



WHY TREND FOLLOWING CAN ENHANCE CHARITABLE TRUST PERFORMANCE



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Introduction

The use of charitable trusts is a common estate planning strategy for transferring wealth to heirs and benefitting charitable interests among the affluent. The success of this planning, however, is predicated on the right mix of contributed dollars, investment returns and payouts.

If this right balance is not achieved, the professional advisor can be subject to:

- ◆ client's ridicule;
- ◆ legal action claiming such a trust was improperly prepared or structured; or
- ◆ a reduction in trust work related referrals.

The purpose of this white paper is to show how charitable trusts can benefit by utilizing trend following investment strategies to enhance returns and protect long-only investments, thereby helping these trusts achieve their charitable and return objectives as intended, while still maintaining the liquidity necessary to meet ongoing distribution requirements as outlined in the trust instruments. This in turn will keep the professional advisor neatly on the grantor's side and away from client ridicule, legal action or road blocks to future work in this planning area.

Charitable Lead and Remainder Trusts Defined

There are two basic types of charitable trusts that we will examine more closely in this white paper, the charitable lead trust and the charitable remainder trust. These trusts can be structured to payout a fixed percentage or sum certain annuity. In this white paper, we will use a simple fixed percentage annuity in our examples (e.g. unitrusts).

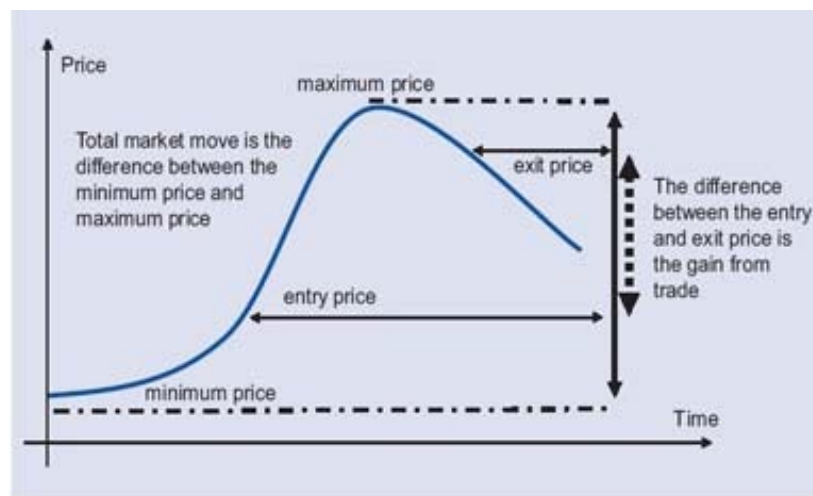
The **charitable remainder unitrust** is a trust from which a *fixed percentage* (not less than 5 percent) of the net fair market value of its assets, *valued annually*, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in IRC §170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of twenty years) or for the life or lives of such individual or individuals.

The **charitable lead annuity trust** is an irrevocable trust that may be established by the donor either *intervivos*, or upon death, and which specifies that an annual "annuity amount" must be paid to charity until the termination of the specified term, at that point the trust assets pass to or in trust for the noncharitable recipients. The annual "annuity amount" must be paid to the charitable beneficiary regardless of the value of the trust assets. Unlike the charitable remainder unitrust, the specified annuity amount does not have to be at least 5% of the net fair market value of the trust assets.

What is Trend Following?

Trend following is an investment technique where the investor/trader looks for major market trends to begin and holds positions in the direction of the trend until they end. **These strategies do not try to predict market or stock movements; instead they capitalize on the market's movements wherever or whenever they occur.** Trend followers respond to what is happening rather than anticipating what might happen.

Typically, a trend is something we see everyday that translates to a continuing price move in a stock or market. An example would be the rising dominance of a country or region of the world that translates into a long and sustained upward move in stocks from that country.



