CORNERSTONE
Independent Asset Management

Why now is the right time to re-evaluate your organization's spending policy?

Society seems to be going through a transitional phase that has accelerated due to the COVID-19 pandemic. Rising unemployment, growing wealth disparity, and strains on municipal budgets have increased the demand for local not-for-profit organizations to spend more now to meet the needs of their communities and constituents. Whether you are a large university or a small local community foundation, the long-term impact on your organization will be substantial. Balancing current needs with the mandate to exist perpetually depends on decisions that boards and staff must make now. How do we engage more donors? Can we go back to our key donors again? Will market returns help us grow our investments to match the need? How can we be sure that earnings and income can support the operations now and in the future?

There are levers that a board can utilize to meet short-term needs and mitigate longevity risk. We consider a three-pronged approach – fundraising, investment returns, and spending. The first two should be commonsense: if they increase, current and future needs will be more easily met. However, the third prong is not necessarily as clear. Perhaps the nuance around spending policies is why these decisions are often the least considered and monitored. Providing consistency in spending dollars allows an organization to deliver on its mission in critical times while giving clarity to donors and the budget process from year to year. Each organization is unique in their goals and culture. A robust spending policy can harmonize an organization's desire for consistent funding with expected market volatility. If a spending policy is too restrictive, current needs may not be met. If the policy is too loose, the goal of perpetuity can be at risk. The spending policy goal for any organization should be a methodology that allows it to be viable relative to the expected long-term returns, inflation expectations and the economic climate.

A fiduciary's duty is to evenly weigh current needs with those of future generations.

Here at Cornerstone, we think now is an appropriate time for organizations to consider a hard look at their spending policy. How can we maintain or increase the dollars we distribute while preserving long-term viability? A big surprise for many people is that the actual rate is important, but not the only input to consider. Different smoothing techniques should be considered to provide more consistency for all the stakeholders of a non-profit – the board, staff, current beneficiaries, donors, future beneficiaries, auditors, rating agencies (if applicable) and the government. A well-crafted spending policy can benefit all stakeholders by aligning expenditures with the organization's mission and goals for longevity. It instills discipline when an organization is developing a budget and investing assets. Finally, it reassures current and prospective donors that there is a strategic plan for their contributions. Spending today must not impair the long-term real value of the fund. What are the different strategies for a board to consider?

Spending rates are important, but so are smoothing techniques.

Simple Formula

Some institutions apply a flat annual dollar amount or annual percentage to the ending market value of the portfolio to determine their distribution. This is a simple formula and easy to understand but brings significant volatility to spending year-to-year. Other organizations may use the traditional income-only (dividends and interest) spending model. But with interest rates low, this may provide inadequate current dollars for an organization.

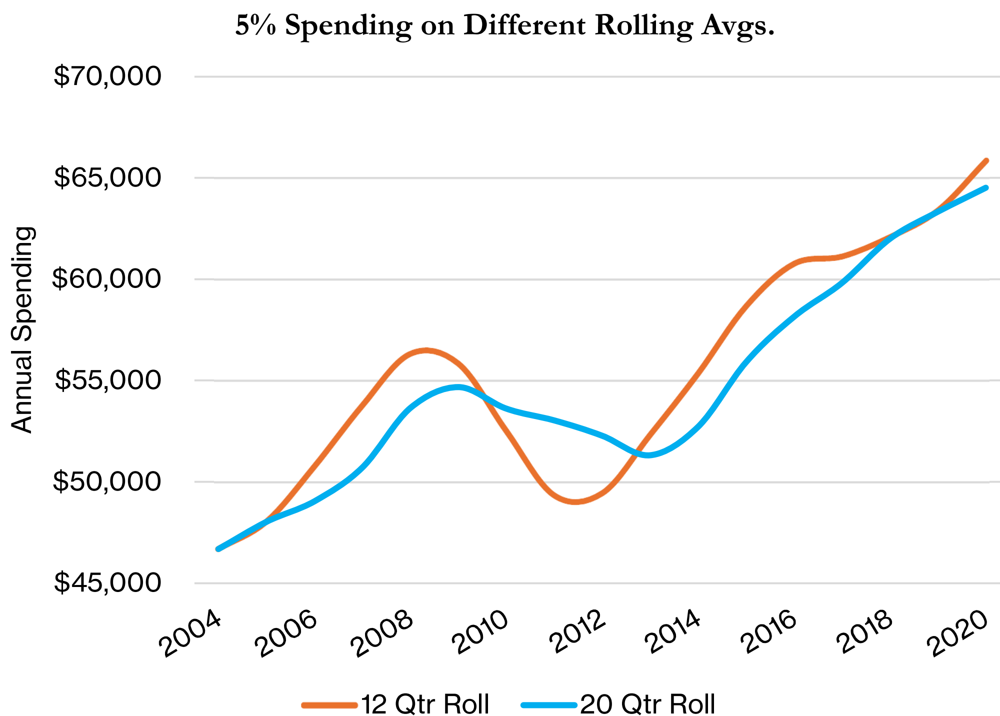
Spending = Annual Income OR Spending Percentage x Ending Market Value

