minimum Payout to Charity</b>	<b>Donor Privacy</b>	<b>Excise Tax?</b>	<b>Family Involvement/ Succession</b>
	Can be significant; subject to strict rules, including restrictions on self-dealing, excess business holdings, etc. (see Glossary)	Legal fees; start-up costs; ongoing costs vary but can be significant	5% of assets	None; detailed public tax returns must be filed on grants, staff salaries, etc.	1–2% of net investment income	Significant opportunities for current and future generations to serve on the foundation's governing body
	Can be significant; subject to most, but not all, of the rules for private non-operating foundations	Legal fees; start-up costs; ongoing costs vary, but can be significant—potentially higher than for private non-operating foundations	Although not subject to the same 5% payout rule as non-operating foundations, minimum distributions apply <sup>§</sup>	None; detailed public tax returns must be filed on grants, staff salaries, etc.	Generally yes; 1–2% of net investment income unless specific tests are met	Significant opportunities for current and future generations to serve on the foundation's governing body

## DETAILED PROJECTIONS OF FOUNDATION LONGEVITY\*

### Probability of Maintaining Original (Nominal) Value

100% Equities		50% Equities/40% Bonds/10% REITs												
	5 years	10 years	15 years	20 years	25 years	30 years		5 years	10 years	15 years	20 years	25 years	30 years	
Giving Level	5%	65%	72%	78%	84%	89%	91%	5%	66%	74%	80%	84%	88%	90%
	6%	60	65	70	74	78	82	6%	57	61	64	67	69	71
	7%	55	57	59	62	64	66	7%	48	47	46	45	44	44
	8%	50	49	49	49	49	49	8%	39	33	29	26	23	20
	9%	45	42	39	36	34	32	9%	31	22	16	12	9	7
	10%	40	34	29	25	21	18	10%	24	14	8	5	3	<2

80% Equities/10% Bonds/10% REITs		35% Equities/55% Bonds/10% REITs												
	5 years	10 years	15 years	20 years	25 years	30 years		5 years	10 years	15 years	20 years	25 years	30 years	
Giving Level	5%	66%	74%	80%	86%	90%	92%	5%	65%	72%	76%	80%	82%	84%
	6%	60	65	69	74	78	81	6%	53	54	55	56	56	56
	7%	54	55	58	60	61	63	7%	41	36	33	30	28	27
	8%	48	46	45	44	43	43	8%	31	21	16	13	11	9
	9%	42	37	33	30	27	24	9%	22	11	6	4	3	2
	10%	36	29	23	18	14	12	10%	15	5	2	<2	<2	<2

65% Equities/25% Bonds/10% REITs		20% Equities/70% Bonds/10% REITs												
	5 years	10 years	15 years	20 years	25 years	30 years		5 years	10 years	15 years	20 years	25 years	30 years	
Giving Level	5%	66%	74%	81%	86%	90%	92%	5%	61%	67%	67%	68%	69%	69%
	6%	59	64	68	72	75	78	6%	45	41	38	37	35	35
	7%	52	52	53	54	55	56	7%	30	20	16	14	13	12
	8%	45	42	39	36	34	33	8%	18	7	5	4	3	3
	9%	38	31	26	21	18	16	9%	10	<2	<2	<2	<2	<2
	10%	31	22	16	11	8	6	10%	5	<2	<2	<2	<2	<2

### Probability of Maintaining Inflation-Adjusted Value

100% Equities		50% Equities/40% Bonds/10% REITs												
	5 years	10 years	15 years	20 years	25 years	30 years		5 years	10 years	15 years	20 years	25 years	30 years	
Giving Level	5%	52%	53%	54%	55%	56%	57%	5%	43%	41%	38%	36%	34%	32%
	6%	47	45	44	43	42	41	6%	36	30	24	19	16	13
	7%	42	38	35	31	28	26	7%	29	21	14	9	6	4
	8%	37	32	26	22	18	15	8%	23	13	7	3	<2	<2
	9%	33	26	19	14	10	7	9%	18	8	3	<2	<2	<2
	10%	29	20	13	9	6	3	10%	13	5	<2	<2	<2	<2

80% Equities/10% Bonds/10% REITs		35% Equities/55% Bonds/10% REITs												
	5 years	10 years	15 years	20 years	25 years	30 years		5 years	10 years	15 years	20 years	25 years	30 years	
Giving Level	5%	50%	50%	51%	52%	52%	53%	5%	38%	32%	27%	22%	18%	16%
	6%	44	42	40	38	3	34	6%	29	20	13	9	6	4
	7%	39	34	29	25	22	19	7%	21	11	5	3	<2	<2
	8%	34	27	21	15	12	9	8%	15	6	<2	<2	<2	<2
	9%	29	20	13	9	6	3	9%	10	3	<2	<2	<2	<2
	10%	25	15	8	5	2	<2	10%	6	<2	<2	<2	<2	<2

