Warning Signs: Identifying and Mitigating Risks in CGA Pools

Dennis P. Dwyer, CFA
Carolyn Freeman

STATE STREET GLOBAL ADVISORS

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Why Does it Matter?

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Trends Seen at SSGA

- Charitable gift annuities are the leading planned gift vehicle today
  - 95% of gift activity
  - 80% of dollar activity
- The "go-to" planned giving vehicle for development staff
  - Easier to open for charity
  - Easier for donor to understand

Source: State Street Global Advisors CAM, as of June 30, 2023
The calculations have been rounded.

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Issues

- Gift annuities are a concern for investment/finance staff
  - High payout rates
  - Liability- gift annuity payments are backed by the assets of the issuing organization (charity)

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The Risks

General Investment Risks

- Inflation Risk
  - The risk that investments will not keep pace with inflation, reducing purchasing power
- Interest Rate Risk
  - The risk that interest rates will increase – prices on existing bonds move in the opposite direction of interest rates
- Market Risk
  - The risk that an investment will decline in absolute value – even as payouts remain constant

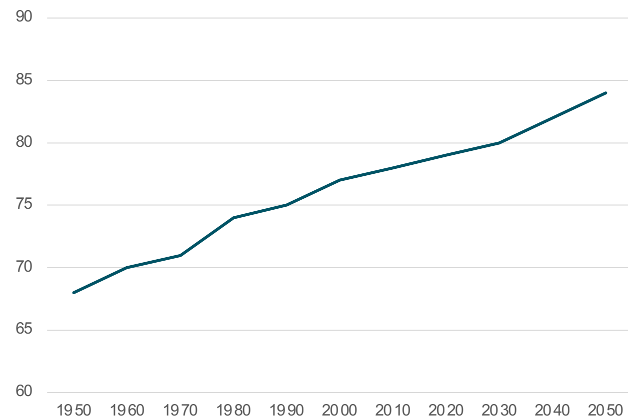
Actuarial Risks

- Payout Risk
  - The risk that the guaranteed payouts increase as a % of the current market value of the gift
- Longevity Risk
  - The risk that income beneficiaries outlive life expectancies, especially as people live longer

Longevity Risks

- Annuitants are living longer
- Annuitants that make up sizable piece of total pool payment presents risk to the total pool health
- Older donors present more risk than younger

Longevity Trends Over Time



Source: Macrotrends.

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Additional Risks for Gift Annuities

- Timing Risk
  - The risk that investment returns are weak in the early years, making it difficult to recover market value (especially with continuing payouts)
- Individual Contract Risk
  - The risk that individual contracts “go negative,” payouts exhaust gift value and leave no remainder value. This is a particular concern for large gift relative to the overall gift annuity assets
- Concentration Risk
  - The risk that one individual donor can have a large percentage of the pool due to one large or multiple gifts

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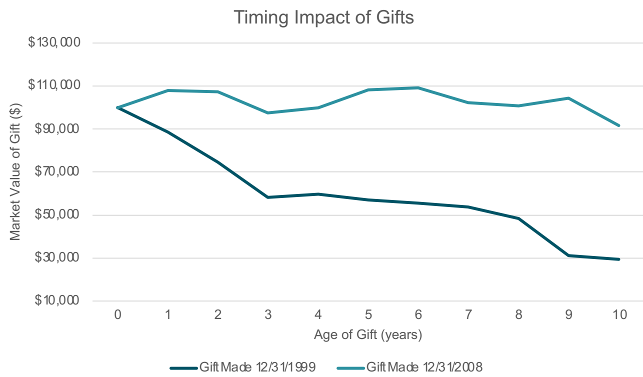
Impact of Timing



Source: SSGA.
Past performance is not a guarantee of future results.