Moving Average

A moving average is the most common and widely used smoothing strategy. An organization multiplies their spending percentage by an average market value over different periods. This strategy smooths spending year over year and serves to mute the impact of market volatility. More data points used in the average yield more stable annual budgets. It is simple to implement and for stakeholders to understand. The one disadvantage is that it is the most correlated to market fluctuations and may cause over or under spending during prolonged bull or bear markets.

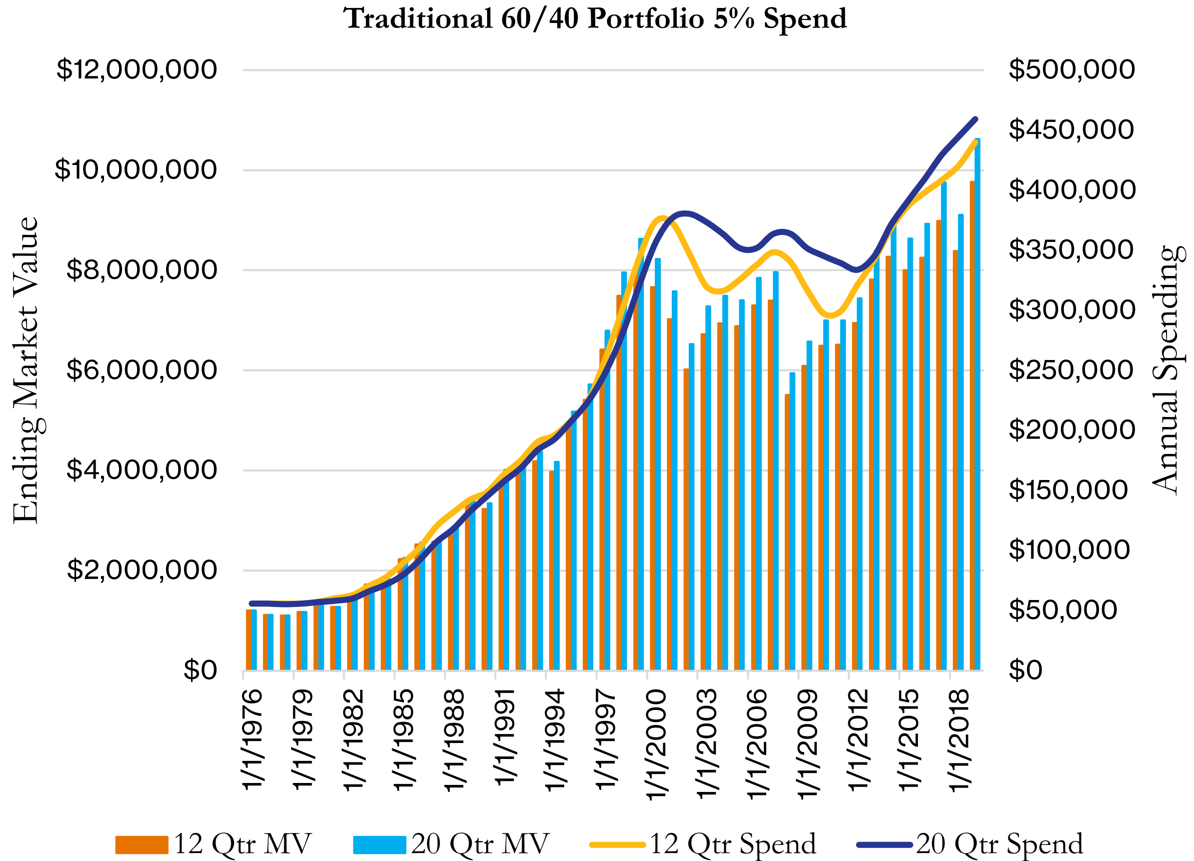
Spending = Spending Percentage x Average ($M_o \ldots M_x$)