65% Equities/25% Bonds/10% REITs		20% Equities/70% Bonds/10% REITs												
	5 years	10 years	15 years	20 years	25 years	30 years		5 years	10 years	15 years	20 years	25 years	30 years	
Giving Level	5%	47%	47%	46%	45%	45%	44%	5%	28%	20%	12%	8%	5%	4%
	6%	41	37	33	30	26	24	6%	19	9	4	<2	<2	<2
	7%	35	28	22	17	14	11	7%	11	3	<2	<2	<2	<2
	8%	29	21	14	9	6	3	8%	6	<2	<2	<2	<2	<2
	9%	24	14	8	4	<2	<2	9%	3	<2	<2	<2	<2	<2
	10%	20	9	4	<2	<2	<2	10%	<2	<2	<2	<2	<2	<2

\*In all the tables above, equities are globally diversified, bonds are taxable, and REITs are represented by the NAREIT Index (see footnote to Display 12, page 16). All these tables are based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 30 years. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 33-35, for further details.

**Growth of \$1—Nominal** (Based on 50% Confidence Level)

<b>100% Equities</b>		<b>50% Equities/40% Bonds/10% REITs</b>												
		5 years	10 years	15 years	20 years	25 years	30 years							
Giving Level	5%	\$1.16	\$1.34	\$1.54	\$1.80	\$2.08	\$2.42	5%	\$1.10	\$1.20	\$1.30	\$1.42	\$1.56	\$1.70
	6%	1.10	1.22	1.32	1.48	1.62	1.80	6%	1.04	1.08	1.12	1.16	1.20	1.26
	7%	1.06	1.10	1.14	1.20	1.26	1.34	7%	0.98	0.98	0.96	0.96	0.94	0.94
	8%	1.00	1.00	0.98	0.98	0.98	0.98	8%	0.94	0.88	0.84	0.78	0.72	0.68
	9%	0.94	0.90	0.84	0.80	0.76	0.72	9%	0.90	0.80	0.72	0.64	0.56	0.50
	10%	0.90	0.80	0.72	0.66	0.58	0.52	10%	0.84	0.72	0.60	0.52	0.44	0.36

<b>80% Equities/10% Bonds/10% REITs</b>		<b>35% Equities/55% Bonds/10% REITs</b>												
		5 years	10 years	15 years	20 years	25 years	30 years							
Giving Level	5%	\$1.14	\$1.30	\$1.48	\$1.68	\$1.92	\$2.20	5%	\$1.06	\$1.14	\$1.20	\$1.28	\$1.34	\$1.44
	6%	1.08	1.18	1.28	1.38	1.50	1.64	6%	1.02	1.02	1.04	1.04	1.06	1.06
	7%	1.04	1.06	1.10	1.14	1.16	1.22	7%	0.96	0.92	0.90	0.86	0.82	0.78
	8%	0.98	0.96	0.94	0.92	0.90	0.90	8%	0.92	0.84	0.76	0.70	0.64	0.58
	9%	0.94	0.86	0.80	0.76	0.70	0.66	9%	0.86	0.76	0.66	0.56	0.50	0.42
	10%	0.88	0.78	0.68	0.62	0.54	0.48	10%	0.82	0.68	0.56	0.46	0.38	0.32

<b>65% Equities/25% Bonds/10% REITs</b>		<b>20% Equities/70% Bonds/10% REITs</b>												
		5 years	10 years	15 years	20 years	25 years	30 years							
Giving Level	5%	\$1.12	\$1.24	\$1.40	\$1.56	\$1.74	\$1.96	5%	\$1.04	\$1.06	\$1.10	\$1.12	\$1.14	\$1.18
	6%	1.06	1.14	1.20	1.28	1.36	1.46	6%	0.98	0.96	0.94	0.92	0.90	0.86
	7%	1.02	1.02	1.04	1.04	1.06	1.08	7%	0.94	0.88	0.82	0.74	0.70	0.64
	8%	0.96	0.92	0.88	0.86	0.82	0.80	8%	0.88	0.78	0.70	0.62	0.54	0.48
	9%	0.92	0.84	0.76	0.70	0.64	0.58	9%	0.84	0.70	0.60	0.50	0.42	0.34
	10%	0.86	0.76	0.66	0.50	0.44	0.36	10%	0.80	0.64	0.50	0.40	0.32	0.26

