Preparing for the Future & Providing for Today

Spending Policy Goals for Endowments & Foundations

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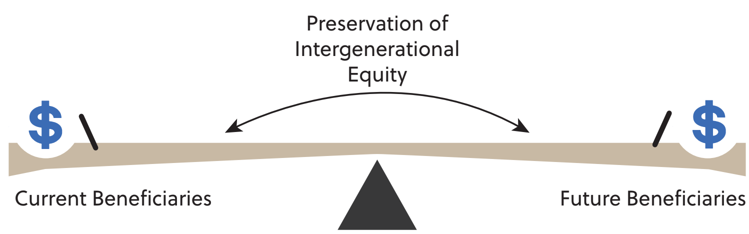
Introduction

Developing and updating a spending policy is one of the most important actions that a board of trustees can take for its endowment or foundation fund. The board is responsible for adopting a spending policy that balances two competing objectives: (1) to provide funding for immediate mission impact, and (2) to preserve and grow investable funds to support the mission over the long term. This balancing act is commonly referred to as the ***"preservation of intergenerational equity."*** In addition, a sound spending policy should seek to minimize the volatility of spending from year to year due to the effects of fluctuations in the capital markets. When market returns are strong, meeting both objectives is simpler. However, during periods of market volatility or economic recessions, balancing these two objectives can become challenging. For example, many endowments struggled to fully recover from the 2008 financial crisis, and some were forced to reduce the size of their programs. A carefully considered spending policy plays a pivotal role in an organization's ability to fulfill its mission with stability and sustainability.

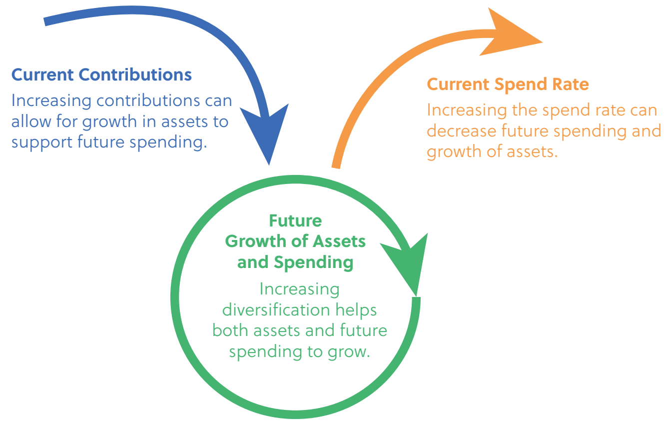


In this edition of PFM InvestEd, we will explore the importance of a spending policy, review the history of the legislation governing endowment spending, and present some of the most common methodologies used by endowments and foundations to determine their annual spending. We will close with some important questions for decision-makers as they consider the adoption of an appropriate spending policy.

What Is a Spending Policy?

A spending policy determines how much of an organization's charitable funds will be spent annually on its mission-related programs, such as scholarships for an education-related foundation, including operating costs. Although, technically, a spending policy applies only to endowment funds (funds not wholly expendable due to donor restrictions), having one in place is helpful to any foundation or charitable organization seeking long-term sustainability and impact.

Each organization is unique in its mission, culture, guiding principles, goals, objectives, resources and other characteristics. Ideally, an organization's spending policy should be harmonized with its unique attributes as well as its overall funding and general economic conditions. Inadequate spending can be perceived as a failure to fulfill the mission, while overspending may jeopardize an organization's long-term sustainability by prematurely depleting its assets. To make matters more complex, fluctuations in the market value of investment funds caused by market volatility may create variability in spending from year to year. This variability can be disruptive to the organization's mission and funding-dependent initiatives.



History of Endowment Spending

In order to fully understand the impact a spending policy has on an endowment or foundation, a review of the history of spending policy governance may be helpful.

