



# Non-profit spending policy options



A useful framework to help support the needs of non-profit communities for generations to come



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# Non-profit spending policy options

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Non-profit fiduciaries seek to balance the needs of their communities today with the desire to maintain and expand support for their communities in the future. The spending policy they select plays a key role in managing current distributions and planning for future ones.

An effective spending policy can provide a steady anchor for non-profit investors to guide their actions in today's uncertain, volatile and evolving markets. What we see time and again is that many organizations do not set a formal spending policy to abide by annually and instead determine the rate each year.<sup>1</sup> We believe that creating a clear and well-defined spending policy is critical, as it not only helps ensure strategic alignment with an organization's mission but also is an important means to creating fiscal discipline and consistency across volatile market environments like the one currently being experienced.

In this paper, which is an update to "Non-profit spending policy options" (Lato, Santo-Walter, Wang, 2018), we unpack the spending policy by breaking it into two components: spending rate and spending methodology. We discuss how these components impact the sustainability of the asset pool and the balance between the interests of current and future beneficiaries. Our hope is that this paper will provide a useful framework for non-profit fiduciaries to craft effective spending policies that help them meet their objectives and support the needs of their communities for generations to come.

## Spending policy components

An organization's spending rate is typically expressed as either a percentage of assets or as a fixed dollar amount to be spent each year. It is coordinated with the organization's overall average portfolio returns as well as its long-term organizational goals to ensure that spending and growth are balanced around the organization's spending priorities. For example, organizations that wish to exist in perpetuity will generally set lower spending rates than organizations that wish to spend down their assets over a finite period of time.

On the other hand, an organization's **spending methodology** defines the time period and mechanism used to calculate the dollar amount that the organization spends each year. It is a means of managing risk as well as ensuring the stability of spending from year to year. For example, fiduciaries could use a three- or five-year average of total portfolio assets as the method to calculate the total spending policy. Or, fiduciaries could choose to adjust the dollar amount spent each year by the annual inflation rate to maintain real spending year over year. These concepts are illustrated in Exhibit 1.

 *The spending policy they select plays a key role in managing current distributions and planning for future ones.*

## Exhibit 1: Sample spending policy components

SPENDING POLICY	SPENDING RATE	SPENDING METHODOLOGY	KEY PARAMETER
4% of 3-year average assets	4%	Percentage of moving average	3-year average
\$4 million annually, adjusted for inflation	\$4 million	Fixed	Adjusted for inflation annually

Non-profit fiduciaries use the spending rate and spending methodology together to set an overall spending policy that dictates how the organization balances the interests of current beneficiaries with those of future beneficiaries. The organization's desired time horizon will determine how much to spend today; how much to save for tomorrow; and how to ensure there are adequate, steady and sustainable cash flows for both groups of beneficiaries. Fiduciaries need to determine whether the organization wishes to exist for as long as possible, prioritize spending today and worry about length of existence later, or spend down its assets over time.

## Spending rate

As fiduciaries determine the trade-offs they wish to make between current and future beneficiaries, the largest lever they have at their disposal is the spending rate. Current beneficiaries may desire more money to help fund or expand their programs and services today, which leads to a preference for a higher spending rate. An increase in current spending would result in fewer assets to invest for the future and could hamper the organization's ability to maintain the real value of its assets over time. Future beneficiaries, however, seek greater future spending, which leads to a preference for a lower current spending rate and higher future spending dollars—potentially at the expense of today's beneficiaries. Conforming to the desires of future beneficiaries increases the chances of asset appreciation over time. However, there may be some instances where spending today results in investments that benefit both current and future beneficiaries. The job of the fiduciary is, therefore, to determine the balance of these two groups' competing needs by aligning the spending rate with the organization's long-term funding and perpetuity goals.

*...the spending rate with the organization's overall average portfolio returns to ensure that spending and growth are well balanced...*

## Coordinating spending rate with portfolio returns

Fiduciaries also need to coordinate the spending rate with the organization's overall average portfolio returns to ensure that spending and growth are well balanced and aligned with their funding priorities. For example, if the spending rate is higher than the portfolio's inflation-adjusted return expectations, then current beneficiaries are likely to receive more support than future generations. For some organizations, this gap can be addressed through fundraising. However, not all organizations are able to fundraise, and many of those that are able to fundraise elect to use new funds to broaden the support they expect to provide their communities into the future rather than subsidize current spending commitments. Conversely, if the spending rate is lower than the portfolio's inflation-adjusted return expectations, then the real value of assets is expected to appreciate through time. This will allow for greater support of future beneficiaries than what current beneficiaries receive.

