UNDERSTANDING THE IMPACT OF THE SPENDING POLICY

Russell Investments

A FRAMEWORK TO HELP SUPPORT THE NEEDS OF NOT-FOR-PROFITS FOR GENERATIONS TO COME

RUSSELL INVESTMENTS RESEARCH

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Understanding the impact of the spending policy

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Not-for-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. It is important not to overlook the impact of all aspects of the spending policy, as the details make a difference in ensuring that the spending policy is aligned with your organisational objectives.

An effective spending policy can provide a steady anchor for not-for-profit investors to guide their actions in today's uncertain, volatile and evolving markets. What we see time and again is that many organisations do not set a formal spending policy to abide by annually and instead determine the rate each year.[1] We believe that creating a clear and well-defined spending policy is critical, as it not only helps ensure strategic alignment with an organisation'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, 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 not-for-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

A spending policy is generally composed of two parts that work in tandem: spending rate and spending methodology.

An organisation'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 organisation's overall average portfolio returns as well as its long-term organisational goals.

On the other hand, an organisation's **spending methodology and its parameters** defines the mechanism and time used to calculate the dollar amount that the organisation spends each year. It is a means of managing risk as well as ensuring the stability of spending from year to year.

These concepts are illustrated in Exhibit 1.

> *In this paper, we unpack the spending policy by breaking it into two components: spending rate and spending methodology.*

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

Not-for-profit fiduciaries use the spending rate and spending methodology together to set an overall spending policy that dictates how the organisation balances the interests of current beneficiaries with those of future generations. The interests of current beneficiaries are best served with high stable spending levels, while the interests of future generations are best served with long-term asset growth.

The organisation'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 organisation wishes to exist for as long as possible or prioritise spending today and worry about length of existence later.

Some organisations may also purposefully spend down their assets over time. This discussion is less relevant for organisations spending down assets over a set time horizon as the spending will be very dependent on the objectives and time horizon in that situation.

The organisation'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.

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. Key considerations in determining the appropriate spending rate are:

- What level of spend will support the impact you want to make on your community today?
- Can you tolerate high investment risk to achieve high returns?
- Is perpetuity an important objective? Or is perpetuity a desired outcome, but not more important than the ability to support the community now?
- Are you able to fundraise? If so, can those inflows subsidise current spending? Or are they only intended to further grow the asset base?

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 organisation'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.

There may be instances where spending today results in investments (e.g., construction of a new park) 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 organisation's long-term funding and perpetuity goals.

Coordinating spending rate with portfolio returns

Fiduciaries need to coordinate the spending rate with the organisation's overall average portfolio returns to ensure that spending and growth are well balanced and aligned with their funding priorities. All else equal, the higher the organisation's returns are, the higher the spending rate can be.

If the spending rate is expected to be higher than the portfolio's inflation-adjusted return expectations, then current beneficiaries are likely to receive more support than future generations. For some organisations, this gap can be addressed through fundraising to subsidise spending. However, not all organisations 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 subsidise current spending commitments.

Conversely, if the spending rate is expected to be 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 generations than what current beneficiaries receive.

Exhibits 2 and 3 illustrate the probability of supporting various spending rates with a variety of asset allocations in perpetuity on a historical and forward-looking basis. The exhibits are based on passive allocations to global equity (U.S. only prior to 1990) and U.S. fixed income. They demonstrate that it has been difficult for organisations to sustainably spend 5% or more in the past, and it will be even harder to sustain a spending rate of 5% or more and maintain the inflation-adjusted value of assets over the next 10 years.

Exhibits 2 and 3 illustrate the probability of supporting various spending rates with a variety of asset allocations in perpetuity on a historical and forward-looking basis.

