BARRON'S

How Smart Investors Give To Charity

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With great power comes great responsibility: Never has this been truer than with donor-advised funds. These philanthropic investment accounts—essentially mutual funds that enable individual investors to emulate private foundations—have surged in popularity recently. "We're the second-largest charitable grant maker in the U.S. after the Bill and Melinda Gates Foundation," says Elaine Martyn, managing director of the private donor group at Fidelity Charitable, the most popular donor-advised fund sponsor. "We do about $4 billion in grant-making a year."

Total donor-advised fund charitable assets stood at $85 billion at the end of 2016 and have been growing rapidly. "We've seen a 50% increase in new accounts so far in our latest fiscal year," says Kim Laughton, president of Schwab Charitable, the third-largest donor-advised fund sponsor.

Four of the largest sponsors—Fidelity, Goldman Sachs, Schwab, and Vanguard—have offshoots that are legally charities themselves, although in reality they act as middlemen, allowing you an immediate tax deduction for your donation while passing it on to other charities whenever you want them to receive it—now or years down the road. "While, legally, Schwab Charitable does control the disposition of the assets, practically speaking, as long as you select any charity deemed eligible by the IRS, we will approve the grant to that charity," Laughton says.

That level of control is typically afforded only to private foundations, which are costly to set up and maintain and have smaller tax benefits. Donor-advised funds, also known as DAFs, allow greater deductions for cash donations—up to 50% of your gross income compared with 30% for foundations—and for appreciated stock donations, 30% of income to foundations' 20%. And donor-advised funds allow you to donate illiquid assets you couldn't easily give directly to most charities—real estate, business interests, even art. In fact, your control is even greater than that of a foundation, which must by law distribute at least 5% of their assets annually. DAFs have no such requirements.

Still, more control means more responsibility. You choose the end charities, the amount and timing of your annual charitable distributions, as well as the right donor-advised fund. Ideally, you want investments in the account to perform well. Two key factors affecting that are the account's administrative costs and its underlying investment options. Both vary, depending on your account size.

At Schwab, the minimum account size is $5,000, and administrative fees start at 0.6% of assets or $100 a year, whichever is greater, for the first $500,000 invested. Fees drop to 0.3% for the next $500,000, then fall at different break points, ultimately to 0.1% for accounts of more than $15 million.

Vanguard has a minimum investment of $25,000, 0.6% administrative fees, and an annual $250 maintenance fee for accounts that drop below $15,000, making it much less affordable for the smallest donors. The administrative fee drops to 0.4% above $500,000, but goes no lower for "standard accounts." There is, however, a "select account" that Vanguard can award at its discretion for accounts with more than $1 million, which charges 0.13% and then drops to 0.05% for assets over $30 million. According to Vanguard: "Approval is unlikely if account activity results in excessive expenses or significant balance fluctuation above and below $1 million."

Fidelity has only four break points, starting at 0.6% or $100, whichever's greater, for accounts of $5,000 to $500,000, then falling to 0.15% for assets above $2.5 million.

There are also the underlying investment options to consider. Vanguard has 15 that are primarily low-cost index funds. But surprisingly, Vanguard is not the low-cost leader, as it often is outside the DAF world. Fidelity and Schwab both match or undercut Vanguard's funds fee-wise with their index offerings, even beating Vanguard's lowest-cost Select fund class.

Moreover, Fidelity and Schwab offer top-notch actively managed funds, such as JPMorgan U.S. Equity(ticker: JMUEX) at Fidelity and Hartford International Opportunities (HAOYX) at Schwab. They also offer socially responsible funds. Although Goldman Sachs' administrative fees are comparable to the other three sponsors, its underlying funds are pricey and DAFs are available only to private wealth clients with assets over $10 million.

TOP MARKS OVERALL go to Schwab, as it has a professionally managed account option for accounts over $250,000, allowing donors who hire an advisor to invest in almost any stock, bond, or fund. Fidelity allows such investment flexibility only at the $5 million level via its Charitable DonorFlex Program.

Yet hiring an advisor actually adds another layer of responsibility for conscientious donors. Unlike most investing, the goal of charity is to give your assets away, yet most advisors are compensated by a percentage of assets. That incentivizes them to hoard the assets, instead of distributing them to the charities that need them—a conflict of interest.

Hoarding donor-advised fund assets means that the tax deduction you received for it is a drain on society, not a help. Some advisors manage the charitable portion of their clients' portfolios for free, Laughton and Martyn both say. That removes the conflict and ensures that they take seriously DAFs' newfound power to foster charity.

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