In the above diagram, you can see that the goal of the trend follower is to let a new trend develop and then invest with that trend. The trend follower then holds that position until there is a reversal. Trend following is based on the premise that there is always a trend taking shape somewhere in the market. The trend will lead to a strong move higher (or lower) in price. If the investor can identify the trend and jump on board, they will make money.

It is a proven system that works in most markets. The key is being able to identify the trend and then profit from it. The smart trend follower does not invest at the exact bottom because he/she wants confirmation that a turn (reversal) has occurred. Likewise the trend follower will generally not sell at the exact top (which is more easily identified after the fact). They sell after a clearly identified change in trend (reversal). Therefore, the trend follower is able to capture the “meat” of the trend.

Another very important point is that the trend follower is indifferent as to whether the trend is going up or down to capture his/her return...as long as there is a trend they can make money. So unlike the “buy and hold” investor which invests long in the hopes that stocks go up, the trend follower sells stocks in a bear market, and quite probably profits by short selling stocks.

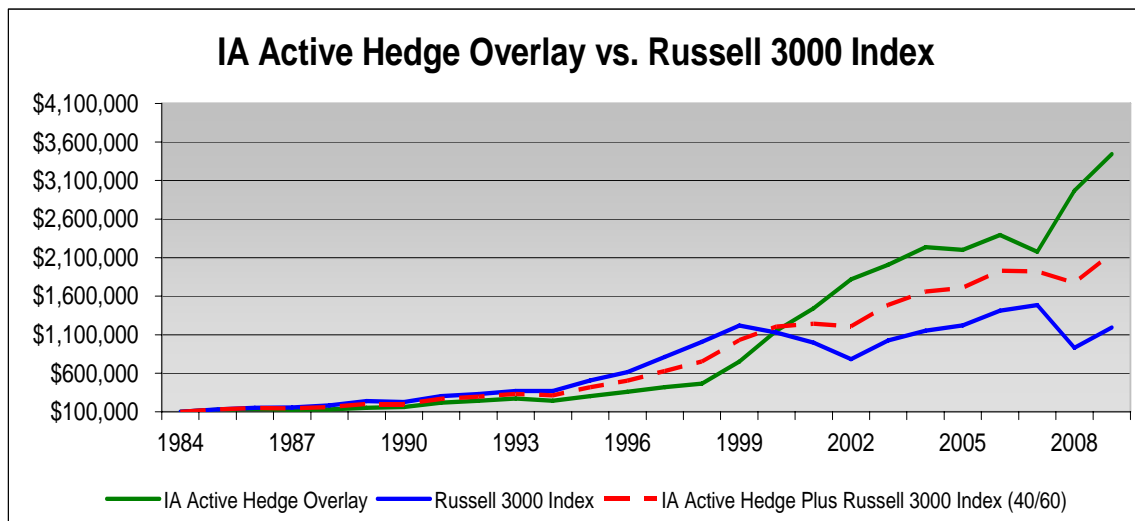
A Trend Following Example

Let's look at an example of one of our trend following systems. It is InTrust's Active Hedge Overlay trend following system. **This solution is designed to protect and enhance returns for an existing portfolio that may or may not be managed by us.**



Imagine this solution as an umbrella that protects another portfolio. When the sun is out (i.e. a bull market), this overlay portfolio attempts to add return to the underlying portfolio and actually reduces portfolio risk. When the sun is under the clouds (i.e. a bear market), its job is to hedge the underlying portfolio and offset some or all of the underlying portfolio losses. It does this job by using three trend following systems over different time frames.

Note how well this strategy (green line) has done to enhance returns and smooth performance in conjunction with more a traditional "buy and hold" strategy (dotted red line).