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, 1900-2023[2]

Lower spending makes perpetuity more attainable

SPENDING RATE	100% EQUITY	80% EQUITY	60% EQUITY	40% EQUITY	20% EQUITY	100% BONDS
3%	77%	76%	73%	66%	49%	36%
4%	68%	69%	64%	54%	36%	27%
5%	62%	57%	54%	39%	26%	22%
6%	53%	50%	40%	25%	20%	14%
7%	43%	37%	25%	14%	11%	10%

Higher equity allocation allows for higher spending

A percentage below 50% indicates that historically less than half the time the asset allocation would have been able to support that spending rate and achieve the objective of perpetuity. A higher spending rate requires a greater allocation to growth assets to meet the objective of perpetuity. A lower spending rate makes it easier to achieve perpetuity, by either having a lower risk asset allocation or higher confidence that an aggressive portfolio will be able to outperform the objective over the long-term.

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' December 2023 Strategic Planning Forwards forecast assumptions[3,4]

Lower spending makes perpetuity more attainable ↑

SPENDING RATE	100% EQUITY	80% EQUITY	60% EQUITY	40% EQUITY	20% EQUITY	100% BONDS
3%	63%	63%	62%	58%	48%	32%
4%	55%	55%	51%	42%	26%	15%
5%	47%	43%	36%	25%	11%	4%
6%	39%	33%	26%	12%	3%	1%
7%	31%	25%	15%	5%	<1%	<1%

← Higher equity allocation allows for higher spending

As difficult as it has been to support a spending rate over 5% historically, it is expected to be even more difficult to support a spending rate over 5% in the future.

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. Conversely, immediately after a market sell-off forward-looking expectations will be relatively high.

However, most organisations are not newly incepted, and in periods of time in which equity valuations are relatively attractive, organisations would likely have recently experienced losses in their investment portfolios. In periods with relatively unattractive equity valuation, it is likely that organisations would have recently experienced large gains in their investment portfolios. Organisations 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.

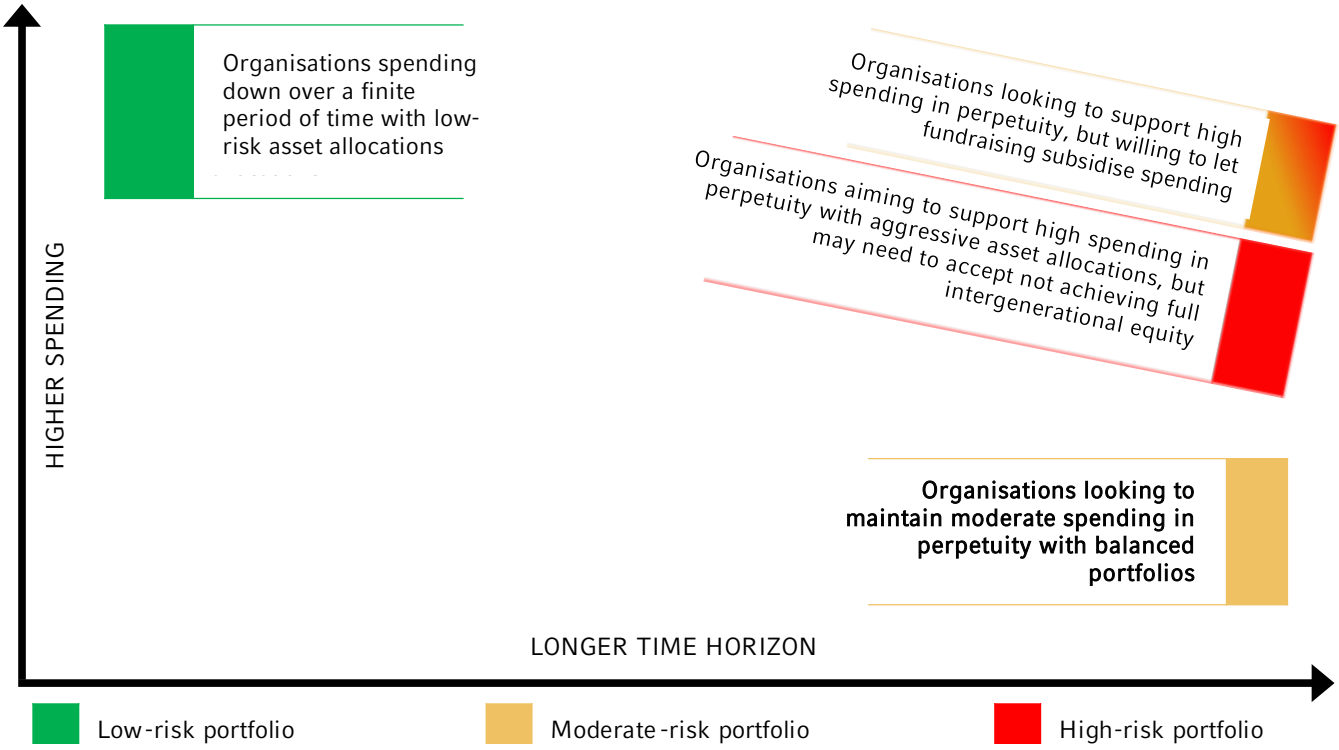
With desired returns potentially higher than forward-looking return expectations, the real value of assets may not be expected to meet organisational aspirations, and organisations are at risk of providing a diminished level of support to their future beneficiaries' needs. We recommend that organisations 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.