Prior to the enactment of the Uniform Management of Institutional Funds Act (UMIFA) in 1972, endowments were invested primarily in fixed-income securities (bonds and mortgages). Trust law limited endowment spending to the "income" (interest and dividends) derived from the securities in the portfolio, and any appreciation in the value of the assets was not distributed. The creators of UMIFA recognized the risks inherent in this strict interpretation of "income," as it greatly limited the investment universe available to endowments by putting the focus on the highest-yielding bonds rather than the investments with the most favorable growth prospects. The enactment of UMIFA paved the way for endowments to begin investing with a total-return focus, thus broadening the investment universe to include equities for long-term growth. Spending policies under UMIFA were determined by the historic dollar value of the endowment. Charitable organizations were able to spend any appreciation above the historic dollar value but were never able to spend below it.[1] The purpose of this rule was to preserve the purchasing power of the endowment. However, with the inclusion of equities, portfolio values had become less stable. When down markets resulted in declining asset values, a board's responsibility to protect the endowment principal (corpus) placed severe limitations on spending.

It was not until 2006, with the adoption of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), that endowments were relieved of their obligation to maintain the historical value of assets. Under UPMIFA, an endowment may spend an amount deemed prudent after taking into consideration the donor's intent that the fund continue in perpetuity, the purpose of the fund and any relevant economic factors. UPMIFA emphasizes maintenance of the purchasing power of the fund as opposed to the original dollars contributed. Further, it encourages the board of trustees of an endowment to adopt a spending policy that will allow flexibility in response to short-term fluctuations in the market value of the fund.[2] As of this paper's publication date, all U.S. states except Pennsylvania have enacted a version of this legislation.

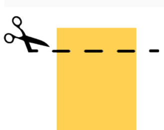
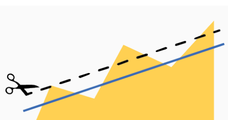
1 Gary, Susan, "UMIFA Becomes UPMIFA," Uniform Law Commission, http://www.uniformlaws.org/Shared/Docs/UMIFA%20Becomes%20UPMIFA.pdf.
2 Dryburgh, Erik, "UMIFA and UPMIFA: The Law of Endowments," American Bar Association, September 12, 2008, https://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint-fall/2008/umifa_and_upmifa.authcheckdam.pdf.

The Spending Rate

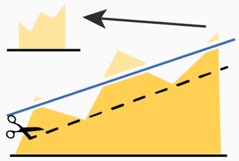
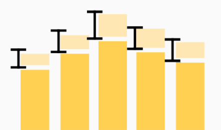
Many endowments and foundations may seek to spend as much as they can every year in order to make a difference. However, if not kept in check, overspending will lead to a loss of purchasing power. Therefore, it is important to establish a spending rate that is economically viable in the long term. Common practice dictates that spending in excess of 5 percent annually will lead to a depletion of corpus. For example, consider an endowment invested in a well-diversified portfolio of global stocks and bonds, with an expected annual long-term rate of return of 7.5 percent. An endowment must consider long-term inflation, as the prices of goods and services required will rise over time. Commonly, the expected long-term rate is 2.5 percent, leaving just 5 percent to actually spend (the real return rate). Spending more than 5 percent will mean a slow depletion of corpus over time. Higher education and healthcare institutions, which arguably face a much higher inflation rate than the typical institution, are faced with an even more difficult challenge of preserving corpus at a 5 percent spending rate unless they're willing to take exceptionally higher investment risks. Generally, we recommend considering a spending rate that is economically viable in the context of expected long-term returns, inflation and other economic conditions. As of fiscal year 2017, the average effective spending rate for most endowments was 4.3 percent.[3]

Comparison of Spending Formulas

While the spending policy for a private foundation is made straightforward by the IRS requirement to distribute a minimum of 5 percent of assets, other types of charitable organizations, such as public charities, endowments and foundations, have the flexibility to adopt a prudent spending policy that takes the unique attributes of their organizations into consideration. Four of the most commonly used formulas and their variations are described below.[4]

