Maximizing Income in a Perpetual Care Fund

by Adam Sheer

MANAGING A CEMETERY DAY-TO-DAY often leaves owners and operators little time to focus on long-term planning. But for those who want to ensure ongoing maintenance and upkeep of cemetery grounds in perpetuity—even after the cemetery is sold out—long-term planning is crucial.

Effective planning is mostly about striking the right balance between your need for long-term growth versus your need for cash flow and income along the way. "Growth" ensures the long-term sustainability of the cemetery; "income" ensures the cemetery's ongoing expenses are always met.

This article will focus on the "income" side of the equation, detailing four income-generating investment options with various pros, cons, and risk profiles. Before diving in, however, there are several questions we think you should answer and discuss with a financial advisor. Here are a few:

- When was the last time the Investment Policy Statement (IPS) was updated?
- What are the regulatory restrictions for Perpetual Care Funds in your state? Have they changed?
- Do you have additional policies in your IPS defining permissible investments?
- Do you have pre-determined asset allocation policies in your IPS?
- What are the fund's long-term investment goals?
- Have you created a forecasting model that projects future revenue, current and future maintenance expenses, planned development projects, and inflation?
- Do these projections analyze the cemetery's needs over the next 10, 20, or even 30 years and beyond?

In our view, these questions are key to determining the optimal investment mix for a Perpetual Care Fund. In addition, regularly reviewing and updating your IPS is a critical component to keeping your Perpetual Care Fund on track. Once you know how much growth versus income you need, what types of investments are allowed, and what type of risk you are willing to take (or need to take), you can determine which income and growth investment options make the most sense for your Perpetual Care Fund.

From an income standpoint, here are four options to consider:

Option 1: Bonds

If a government or a corporation wants to borrow money, it can issue bonds. A bond represents a borrower's obligation to repay the principal of the bond, with interest, over a set number of years (generally one to 30 years).

A bond's risk generally depends on the credit-worthiness of the bond issuer. Buying U.S. Treasury bonds means you are effectively loaning money to the U.S. government, which is generally viewed to be a low-risk investment. The U.S. government has never defaulted on a loan. Buying bonds from a small U.S. energy company struggling to make ends meet, however, would be considered high risk—the company may go bankrupt and default on the bond. Generally speaking, risky borrowers should pay higher interest rates, which can mean more income (and risk) for the investor.

Similarly, the interest rate of a corporate bond largely depends on the risk of the corporation issuing it. The interest rate on an Apple Inc. bond, for example, is likely to be significantly lower than the interest rate offered on an Uber Inc. bond. Apple reports a huge profit each year. Uber does not. There are ratings agencies like Moody's, Fitch, and Standard & Poor's that help investors navigate risk by categorizing corporate bonds using ratings like AAA (low risk) down to D (high risk, "junk").

The chart below (Figure 1) shows how interest rates are historically higher for corporate bonds (higher risk) and lower for U.S. Treasuries (lower risk). When building a bond portfolio, investors must balance their desire for yield with their willingness to accept risk.

