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MANAGING WEALTH FOR PHILANTHROPIC RISK

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When Microsoft founder Bill Gates and uber-financier Warren Buffet decided to give away most of their fortunes, rather than pass the money on to their children — a combined amount that could exceed $100 billion — they became the two biggest examples of a growing trend: successful entrepreneurs who are liquidating much of their estates for charitable purposes, rather than attempting to create multi-generational wealth dynasties.

Their motives are surely complicated and altruism plays an important role, but the status and prestige that come with major philanthropic gifts must matter too. Gates might even have been influenced by the Northwest Indian practice of the potlatch, in which a tribal leader gives away his possessions and the highest status is conferred on he who gives away the most.

When clients — especially clients with more modest means than Gates or Buffett — decide to make charity a central part of their life plans, they present an unusual challenge to their wealth management professionals. The problem is: They add another factor to the already difficult balancing act involved in managing an individual or family's wealth. I call this new category "philanthropic risk" and managing it is a unique challenge.

Normally, when engaged in financial planning, an adviser must take two main factors into account: wealth and income. A client declares certain income needs, an adviser analyses the client's risk profile, and the adviser crafts a wealth management strategy designed to achieve the income target and maximize wealth, while respecting the client's risk limits.

Where does charitable giving fit in? Traditionally, most advisers have included charitable gifts either as part of a client's regular expenditures — like living expenses but with different tax treatment — or as part of the client's estate plan, through charitable remainder trusts, charitable gift annuities and other such instruments.

In both cases, what advisers generally do not factor in is the possibility of a failed gift. That is, they generally do not consider the possibility that a particular charitable donation will be abused, and later regretted by the donor, in some instances angering, and in others embarrassing him, but in any event proving to be a disappointment. And since such a possibility is not even on the radar screen, there is no plan to avoid such a tragic occurrence.

I work with many donors who have been disappointed with previous philanthropic gifts, often involving millions of dollars at a time. They come to me because they feel they have been cheated or shortchanged in some way.

At the same time their charitable impulses remain strong and they continue to want to give back. Many contemporary entrepreneurs fit this mold. And a rising generation of such philanthropists, largely Baby Boomers, is turning to charity as retirement approaches.

Donor Intent and Philanthropic Risk

But even good deeds come with risks.

Among the most common and emotionally painful risk that philanthropists face is the the violation of donor intent. This occurs when charitable gifts are diverted from the purpose for which they were given — and used, entirely or in part, for something else.

When donor intent is flagrantly violated it is something akin to a total loss for the "philanthropic investor."

When thinking about how philanthropic risk compares to other financial or wealth management risks, one should think in terms of a catastrophic investment failure, such as a bond default or the bankruptcy of a company in which one has an equity investment.

In some instances, it may be even

worse. Public policy advocacy, for example, has become an increasingly important part of many charities' programs. The public policy positions taken by non-profit managers, however, may be at odds with the positions of major donors. A donor might be motivated to give to a program for the indigent, for instance, in order to reduce the dependence of the very poor on government services. The recipient organization, however, might engage in significant advocacy for increased government spending on the very same programs. Another donor might contribute works of art from classical periods to bolster a museum's traditional collection, only to have the museum sell the art to purchase more avant-garde works.

Such violations of donor intent are by no means the sole problem of conservative donors. Jane Fonda famously demanded and received repayment of a $12.5 million gift to Harvard University to protest the university's sluggishness in hiring faculty for the gender studies program she sought to establish. Another donor-intent controversy involved the controversial sale by St. Olaf College in Northfield, Minnesota, of the first listener-supported public radio station in the United States, WCAL. Other major institutions caught up in recent donor-intent controversies — none of them involving a clash of ideologies, just the alleged misuse of donated funds — have included the University of New Mexico, Princeton University (the ongoing Robertson v. Princeton lawsuit), the University of South Dakota, Tulane University, and the New York Metropolitan Opera.

If a donor is not careful, therefore, his or her gift may be used for a purpose other than that for which it was given – or used for "exactly the opposite" purpose than intended. In the latter case, calculating the philanthropic "return" on the gift would not only involve the loss of principal, but would actually be negative! One analogy might be a total loss on a highly leveraged investment that goes belly up, leaving a large debt to pay.

Managing Philanthropic Risk

No wealth adviser wants to be responsible for bad investment decisions, including bad philanthropic investments. Because of their lack of experience in the non-profit world and the complexity of giving money away effectively, however, most wealth advisers shy away from making specific recommendations on particular gifts.

This is understandable, and a relatively new market of professional philanthropic advisers is emerging to fill this void.

But wealth managers with clients worried about donor intent should be aware that they, too, need to rethink the conventional wisdom on achieving income goals, while maximizing wealth, when their clients have significant charitable-giving aspirations. In order to help their clients reduce the risk of charitable gifts going bad, some assumptions about wealth management may need to change.

Before going into the specific modifications one might make in managing a client's portfolio, let me outline the steps some philanthropists have taken to increase the likelihood that donor intent is followed.