Concentration Risks

- Annuitants that make up a sizable piece of total pool payment
- Present risks to the pool if gift/s become unhealthy
- Pool health too dependent on just a few annuitants
- Other risks (longevity, timing, market) can be magnified if a pool has high concentration risk
- Concentration risk more likely to be seen in smaller pools

Concentration Risks

Beneficiary	Bene 1 Age	Gift Date	Gift Type	Gift Amount	Market Value	Current MV Original GV	Contract Payout*	Annual Payment	% of Total Payment	Effective Payout	Projected Exhaustion	Bene 1 Life Expectancy
				$1,410,600	$993,900	70%	5.69%	$80,238		8.07%		
Donor 1	**82**	**11/21/2007**	**Standard**	**$500,000**	**$215,000**	**43%**	**6.20%**	**$ 31,000**	**38.63%**	**14.4%**	**10**	**10**
Donor 2	67	6/29/2020	Standard	$65,000	$59,000	91%	4.60%	$ 2,990	3.73%	5.1%	21	21
Donor 3	73	4/9/2020	Standard	$65,000	$62,000	95%	5.10%	$ 3,315	4.13%	5.3%	16	16
Donor 4	89	6/1/2017	Standard	$51,000	$30,000	59%	6.50%	$ 3,315	4.13%	11.1%	14	7
Donor 5	82	1/27/2006	Standard	$50,000	$25,000	50%	6.00%	$ 3,000	3.74%	12.0%	12	10
Donor 6	87	10/27/2017	Standard	$50,000	$38,000	76%	7.20%	$ 3,600	4.49%	9.5%	15+	7
Donor 7	73	8/19/2013	Standard	$50,000	$47,000	94%	4.80%	$ 2,400	2.99%	5.1%	20+	16
Donor 8	77	2/25/2015	Standard	$35,000	$30,000	86%	5.00%	$ 1,750	2.18%	5.8%	20+	13
Donor 9	78	10/25/2007	Standard	$30,000	$20,000	67%	5.60%	$ 1,680	2.09%	8.4%	15+	12
Donor 10	72	8/13/2012	Standard	$30,000	$31,000	103%	4.50%	$ 1,350	1.68%	4.4%	20+	17
Donor 11	96	7/10/2018	Standard	$25,000	$17,000	68%	9.30%	$ 2,325	2.90%	13.7%	11	4
Donor 12	73	1/22/2010	Standard	$75,000	$67,000	89%	4.80%	$ 3,600	4.49%	5.4%	20+	16
Donor 13	73	12/17/2013	Standard	$20,000	$17,900	90%	4.80%	$ 960	1.20%	5.4%	20+	16
Donor 14	77	10/17/2008	Standard	$20,000	$22,000	110%	5.40%	$ 1,080	1.35%	4.9%	20+	13
Donor 15	70	12/12/2017	Deferred	$19,600	$21,000	107%	5.20%	$ 1,019	1.27%	4.9%	20+	19
Donor 16	83	12/22/2017	Standard	$18,000	$17,000	94%	6.40%	$ 1,152	1.44%	6.8%	15+	10
Donor 17	77	6/30/2008	Standard	$75,000	$70,000	93%	6.00%	$ 4,500	5.61%	6.4%	15+	13
Donor 18	75	11/1/2017	Standard	$87,000	$78,000	90%	5.10%	$ 4,437	5.53%	5.7%	20+	15
Donor 19	70	11/1/2017	Standard	$95,000	$92,000	97%	4.70%	$ 4,465	5.56%	4.9%	20+	19
Donor 20	86	6/29/2010	Standard	$50,000	$35,000	70%	4.60%	$ 2,300	2.87%	6.6%	20+	8

Source: SSGA.
Past performance is not a guarantee of future results.

