

Since a portion of the couple's \$5,600 annual income is a return of capital, they would receive \$3,506 tax free and pay ordinary income taxes on only \$2,094. Figure in taxes at 40% and they're getting an aftertax \$4,762, or 5.4% of their net investment. After 20.5 years the return of capital deduction is exhausted and the aftertax return drops to \$3,360.

How does this compare with private-sector annuities? For our 70-year-old couple, low-cost Vanguard Group quotes annual payments on a second-to-die annuity of \$7,578 per \$88,749 invested. Figure in the return-of-capital deduction, and they're getting \$6,278 aftertax. That's a 7.1% return.

There is some risk in the charitable annuity: The college or charity with your money might go bust. But private annuities aren't sure things, either. You might get goose bumps on discovering that, while the assets behind Vanguard's annuities are safely walled off, the annuity policies are issued and guaranteed by financially ailing American International Group.

Annuities remain a small part of overall charitable giving, with perhaps \$20 billion in gift annuities outstanding and another \$1 billion added annually, figures Seattle planned giving expert Frank Minton. Competition has prompted a handful of charities to offer above-average payouts. Harvard, with the country's largest college endowment at \$29 billion (as of Oct. 31), offered our couple a \$5,800 annual payout. The Humane Society of the United States (endowment: \$150 million) beat that by \$50 a year. California's elite Pomona College, with \$59 million in annuities payable and a \$1.5 billion endowment, offered 7%. (With that payout your charitable deduction falls to \$10,159.) Yale University is the cheap skate, offering our couple 4%.

A number of nonprofits, including

World Vision and the Leukemia & Lymphoma Society, troll for annuity clients by sponsoring Google links. A request for a quote from American Bible Society, which recently suffered a scandal and financial problems, elicited an e-mail proposal and five follow-up calls. Other Google ads for what looked like gift annuities were planted by insurance agents flogging costly annuities.

Gift annuities are regulated by the states. Although protections vary widely, defaults and fraud are rare among well-established charities. Many states, including Nebraska, do not require reinsurance or segregation of annuity accounts. Even so, the National Arbor Day Foundation of Lincoln takes a conservative approach, segregating contributions and not withdrawing a dime for its own benefit until after the annuitant dies.

Two big downsides to gift annuities: Payouts are not indexed to inflation, and unlike some commercial products, they do not offer options to return a portion of capital to heirs if a customer dies shortly after annuitization. If you feel more charitable about your heirs than about your alma mater, you'd probably be better off buying municipal bonds.

Don't pay a broker to find a gift annuity. Instead, type "gift annuity" of a charity that interests you into the Web site's search box. If all looks good, review its financial statements or tax returns to make sure its endowment amply covers its annuity obligations. **F**

## Like Fine Wine

Below, what nonprofits generally pay for a \$100,000 charitable gift annuity.

STARTING AGE	EARLY PAYOUT	
	ONE PERSON	WITH SPOUSE 5 YRS YOUNGER
50	\$5,100	\$4,100
55	5,300	4,400
60	5,500	4,700
65	5,700	5,300
70	6,100	5,500
75	6,700	5,800
80	7,600	6,200

Source: American Council on Gift Annuities.

## SOUND ADVICE

# Conflict Resolution

When the Treasury needed advice on dishing out \$700 billion, it picked a consultant free of the usual conflicts of interest. You should do the same with your money.

By Richard C. Morais

**A**S MARKETS MELTED DOWN in October, the U.S. Treasury asked six investment consultants for proposals on how they could help it dish out \$700 billion under the Troubled Asset Recovery Plan (Tarp). Treasury's ultimate pick: Ennis Knupp & Associates.

"Who the \*&?# is Ennis Knupp?" asked Housingwire.com. Good question. Better question: How does this firm get compensated when it gives advice about billion-dollar portfolios? There's a powerful lesson for retail investors in the Treasury's choice. Namely that conflict-free advice is worth seeking out, wherever it may be.

With 121 employees in Chicago, Ennis Knupp advises 160 institutions on how to manage \$820 billion. They range from IBM to the Texas Municipal Retirement System to the John D. & Catherine T. MacArthur Foundation. Beyond its business, however, EK is little known.

"We keep a low profile," says Chief Executive Stephen Cummings. EK doesn't pick stocks; it helps investors pick stock pickers. Firms in this Wall Street specialty usually call themselves "pension advisers." A more informative label would be "money manager managers." They advise pensions on allocation (stocks versus



Stephen Compton: The man with the honest advice behind Treasury's Tarp.

Ennis Knupp, by contrast, charges pension funds and endowments \$175 to \$625 an hour, or typically \$60,000 to \$1 million annually per client. It does not take money from money managers. It even returns tins of Christmas sweets to those seeking to curry favor. (Read more about Ennis Knupp at [forbes.com](http://forbes.com).)

Like rivals, Ennis Knupp sifts through reams of performance data to select

## Conflict-free advice is worth seeking out, wherever you find it.

money managers. Suzanne Bernard, the firm's "opportunistic strategies" principal, is, for example, digging through asset managers looking for skill in picking up downtrodden assets, like corporate bonds. These days she's telling clients to shift money from low-yielding Treasuries into high-grade corporate debt, although she doesn't pick securities.

"A big thing for us is that the advice we get is untainted," says Peter Leslie, chairman of the \$8 billion (assets) Maine Public Employees Retirement System, which has been an EK client since 1991.