Disclosures: *The above performance is back tested performance through July 2009. Past performance is not indicative of future returns. The back test assumed a trade cost of \$17.95 for each buy and sell order filled at the close. It also assumed no leverage and interest at a weighted average 3% on excess cash balances during the entire back test period. Historical performance and back tested performance are net of all fees and expenses..*

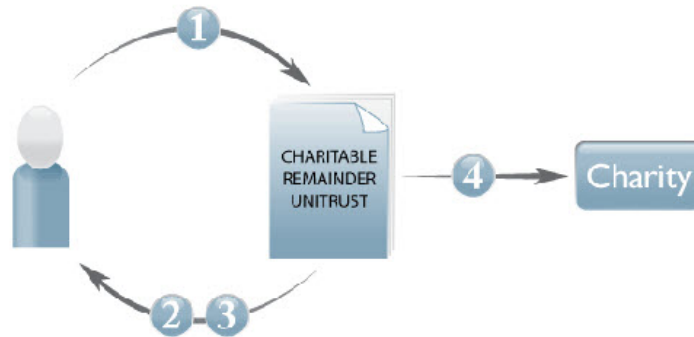
This trend following system's annual return of 15.21% has trounced the 10.43% return of the pure "buy and hold" strategy of the Russell 3000 Index with dividends reinvested over the same period. Additionally, the system's correlation to the market's movements is negative. This means it makes money when the broader markets do not, which makes it the perfect complement for a traditional "buy and hold" portfolio.

Also note that the volatility or return (or standard deviation) has been reduced from over 18% for the Russell 3000 index over this period to under 13% for the IA Active Hedge plus Russell 3000 index, a 30% reduction in portfolio volatility.

Example of Charitable Trusts using both “Buy and Hold” and Trend Following Strategies

The Charitable Remainder Unitrust (CRUT)

Bob Dorfman, age 78, has decided to (1) transfer \$10 million to a charitable remainder unitrust that will (2) make payments to him of 5 percent of the value of the trust corpus each year for a term of 20 years or his lifetime, whichever is shorter. He thus creates a stream of income for himself that will last until his death, but in no event would the institution have to wait more than 20 years to receive the remainder of the trust.



Bob funds the trust with highly appreciated, low yielding securities. The securities will subsequently be sold by the trust and reinvested into equities.

If the trust earns a total return of 8 percent and the donor lives for his ten-year life expectancy, his income would grow from \$500,000 the first year to some \$671,000 over that time and the (4) institution will receive more than \$13 million at his death. Because of the future charitable gift, Bob is entitled to an immediate (3) income tax deduction of more than \$6.5 million.

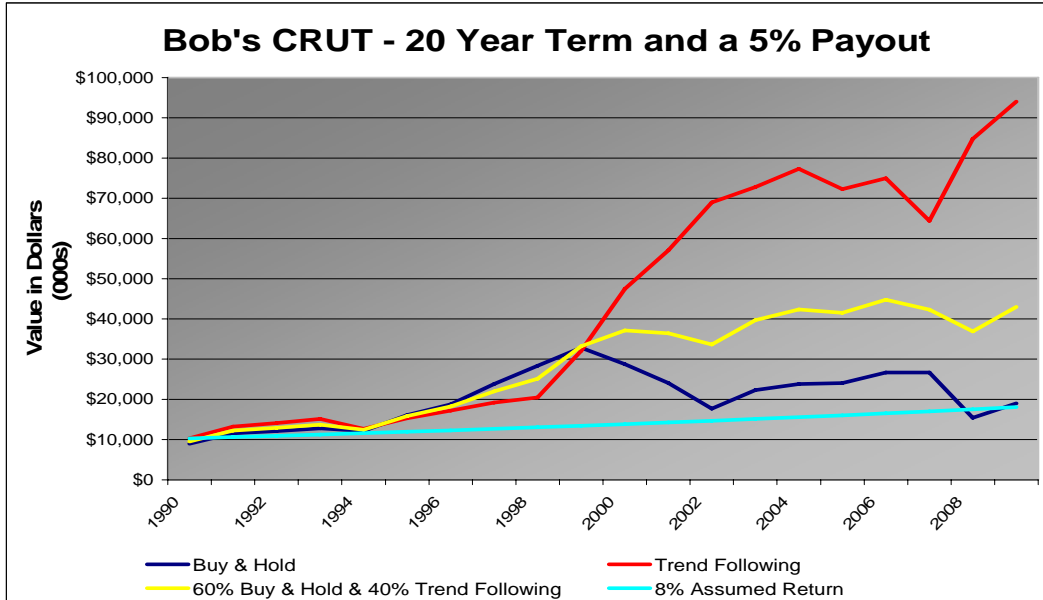
However, what guarantees that Bob will make 8 percent on this trust’s investment assets? What if Bob just happens to be unfortunate enough to have put this trust together at the start of a period of below normal returns? What then?