Exhibits 2 and 3 illustrate examples of organizations with various spending rates and asset allocations. The exhibits are based on passive allocations to global equity (U.S. only prior to 1990) and U.S. fixed income; and they demonstrate that it has been difficult for organizations to sustainably spend 5% in the past, and it will be even harder to sustain a 5% spending rate and maintain the inflation-adjusted value of assets over the next 10 years.

### Exhibit 2: Percentage of historical rolling 10-year periods over which the real asset base would have been maintained

Based on spending rate and asset allocation, 1900-2019<sup>2</sup>

SPENDING RATE	100% EQUITY	80% EQUITY	60% EQUITY	40% EQUITY	20% EQUITY	100% BONDS
3%	75%	75%	71%	66%	50%	37%
4%	66%	67%	64%	54%	37%	28%
5%	60%	57%	53%	41%	26%	23%
6%	50%	49%	38%	26%	20%	14%

### Exhibit 3: Forward-looking probability of maintaining the real asset base for the coming 10-year period

Based on spending rate and asset allocation, from Russell Investments' March 2020 strategic planning forecast assumptions<sup>3,4</sup>

SPENDING RATE	100% EQUITY	80% EQUITY	60% EQUITY	40% EQUITY	20% EQUITY	100% BONDS
3%	61%	58%	51%	39%	18%	2%
4%	53%	49%	41%	24%	6%	<1%
5%	47%	41%	29%	14%	2%	<1%
6%	41%	32%	20%	7%	<1%	<1%

Exhibit 3 lays out the organization's chances of investment success based on a variety of simple asset allocations and spending rates. A success rate below 50% favors current beneficiaries relative to future beneficiaries. Why is this the case? If the real asset base is expected to decrease in value over time, spending the same percentage of that smaller asset base provides a lower level of support to future beneficiaries. If the probability of success is above 50%, then the real asset base would be expected to grow over time<sup>5</sup> and favor future beneficiaries relative to current beneficiaries; this is because real spending amounts increase as the real asset base grows.

The likelihood of a portfolio supporting future spending based on future returns is driven by return expectations, and therefore market valuations, at the time of the analysis. Following a prolonged bull market, equity valuations are likely to be elevated leading to lower forward-looking equity return expectations, and reduced likelihoods of meeting objectives. This was seen in analysis completed based on December 2019 capital market assumptions. Conversely, immediately after a market sell-off forward-looking expectations will be relatively high. However even after the most recent market sell-off in March 2020 with forward-looking expectations high

**Exhibits 2 and 3...demonstrate that it has been difficult for organizations to sustainably spend 5% in the past, and it will remain difficult to sustain a 5% spending rate and maintain the inflation-adjusted value of assets over the next five to 10 years.**

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relative to recent history, expectations were still below realized historical returns. Historical returns have been propelled by a long period of declining interest rates and rising equity valuations—and that is not expected to continue.


However, most organizations are not newly incepted, and in periods of time in which equity valuations are relatively attractive, organizations would likely have recently experienced losses in their investment portfolios. In periods with relatively unattractive equity valuations it is likely that organizations would have recently experienced large gains in their investment portfolios. Organizations will need to determine if their goal is to support spending on a going-forward basis and maintain the current real asset base in perpetuity, or to also account for recent experience. As of end March 2020, if the goal included recouping recent losses to maintain spending based on beginning-of-year assets, then a real return in excess of the spending rate would have been targeted.

With desired returns potentially higher than forward-looking return expectations, the real value of assets may not be expected to meet organizational aspirations, and organizations are at risk of providing a diminished level of support to their future beneficiaries' needs. We recommend that organizations seek enhanced returns in a risk-controlled manner through a combination of strategic decisions, active and passive portfolio management, and alternative investments to pursue returns that are greater than expected by these simplistic asset allocations. Organizations should also consider ways to support their future beneficiaries through fundraising, if possible. Organizations that have more flexibility in their spending, and that wish to exist in perpetuity, are encouraged to adopt lower spending rates that would shore up support for their future beneficiaries—provided this would still allow them to sufficiently support their current beneficiaries. Organizations that don't have flexibility in their spending, either due to the needs of their current beneficiaries or due to the IRS requirement for private, non-operating foundations to spend 5%, may need to reconsider their objective of perpetuity and determine whether full intergenerational equity is likely.

## Spending methodology

Despite its relatively lower impact, the spending methodology is a key ingredient in determining how to balance the needs of current beneficiaries with those of future beneficiaries. Not considering and following a spending methodology can create governance risks, as the chosen amount of spending in any given year may be driven by external factors that are separate from the organization's long-term objectives.

