

Spending Rules and Bad Markets

What's at Stake?

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The importance of U.S. nonprofits has grown dramatically in the past decade. As of 2006, nonprofits held assets of more than \$3 trillion, nonprofit revenues accounted for 5 percent of gross domestic product (GDP), and nearly one of every 10 U.S. workers was employed by a nonprofit. Critical services such as health care, education, childcare, and cultural enrichment are provided by the nearly 1.5 million U.S. nonprofits.¹

The current economic downturn has devastated the financial operations of U.S. nonprofits. With revenues from both public and private sources in freefall, proper financial management is critical if nonprofits are to sustain their missions and services. One key challenge facing nonprofit financial managers is determining the appropriate withdrawal from long-term reserves (such as an endowment) to sustain the organization.

We've been here before, and not so long ago. The bear market and recession of 2000–2002 produced valuable lessons we can draw on now. Both crises were triggered by a bubble collapse, and both required nonprofits to painfully retrench, cutting budgets and staffs. Those that survived 2000–2002 acted quickly and decisively to adjust their operations and spending. In many cases, this retrenchment meant suspending the expenditure of a set percentage of the endowment.

This challenge now has reappeared, and in this article we will try to place it in a broader perspective.

Consistent and Growing Financial Support

One of the two purposes of long-term asset pools for nonprofit organizations

is to provide consistent and, it is hoped, growing financial support to help the organization fulfill its mission. The other is to provide a rainy-day fund that can support the organization in times of financial stress. One of the most important risks for an endowed nonprofit is that the institution's endowment will be unable to provide sufficient support each year to its operating budget (or, in the case of private foundations, its grantees). In the current economic environment—characterized by negative investment returns, declining government support and donations, illiquid markets, and tight credit—many institutions are concerned that their endowments won't provide the same level of support as in the past. Many finance and investment committees are debating the pros and cons of spending more from their endowments because short-term needs may be overwhelming the long-term goal of maintaining fund values.

How to Analyze Spending

At times like this, it's important to review the policy options available to nonprofits to bridge the gap between

mission demands and available resources. Bear in mind the strategic goal of intergenerational equity: the idea, first developed by Nobel Laureate James Tobin in the 1970s, that future generations should be neither advantaged nor disadvantaged by endowment spending that takes place today. The interplay between these two factors—the imperative of sustaining current programs and keeping faith with future generations—creates the tension out of which spending policies and spending rules have been developed.

An organization's spending rate can be expressed in two ways:

1. The policy rate is the long-term rate set forth in the organization's investment policy statement—typically between 4–5.5 percent, sometimes higher or lower.
2. The effective rate is derived by dividing the actual dollars spent in a fiscal year by the endowment market value at the beginning of that year.

The policy rate is the expression of the board's judgment regarding prudent spending; the effective rate is most often quoted in the press—often, unfortunately, in a misleading context.

TABLE 1: SPENDING POLICY* FOR FISCAL YEAR 2008

Spending Policy	Total Institutions ²
	629
Percentage of a Moving Average	77
Average percentage	4.8
Pre-specified Percentage of Beginning Market Value	4
Average Pre-specified Percentage Spent	4.3
Weighted Average or Hybrid Method (Yale/Stanford Rule)	6
Last Year's Spending Plus Inflation with Upper and Lower Bands	3
* Multiple responses allowed Source: 2009 Commonfund Benchmarks Educational Endowment Report	



A nonprofit organization calculates its spending goal each year using a spending policy or spending rule. According to the 2009 *Commonfund Benchmarks Study® Educational Endowment Report*, the main spending rules currently in use are shown in table 1.

These rules and rates, acting in combination, have different effects on the budgets and endowment values of an institution. Let's examine them and their implications.

Percentage of a Moving Average

As shown in table 1, most endowments calculate their annual spending based on a rolling average, usually based on the past three years' or 12 quarters' market valuations (though 7 percent of all institutions use five years or 20 quarters). This methodology smooths spending volatility, and the average reflects the compounded average total return of the endowment.

In times of strong market advances or retreats, however, events can overwhelm the three-year formula. For example, when markets are rising quickly, and the average annual percentage gain exceeds the policy rate, the three-year moving average rule will permit increased spending even if the policy rate remains the same. On the other hand, the effective spending rate (determined by dividing spending by the beginning endowment value) will be lower than the policy rate. It is thus possible for an institution to spend more dollars each year while the effective spending rate declines. This happened with many endowments during 1995–2000 and 2003–2007. Negative press and political attention to low or declining spending rates almost always focuses on effective rates, reflecting poor understanding of spending issues among journalists, consumer watchdogs, and politicians, and highlighting the importance of clear communication.

When markets are declining, the three-year average formula cushions spending by averaging the years of negative returns into the positive years.