**Growth of \$1—Inflation-Adjusted** (Based on 50% Confidence Level)

<b>100% Equities</b>		<b>50% Equities/40% Bonds/10% REITs</b>												
		5 years	10 years	15 years	20 years	25 years	30 years							
Giving Level	5%	\$1.02	\$1.04	\$1.06	\$1.08	\$1.10	\$1.14	5%	\$0.96	\$0.92	\$0.88	\$0.86	\$0.84	\$0.80
	6%	0.96	0.94	0.90	0.90	0.86	0.84	6%	0.92	0.84	0.76	0.70	0.66	0.60
	7%	0.92	0.84	0.78	0.72	0.66	0.62	7%	0.86	0.76	0.66	0.58	0.50	0.44
	8%	0.88	0.76	0.68	0.60	0.52	0.46	8%	0.82	0.68	0.56	0.48	0.40	0.32
	9%	0.84	0.70	0.58	0.48	0.40	0.34	9%	0.78	0.62	0.48	0.38	0.30	0.24
	10%	0.80	0.62	0.50	0.40	0.30	0.24	10%	0.74	0.56	0.42	0.32	0.24	0.18

<b>80% Equities/10% Bonds/10% REITs</b>		<b>35% Equities/55% Bonds/10% REITs</b>												
		5 years	10 years	15 years	20 years	25 years	30 years							
Giving Level	5%	\$1.00	\$1.00	\$1.00	\$1.02	\$1.02	\$1.04	5%	\$0.94	\$0.88	\$0.82	\$0.78	\$0.74	\$0.68
	6%	0.96	0.90	0.86	0.84	0.80	0.78	6%	0.90	0.80	0.72	0.64	0.56	0.50
	7%	0.90	0.82	0.74	0.68	0.62	0.58	7%	0.84	0.72	0.62	0.52	0.44	0.38
	8%	0.86	0.74	0.64	0.56	0.48	0.42	8%	0.80	0.66	0.52	0.42	0.34	0.28
	9%	0.82	0.66	0.56	0.46	0.38	0.32	9%	0.76	0.58	0.44	0.34	0.26	0.20
	10%	0.78	0.60	0.48	0.36	0.28	0.22	10%	0.72	0.54	0.38	0.28	0.20	0.14

<b>65% Equities/25% Bonds/10% REITs</b>		<b>20% Equities/70% Bonds/10% REITs</b>												
		5 years	10 years	15 years	20 years	25 years	30 years							
Giving Level	5%	\$0.98	\$0.96	\$0.96	\$0.94	\$0.94	\$0.92	5%	\$0.92	\$0.84	\$0.76	\$0.70	\$0.62	\$0.58
	6%	0.94	0.88	0.82	0.78	0.72	0.68	6%	0.86	0.76	0.66	0.56	0.48	0.42
	7%	0.88	0.80	0.70	0.64	0.56	0.50	7%	0.82	0.68	0.56	0.46	0.38	0.32
	8%	0.84	0.72	0.60	0.52	0.44	0.38	8%	0.78	0.62	0.48	0.38	0.30	0.22
	9%	0.80	0.64	0.52	0.42	0.34	0.28	9%	0.74	0.56	0.42	0.30	0.22	0.16
	10%	0.76	0.58	0.44	0.34	0.26	0.20	10%	0.70	0.50	0.36	0.24	0.18	0.12

(continued)

**How Long Will the Foundation Last?** (Probabilities if Spending Greater of % or Prior Year's Payout)

<b>100% Equities</b>		5 years	10 years	15 years	20 years	25 years	30 years
<b>Giving Level</b>	5%	>98%	>98%	>98%	96%	88%	78%
	6%	>98	>98	97	86	70	55
	7%	>98	>98	90	70	49	32
	8%	>98	98	79	51	29	15
	9%	>98	94	64	33	15	6
	10%	>98	88	48	20	7	<2

<b>80% Equities/10% Bonds/10% REITs</b>		5 years	10 years	15 years	20 years	25 years	30 years
<b>Giving Level</b>	5%	>98%	>98%	>98%	>98%	94%	87%
	6%	>98	>98	>98	92	79	73
	7%	>98	>98	95	77	56	37
	8%	>98	>98	85	57	32	16
	9%	>98	>98	70	36	15	5
	10%	>98	93	52	20	6	<2

<b>65% Equities/25% Bonds/10% REITs</b>		5 years	10 years	15 years	20 years	25 years	30 years
<b>Giving Level</b>	5%	>98%	>98%	>98%	>98%	97%	92%
	6%	>98	>98	>98	96	85	69
	7%	>98	>98	98	83	60	39
	8%	>98	>98	91	60	32	15
	9%	>98	>98	75	36	13	4
	10%	>98	96	54	17	4	<2

<b>50% Equities/40% Bonds/10% REITs</b>		5 years	10 years	15 years	20 years	25 years	30 years
<b>Giving Level</b>	5%	>98%	>98%	>98%	>98%	>98%	96%
	6%	>98	>98	>98	>98	90	74
	7%	>98	>98	>98	88	63	39
	8%	>98	>98	95	63	31	12
	9%	>98	>98	79	34	10	2
	10%	>98	>98	54	13	2	<2