The spending methodology determines the extent to which market volatility and potential drawdowns impact an organization's ability to spend today versus in the future. Future beneficiaries are primarily interested in growth of assets, but they also typically favor a narrower, rather than broader, range of possible future asset values. However, the interests of current beneficiaries are somewhat more nuanced. In addition to often desiring larger rather than smaller current outlays, current beneficiaries generally prefer predictability in the level of expenditure. Large variations in year-over-year spending can be disruptive to the programs and services that organizations seek to provide—but these can help stabilize the growth in assets for future beneficiaries.



*Large variations in year-over-year spending can be disruptive to the programs and services that organizations seek to provide—but these can help stabilize the growth in assets for future beneficiaries.*

## Commonly used spending methodologies

According to the 2019 NACUBO-TIAA Study of Endowments, a majority of organizations—a mix of endowed and non-endowed pools—compute their spending by applying their spending rate to a moving average value of assets. This is shown in Exhibit 4. The spending methodology provides a mechanism for risk-sharing between interested stakeholders.

**Exhibit 4: Common spending methodologies used by non-profit investors**

SPENDING METHODOLOGY	DESCRIPTION	PERCENTAGE ENDOWMENTS USING RULE	PERCENTAGE PRIVATE FOUNDATIONS USING RULE
Percentage of moving average assets	Spending a fixed percentage of the average asset value over a determined number of years	74%	38%
Select spending rate each year	Annually determining the percentage of assets to spend	6%	23%
Hybrid rule	Spending based on a blended weighting of last year's spending and a percentage of the current assets	8%	2%
Spend all current income	Spending all income generated from your investment program in a given year	2%	0%
Percentage of beginning-of-year (BoY) market value	Spending a percentage of the BoY market value	3%	2%

Source: NACUBO-TIAA Study of Endowments, 2019—percentages are based on 774 study participants. 2018 Council on Foundations-Commonfund Study of Foundations—percentages based on 161 study participants. Please note that multiple responses to this question were allowed and not all possible responses were included in this table, resulting in total responses under or in excess of 100%.

Of the methodologies listed in Exhibit 4, we often find that the **percentage of moving average assets** and **hybrid rule methodologies** best balance the needs of current and future beneficiaries for many of the fiduciaries that we work with. Both methodologies allow organizations to maintain relatively predictable spending while allowing for some reduction in spending after market losses.

### Impact of parameters used

However, it is important to note that for both methodologies, the parameters chosen will impact the extent to which they either stabilize the asset base or stabilize spending in volatile markets. Exhibit 5 (next page) illustrates the weighting of current and past asset values based on chosen parameters for both methodologies. The parameters determine the extent to which the current asset value impacts the dollar spending in the current year.

*The spending methodology provides a mechanism for the risk-sharing between interested stakeholders.*



## Exhibit 5: Weighting of current and past asset values based on spending methodology and parameters

ROW	METHODOLOGY	PARAMETERS	CURRENT ASSETS	1-YEAR AGG	2-YEARS AGG	3-YEARS AGG	4-YEARS AGG	5-YEARS AGG	6-YEARS AGG
1	Percentage of moving average	Beginning of year	100%						
2	Percentage of moving average	3 years	33%	33%	33%				
3	Hybrid <sup>6</sup>	70%	30%	21%	14.7%	10.3%	7.2%	5.0%	...
4	Percentage of moving average	5 years	20%	20%	20%	20%	20%		
5	Hybrid	80%	20%	16%	12.8%	10.2%	8.2%	6.6%	...

For the **percentage of moving assets methodology**, the parameter chosen is the period of time in which assets are averaged when calculating the asset value that is applied to the spending rate. If the spending methodology is based on the beginning-of-year value, all that matters is the current asset value; whereas, if the spending methodology utilizes a five-year average, the current asset value only has a 20% (as it is one of five data points used in the average) impact on the asset value used in the spending calculation and, therefore, the current year's spending.

The **hybrid methodology** instead focuses on the extent to which the current asset value factors into the current year's spending level. It does this by dictating the percentage of the current year's spending that is based on the spending from the prior year—with the remainder being calculated as a percentage of the current asset value. The higher the percentage used in the hybrid methodology, the higher the impact of the previous year's spending, and the lower the impact of the current asset value on setting the spending for the current year.

A percentage of moving average assets methodology with either no, or a shorter, averaging period (rows 1 and 2) or a hybrid methodology with a slightly lower weight to the prior year's spending (row 3) will put a relatively higher weight on the current asset value in determining spending. This will provide greater protection to the asset base in periods of market stress, as the annual spending will be more reactive to changes in the asset base. However, this means that the organization cannot plan spending in advance, which may create organizational instability. By protecting the asset base, the organization is helping its future beneficiaries but compromising the stability of support to current beneficiaries.