So let’s take a look at two historical scenarios. In the first, Bob funded this trust in 1990 and he somehow managed to outsmart the mortality tables and live the entire trust term. In the second, Bob was unfortunate enough to form his trust in 2000 at the beginning of a period of below average market returns.

Let’s now compare how Bob would have done in each scenario had he used a straight 8% assumption, a pure “buy and hold” strategy using the Russell 3000 index as a proxy, a

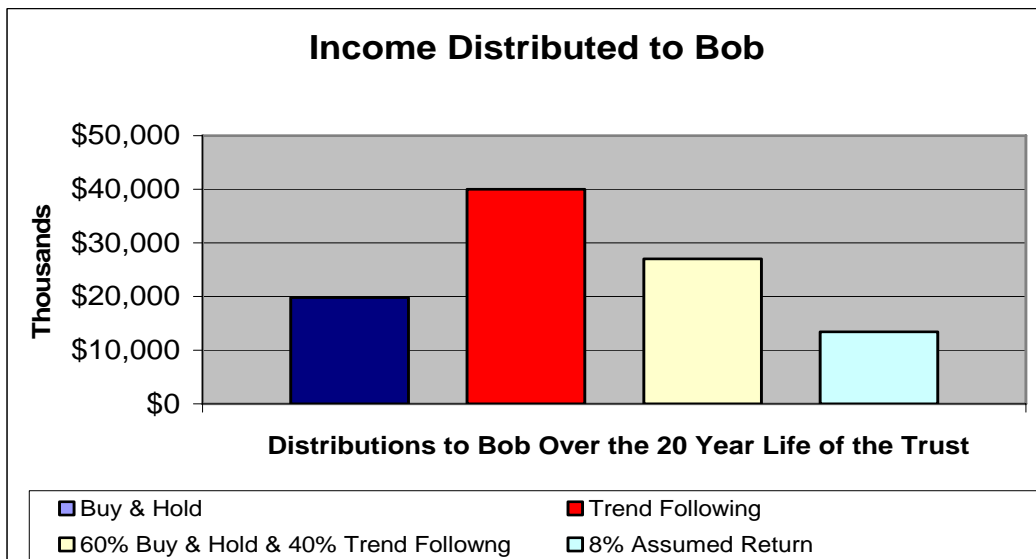
pure trend following strategy (based on InTrust’s Active Hedge Overly models) and finally a 60%/40% combination of “buy and hold” and trend following (“60%/40%”).