<b>35% Equities/55% Bonds/10% REITs</b>		5 years	10 years	15 years	20 years	25 years	30 years
<b>Giving Level</b>	5%	>98%	>98%	>98%	>98%	>98%	97%
	6%	>98	>98	>98	>98	93	77
	7%	>98	>98	>98	93	64	36
	8%	>98	>98	98	63	25	8
	9%	>98	>98	83	28	5	<2
	10%	>98	>98	53	7	<2	<2

<b>20% Equities/70% Bonds/10% REITs</b>		5 years	10 years	15 years	20 years	25 years	30 years
<b>Giving Level</b>	5%	>98%	>98%	>98%	>98%	>98%	>98%
	6%	>98	>98	>98	>98	94	74
	7%	>98	>98	>98	94	58	25
	8%	>98	>98	>98	59	13	2
	9%	>98	>98	83	14	<2	<2
	10%	>98	>98	43	<2	<2	<2

## GLOSSARY

### **Private Foundations**

**Disqualified Persons:** Persons who are prohibited from engaging in certain transactions with private foundations; they include:

1. Substantial contributors to the foundation (anyone who contributed more than \$5,000 to the foundation, if that amount was more than 2% of the contributions received in that taxable year);
2. Owners of more than 20% of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interests of a trust or unincorporated enterprise that is a substantial contributor to the foundation;
3. Certain foundation managers (officers, directors, trustees, or their equivalents);
4. Members of the family (including spouse, ancestors, and descendants and their spouses down to great-grandchildren) of any of the above;
5. Corporations, partnerships, trusts, or estates in which persons described in items 1, 2, 3, or 4 above own more than 35% of the combined voting power, profits interest, or beneficial interests;
6. Government officials (with reference only to self-dealing; see glossary item below); and
7. Another private foundation that is related in certain ways to the foundation in question (with reference only to excess business holdings; see glossary item below).

**Excess Business Holdings:** Essentially, the combined holdings of a foundation and its “disqualified persons” are not allowed to exceed any of the following: 20% of a corporation’s voting stock; 20% of the profits interest in a partnership; or 20% of the beneficial interests in other entities (such as trusts or unincorporated business enterprises). A penalty equal to 5% of such excess holdings is imposed on a foundation that at any time during the tax period had “excess business holdings” greater than those permitted. If the foundation fails to divest its excess business holdings by the end of the tax period, an additional penalty equal to 200% of such excess holdings will be imposed. However, a five-year period is allowed for divestiture (if the private foundation received the business holdings by gift or bequest), and there are some exceptions.

**Excise Tax on Net Investment Income:** Private foundations must pay an annual 2% excise tax on “net investment income.” (It does not apply to “unrelated business income.”)

Non-operating foundations may pay a reduced 1% excise tax rate if their “qualifying distributions” for that year are greater than their five-year rolling average of qualifying

distributions plus 1% of that year’s net investment income. In other words, the reduced rate is an incentive for non-operating foundations to increase their rate of giving over time. Operating foundations may be completely exempt from the excise tax for a particular year if they (1) maintain public support in the form of income or contributions received over a 10-year period, (2) have governing bodies that are representatives of the general public and consist of no more than 25% “disqualified persons” for that year, and (3) have no “disqualified person” as an officer during that year.

**IRS Section 501(c)(3):** The Internal Revenue Code section that designates an organization as charitable and exempt from federal income taxes. Both public charities and private foundations are 501(c)(3) organizations.

**IRS Section 509(a):** The Internal Revenue Code section that defines private foundations and public charities. A 501(c)(3) organization must also meet certain 509(a) standards to be classified as a public charity.

**Jeopardy Investments:** Foundation assets may not be invested in a way that jeopardizes carrying out the foundation’s charitable purposes. No particular investment is automatically considered a jeopardy investment. Instead, the test is one of process. An investment is considered “jeopardized” if the foundation’s officers, directors, or trustees failed to exercise ordinary care and prudence when the investment was made (the “prudent investor” or “prudent trustee” test). The initial penalty imposed on the foundation and its manager is 5% of the jeopardizing investment. If the investment is not corrected within the taxable period, an additional penalty of 25% of the investment is imposed on the foundation and another 5% of the investment on its manager if he refused to agree to the removal from jeopardy.

**Net Investment Income:** The sum of interest, dividends, net income from realized capital gains, and other income earned outside of a foundation’s charitable purpose, minus deductions.

**Private Foundation:** A corporation, association, or trust that provides charitable support or conducts charitable activities. Along with public charities, private foundations are exempt from federal income taxes under IRC section 501(c)(3). Private foundations generally receive financial support from a relatively small number of sources rather than the general public, and they are typically controlled by an individual, family, or corporation. Because of their lack of accountability to the public and their perceived potential for abuse, private foundations are subject to greater federal regulation than public charities.