However, the same methodology with a long averaging period (row 4), or a hybrid methodology with a high weight to the prior year's spending (row 5), will put a relatively low weight to the current asset value in determining spending. With these parameters, there is likely to be greater permanent impairment of the asset base after extreme market downturns. On the positive side, these methodologies offer current beneficiaries more predictable spending and support.

In choosing a spending methodology and defining its parameters, an organization must carefully weigh the trade-offs between predictable spending and a strong asset base in down markets. The possibilities discussed above by adjusting the parameters of the percentage of moving average assets and hybrid rule methodologies is how we typically see organizations weigh these trade-offs. Two extremes in terms of balancing this trade-off are **fixed spending** and **performance-based spending**. Fixed spending is when the nominal or real spending dollars remain constant year over year, despite fluctuations in the asset base. Performance-based spending is

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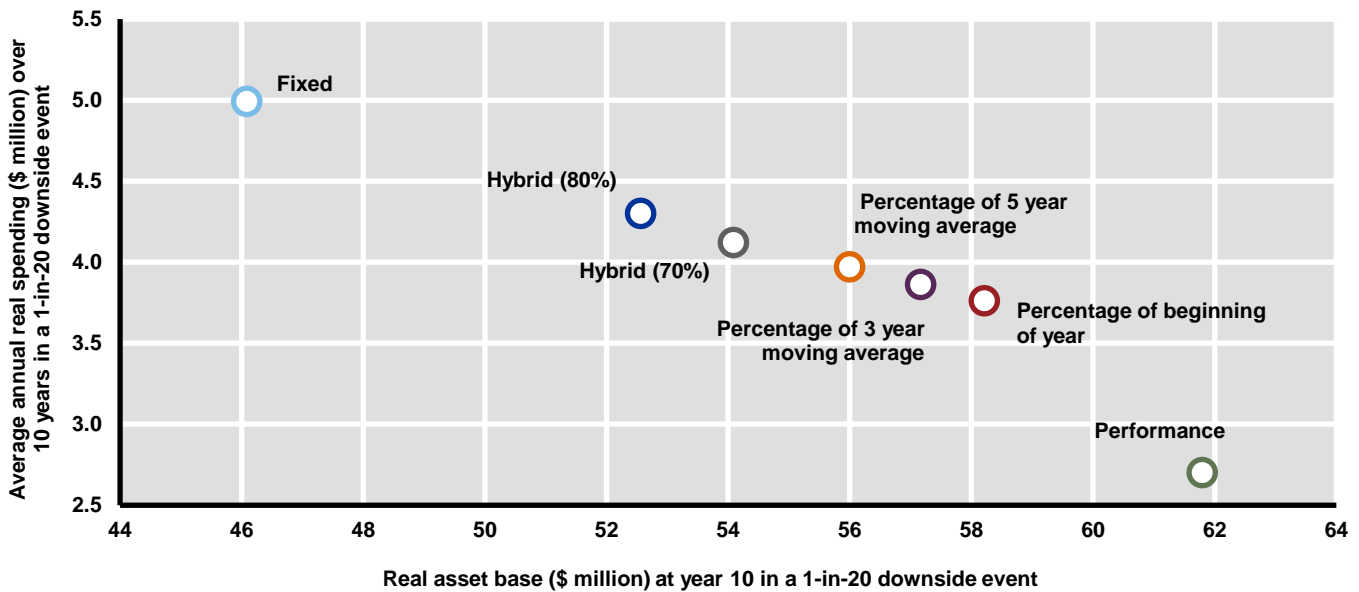


based on the nominal or real returns of the portfolio, allowing for high spending in years of strong performance and the ability to cut spending when asset returns are low or negative. We do not typically recommend either of these methodologies; however, organization-specific circumstances, such as recurring fixed dollar grants or high mortgage payments, which prevent year-on-year spending reductions may require a fixed spending methodology.

Exhibit 6 illustrates that in severely negative market environments, the spending methodology dictates the extent to which asset losses can lead to a reduction in expected annual spending, a significantly reduced asset value or a combination of the two.

**Exhibit 6<sup>7,8</sup>: The impact of spending methodology on annual spending and asset base in negative market environments**

Based on \$100m starting asset base and 5% spending rate, 10-years forward-looking<sup>9</sup>



For illustrative purposes only.