Scenario One – Trust formed in 1990

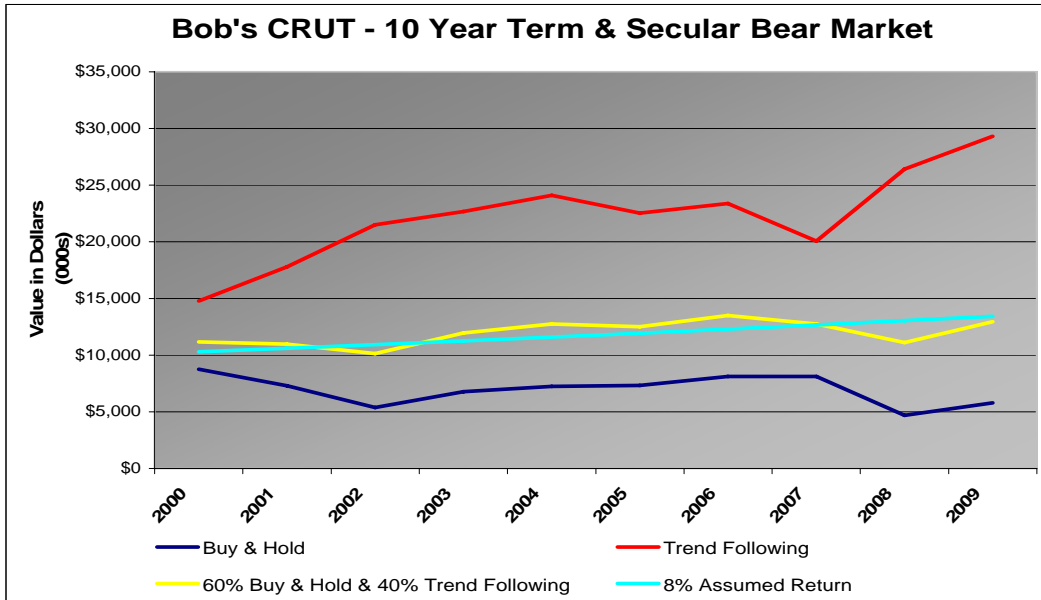


Notice how Bob’s CRUT returns from a “buy and hold” strategy pretty much equaled his 8% per annum return expectations (dark and light blue lines) over the trust term of twenty years. However, the trust had been up significantly more prior to 2000.

The trend following and combined 60%/40% strategies started slower and were actually a drag on performance prior to 2000. However, subsequent to 2000, they have turbo charged trust returns and enhanced the value of its assets providing Bob with a larger annual distribution (see below) and his favorite charity with a larger final payout.



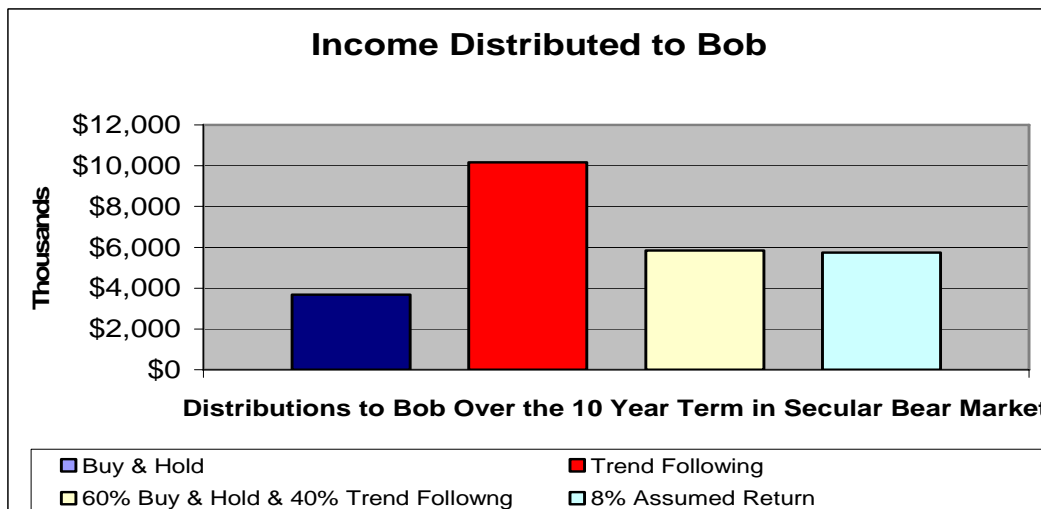
Scenario Two – Trust formed in 2000



In this scenario, Bob formed his CRT in early 2000. You can see that a pure “buy and hold” strategy would have been hard pressed in achieving Bob’s goal of an 8% per annum return (dark and light blue lines) over this ten year period. In fact, the trust value would only be slightly more than \$5.77 million at the end of 2009.