First, savvy donors are increasingly restricting their gifts to well-defined purposes, rather than making general contributions to an organization or institution. By placing clear parameters around what is expected in a gift, including provisions for periodic review of the program and sanctions if gift agreements are violated, donors reduce the chance that an agreement will be abused, or funds siphoned off for unrelated purposes.

Second, donors are increasingly realizing that philanthropic investments have an appropriate time horizon. What that horizon is depends on the nature of the gift — it could be one year or it could be 40 years. It is unlikely to be and almost never should be forever. So savvy donors are increasingly amortizing their gifts over a period of years and creating an oversight structure to match.

Warren Buffett has instructed Bill and Melinda Gates to spend all the funds he has donated to the Gates Foundation during their lifetimes, rather than roll them into a perpetually endowed foundation. Indeed, he requires the Gates Foundation to meet annual spending targets. Other donors are following this same strategy.

Finally — and most importantly for wealth managers — philanthropists are increasingly giving away as much of their charitable assets as is prudent during their lifetimes, rather than making charitable giving primarily an estate planning matter. Doing so allows them to watch their gifts and correct their giving programs along the way.

As Andrew Carnegie observed in the *North American Review* in 1889: "Knowledge of the results of legacies bequeathed is not calculated to inspire the brightest hopes of much posthumous good being accomplished.

"The cases are not few," he warned, "in which the real object sought by the testator is not attained, nor are they few in which his real wishes are thwarted."

The conclusion one should draw from Carnegie's message: Give your money away while you're still around to monitor its use, because after you're gone anything can happen.

Incorporating Philanthropic Risk into Overall Risk Management

For those families for whom philanthropy plays only a minor or at most secondary role in their overall finances, philanthropic risk can be managed without much effect on the rest of their finances. But where charitable giving is central, assessing philanthropic risk is essential. Consider the hypothetical example of an elderly couple with an estate valued somewhat over 20 times their annual living expenses, including taxes. If they are 80, they might have a life expectancy of 10 years, but with good genes, healthy habits, and a little luck, they could live another 15-20 years or more. In such a case,

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even a conservatively invested portfolio would generate enough income to cover their expenses without ever dipping into principal.

Let's assume for illustration purposes that whatever they've decided to transfer to children, grandchildren and other beneficiaries already has been subtracted from these figures. This couple wants to donate as much as possible to charity while they're still able to be actively involved in the decision making. They would prefer to do so over a 10-year period, on the assumption that in the last five years of their expected lives they will have other priorities or failing faculties. What does that do to their investment program?

First, it creates a big bubble in required income for 10 years, followed by a precipitous drop off. This might dramatically affect income taxes for the couple and appropriate responses need to be developed. In addition, unusually high charitable gifts during those 10 years will likely lead to accumulated deductions, which can then be used to offset taxes in the years after the charitable giving ceases. If the couple plans this early enough, some of the funds destined for charity might be placed in a family foundation or donor advised fund even before initiating the major giving program. All of this needs to be taken into account when structuring the overall wealth management strategy.

Finally, the unusual expense bubble will lead to a very different kind of investment risk problem.

The best way to look at this is to divide the couple's portfolio into two portions: 1) the amount of funds needed to sustain their actual living expenses over a 15-year period, as well as an appropriate cushion, and 2) what is left, which can safely be allocated to charity.

The different time horizons of the two parts of the portfolio alone will imply different investment strategies. At the same time, the existence of the two-part portfolio changes things as well. For instance, the charity part of the portfolio, with a shorter time horizon, will necessarily need to be invested more conservatively, and in the later years might even need to be mostly in cash, to preserve liquidity and assure that grant commitments can be upheld.

The existence of these conservatively invested funds, so long as they are not subject to legally or morally binding grant commitments, should allow the couple to invest the living expense part of their portfolio more aggressively, at least in the early years of the program.

By contrast, if the investment returns of the living expense portfolio are exceptional, some of the "excess" returns can, in turn, be allocated back to charity, either during the initial 10-year period or perhaps in the final five years of our predicted 15-year life span. Either way, the decision of the couple to avoid philanthropic risk by giving during their lifetime requires a very different kind of thinking regarding their overall wealth management.

We are about to experience the greatest intergenerational transfer of wealth in history. Just as more individuals are becoming strategic about their wealth management, they are also becoming more entrepreneurial and strategic with regard to their philanthropy. Providing them with sound, professional advice is one of the big challenges all of us face, whether on the wealth management or philanthropic side of the business.

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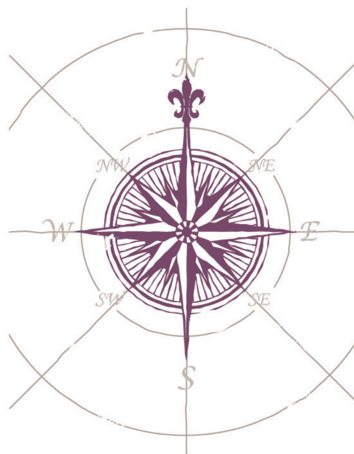

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