(continued)

Private foundations may be grouped by the type of charitable support they provide (see “Private Operating Foundations” and “Private Non-Operating Foundations”). They may also be categorized by who primarily funds and controls them. “Family foundation” is a term often used to describe a private foundation whose funding and control come largely from a single family. “Corporate foundations” are typically funded from the profits of a particular corporation and may have significant involvement by corporate personnel. “Independent foundations” are those not primarily funded or controlled by a single family or corporation.

*Taxes and Restrictions on Private Foundations:* Both operating and non-operating private foundations (see below) must file an annual informational return with the IRS—Form 990-PF. While they are exempt from income tax, they must pay other taxes, including a tax on “unrelated business taxable income” (see below); an excise tax on “net investment income” (see above); and confiscatory taxes on acts deemed to be against the public interest, including “jeopardy investments” (see above), acts of “self-dealing” (see below), failure of a non-operating foundation to make the required distributions; maintaining “excess business holdings” (see above), and expending funds on prohibited activities such as campaigning for or against candidates or attempting to influence legislation.

**Private Non-Operating Foundation:** A private foundation that generally supports charitable programs indirectly, providing grants to other nonprofit organizations rather than operating programs of its own. Non-operating foundations are required to distribute a minimum amount for charitable purposes each year.

*Distribution Requirement for Non-Operating Foundations:* Private non-operating foundations are required to expend a certain amount for charitable purposes. The amount, which is calculated each year on the Form 990-PF, works out to about 5% of the average market value of the foundation’s assets. The foundation has two years to pay out a “distributable amount” based on the average value of its assets in the first year. So, for example, a foundation filing its 2005 return will have until the end of 2006 to make the required payments.

The “distributable amount” is based only on the foundation’s “non-charitable-use” assets; it excludes “charitable-use” assets. As the names suggest, charitable-use assets are used directly for conducting charitable activities—for example, the foundation’s office building or art held by museums. Non-charitable-use assets are those held as investments, such as securities or real estate rental property. These non-charitable-use assets are valued each year. Cash and securities are valued monthly and averaged, while other types of assets tend to be valued annually. The foundation’s “minimum investment return” is defined as 5% of the value of its non-charitable-use assets. From the minimum

investment return, the foundation subtracts the 1% to 2% excise tax it has to pay on “net investment income” (see above). The result is the “distributable amount.” In other words, the foundation gets to count its excise tax payment toward its required distributions.

The other main group of payouts that can be counted toward the “distributable amount” is known as “qualifying distributions” (see below). If a foundation pays out more than it needs to in a particular year as qualifying distributions, there is an “excess distributions carryover” that allows the additional amounts to be carried over and credited against the distributable amount for up to five subsequent years.

**Private Operating Foundation:** A private foundation directly involved in the operation of its own charitable activities, such as operating a library or museum or conducting scientific research. It must meet certain criteria to qualify as operating. In 2001, about 90% of private foundations were non-operating, 10% operating. The key consequences of the distinction are: (1) Non-operating foundations must distribute approximately 5% of their asset value each year, while operating foundations are exempt from that requirement, instead spending most of their income each year on their charitable operations. (2) Operating foundations may also qualify as exempt from the excise tax on net investment income that non-operating foundations must pay annually. (3) Individuals may deduct a higher percentage of their adjusted gross income each year for contributions to operating foundations, putting them on the same footing as public charities.

**Program-Related Investment:** A loan or investment made by a private foundation to another organization for a project related to the foundation’s charitable purposes. Program-related investments are counted as “qualifying distributions” in the year paid. When the program-related investment is repaid, it is included in the foundation’s gross income in the year of repayment. A program-related investment is defined as a specific exception to “jeopardy investments.” Examples of program-related investments include low-interest or interest-free loans to needy students, high-risk investments in low-income housing, and loans to small businesses where commercial sources of funds are unavailable.

**Qualifying Distributions:** Expenditures of a private non-operating foundation that will satisfy its annual charitable payout requirement. These include:

1. Disbursements for charitable purposes
  - a. Grants to charities
  - b. Direct expenditures to accomplish charitable purposes
  - c. Reasonable operating and administrative expenses that count as charitable purpose (but not those related to investments)
2. Amounts paid to acquire charitable-use assets
3. Charitable “program-related investments”
4. Amounts set aside for future charitable projects

The Internal Revenue Code and regulations do not define the types or amounts of operating and administrative expenses that may qualify. In 2001, foundations' returns listed a number of expenses as qualifying distributions, including compensation of officers, directors, trustees, and employees; professional fees for lawyers, accountants, and others; travel, conferences, and meetings; printing and publications; occupancy; and taxes, interest, advertising expenses, return filing fees, office supplies and equipment, equipment rentals, and maintenance. Of course, on any given return, some of these expenses may have to be allocated between charitable-purpose expenses and investment expenses. Consult your legal or tax advisor.