While the analysis in Exhibit 6 focuses on the spending methodology’s implications in negative market environments, it should be noted that in periods of strong asset performance, the impact will be the opposite. In periods of strong asset performance, maintaining a variation of the percentage of moving average assets or hybrid methodologies that lead to stable spending will allow the gains to accumulate for future generations without providing increased support to current beneficiaries. At the same time, a performance-based methodology, which is based on spending all of the real returns of the portfolio, will spend all gains on the current generation, leaving no additional gains to accrue to future generations.

In balancing these trade-offs, organizations can arrive at spending methodologies that best allow them to plan future spending while not unduly reducing the probability of recovering portfolio assets after market losses. Examining various spending methodologies is an important process that allows organizations to formulate a spending policy to best meet their objectives, and then ensure that spending is maintained within a well-governed framework through all market environments.

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## Conclusions

The spending policy can be structured in ways that seek to ensure intergenerational fairness, to maximize current spending, to encourage stable distributions from year to year and/or to achieve other goals. At the end of the day, despite the nuanced differences between what current and future beneficiaries prefer, the reality is that both groups have an interest in the sustainability of the organization and its spending program. Spending policies that are unsustainable in unfavorable markets are unlikely to serve either group's interests. In addition to current and future beneficiaries that must share overall market uncertainty, fiduciaries also have an interest in the sustainability and predictability of distributed amounts.

The spending policy can be a powerful tool in times of volatility and uncertainty. However, in order to wield it effectively in today's evolving markets, it is important to truly understand its various components, and to effectively design a policy that does not unintentionally favor one group of beneficiaries over the other. This will allow non-profit fiduciaries to balance their more immediate objectives while also supporting their communities going forward.

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<sup>1</sup> According to the latest NACUBO-TIAA and Council on Foundations-Commonfund Studies, 23% of private foundations, 12% of community foundations and 6% of endowments state that they decide on an appropriate spending rate each year.

<sup>2</sup> Representative and back-tested performance is shown for informational purposes only and is not indicative of future performance nor a guarantee of future performance of any Russell Investments' products.

<sup>3</sup> As equity markets experienced high levels of volatility in February through April, the analysis uses forecasts that assume no valuation reversion to impact expected equity returns. Although Russell Investments does produce market conditional forecasts that assess the impact of market valuations on expected returns, equity market valuations are fluctuating with the equity market so the perspective of valuations on a given day cannot be considered a reliable indicator of valuations in the future given the extreme volatility.

<sup>4</sup> Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

<sup>5</sup> In stating whether or not the real asset base is expected to grow or decline, we consider whether there is a greater than 50% likelihood of growth or depreciation. Due to skew in return expectations, the average expected growth in the asset base may or may not align with the stated expectations.

<sup>6</sup> The Hybrid methodology 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, 70% in this example, affects the weighting for asset averaging. In determining the weighting to prior asset values, the weight to the current asset value is 1 minus the weight to spending in the prior year, which in this first case is 30%. However, because the prior year's spending was partially based on its beginning-of-year value, the 70% weight to the prior year's spending also reflects a 21% (70% x 30%) weight to the prior year's asset value. Because of the uncertainty of year-to-year inflation, its relatively minor impact has been ignored in providing these representative weights.

<sup>7</sup> Spending methodologies illustrated in Exhibit 6 are defined as: 'Fixed' spending – based on 5% of the starting market value, with that dollar spending increasing annually with inflation. 'Hybrid' spending rules – based on 70% or 80% of last year's spending increasing with annual inflation plus 1.5% or 1% (5% x 30% or 5% x 20%) of the beginning-of-year asset value. 'Percentage of X year moving average' – based on spending 5% of the three- or five-year average asset value. 'Percentage of beginning of year' – based on 5% of the asset value at the start of each year. 'Performance' – based on spending the annual real return on the portfolio (floored at 0).

<sup>8</sup> Similar work was done by Fan and Murray in the 2004 Russell Investments Research Report, "Understanding the effects of spending policies for endowments and foundations."

<sup>9</sup> X-axis shows the inflation-adjusted asset base (\$ million) at 10 years in a one-in-20 downside event; y-axis shows the inflation-adjusted average spending (\$ million) over 10 years, both are based on a starting portfolio value of \$100 million and the December 31, 2019 Market Conditional capital market assumptions.

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## Related reading

National Association of College and University Business Officers and Commonfund Institute. (February 2018). 2017 NACUBO-Commonfund Study of Endowments.

Russell Investments. (September 2017). The Non-profit Fiduciaries' Handbook: A step-by-step guide to investment strategy for non-profit investors. Second Edition.

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