Cooperative Funeral Fund Inc.

Are your preneed funds earning what they need to?

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ICCFA Magazine author spotlight

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➤CFF specializes in the management of preneed and endowment care fund accounts. CFF has provided a program for the death care industry to facilitate the creation, investment, tax compliance and payout of preneed trusts since 1989.

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PRENEED FINANCES

The effect of inflation on preneed funds always needs to be taken into account, but that's especially true when interest rates are keeping fund earnings low.

Are your preneed funds earning what they need to?

Engaging in preneed sales involves inherent risks for both the consumer and the funeral provider. Fortunately, if understood, the risks are manageable and can make it a worthwhile venture for both parties. One of the risks the funeral provider takes on that often is not analyzed enough is the financial risk.

Everyone pays attention to interest rates. But how many funeral providers pay attention to the impact inflation rates have on the interest they are earning—as well as their profits?

The profit margin ratio is a tool that can be used to measure the amount of net income earned as a percentage of sales by comparing net income and net sales (revenue). In other words, the profit margin ratio shows what percentage of sales are left over after all expenses are paid by the business.

Profit Margin Ratio = Net Income / Net Sales

This ratio indirectly measures how well a company is managing its expenses relative to its net sales. When budgeting at-need sales, funeral providers are able to analyse and control their profit margin ratio by determining ways to generate more revenue while keeping expenses constant or keeping revenues constant and lowering expenses.

But understanding the profit margin on those preneed sales funded by trust or insurance means adding the wrinkle of inflation to the cost side of the equation. As time passes, inflation may slowly erode profit margin unless investment returns are managed carefully.

As an example, let's follow a $5,500 preneed funeral contract over a five-year period to see how the profit margin would be impacted by inflation over time. I'll use the following assumptions: 100 percent funded preneed trying to maintain a 6 percent profit margin ratio over the five-year period from 2009 to 2013.

Preneed sale	**$5,500**
Cost	**$5,170**
Net income	**$ 330**
Profit margin ratio	**6%**

Inflation is the general increase in prices. The chart below shows the historical inflation rates on sales with caskets from 2009 to 2013.

Due to inflation, the original $5,500 sales price of the preneed funeral contract would grow to $6,156 after the five-year

Inflation rate on preneed sales

Preneed Sale	Inflation Rate[1]	Beginning Sales Price	Price Inflation	Ending Sales Price
2009	2.95%	$5,500	$162	$5,662
2010	1.57%	$5,662	$89	$5,751
2011	1.02%	$5,751	$59	$5,810
2012	3.48%	$5,810	$202	$6,012
2013	2.40%	$6,012	$144	$6,156
Total Price Inflation over 5 years:			$656	

[1]SOURCE: Federated Funeral Directors for America, Inc.

If your trust investments are yielding low returns that are not keeping pace with inflation, then the longer the contract is active, the more your profit margin decreases. There may even be a point in time when the preneed investments haven't grown enough to cover the costs, resulting in a loss.

period. In order to maintain a 6 percent profit margin over this period, the returns you receive on your preneed investment vehicle need to keep pace with inflation. You would need to ensure your investment grows by $656 (i.e. $6,156 - $5,500) to ensure your 6 percent profit margin ratio is preserved.

Investment options

Here are some specifics of different preneed investment options.

Certificates of deposit

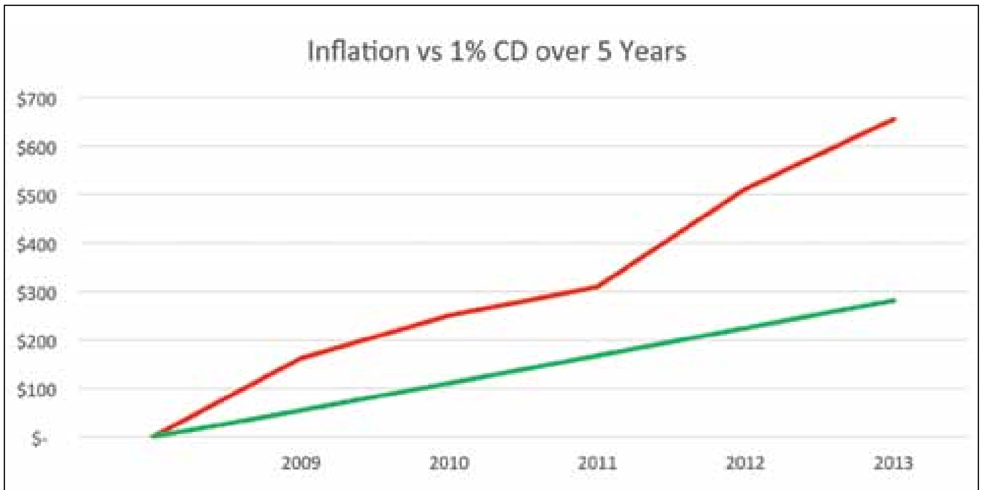
Certificates of deposit are interest-bearing time deposits that have a fixed term and fixed interest rate. Typically, it is intended for a CD to be held until maturity.