**Self-Dealing Rules:** Acts of "self-dealing" between "disqualified persons" and a private foundation are strictly prohibited, including sales, leases, loans or extensions of credit, the provision of goods and services, and the use of assets. If acts of self-dealing occur, an initial penalty of 5% of the value of the transaction will be imposed on the disqualified person involved. A penalty of 2.5% of the value of the transaction will be imposed on the foundation manager if the manager knew it was an act of self-dealing, unless such act was not willful and was engaged in for reasonable cause. If the act is not corrected, additional penalties of 200% of the value of the transaction are imposed on the disqualified person, and a penalty of 50% of the transaction is imposed on the manager. The rules on self-dealing are extremely complicated; consult your tax or legal advisor.

**Taxable Expenditures:** Any expenditure that a private foundation is not allowed to make will be penalized by the IRS. These include grants to organizations that don't qualify as public charities or private foundations, as well as expenditures to carry on propaganda or influence legislation, to influence the outcome of elections or carry on voter registration drives, to finance an individual's travel or study (unless such expenditures satisfy additional criteria), or to engage in other non-charitable initiatives. Taxable expenditures that the foundation fails to correct will be penalized.

**Unrelated Business Income Tax:** A tax imposed on "unrelated business taxable income," which is income from any trade or business regularly carried on by the foundation that is not substantially related to the foundation's charitable purpose or debt-financed income (such as from mortgaged real estate). The tax will be imposed at corporate income tax rates (if the foundation is a corporation) or trust income tax rates (if the foundation is a trust). The goal of the tax is to place non-charitable businesses on the same tax footing as if they were not owned by a charity.

## **Other Ways to Give to Charity**

**Charitable Gift Annuity:** A contract between an individual and a charity. The individual pays the charity a lump sum, which may be in cash or in assets, such as stock. The charity promises to pay the individual a fixed dollar amount each year, starting on a specified date, usually for the rest of the individual's life. Part of the lump sum is meant to cover the annuity payments back to the donor, while the rest is expected ultimately to benefit the charity. Accordingly, upon setting up the charitable gift annuity, the donor receives a charitable income-tax deduction only for the portion expected to go to charity. If the charitable gift annuity is purchased with appreciated assets, the capital gain on that appreciation is deferred and will be realized gradually as part of each annuity payment received.

**Charitable Lead Trust (CLT):** A trust that pays a fixed dollar amount (charitable lead annuity trust) or a percentage of trust assets (charitable lead unitrust) to one or more charitable organizations for a number of years. The remainder may go back to the donor or to the donor's family, depending on the type of CLT desired.

In a grantor CLT, the donor receives an initial charitable income-tax deduction based on the present value of what is expected to go to charity over time. The grantor then pays all the income taxes on income and capital gains generated by the trust assets during its term.

In a non-grantor CLT, the donor does not receive a charitable income-tax deduction. Instead, the trust itself receives a deduction for the income paid to charity each year and pays taxes on any income and capital gains not paid to charity that year.

**Charitable Remainder Trust (CRT):** A trust that pays a fixed dollar amount (charitable remainder annuity trust) or a percentage of trust assets (charitable remainder unitrust) to the donor or another recipient for a term of years or someone's life. The remainder goes to one or more charitable organizations. The trust itself is exempt from income taxes, so if appreciated property is contributed to and sold by the trust, the capital gain on that appreciation is deferred and will be realized over time by the recipient as part of each annual payment received.

**Community Foundation:** A charitable organization that raises annual funds and holds permanent funds established by many separate donors to benefit a wide range of charities serving the residents of a defined geographic area (typically a town, city, county, or state). Establishing a donor-advised fund or other endowment through a community foundation can be a more cost-efficient alternative to establishing a private foundation or supporting organization, especially for smaller gifts, as administrative and legal costs are spread across many donors.

*(continued)*

**Donor-Advised Fund:** A fund held by a community foundation, a mutual fund or investment company, or a charitable organization whose donor may recommend (but cannot dictate) eligible charities for grants from the fund. The entity holding the fund must have the final say on where the money goes. The donor may designate one or more people to make the recommendations, and the fund may continue after the donor's death. Since the fund will be held by or affiliated with a public charity, donors may use the higher adjusted gross income limits on deductions that apply to public charities rather than the lower limits that apply to private foundations. A donor-advised fund is not its own separate entity or organization.

**Public Charity:** A public charity is a charitable organization that (like a private foundation) is exempt from federal income tax under Internal Revenue Code Section 501(c)(3). It achieves its classification as a public charity, rather than a more stringently regulated private foundation, in one of three ways: (1) Religious, educational, and medical institutions are automatically deemed public charities. (2) It may pass a "public support" test, receiving its financial support from a broad segment of the general

public. (3) It may be a "supporting organization" that is formed solely to support another public charity. Donors to public charities are allowed to take charitable income-tax deductions that are a higher percentage of their adjusted gross income than donors to private foundations.

