Endowment & Foundation Spending Policies: One Size Does Not Fit All

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Unlike pension plans, which are established to fund specific future liabilities over finite time periods (the lifetimes of their beneficiaries), endowment funds are typically set up to last forever. This presents unique challenges to the sponsor of the endowment who must establish annual spending rules given a long-term target spending rate that is tied to the fund's financial goals. The sponsor must also determine the sustainability of the long-term spending rate based upon the endowment's investment policy.

Financial Goals for the Endowment

Before addressing the particulars of a spending policy, an endowment must first decide on an appropriate level of spending over time. Unlike a private foundation, which is required to pay out five percent of the average market value of its assets each year to avoid excise taxes, an endowment has no set spending requirement in the United States. However, both endowments and foundations should manage their asset pools with the goal of providing stable support for the sponsoring organization. This means that cash contributions should be predictable with low volatility from year to year. This eliminates the uncertainty surrounding the preparation of annual budgets and organizational planning.

The Basics of Spending Policy

According to a recent survey of 177 endowments and foundations by SEI, approximately 91% have a formal spending policy in place. The majority of plans set spending in the 4-5% range. By comparison, plans that do not have a formal spending policy reported an average yearly spending rate of 5.4%.

The techniques used to determine spending policies are specific to each plan. However, there are four general models that have been used historically by endowments and foundations as a guideline to set spending policy. The particulars of each approach are outlined below.

Income Only Models: Under the income only model, spending is limited to coupon and dividend payments received on the underlying investments held by the endowment. Since principal cannot be spent, this type of policy tends to preserve the purchasing power of the plan over time. It also provides stability in year-to-year spending.

One disadvantage of an income only spending policy is that the corresponding investment policy is usually more oriented toward a conservative asset allocation that emphasizes fixed income rather than riskier asset classes such as equities. As such, this approach may reduce the growth of the fund and the probability of preserving future purchasing power. Another limitation on the income only policy is its sensitivity to fluctuations in interest rates, which can reduce the levels of spending as a percentage of assets over time.

Market Value Related Models: A second approach to formulating spending policy uses a fixed percentage of the endowment's market value each year. Typically, a spending policy is calculated based upon a percentage of the beginning market value, the ending market value, or the average market value over a particular time period.

Market value based spending rules require an investment policy that uses a total return approach to asset allocation. Assuming that the appropriate spending target is implemented, such rules tend to favor preservation of plan assets and a sustainable rate of long-term spending into the future since any change in market value will coincide with a change in the amount spent by the plan.

The drawback to market value related models is the lack of stable and predictable spending levels. Over time, a market value based spending policy will result in more dollars for the institution. However, the possible year-to-year volatility in the values of the underlying assets in the fund will make annual budgeting more difficult. A partial remedy is to use a moving average market value, which will reduce spending volatility, albeit at the possible expense of plan asset values during market declines.

Inflation-Adjusted Models: Inflation-adjusted spending policies mandate that an endowment spend an amount equal to the prior year's outlays with an additional amount designed to adjust for inflation. The key advantage to this policy is stable and predictable spending over time. This facilitates the budgeting process and allows institutions to anticipate (often years in advance) the level of funding they will have in the future. These types of models also can be readily supported by total return investment policies.

The main disadvantage to inflation-adjusted spending models is that they do not adjust to the value of the underlying assets in the endowment over time. During rising markets, the model will usually result in a spending rate that is less than the trust can support. If the endowment amends the current spending rate to reflect the growth of assets, the sustainability of future outlays may be affected. During down markets, inflation-adjusted models can result in a rate of spending which cannot be sustained due to the drop in value of the trust.

Hybrid Models**:** Some institutions attempt to combine the goals of stable spending and preserving value and purchasing power by implementing more than one type of spending model. One example of such an approach is the rule developed by Yale economists James Tobin, William Brainard, Richard Cooper and William Nordhaus. This “Yale Model” sets spending for a particular year as the weighted average of the spending target based upon the current endowment value and last year’s spending adjusted for inflation. The implementation of this rule typically places the most weight on last year’s spending. The inclusion of prior year spending levels helps to smooth the year-over-year fluctuations in outlays from the trust.

Hybrid models provide the most flexibility to the endowment. The weighted-average formula allows the institution to determine the level of importance to be placed upon stable outlays in relation to the preservation of asset value, especially during down markets. The hybrid approach allows an endowment to design a spending policy to meet its exact needs. Of course, the challenge is to find the right combination and stick with it during difficult times.

Within the four general approaches outlined above, there are countless combinations that have been designed to fit the specific needs of the particular institution. Adjustments are typically made to reduce the volatility of spending or protect the value of the trust during down markets. As an example, during declining markets, an inflation-adjusted approach that emphasizes predictable spending over asset value growth can be supplemented by placing a ceiling or dollar limit on spending. The most common threshold is usually equal to the sum of the cumulative contributions (historic dollar value) that formed the trust. Another approach adjusts this historic dollar value for inflation.

Spending floors, which are dollar limits on outlays from the endowment, can also be used to help stabilize in the event of weak market results or deflation. Spending floors are most useful for trusts that use market value related models. An example is imposing a current year minimum spending limit equal to or greater than the amount spent in the previous year in nominal dollars.

An additional method would be to place a floor or ceiling on the percentage growth in year-over-year spending. This should limit the volatility during extreme periods.

Conclusion

As reflected in this article, there are several basic approaches to setting spending policy with an almost infinite number of variations to fit the specific needs of an individual trust. It is important that a rational spending policy be identified and implemented to balance between the competing needs of stable outlays from the trust and the preservation of assets for future generations. Increased volatility in the market values of underlying assets has contributed to the complexity of setting an effective spending policy. The development of hybrid policies that attempt to provide more predictability in spending while protecting against inflation seems to be the approach that is gaining favor among institutions.

The growth of investments in alternative asset classes has also led to more consideration of liquidity constraints when setting spending requirements. Accordingly, many endowments are also attempting to factor maximum spending limits into the liquidity constraints of their alternative investment portfolios. The development of formal liquidity policies that address the connection between adhering to a spending policy and maintaining exposure to the alternative asset space will likely also become more prevalent among endowments in the future.