If you were to go to your local bank and invest in a CD, you could try to invest your preneed deposits by combining money collected from several preneed contracts to purchase a "jumbo CD" in an effort to obtain a higher return.

However, you would have to wait for each preneed contract associated with the jumbo CD to be fulfilled (i.e. until each contract beneficiary dies) before you would be able to withdraw the CD, or you could incur a fairly steep penalty for withdrawing early.

If you choose to invest the funds from each preneed contract individually, your options would be to either select a long-term CD with a higher rate (and risk an early withdrawal penalty if you need to break the CD before its maturity), or a short-term CD that would yield approximately 1 percent in this current market.

The chart at the top of the page (#1) shows how a 1 percent CD would have performed against the inflation for the five-year period from 2009 to 2013.



#1

The 1 percent growth on the original $5,500 over five years would earn $282 interest, so your investment would have grown to $5,782. However, we previously calculated that we would need the investment to grow by $656 in order to maintain the 6 percent profit margin ratio.

So in this scenario, your profit margin would have shrunk from 6 percent to -0.08 percent. In other words, even though the preneed investment was earning interest, the growth was not able to cover expenses.

Prefunding programs

There are trust administration service providers that offer other trust investment vehicles that can obtain higher interest rates by using the buying power of multiple preneed accounts to buy into investments.

This next example will show how the results can change even with a modest improvement to the return. The chart at the bottom of the page (#2) shows how an investment with a 2.5 percent rate would have performed against the same inflation for the five-year period from 2009 to 2013:

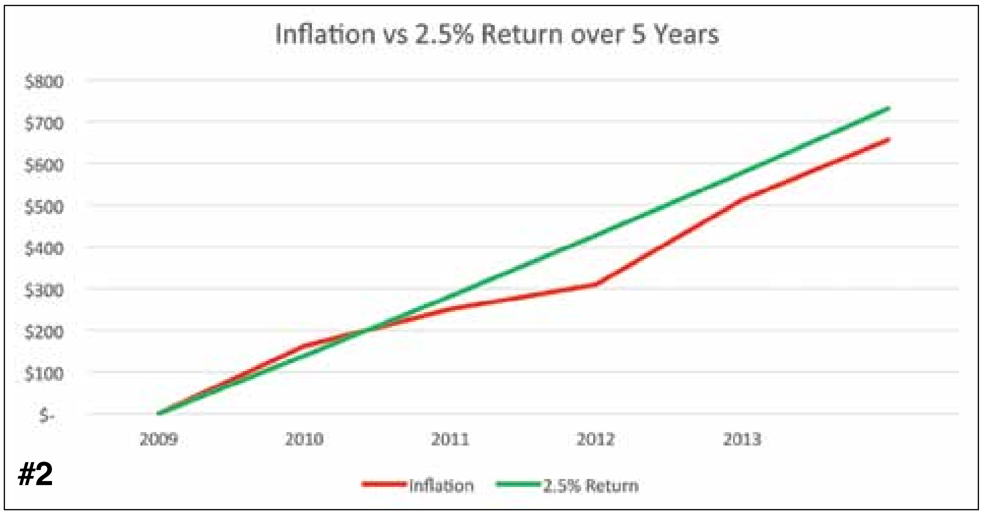
In this scenario, the 2.5 percent growth on the original $5,500 over five years would earn $732 interest, so your investment would have grown to $6,232.

We previously calculated that we would need the investment to grow by $656 in order to maintain the 6 percent profit margin ratio. In this scenario, your margin would have grown from 6 percent to 7.22 percent. By better managing the trust investments you would have been able to increase your profit margin by 1.22 percent.

Funeral insurance

Funeral insurance is another investment option for funding preneed sales. With preneed insurance, often the funeral provider is licensed to sell the insurance. In addition to any growth on the preneed policy, the funeral provider would also receive a commission upfront.