Individual investors would do well to take a page from the Treasury and Maine playbooks and shun advice from those

bonds versus commodities) and protect them from overcharging and chicanery.

Yet more than half of pension advisers take payments from the money managers they're supposed to objectively rate, according to a 2005 study by the Securities & Exchange Commission. The classic form of payment was directed brokerage; the money manager would send a certain amount of its trades to a brokerage in which it had a financial interest. Nowadays the conflict is a little more subtle. A firm in the pension advisory business may have an arm that sells (expensive) advice or conference tickets to money managers. Often the pension advisers fail to reveal these conflicts of interest to their clients, the SEC found.

## KEEPING THEM HONEST

You wouldn't ask a barber if you needed a haircut, but an awful lot of people hand over their savings to advisers and money managers with ulterior motives. Here are questions to ask to avoid such mistakes. For more, visit [www.napfa.org](http://www.napfa.org).

- ◆ How long have you been in business?
- ◆ Have you ever been cited by a professional or regulatory body for disciplinary reasons?
- ◆ Are you engaged in any other business?
- ◆ How is your firm paid, and are you willing to spell it out in writing? (Fee-only and a percentage of assets have the fewest conflicts; be wary of commissions, fees-and-commissions and flat fees "offset" by commissions.)

—R.C.M.

who get paid based on what, and how much, they sell. That includes the legion of stockbrokers and insurance agents whose income takes the form of commissions on financial products.

"You weed out so many problems if you remove the conflicts of interest," says Mary Malgoire, president of Family Firm, a Bethesda, Md. fee-only financial adviser.

Among the nation's 600,000 financial advisers, only 12,000 could potentially qualify as fee-only, according to Ellen Turf, chief executive of the National Association of Personal Financial Advisers.

NAPFA's members charge by the hour (typically \$180 to \$300), work on retainer or charge a percentage of the assets they advise. Malgoire at Family Firm charges a fairly stan-

dard 1% a year for first \$1 million, with the rate falling to 0.8% for sums up to \$3 million.

Britain's Financial Services Authority last month announced it plans to require that investment advisers make a "distinction between independent advice and sales advice." The FSA's aim: "removing the possibility of commission-bias." Chalk one up for investors. **F**

BEYOND THE BALANCE SHEET

# Quality Control

Tough times encourage weak companies to get creative in coming up with earnings gains. Knowing the tricks can save you a bundle | By Jack Gage

**C**AN INVESTORS TRUST THE NUMBERS THROWN AT them? Evidently not, to judge from nearly simultaneous accusations of fraud against a distinguished lawyer and a famous stock trader. But it's not just outright speculations that you have to worry about. It's the risk that reported earnings are stretched or fudged.

As tough times take a toll on corporate performance, pressure mounts on managers to fill the breach with creative accounting. So, with help from the Los Angeles firm Audit Integrity, we took a look at what makes for high—and low—quality in an earnings figure. AI's analysis encompasses a range of numerical and qualitative assessments of whether a company's earnings could be getting an artificial boost or are otherwise at risk of crumbling apart.

All these are black marks in AI's book: lots of goodwill (which might get hit with an impairment charge), high deferred taxes (which drain cash down the road, when it's time to pay the IRS), pileups in receivables or inventory (which drain cash right now), executive pay tilted heavily to options (which provide temptations to inflate earnings) and unfunded pension liabilities.

You don't have to be a short-seller to profit from AI's analysis. Companies that get high marks for earnings quality and that are also trading at low multiples of those earnings can be unloved values plays.

Among AI's top-rated companies (*see table, p. 50*) is CenterPoint Energy. Although the stock is off its October lows, the \$11 billion (sales) Houston natural gas utility still trades at a modest ten times 2008 earnings, which is a 37% discount to the S&P 500 multiple. As of Sept. 30 Center-

Point's pension obligation as a proportion of total liabilities was 31% below the average reported by its utility peers. On a Nov. 5 earnings call with investors, CenterPoint committed to either maintaining or increasing its 5.7% dividend.

Callaway Golf and Continental Resources also receive high marks for earnings quality and trade below the market's average 16 times 2008 earnings.

Among the companies Audit Integrity has warned investors to steer clear of is faddish shoemaker Crocs. Audit Integrity noticed that Crocs inventory was piling up, flagging the trend in August 2008. Three months later Crocs announced it would give the value of its inventory a 30% haircut in the third quarter and slash fourth-quarter sales guidance 40% below analyst expectations. That sent its stock into a one-day 45% tailspin, even as the broader market rose 7%.

One company raising Audit Integrity's suspicions these days is Eastman Kodak. In June the film manufacturer announced a stock buyback, which is often a sign of confidence. In Kodak's case it looks more like a sign of desperation. The plan authorized Kodak to repurchase up to \$1 billion of stock, with \$581 million of the money coming from a refund of taxes it paid in the 1990s.

If carried through, the buyback will shrink Kodak's shares outstanding by 25% and thus lift EPS—but not add a penny in earnings. Quite apart from the synthetic flavor to the EPS gains is the matter of timing: Shares that Kodak bought back last year are now worth less than half of what it paid.

Another red flag: As Kodak burned through more than a third of its cash in 2008, it lifted the rate of return it assumes its pension fund will earn from 8.6% to 9%, thereby lowering

Callaway and Nu Skin: profits through sales, not gimmicks.