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Effective Payout vs Contract Payout

- Effective Payout = Annuity Payment/Current Market Value
- Contract Payout = Annuity Payment/Original Gift Value
- Widening spread between the two can be a warning sign gift/pool is becoming unhealthy

Asset to Liability Ratio

- Measures how well a charity can cover its annuity obligations
- The lower the ratio the unhealthier the gift/pool
- Declining ratio can be a warning sign

Market Drawdown

- A sizable drawdown in assets can cause damage to a CGA pool
- Dot com bubble & Global Financial Crises
- Duration of drawdown matters
  - GFC vs COVID

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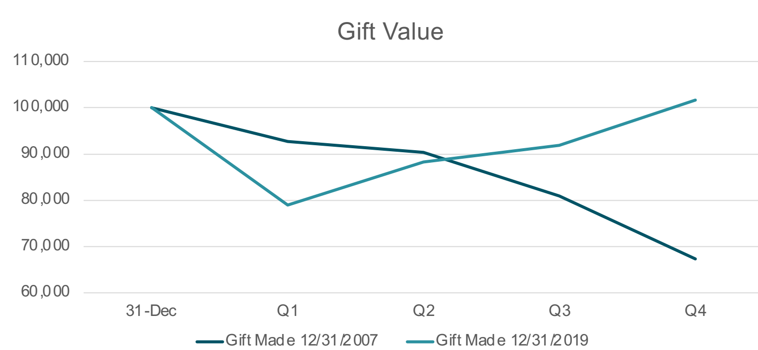
Duration of Drawdown



Source: SSGA.

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Concentration

- Pool health too heavily influenced by just a few annuitants
  - Poor timing of a large gift can have an adverse impact on effective payout and Asset-to-Liability Ratio
- Annuitant diversification usually means a healthier pool

Inconsistent Gift Activity

- Infrequent gift activity leaves pools more exposed to market timing risk
- Consistent gift activity provides support to the effective payout and A/L ratio

Mitigation

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Follow CGA Best Practices

- Follow ACGA rates
- Establish minimum ages and amounts
- Comply with state regulatory requirements
- Invest the entire amount of the gift
- Invest the assets in a prudent manner
- Understand what assets will be accepted

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Establish Reserve Pools

- Help fund underwater CGA's
- Established in a variety of ways
  - Use seed money
  - Charge a fee to the pool
  - Leave unrestricted terminations in the pool
  - Set aside a set percentage of terminations leaving the pool

Proactive donor outreach

- Approach donors with exhausted gifts or gifts projected to exhaust
- Checking in with deferred gift donors before payments are scheduled to start
- Checking in with existing donors who have smaller payments

Reinsurance

- Removes the liability from issuing organization
- Transfers the investment, longevity, and concentration risk to the insurance company
- Ideal for large gifts into smaller pools

Tactical Asset Allocation

- TAA can be an effective way to exploit asset class mis-pricings
- Ability to express a shorter-term macro view
- Risk management ➡ Downside protection

Appendices

Appendix A: Important Disclosures

Important Disclosures

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations. Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

Investing in REITs involves certain distinct risks in addition to those risks associated with investing in the real estate industry in general. Equity REITs may be affected by changes in the value of the underlying property owned by the REITs, while mortgage REITs may be affected by the quality of credit extended. REITs are subject to heavy cash flow dependency, default by borrowers and self-liquidation. REITs, especially mortgage REITs, are also subject to interest rate risk (i.e., as interest rates rise, the value of the REIT may decline).

Investing in high yield fixed income securities, otherwise known as junk bonds, is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Increase in real interest rates can cause the price of inflation-protected debt securities to decrease. Interest payments on inflation-protected debt securities can be unpredictable.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Government bonds and corporate bonds have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

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United States: State Street Global Advisors, One Iron Street, Boston MA, 02210.

Web: www.ssga.com/cam

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Appendix B: Biographies

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Dennis Dwyer *Vice President of State Street Global Advisors and a Senior Portfolio Manager* in the firm's Investment Solutions Group dedicated to Charitable Asset Management. He is responsible for assisting clients in the development of asset allocation and investment strategies for their planned giving portfolios. Prior to joining SSGA in 2000, Dennis worked in State Street's Mutual Fund Division as a Fund Accountant.