It's important to understand the terms of the insurance product you are using



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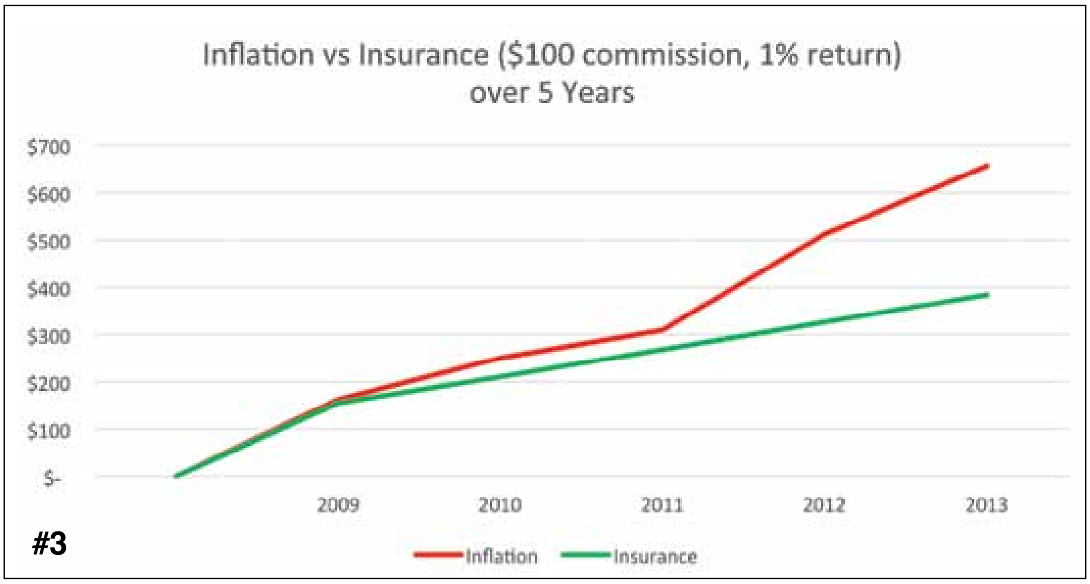

to fund your preneed sales, as normally the higher the commission paid by the insurance product, the lower the rate of return on the underlying investment.

The example shown in the chart at the top of this page (#3) shows the same sale funded by a funeral insurance policy that pays $100 commission upfront and a 1 percent return.

With the $100 commission and the 1 percent growth on the original $5,500, over five years the investment would earn $385, so your investment would have grown to $5,885.

As previously calculated, we would need the investment to grow by $656 in order to maintain the 6 percent profit margin ratio. In the first year, the commission paid upfront helps offset inflation; however, over time, the low interest rate would not be able to pace inflation, and as a result your margin would have shrunk from 6 percent to 1.59 percent after five years, even with the $100 commission.

There may be value to selling preneed funeral insurance to receive a commission upfront, but you would have to do the analysis to understand the long-term impact of that investment decision. This becomes especially important when a funeral provider uses outside insurance salespeople to sell their preneed. Some funeral providers like this model, since they won't necessarily have to pay a salary to the preneed sales person (i.e. the insurance carrier would pay the commission to the salesperson), while they still benefit from having preneed sales generated for them.

It's important to review which insurance product is being sold for you in this scenario, as most likely the insurance product being sold will be paying one of the higher commission rates on the commission schedule to the salesperson while yielding one of the lowest returns on the schedule for the funeral provider.

The average life of a preneed contract is five to seven years. As you have seen from the previous examples, if your trust investments are yielding low returns that are not keeping pace with inflation, then the longer the contract is active, the more your profit margin decreases. There may even be a point in time when the preneed investments haven't grown enough to cover the costs, resulting in a loss.

Summary

In order to maintain your profit margin, every funeral provider should determine whether their preneed investments are earning enough to outpace inflation.

Most state requirements limit the allowable types of preneed investments to secure investments that generate very low returns. This makes it difficult to invest in today's economy, when the Fed has maintained near-zero interest rates for the past six years.

Some funeral providers may feel it's easier to simply continue with their existing preneed investments, but without understanding how inflation impacts their businesses, they may be letting it eat away their profit margins.

There are other investment options available for preneed while still keeping the funds in a low-risk investment and complying with state laws. Now may be the time to look at what your preneed funds are invested in and who is selling your preneed for you. ❐