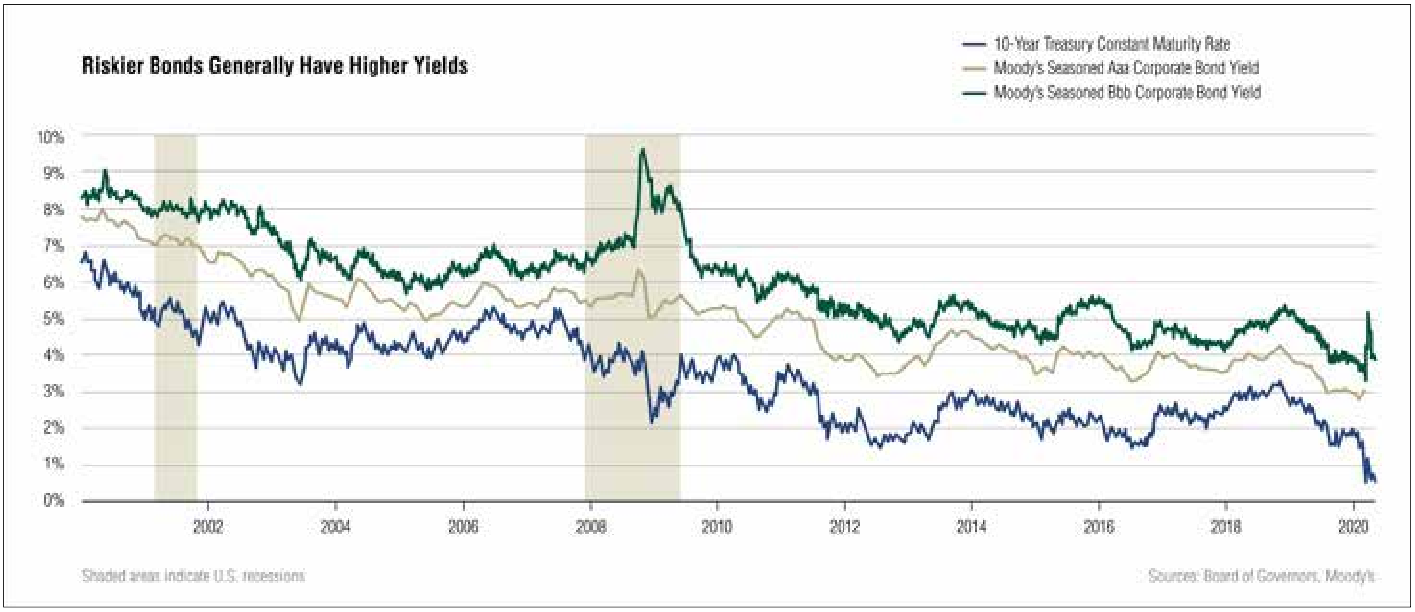
Option 2: Preferred Securities

Companies can issue debt to raise money (bonds), or sell shares of the company in the equity markets (stocks). Preferred securities fit somewhere in between and are largely considered hybrid securities.

Like bonds, investors who buy preferred securities can expect to receive regular fixed payments over time with the full "par value" returned when the securities mature or are redeemed by the issuer. Preferred securities often pay higher yields than bonds and come with more risk.

For example, preferred securities generally do not benefit from increases in the stock price of the underlying company—even though the investor has ownership interest. Preferred securities also do not carry the same interest payment guarantees bonds do. If a company goes through a difficult period, management can delay or defer payments to preferred security holders

FIGURE 1: Chart Comparing Yields of U.S. Government Bonds vs. Corporate Bonds



SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS

(which cannot be done with bonds), and if a company goes bankrupt, the bond holders are paid before the preferred security holders. Finally, about 80 percent of preferred securities are issued by financial services companies, which means investors have few options for diversification across different industries and sectors.

On the plus side, preferred securities can enhance portfolio income without significantly detracting from a portfolio's overall credit quality. Preferred securities also typically offer low correlation to stocks and bonds, meaning they can help diversify your overall portfolio.

Option 3: Closed-End Funds & BDCs

A closed-end fund (CEF) is an investment structure, not an individual security like a stock or a bond. CEFs are portfolios of pooled assets that raise a fixed amount of capital through an initial public offering. Closed-end funds resemble mutual funds in their structure and the types of securities they invest in, which means they often come with the benefit of being diversified, professionally managed, and transparently priced. They also tend to earn higher yields than open-end funds (a mutual fund is an example of an open-end fund), with distributions (income) paid to investors quarterly, or in many cases, monthly.

Some downsides to closed-end funds are that they trade like stocks, meaning they are subject to market volatility. Because a CEF can also issue debt or preferred shares to leverage their assets, it could mean added risk and limited liquidity.

One type of closed-end fund worth considering is a Business Development Company (BDC). These are investment companies listed and traded on public exchanges, consisting primarily of floating rate bonds and loans issued to small to medium-sized businesses. BDCs can raise capital by borrowing at short-term rates and use the proceeds to make additional loans and investments for its portfolio.

Option 4: Dividend-Paying Stocks

Dividend-paying stocks offer a fourth option for generating income in an investment portfolio. Many publicly traded companies choose to make cash payments to shareholders based on the company's profits. Generally speaking, reliable dividend-paying companies are well-established, "large cap" companies with formidable businesses and strong earnings. Think AT&T, IBM, Disney, and so on. When a company consistently pays dividends, it can be a sign that revenues and profits are healthy enough to devote a portion of the profits to shareholders.

On the plus side, an investor can buy stock in large-cap companies, receive

Preferred Securities Hierarchy in the Capital Structure

Seniority	Creditor Class	Asset Class
Higher	Senior Secured Bank Loans	Debt
	Senior Secured & Unsecured Debt Holders	Debt
	Subordinated Debt Holders	Debt
	Junior Subordinated Debt Holders/Hybrid Preferreds	Preferred Securities
	Traditional Preferred Stockholders	Preferred Securities
Lower	Common Stockholders	Equity

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dividend payments, *and* participate in the long-term growth of the company (via stock price appreciation over time). In this sense, investing in dividend-paying stocks can afford the investor both growth and income over time.

On the risk side of the equation, however, stock market volatility is always a factor, and changing economic conditions can cause a company to slash or eliminate dividends. In the current crisis, for example, high-profile dividend payers like Airbus, HSBC, and Standard Chartered have suspended dividends for 2020.

Bottom Line

For nearly all cemetery owners and operators, it is essential to utilize your Perpetual Care Fund to generate income over the long-term. But *figuring out how* to generate the income can be a complex, time-consuming, and challenging undertaking. In all likelihood, it will mean diversifying across multiple income-generating investment options, like the ones listed above, to reduce risk and create the cash flow needed for maintenance of cemetery grounds in perpetuity. M

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