Dennis received a BS degree in Marketing/Management from the University of Connecticut. He holds the Chartered Financial Analyst designation and is a member of the Boston Security Analysts Society, as well as the CFA Institute.

Carolyn Freeman *Vice President of State Street Global Advisors and is Head of Relationship Management* in SSGA's Charitable Asset Management group, responsible for the client service and administration of planned gifts.

Carolyn joined State Street Global Advisors in 1990. She speaks on Planned Giving topics at conferences nationwide. She has served as chairman of the Charitable Asset Management Training Committee, Work/Life Initiative Committee and the Thought Leadership Committee.

She is on the Board of the Planned Giving Group of New England and is a past member of the Tufts Medical Center Planned Giving Committee.

Carolyn received her BA from Fordham University.

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Dennis P. Dwyer, CFA
Carolyn Freeman
Michael Nadler, CFA

Workshop Scenarios

- The following slides provide examples of scenarios we have seen through the years working with our clients.
- It is important to know there are not 'hard and fast' rules on what to do in each of the following scenarios. The most beneficial part of the discussion is educating clients on the potential benefits, and more importantly risks, of each decision.

Scenarios and Discussion

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Scenario 1

Client A has a CGA pool that was very active in the mid to late 90's, but gift activity has fallen off over the last several years. Some of the beneficiaries from the gifts taken in the late 90's have outlived life expectancy and the gifts have exhausted or are approaching exhaustion.

- What types of risk can we identify in this scenario?
- What can be done to mitigate the risk?

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Scenario 2

A 60-year-old donor approaches you asking about a $1M gift. The current ACGA rate is 5.2%, meaning the annuitant would receive $52k per year. Below is the current health of the pool:

CGA Characteristics	
Current Market Value	3,500,000
Annual Payout ($)	175,000
Contract Payout (%)	5.5
Effective Payout (%)	5.0
Assets/Liabilities Ratio (%)	197

- Is it okay to accept this gift?
- What are the biggest risks?

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Scenario 3

A 60-year-old donor approaches you asking about a $1M gift. The current ACGA rate is 5.2%, meaning the annuitant would receive $52k per year. Below is the current health of the pool:

CGA Characteristics	
Current Market Value	3,500,000
Annual Payout ($)	175,000
Contract Payout (%)	5.5
Effective Payout (%)	5.0
Assets/Liabilities Ratio (%)	197

- Your finance staff thinks this gift is too risky for your organization. What other options could you offer the donor?

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Scenario 4

You are a planned giving director of an organization with a healthy CGA program. After a recent review with your planned gift partner, your finance staff approaches you and wants to take money out of the CGA program because it is urgently needed elsewhere.

- What information should you use to make your decision?

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Scenario 5

A smaller program with sporadic gift activity notices in a recent review of their program that the spread between the effective payout and contract payout is widening.

- What can be done ?

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Scenario 6

An organization with an established gift annuity pool is approached by a donor who wants to establish a $500K charitable gift annuity. When the planned giving staff informs the potential donor of the current ACGA rate, he pushes back and says another organization I support is willing to give me a higher rate.

- Should you give the donor the higher rate?
- What are some other options you can present to the donor?

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Scenario 7

Donor approaches you and wants to gift shares of a thinly traded security.

- What should you do?

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Scenario 8

Your organization hires a new CFO. The new CFO does not like Charitable Gift Annuities and is considering shutting down the program.

- What would you say to convince the new CFO to keep offering CGA's?

Scenario 9

Your organization currently has a $1M CGA pool. You are approached by a 90-year-old donor that wants to establish a $5M CGA. You decide to take the gift at the current ACGA rate. The current asset allocation for the pool is 70% equities and 30% bonds.

- Should your investment advisor consider an asset allocation change?

Open Discussion

- Any other scenarios presented by participants
- Q&A for any topics previously discussed

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THANK YOU

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