

Russell Research

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OCTOBER 2011

Non-profit spending rules

As nonprofit organizations seek to balance the needs of their constituents with the desire to maintain and expand support for their communities in the future, spending policy plays a key role in managing current distributions and in planning for future ones. Spending rules are ultimately designed to advance the mission of an organization and its multiple goals. In addition to current and future beneficiaries who must share overall market uncertainty, boards, investment committees, managers and staff will also have an interest in maintaining sustainable and predictable payouts.

In the early years, prior to enactment of the Uniform Management of Institutional Funds Act (UMIFA) in 1972, spending from endowments was often linked to the income generated by holdings and did not include appreciation in the value of the assets themselves. UMIFA changed this practice, and a focus on the total returns of an investment pool has been adapted by both endowed and non-endowed organizations.

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Regulatory developments

Spending based solely on income is in fact discouraged by UMIFA, and this has been reinforced with recent regulatory guidelines. The Uniform Prudent Management of Institutional Funds Act (UPMIFA) legislation adopted by most states¹ in more recent years specifically focuses on total return, treating income-based spending as an exception rather than the standard; but many endowments continue to operate with income-only guidelines outlined in the gift agreements under which they were originally established. UPMIFA serves as a default in cases where a gift agreement is unavailable and also outlines a process by which organizations (which are often composed of many individual accounts which must be separately evaluated) can seek to modify terms of the original agreement.

¹ At the time of this writing, only Pennsylvania, Mississippi and Puerto Rico have yet to enact a version of UPMIFA. Legislation has been introduced in Mississippi.

Under the earlier legislation, UMIFA, protecting an endowment's corpus often had the effect of limiting or preventing spending for new funds facing down markets and declines in asset values. UPMIFA provides relief for some underwater organizations seeking to distribute assets in pursuit of their charitable purposes, even though such action may lead to invasion of the historical endowed value of assets.

For non-endowed pools of charitable assets, there is typically greater freedom in determining spending amounts. Public charities generally have wide latitude in setting spending rates, though private non-operating foundations must satisfy a 5% minimum-spending requirement. Those organizations with discretion to establish spending rates lower than 5% must also recognize that setting the rate too low may discourage future donors in their desire to support current community needs.

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Common spending rules

According to the NACUBO-Commonfund Study of Endowments 2010 survey, the majority of organizations (a mix of endowed and non-endowed pools) determine spending as being a portion of assets rather than the level of interest, dividends, royalties, rents and leases generated by investments. As indicated in Exhibit 1, the majority of educational and charitable organizations determine spending based on a percentage of assets, though the weighting of current and past assets may vary. Averaging assets over 3 or 5 years is a common choice.

Exhibit 1: Percentage using rule

Percentage of moving average assets	75%
Percentage of beginning market value	4%
Hybrid rule (Yale/Stanford)	7%
Spend all current income	4%
Select rate each year	11%

Values do not add to 100% due to rounding

Source: NACUBO-Commonfund Study of Endowments 2010 survey

Spending rules can be thought of in two components: a spending rate or level, and the structure of the rule. A common example would be to spend 4% of 3-year average assets; 4% reflects the spending rate, and 3-year averaging is a description of the structure of the rule. An alternative rule is to spend \$4M annually, adjusting for inflation. \$4M provides a statement of the spending level, and the annual inflation adjustments describe the structure. Generally speaking, the spending rate or spending level needs to be coordinated with overall average portfolio returns to ensure that spending and growth are well balanced. Spending more than generated returns on an ongoing basis is a recipe for a decline in assets, regardless of the number of years of asset averaging and other features of the spending rule. The structure of the spending rule provides a mechanism for the risk sharing between interested stakeholders and provides a means of managing the stability of spending from year to year.

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Exhibit 2: Weighting of current and past asset values for the first three rules

	Current Assets	1 Year Ago	2 Years Ago	3 Years Ago	4 Years Ago	5 Years Ago	6 Years Ago
1 Year Avg.	100%						
3 Year Avg.	33%	33%	33%				
5 Year Avg.	20%	20%	20%	20%	20%		
Yale (80%)*	20%	16%	12.8%	10.2%	8.2%	6.6%	...
7 Year Avg.	14.3%	14.3%	14.3%	14.3%	14.3%	14.3%	14.3%

* The Yale Rule has two components: the first is last year’s spending, increased by inflation; and the second is the spending rate to be applied to current assets. Only the former, 80% in this example, affects the weighting for asset averaging. Because of the uncertainty of year-to-year inflation, its relatively minor impact has been ignored in providing these representative weights.
Source: Russell Investments

Exhibit 2 outlines the weighting of current and past asset values for the first three rules, which account for the vast majority of responses in the NACUBO-Commonfund Study of Endowments 2010 survey. As indicated, the Yale Rule is a variation of the rules that use a simple average of current and past assets.