BASIC FORMULAS		PROS	CONS
	Spend All Current Income Spend all current income (dividends, interest) and add unspent income to the principal of the endowment	Straightforward, easy to calculate	Heavily dependent on interest rates and dividend yields, which may result in underspending or loss of purchasing power in times of low yields Spending is limited to cash flow and tends to be relatively low
	**Spend a Set Percentage** Decide on an appropriate spending rate each year, or use a constant spending rate each year	Highly responsive to operational needs of organization, good for organizations that can tolerate volatility	Spending is volatile, completely dependent upon market movements year over year
SMOOTHING FORMULAS			
	**Rolling Average** Spend specified percentage of market value, typically based on three-, five-year or longer moving average	Can minimize spending variability caused by market value fluctuations over time. The longer the smoothing period, the more effective the policy	Reliance upon historical market values can cause over- or under-spending in periods of extended market expansions or contractions, especially for shorter smoothing periods
	Spending Reserve Segregate specific percentage of market value in separate account, invest it in safe and liquid securities	Spending reserve provides cushion to offset underperformance and minimize invasion of principal, especially during a recession	Significant cash allocation may reduce endowment returns over the long term

3 NACUBO, 2017.
4 This chart was adapted from the analysis of spending policy formulas found here https://www.philanthropysouthwest.org/sites/default/files/resources/Endowment%20Spending%20-%20Building%20a%20Stronger%20Policy%20Framework.pdf as well as internal PFM knowledge.

	**Stabilization Fund** Create a separate fund from the returns in excess of spending, invest alongside endowment	Spending reserve provides cushion to offset underperformance, minimizes invasion of principal, especially during a recession	Excess returns may not be enough to cover spending needs in extended periods of underperformance Risk profile of stabilization fund is similar to endowment, so the fund will perform similarly to endowment in down markets
INFLATION-BASED FORMULAS			
	Inflation-Protected Increase spending at a predetermined inflation rate	Easy to calculate, minimizes spending variability	Disregards market value, increases potential for overspending, especially in down markets
	**Banded Inflation** Increase spending at a predetermined inflation rate, but upper and lower limits are placed on the percent of market value spent in a given year	Minimizes spending volatility, increases spending predictability for budgeting purposes Spend less during market upswings when compared to rolling average method; builds in reserves for support in times of market decline Spend more during market downswings when compared to rolling average method; eliminates stress of budget cuts when market values decline	In times of extreme or prolonged market declines, the spending cap as a percentage of asset value may severely limit spending
HYBRID FORMULAS			
	Weighted average of x% of the prior year's spending adjusted for inflation and y% of the rolling average market value	Highly customizable for each unique nonprofit Moderates spending, increases likelihood of maintaining purchasing power of endowment over time	Amount spent over time tends to be less than with other methods Potential for spending cuts in times of falling markets if heavily weighted toward banded inflation method

Considerations for Boards and Decision-Makers

There is no one-size-fits-all spending rule that fulfills the unique needs of every endowment or foundation. While many tend to select hybrid formulas to stabilize spending, preserve future purchasing power and maintain intergenerational neutrality, we have seen that smoothing formulas based on a period greater than the traditional three or five years can be just as effective at accomplishing these goals. Before adopting a spending policy, we believe it is important for the board of trustees to first thoughtfully consider the core elements that define the organization. The questions below can help to focus this discussion:

- What is our specific mission?
- What are our goals, objectives, future cash-flow needs and investment time horizon?
- Does our spending policy balance current needs with future goals?
- Are there any restrictions on our spending?
- Have spending levels become fixed or entitlement-driven?
- Are we reviewing our spending policy annually and making changes if necessary?
- How sensitive are we to spending volatility?
- How do our illiquid investments impact our long-term spending plans?

To begin answering these questions, boards can use analytical modeling techniques that factor in the organization's unique goals and objectives along with projected future expenditures, sources of funding, historical returns, various asset allocations and asset-return assumptions. Investment advisors who work with endowments and foundations typically utilize analytical modeling to help guide the development of customized spending policies. In addition, investment advisors should work with a board to ensure consistency between its spending policy and its investment policy.

Ultimately, the appropriate spending policy should not rely solely on mathematical outputs or subjective inputs, but should strike a balance between both so the board of trustees can achieve its ultimate goal of providing sustainable support to drive the mission while allowing the corpus to grow in real terms to safeguard and ensure the long-term sustainability of the organization.

About PFM

For more than 20 years, PFM's investment professionals have worked with endowments and foundations to develop comprehensive investment programs that are cost-effective and customized to their unique missions. Please contact us to speak with our dedicated professionals about how we can partner with you to help you achieve your mission.

Contact Us

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