HEDGEWORLD'S FREE MONTHLY MAGAZINE
ACCREDITED INVESTOR

Donor-Managed Investment Accounts: The Gift You Grow Yourself

Some money managers can't stand to see their gifts bringing in returns that aren't up to their standards. Now they can do something about it.

By Jacob Bunge, Financial Correspondent | Wednesday, October 05, 2005

"Whenever I speak to development officers at large charities, colleges and universities, almost every one has a story to tell about a big donor who calls them up every year when endowment performance is announced," says Mark Rakov, senior managing director for Winklevoss Consultants, a Greenwich, Conn.-based insurance and pension consulting firm. "They'll say something like, 'gee, you earned X percent on your endowment this year? I could have done better than that …' It's a constant source of frustration for development officers."

With a new approach to planned giving known as a donor-managed investment account, those development officers can offer such financially savvy donors the chance to put their money management skills where their mouths are.

A donor managed investment account allows a donor to make an irrevocable gift to a charity, claim an immediate tax deduction and, instead of lumping it in with the rest of the charity's investment or endowment, invest it in a separate portfolio that the donor (or a money manager of the donor's choice) manages for up to 10 years following the initial gift.

Winklevoss Consultants Founder Howard Winklevoss developed the DMI account concept in 2002, following the death of his daughter. A memorial scholarship was established through the acting troupe that she was involved in, with family and friends contributing approximately US$35,000. It was a start, but Mr. Winklevoss wanted to take it further.

"I was hoping to get it up to US$100,000 so we could give some meaningful scholarships away," he says. "I knew the board would do the standard 50/50 stock-bond mix, so I asked permission to run the money," while agreeing to cover any losses the fund sustained. Mr. Winklevoss asked his firm's general counsel to research the legalities and, after contacting the IRS, he received a private-letter ruling approving the concept. That's when Mr. Winklevoss realized he may have found a new approach to charitable giving.

DMI ACCOUNT BASICS

To set up a DMI account, a charity must first decide to offer the option to a specific donor. A gift agreement is completed between the donor and the charity that spells out the terms and conditions, covering details like the size of the gift, whether the gift is to be applied to a particular use, the length of the investment management period and any investment guidelines the charity wishes to instate to reflect its particular risk profile.

A limited power of attorney is granted to the donor by the charity, extending the right to direct the investment management of the funds for the agreed-upon time period (the IRS currently specifies a maximum of 10 years). The other component of the agreement is the performance threshold—if the funds in the account fall below a specified amount, or if returns fall below a certain percentage, the donor's investment management privilege can be revoked.

Once the agreement is complete, an account is opened in charity's name at the donor's brokerage firm of choice; after that account is funded by the donor, the gift is final and irrevocable, and tax deductibility can be determined (50% of adjusted gross). The funds are then invested in stocks, bonds, mutual funds, hedge funds or any other investment vehicles approved by the charity.

During the investment period, Winklevoss Consultants provides periodic reports to the charity tracking the donor's trading activity, investment performance and compliance with the agreed-upon investment guidelines. For that service, the firm collects a fee from the charity, usually around 0.75% of assets yearly, set by a sliding scale based on the amount of assets under management in the program. When the investment management term ends, responsibility for the funds in the DMI account reverts back to the charity.

While funds are invested in a DMI account, the donor and charity decide together how the proceeds will be applied—they can agree to let the funds remain untouched to accumulate the largest returns, for instance, or spin off a certain percentage annually to cover operating expenses, scholarships or a pet project specified by the donor. "If the football team needs new shoulder pads, a donor could set aside an annual expenditure for that," said Mr. Rakov.

Winklevoss Consultants has applied for a patent on both the methodology and the business apparatus underpinning the DMI account concept, and is about two and a half years into the four-year process, Mr. Winklevoss said.

The DMI account concept offers a different take on donor involvement compared to donor-advised funds, which allow donors to contribute cash or stock, claim an immediate tax deduction and later direct how much money goes to each charity, and when. Donor-advised funds are offered through more than 600 community foundations; a 1% fee is generally charged for investing and holding the money and US$10,000 is the typical minimum. The funds are not managed by the donor, however, and investment is limited to mutual funds or broad investment strategies.

At the other end of the spectrum, private foundations provide donors the complete control over investment management, but consume much more time, money and administration.

Dr. Paul Schervish, director of the Center on Wealth and Philanthropy at Boston College, contributed research to the development of the DMI account concept and said that it is geared toward a phenomenon he terms "hyper agent" donors—wealth-holders who see themselves as active, entrepreneurial investors in a charity, as opposed to simply writing a check and walking away.

HEDGE FUND MANAGER: DMI ACCOUNT POSTER CHILD

A program targeted toward potential donors with investment acumen and millions of dollars to spare—it isn't hard to imagine that Greenwich, Conn.-based Winklevoss Consultants had hedge fund managers in mind when it decided to make DMI accounts available to the masses.

"It does seem like it's right up their alley," said Mr. Winklevoss, who added that he has three or four billionaire neighbors around his Greenwich home. "Generally, those I've spoken to about this have been very interested."