The spending rules we most commonly encounter include the spending rate with asset averaging over some number of years. We also frequently work with organizations that employ alternative rules that define spending more or less independently of the current level of assets. These alternative rules include: spending a fixed amount, with or without escalation; spending only income; spending all portfolio return above some level (often inflation); or spending a portion of the historic value of assets. We have also evaluated rules that provide differential treatment to above-water and underwater accounts. Depending on the details, these rules can have features of rules that are defined in terms of a spending rate and of rules that focus on other characteristics as well.

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Ensuring sustainability

While future beneficiaries are primarily interested in rapid growth of assets, they typically favor a narrower range of possible future account balances, rather than a broader one. This is the classic “expected return versus volatility” trade-off faced by many long-term investors. The interests of current beneficiaries are somewhat more nuanced. In addition to desiring larger rather than smaller outlays, they also desire predictability in the level of expenditure. Large variations in year-over-year spending can be disruptive to the programs and services they seek to provide. Both current and future beneficiaries have an interest in the sustainability of the spending program. Spending rules that are unsustainable in unfavorable markets serve neither group’s interests.

Exhibit 3 summarizes spending rule features based on the preferences of current and future beneficiaries.

Exhibit 3: Preferences of current and future beneficiaries

	Higher future spending	Sustainability	Higher current spending	Predictability	
Favored by future beneficiaries	Lower rate	Lower rate	Higher rate*	Longer averaging**	Favored by current beneficiaries
	Lower level	% of asset rules	Higher level	Fixed amount	
	Return-linked	Above- / under-water		Inflation-indexed	
				Tied to historic value	

* Spending rates above 5% are difficult to maintain without erosion of the inflation-adjusted value of assets.
 ** Averaging beyond 5 years appears to provide limited improvements to predictability of the distributed amount.
 Source: Russell Investments

Future beneficiaries are better off if the asset base grows larger and can support greater future inflation-adjusted payouts. This can be accomplished by lowering overall current spending to allow assets to accumulate at a more rapid pace. Depending on the selected rule, lower overall spending is accomplished either through a lower spending rate or (for rules that are not based on a spending rate) lower overall spending levels. Rules that shield the growth of assets from the variability of market returns are also to the benefit of future payout recipients.

Future beneficiaries also favor sustainable spending and might want to avoid rules that could fail in unfavorable market environments. For example, fixed dollar amount rules could lead to a lack of sustainability if the asset base falls and causes the fixed spending to become 10% or 20% of the assets, or a similar unsustainable level. In reality, such a situation would probably lead the decision makers to reduce spending, which would cause current beneficiaries to suffer; thus, boards and investment committees have an interest in sustainability as well.

In addition to sustainability, current beneficiaries are interested in high current distributions, and this is a consequence of high spending rates or overall spending levels. Of course, if rates are too high, they become unsustainable, so a balance must be maintained. Current beneficiaries also desire predictability. If the amount they receive varies from year to year, this may make it difficult for them to set budgets and plan for stable programs and services for the community. Predictability can be improved through longer averaging periods (up to a point) or by using a rule that defines the spending as a dollar amount rather than as a percentage of assets. Fixed-amount spending with or without inflation indexing is one way to accomplish this. Rules that focus on the historic value of the assets tend to be buffered from market variability and can be thought of as close cousins to fixed-amount spending. Depending on the details, they would tend to provide predictability.

Amidst the details and variations of spending rules, it is most critical to recognize that the spending rate or spending level needs to be coordinated with overall average portfolio returns to ensure that spending and growth are well balanced. The structure of the spending rule provides a mechanism for the risk sharing between interested stakeholders. In addition to current and future beneficiaries who must share overall market uncertainty, boards,

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investment committees, managers and staff will also have an interest in the sustainability and predictability of distributed amounts.

Conclusions

Spending rules can be structured in ways that seek to ensure intergenerational fairness, to maximize current spending, to encourage stable distributions from year to year or to achieve other goals. In other research², we have found that private foundations which are subject to the 5% spending requirement, and which usually don't have access to ongoing donations, are likely to have difficulty maintaining an inflation-adjusted assets value. There is little leeway for spending rule variations within mandated spending requirements, and our recommendation is to base distributions on the regulatory requirements.

For other charitable organizations, a 3.5% to 4.5% spending rate serves as a target that can reasonably support, from investment returns, the inflation-adjusted value of assets while providing sustainable payouts for current programs. Organizations with a predictable stream of donations must decide whether those inflows are best deployed immediately through increased spending or invested for future growth.

Asset averaging can lend meaningful smoothing to payouts, but smoothing beyond five years has limited effect. Organizations that target spending by use of specific dollar amounts are encouraged to carefully track asset growth to avoid situations in which spending becomes an unsustainable percentage of the investment pool.

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First used: October 2011

USI-11046-10-13

² Murray, S. (November 2009). Update: Are 5% distributions an achievable hurdle for foundations? Were they ever? *Russell Research*.