**Supporting Organization:** A supporting organization is a charitable organization that qualifies as a "public charity" because it supports another public charity. As a result, donors may use the higher adjusted gross income limits on deductions that apply to public charities rather than the lower limits that apply to private foundations. In addition, the rules and restrictions governing private foundations do not apply, such as prohibitions against self-dealing or excess business holdings.

To qualify as a supporting organization, the entity must meet one of several complex legal tests designed to assure that the public charity being supported has some influence over the actions of the supporting organization. In addition, a majority of the governing body must not be controlled by the donor. Unlike a "donor-advised fund," a supporting organization is a separate legal entity.

## NOTES ON WEALTH FORECASTING SYSTEM

### 1. Purpose and Description of Wealth Forecasting Analysis

Bernstein's Wealth Forecasting Analysis is designed to assist investors in making their long-term investment decisions regarding their allocation of investments among categories of financial assets. Our planning tool consists of a four-step process: (1) Client-Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his cash-flow stream is likely to be, whether his portfolio can beat inflation long term, and how different asset allocations might impact his long-term security; (3) The Capital Markets Engine: a model that uses our proprietary research and historical data to create a vast range of market returns, which takes into account the linkages within and among the capital markets (not Bernstein portfolios), as well as their unpredictability; and finally (4) A Probability Distribution of Outcomes: 80% of the estimated returns and asset values the client could expect to experience based on the assets invested pursuant to the stated asset allocation, represented within a range established by the 10% and 90% probabilities. However, outcomes outside this range are expected to occur 20% of the time; thus, the range does not establish the boundaries for all outcomes. We also often consider 90% of the estimated returns, within a range established by the 5% and 95% probabilities. Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market, and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

### 2. Rebalancing

Another important planning assumption is how the asset allocation varies over time. We attempt to model how the portfolio would actually be managed. Cash flows and cash generated from portfolio turnover are used to maintain the selected asset allocation among cash, bonds, stocks, REITs, and hedge funds over the period of the analysis. Where this is not sufficient, an optimization program is run to trade off the mismatch between the actual allocation and targets against the cost of trading to rebalance. In general, the portfolio will be maintained reasonably close to the target allocation. In addition, in later years there may be contention between the total relationship's allocation and those of the separate portfolios. For example, suppose an investor (in the top marginal federal tax bracket)

begins with an asset mix consisting entirely of municipal bonds in his personal portfolio and entirely of stocks in his retirement portfolio. If personal assets are spent, the mix between stocks and bonds will be pulled away from targets. We put primary weight on maintaining the overall allocation near target, which may result in an allocation to taxable bonds in the retirement portfolio as the personal assets decrease in value relative to the retirement portfolio's value. Positions in a single stock are not rebalanced.

### 3. Expenses and Spending Plans (Withdrawals)

All results are generally shown after applicable taxes and after anticipated withdrawals and/or additions, unless otherwise noted. Liquidations may result in realized gains or losses, which will have capital-gains tax implications.

### 4. Modeled Asset Classes

The following assets or indexes were used in this analysis to represent the various model classes:

Asset Class	Modeled as...	Annual Turnover Rate
Cash Equivalents	3-month Treasury bills	100%
Intermediate-Term Diversified Municipal Bonds	AA-rated diversified municipal bonds of 7-year maturity	30
Intermediate-Term Taxable Bonds	Taxable bonds with maturity of 7 years	30
Diversified U.S. Stocks	S&P 500 Index	15
U.S. Value Stocks	S&P/BARRA Value Index	15
U.S. Growth Stocks	S&P/BARRA Growth Index	15
Developed-International Stocks	MSCI EAFE Index (Unhedged)	15
Emerging-Markets Stocks	MSCI Emerging Markets Index	20
Single Stock (Avg. Volatility)	Volatility: 28%; Dividend: 1.7%; Beta: 1.0	0
Real-Estate Investment Trusts	NAREIT Index	30
Hedge Funds—Long/Short Equity	CSFB Tremont Long/Short Equity Hedge Fund Index	0
Hedge Funds—Relative Value	CSFB Tremont Equity Market Neutral Hedge Fund Index	0

(continued)

## 5. Volatility

Volatility is a measure of dispersion of expected returns around the average. The greater the volatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volatility for each asset class used in this analysis is listed in Note #10. In general, two-thirds of the returns will be within one standard deviation. For example, assuming that stocks are expected to return 8.0% on a compounded basis and the volatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will be between (8.9)% and 28.9%. With intermediate government bonds, if the expected compound return is assumed to be 5.0% and the volatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between (1.1)% and 11.5%. These ranges are slightly skewed relative to what you might expect because the volatility calculation assumes the returns are log-normally distributed. Bernstein's forecast of volatility is based on historical data and incorporates Bernstein's judgment. It should also be noted that volatility varies in different time periods, particularly for inflation and fixed-income assets.