But when the market goes down as far and as fast as it did in 2008, even a smoothing formula will quickly begin to dictate spending reductions. In the fiscal year that began June 30, 2008, for example, an educational endowment with an asset allocation and return on investment identical to the *Benchmarks Report* average would have returned –24.1 percent through December 31, 2008.³ Averaged into past years' returns,

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this result requires a spending decrease of approximately 8.6 percent from the previous year. Paradoxically, in this environment the effective rate will rise as the endowment value falls faster than the policy rate. Unfortunately, the press and politicians rarely if ever point to this higher spending rate as an indication that nonprofits and private foundations are doing their duty to spend more to support their missions and grantees.

Pre-specified Percentage of Beginning Market Value

A relatively small number of institutions spend a pre-specified percentage of the endowment's beginning market value. Here, the results can be more volatile than with the moving average method because annual spending increases or decreases in direct proportion to returns. If the endowment returns 10 percent, spending will increase 10 percent; if it returns –24 percent, spending is supposed to decrease 24 percent. Such a cut would be traumatic for any organization, and as a practical matter these organizations probably will be forced to break this rule this fiscal year and make special appropriations.

The two other spending rules in general use are the weighted average or hybrid method (the Yale/Stanford rule) and the formula that uses last year's spending plus inflation with upper and lower bands (sometimes called the banded inflation rule). These rules seek to dampen spending volatility by placing less emphasis on market values than the moving average or pre-specified percentage rules.

Weighted Average or Hybrid Method (Yale/Stanford Rule)

Under the Yale/Stanford rule, an 80-percent weighting is given to last year's spending plus inflation and a 20-percent weighting is given to the policy rate applied to the endowment's beginning market value.⁴ This rule shifts the risk of market volatility to the endowment and away from the operating budget. It recognizes that many parts of an institution's budget—such as financial aid, tenured faculty, unionized employees, and multi-year grant recipients—cannot realistically be subjected to year-to-year volatility in spending. It also honors the influence that market moves can have on long-term endowment values by giving a 20-percent weighting to that factor.⁵

Last Year's Spending Plus Inflation with Upper and Lower Bands (Banded Inflation Rule)

The banded inflation rule ignores market values and dictates a payout based on the previous year's spending plus inflation. This is subject, however, to upper and lower bands, or limits, designed to prevent the effective rate from falling too low (in a strongly rising



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market) or rising too high (in a strongly falling market). Typically, these bands would be set at a low of 2 percent of assets and a high of 6 percent of assets.

These rules differ in their emphases and they lead to different spending results. If spending is determined simply by the previous year's returns, the endowment's contribution will be as volatile as the market's returns. A smoothing rule such as the three-year moving average dampens this volatility but still can leave the budget exposed to significant cuts in a lengthy declining market such as 2000–2002. The Yale/Stanford rule and the banded inflation rule both mitigate this volatility but require that the endowment spend to sustain the budget during down markets, which may lead to smaller endowments over time.


How to Make the Right Spending Decision

Many institutions are finding that deciding how much to spend is a more complex process as revenues decline from all sources: tuition, fees, gifts, and government subsidies as well as endowment income. Many are cutting budgets, freezing hiring and compensation, and delaying new capital initiatives. Some institution leaders may panic and simply cut spending in a tactical, rather than a strategic, way.

In this environment where emotions can swamp judgment, remember the second function of endowments and other long-term funds: to act as rainy day funds. With that in mind, many nonprofits are adjusting spending rates depending on their unique circumstances. Those that depend heavily

on endowments to support operating budgets may be forced to increase rates or amounts of spending and suspend spending policies to do so. Others may have sufficient cash resources to leave the rate and policy alone.

Address Spending Strategically

Our view is that this process presents an opportunity to address spending strategically. Rather than making across-the-board cuts or reaching for temporary savings, nonprofits should try to identify permanent cuts that won't harm the institution's mission. In that sense, times like this present organizations with the opportunity to revisit their missions and to match those missions with available resources. Boards need to consider carefully the impacts of these actions, both short- and long-term. If the institution recently has developed a strategic plan, revisit that plan to determine which short- and long-range goals can be achieved and which should be deferred or abandoned. Stress shortens the time horizon. A thoughtful, realistic assessment of the institution's goals in light of resources provides boards with a healthful discussion. If done correctly and with integrity, this process can lead an organization through this period of bad markets to emerge with a stronger mission and a better strategy for accomplishing it. 

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Endnotes

¹ Source: The Urban Institute, *The Nonprofit Almanac 2008*.

² The 2009 *Commonfund Benchmarks Study of Educational Endowments* surveyed investment, spending, financial, and governance practices among 629 educational endowments, including 308 private colleges and universities, 159 independent schools, 55 public system funds, and 55 state institution-related foundations. Assets totaled \$262.8 billion as of June 30, 2008.

³ The 2009 *Commonfund Benchmarks Endowment Study Year-End Update* surveyed returns, asset allocation and other metrics as of December 31, 2008, for 235 of the institutions that participated in the 2009 *Endowment Study*.

⁴ Stanford's weightings are 60 percent and 40 percent, respectively; other institutions use different weightings.

⁵ In his letter to faculty and alumni dated December 16, 2008, Yale President Richard Levin acknowledged this balance, stating, "Fortunately, our endowment spending policy spreads the effect of market changes over several years, allowing us to respond gradually."