The chart below illustrates the lower volatility of a 20-quarter rolling average versus a 12-quarter average.



» **Changing smoothing techniques can negatively impact short-term spending in the early years after the change. An organization can consider setting up a "glide path" from a higher spending percentage to a lower one over several years to mitigate the impact on budgets in early years.** «

The chart below illustrates that dollars spent per year would be about $10,000 higher using the longer smoothing technique. Over the entire time period, the 20-quarter rolling average leaves the endowment at a higher value in the end with a balance of about $10.6 million vs. $9.7 million using the 12-quarter rolling average if the investment was 60% S&P 500 / 40% Bloomberg Aggregate Bond Index, rebalanced quarterly since 1976.



Real Spending (Constant Growth)

Inflation based formulas can be used to increase spending at a rate of inflation. The spending percentage is adjusted annually with an inflation component using either the Consumer Price Index (CPI) or HEPI (Higher Education Price Index). The advantage to this method is to smooth spending, it is predictable with an expectation that spending increases each year. It does need the board to make a judgement on setting the appropriate spending percentage and a maximum year over year change. This method does not consider the endowment market value at the time of distribution.

$$\text{Spending} = \text{Spending}_{\text{Year - 1}} \times (1 + \text{Inflation Rate})$$

Real Spending (Constant Growth) w/ Bands

This strategy takes the Real Spending model – growing the spending dollars as inflation grows – but provides a range to contain the spending relative to the prior year's market value. This provides some predictability for budgets and during strong markets limits spending growth (thus bolstering the endowment's market value.) However, during prolonged bear markets, spending dollars can remain higher.

$$\text{Lower Band} < \text{Spending}_{\text{Year - 1}} \times (1 + \text{Inflation Rate}) < \text{Upper Band}$$

Hybrid (Yale Model)

Hybrid spending policies are most common in higher education and combines two spending policies while weighting the importance of each policy depending on the organization's goals and objectives. The hybrid model that has been pioneered by Yale University takes into account prior year's spending for stable budgeting and adds spending off of the new contributions and market returns. Traditionally, this is what the hybrid model looks like:

$$80\% \times (\text{Prior Year's Spending} \times [1 + \text{Inflation}]) + 20\% \times (\text{Current Portfolio Value} \times \text{Spend Rate})$$

This method can provide stable distributions or maintain the purchasing power of the assets. It also allows the organization to customize their spending rules to fit specific needs but finding and maintaining those spending rules can be difficult. Even Yale has adjusted it calculation multiple times. This method is also complex for stakeholders to understand.

»Not specifically discussed in this piece is the fact that lower spending rates can lead to more spending over the long-term since more principal is left in the endowment to compound. «

Considerations and Summary

When determining the appropriate spending policy, it is good to understand the options and consider what other organizations are implementing; however, one size will never fit all. It is important for the board and staff to consider the goals and objectives of the organization, its current and future cash flow needs, and any specific spending restrictions. Finally, fiduciaries need to determine how much spending volatility the organization can accept for budgeting purposes.

We at Cornerstone are strategic partners with our clients. In an environment where long-term market return expectations are lower, and the pressures and needs on non-profits are growing, we are working with our clients on all areas to improve the probability in meeting their current and future goals and objectives. Educating boards and staff on various spending policy options can help determine

success now and for the next generation. A sensible, well-thought out spending policy will help in maintaining donors and attracting new ones.

Disclosure:

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