While those billionaire neighbors are likely to have their own private foundations, Mr. Winklevoss said that the DMI account is a solution for wealthy donors that don't have the money to justify a foundation, but still have a sizeable amount to invest.

There's no minimum figure necessary to open a DMI account, Mr. Rakov said, but after talking with many nonprofits in the process of developing the concept, Winklevoss Consultants settled on a general starting point of US$250,000, with respect to the time and administration the account requires.

"What we've found is that most charities want to use this as a premium kind of offering," said Mr. Rakov. "However, some charities have introduced it to their donors with a lower minimum threshold, with the hope and expectation that donors will bootstrap themselves up to that US$250,000 level."

But when deep-pocketed donors come calling with caveats about how their money is to be managed, in most cases the charities will find a way to accommodate their request. According to Ned Donoghue, director of planned giving for the Philadelphia Orchestra Association, the DMI account is another tool for donors who might otherwise hang onto the gift for a few more years, to allow the money more time to grow.

"When you're in that situation, you don't want to lose the gift, but on the other hand you don't want to compromise your principles or your process, so you have to think very hard," he said. In the end, "the charity would be motivated to find a way to make it work."

CHECKING FOR THE RIGHT FIT

A DMI account is not appropriate for every nonprofit. Mr. Rakov noted that charities without endowments, that usually spend all donated funds over the course of the year, may not be able to subsist on the funds spun off while the rest of the gift is under management. Other charities—the Hurricane Katrina relief effort, for example—require action as quickly as possible.

Casey Roach, managing director of Jamison Prince Asset Management, discusses the DMI account concept with nonprofit institutions he is working with, and said that allowing the donor to manage the gifted funds can be a significant leap of faith for development boards.

"You're looking at sizeable dollars, yet you're going to allow a third party to manage that money," he said. "Particularly today, in light of the nefarious issues we read about from time to time… the trustees of a college or hospital are going to be hesitant if not reluctant to allow firms of individuals without longstanding track records and good biographies to manage their money."

The DMI account is the best fit when the board or development officer is financially sophisticated, said Tony Martignetti of nonprofit consultancy Martignetti Planned Giving Advisors. Mr. Martignetti is working with a senior executive of a financial institution to set up a ten-figure DMI account for a public college in New York City, and while he sees "terrific" potential for giving through DMI accounts, the donor's free reign over the funds could prove problematic if the donor's money management acumen isn't up to snuff.

"We're talking about ego… we're talking about a donor who is wealthy and may have a high profile in the financial world or may be a member of the board," Mr. Martignetti said. If returns are falling, "I think the nonprofit, though it has the right to revoke the money management privilege at any time, may be loathe to do so. I can see the donor asking, ‘give me another quarter, two quarters, I can turn it around.'"

And if the privilege is revoked, Mr. Martignetti said, feelings could be hurt—which could lead to a donor relations problem for the institution, or even public relations issues. "I'm not sure if some nonprofits are thinking about that possibility."

Dr. Schervish, meanwhile, counseled patience for donors leaning toward the "hyper agent" style, who may become discouraged when the results they're looking for don't immediately appear.

Such entrepreneurial donors look to the approaches and ideas that brought their own success and desire to impress the same kind of disciplines upon charities, Dr. Schervish said. But in many instances the outcomes that a charity is working toward are difficult to measure, not measurable at all or may not be apparent in the short term.

BUILDING ACCEPTANCE IN A SLOW-MOVING INDUSTRY

It's a bit early to tell if the increased donor involvement offered by the DMI account concept will garner the same popularity enjoyed by donor-advised funds, where assets have grown from US$2.4 billion in 1995 to more than US$15 billion today, according to Beyond Foundations Magazine. After receiving IRS approval a little over a year ago, approximately 10 institutions have set up DMI accounts with donors, including the Woodside Priory School, Skidmore College and the Jewish National Fund. Winklevoss does not release figures for total assets under management.

Mr. Winklevoss said that new vehicles in planned giving are fairly infrequent, and noted that Dr. Schervish called the DMI account the first innovation for organizing direct donations to charities by individuals since the Tax Reform Act in 1969.

"One thing I have learned is that the philanthropic world moves slowly—the boards don't want to make a mistake and get their lawyers involved, so there's a lot of due diligence that is done," said Mr. Winklevoss. "It's going slower than I would have guessed, but it's donors and charities making sure they're doing the right thing, and that's impressive."

Winklevoss Consultants is already moving forward with development of a new version of the DMI account geared toward lower investments, Mr. Rakov said, spurred by demand from the philanthropic community. "We don't think this should be limited to donors who can afford to give US$250,000 or more," he said.

Ultimately, Dr. Schervish said, donors themselves will determine whether or not DMI accounts flourish in the future.

"In charity, when determining whether a relationship comes about, it's supply-led," he said. As competition among charities continues to grow, appealing to the donor becomes more and more important, "and the DMI account is one way of making the relationship more appealing to the donor."