## 8. Tax Rates\*

Bernstein's Wealth Forecasting Analysis has used the following marginal tax rates for this analysis:

Start Year	End Year	Federal Income-Tax Rate	Federal Capital-Gains Tax Rate	Qualified Dividend Rate	State Income-Tax Rate	State Capital-Gains Tax Rate
2005	2008	35.00%	15.00%	15.00%	6.00%	6.00%
2009	2010	35.00	20.00	35.00	6.00	6.00
2011	2034	39.60	20.00	39.60	6.00	6.00

*\*The federal income-tax rate represents Bernstein's estimate of either the maximum marginal tax bracket or an "average" rate based on the marginal-rate schedule. The federal capital-gains tax rate is represented by the lesser of the maximum marginal income-tax bracket or the current cap on capital gains for an individual or corporation, as applicable. Federal tax rates are blended with applicable state rates by including, among other things, federal deductions for state income and capital-gains taxes. The state tax rate generally represents Bernstein's estimate of the maximum unified rate, if applicable.*

## 9. Hedge-Fund Asset Classes

The hedge-fund investment(s) modeled represented hedge-fund indexes. The risk of an individual hedge fund, or even a fund of funds, may be substantially higher. For a number of reasons, including survivor bias and voluntary reporting, even hedge-fund index performance and volatility can be misstated.

## 6. Technical Assumptions

Bernstein's Wealth Forecasting Analysis is based on a number of technical assumptions regarding the future behavior of financial markets. Bernstein's Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs that summarize the condition of the capital markets as of March 31, 2005. Therefore, the first 12-month period of simulated returns represents the period from March 31, 2005, through March 31, 2006, and not necessarily the calendar year of 2005. A description of these technical assumptions is available on request.

## 7. Tax Implications

Before making any asset-allocation decisions, an investor should review with his/her tax advisor the tax liabilities generated by the different investment alternatives presented herein, including any capital gains that would be incurred as a result of liquidating all or part of his/her portfolio, investments in municipal or taxable bonds, etc.

(continued)

**10. Assumptions: Capital-Market Statistics**

	<b>Annualized Compound Return</b>	<b>Average Annual Return</b>	<b>Average Annual Income*</b>	<b>1-Year Volatility</b>	<b>20-Year Annualized Equiv. Volatility</b>
Cash Equivalents	2.4%	2.4%	2.4%	0.7%	6.7%
Int.-Term Diversified Munis	3.1	3.2	3.0	4.2	4.7
Int.-Term Taxable Bonds	4.5	4.7	4.4	5.8	6.0
Diversified U.S. Stocks	7.7	9.7	2.3	18.3	13.1
U.S. Value Stocks	7.7	9.5	3.0	18.0	12.6
U.S. Growth Stocks	7.7	9.8	1.6	19.5	14.9
Developed-Int'l Stocks	8.0	10.9	3.0	21.6	13.6
Emerging-Markets Stocks	7.0	11.5	3.4	27.3	21.0
Single Stock (Avg. Volatility)	4.8	9.6	1.7	30.5	28.4
Real-Estate Investment Trusts	5.8	6.7	6.5	12.7	12.5
Hedge Funds—Long/Short Equity	8.9	10.6	8.9	16.5	18.2
Hedge Funds—Relative Value	4.1	4.4	4.1	6.9	13.0
Inflation	2.6	2.6	N/A	1.5	6.9

*Based on 10,000 simulated trials, each consisting of 20-year periods. Reflects Bernstein's estimates and the capital-market conditions as of March 31, 2005. Does not represent any past performance and is not a guarantee of any future specific risk levels or returns or any specific range of risk levels or returns.*

*\* For hedge-fund asset classes, "Average Annual Income" represents income and short-term capital gains.*



BERNSTEIN WAS ESTABLISHED IN 1967 to manage investments for families and individuals. As of midyear 2005, we were overseeing \$67 billion in private client assets and offering global portfolios in stocks, bonds, hedge funds, private partnerships, and real estate.

Investment planning is at the heart of Bernstein's asset-management principles. Along those lines, we've developed proprietary planning tools to help our clients make better-informed decisions about the issues that concern them most. Among such issues are retirement planning, complex asset-allocation strategies, annual budgeting, single-stock strategies, philanthropic gifting, and multi-generational financial planning. Our goal for each client is to assemble a portfolio that best suits his or her long-term wealth goals and risk-tolerance parameters.

Each of our clients' portfolios is tailored to his or her specific needs, yet all share the goal of maximizing return over full market cycles at a controlled risk level. Each portfolio is managed according to strict buy/sell disciplines, and all are driven by fundamental research. Tax considerations are integrated into our decision-making process, as appropriate for each client. For most clients, we advocate portfolios that are diversified among imperfectly correlated asset classes from the world's capital markets.

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