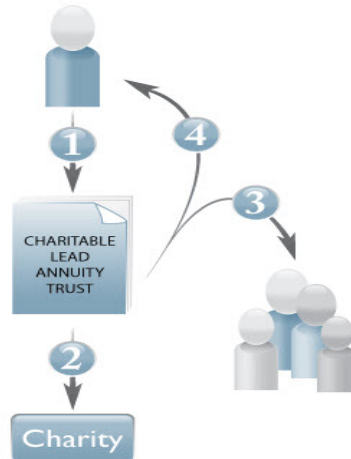
The trend following and combined 60%/40% strategies really were the stars here, making money in down markets and/or hedging pure “buy and hold” investments allowing them to better meet Bob’s return objectives.

Again the end result is that Bob ends up with larger cumulative distributions from the trend following and 60%/40% strategies (see below) and leaves his favorite charity with a larger final payout.



The Charitable Lead Annuity Trust (CLAT)

At the same time the unitrust is funded, (1) Bob transfers \$10 million to a charitable lead annuity trust that will make annual (2) payments to the institution of \$800,000 per year for 20 years. At the end of 20 years, the balance of the lead trust will be (3) transferred to Bob's grand nieces and nephews at its then market value.



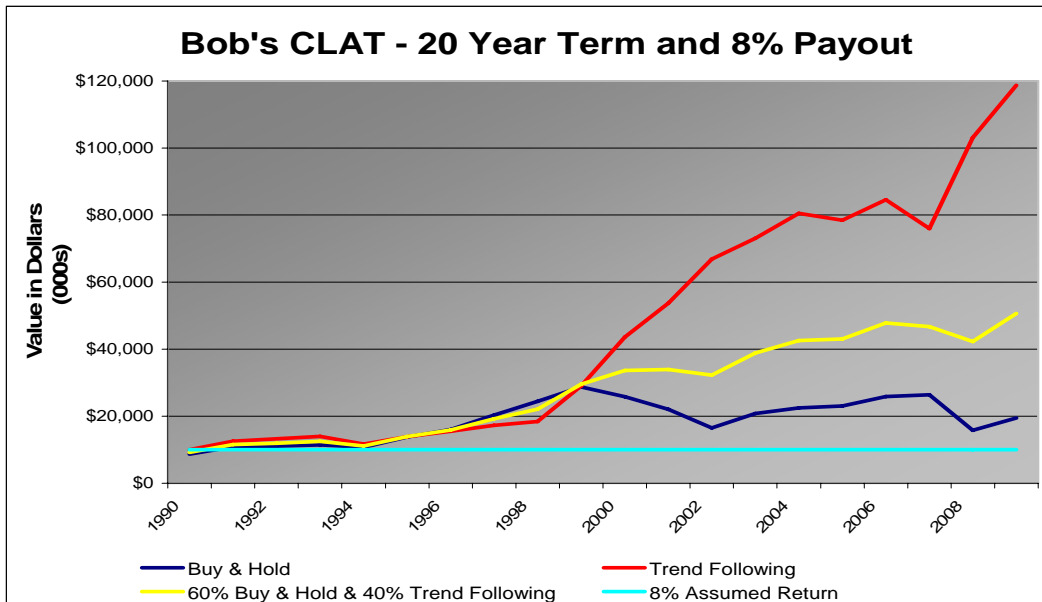
While Bob must report a gift of \$10 million to his heirs at the time the trust is created, he is entitled to an (4) offsetting charitable deduction of \$10 million, resulting in no taxable gift.

Bob's goal is to earn at least 8% on the CLAT assets. Here again what guarantees that Bob will earn 8 percent on this trust's investment assets to recoup the \$800,000 annual contributions to charity? What if Bob just happen to be unfortunate enough to have put this trust together at the start of a period of below normal returns? What then?

So let's take a look at two historical scenarios. In the first, Bob funded this trust in 1990. In the second, Bob was unfortunate enough to form his trust in 2000 at the beginning of a period of below average market returns.

Let's now compare how Bob would have done in each scenario had he used a straight 8% assumption, a pure "buy and hold" strategy using the Russell 3000 index as a proxy, a pure trend following strategy (based on InTrust's Active Hedge Overlay models) and finally a 60%/40% combination of "buy and hold" and trend following ("60%/40%").

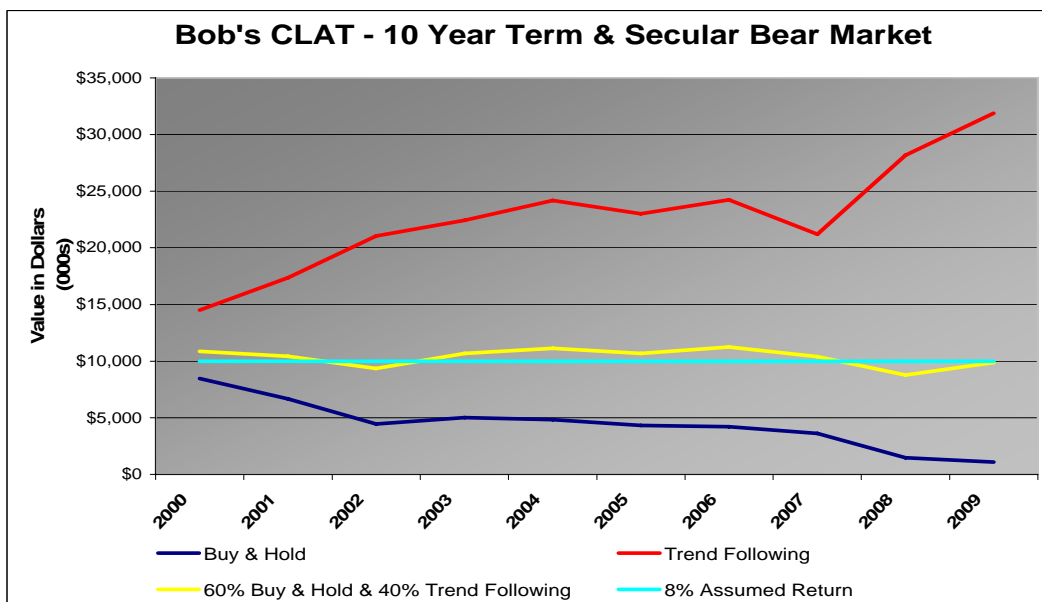
Scenario One – Trust formed in 1990



As with the CRUT, Bob’s CLAT returns from a “buy and hold” strategy pretty much equaled his 8% per annum return expectations (dark and light blue lines) over the trust term of twenty years. However, the trust had been up significantly more prior to 2000.

The trend following and combined 60%/40% strategies started slower and were actually a drag on performance prior to 2000. However, subsequent to 2000, they have enhanced the value of its assets providing Bob’s heirs with a larger gift in trust.

Scenario Two – Trust formed in 2000





In this scenario, Bob formed his CLAT in early 2000. You can see that a pure “buy and hold” strategy would have been hard pressed in achieving Bob’s goal of an 8% per annum return (dark and light blue lines) over this ten year period. In fact, the trust value would only be slightly more than \$1.0 million.

The trend following and combined 60%/40% strategies really did well, making money in down markets and/or hedging pure “buy and hold” investments allowing them to better meet Bob return objectives. The end result is that Bob ends up supporting his favorite charity, while significantly growing and maintaining the value of what he bequests in trust to his family using the trend following and 60%/40% strategies.

Conclusion

Trend following in combination with more traditional “buy and hold” strategies it can really help charitable trust grantors to diversify across multiple strategies, smooth investment returns and outperform in markets that have strong upward or downward trends.

Further, it can be one more protection for the professional advisor against:

- ◆ a client’s ridicule;
- ◆ legal action claiming such a trust was improperly prepared or structured; or
- ◆ a reduction in trust work related referrals.

If you would like more information on InTrust Advisors or the investment strategies mentioned in this report, please visit our website or contact us directly.

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Disclosures:

The Russell 3000 index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

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