Organisations should also consider ways to support their future beneficiaries through fundraising, if possible. Organisations 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. Organisations that don't have flexibility in their spending, either due to the needs of their current beneficiaries or due to a local regulatory requirement to spend a minimum percentage, may need to reconsider their objective of perpetuity and determine whether full intergenerational equity is likely.

Exhibit 4 demonstrates the interaction between spending, time horizon, and asset allocation, as discussed.

We recommend that organisations 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.

Exhibit 4: Interaction between spending, time horizon, and portfolio risk posture



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 organisation's long-term objectives. Key considerations in determining your spending methodology are:

- Do you anticipate lumpy cash into or out of the asset pool?
- Do you prefer a known (budgeted) amount of spending?
- Do you have high fixed costs that could not be reduced in the short-term?
- Do the needs of your community grow in an economic downturn? And would you prioritise meeting those needs over future generations?
- Is maintaining the asset pool in all market environments to support future generations important?

The spending methodology determines the extent to which market volatility and potential drawdowns impact an organisation's ability to spend today versus in the future. Future beneficiaries are primarily interested in the growth of assets, but they also typically favour a narrower, rather than broader, range of possible future asset values. This leads to the interests of future beneficiaries being aligned with a more reactive spending policy which reduces spending to protect the asset base in negative market environments.

However, this differs from the interests of current beneficiaries. In addition to often desiring larger rather than smaller current outlays, current beneficiaries generally prefer predictability in the level of expenditure, which leads the

interest of current beneficiaries to be aligned with a less reactive and more fixed spending policy. A less reactive spending policy provides more consistent support to current beneficiaries but crystallises a higher level of losses in a negative market environment. Large variations in year-over-year spending can be disruptive to the programs and services that organisations seek to provide—but these can help stabilise the growth in assets for future beneficiaries.

Commonly used spending methodologies

According to the 2022 NACUBO-TIAA Study of Endowments, most organisations—a mix of endowed and non-endowed pools—compute their spending by applying their spending rate to a moving average value of assets, as illustrated in Exhibit 5. The spending methodology provides a mechanism for risk-sharing between interested stakeholders.

Exhibit 5: Common spending methodologies used by not-for-profit investors

SPENDING METHODOLOGY	DESCRIPTION	PERCENTAGE ENDOWMENTS USING RULE	PERCENTAGE PRIVATE FOUNDATIONS USING RULE	PERCENTAGE COMMUNITY FOUNDATIONS USING RULE
Percentage of moving average assets	Spending a fixed percentage of the average asset value over a determined number of years	75%	40%	79%
Select spending rate each year	Annually determining the percentage of assets to spend	5%	28%	10%
Hybrid rule	Spending based on a blended weighting of last year's spending and a percentage of the current assets	10%	1%	0%
Spend all current income	Spending all income generated from your investment program in a given year	2%	1%	1%
Percentage of beginning-of-year (BoY) market value	Spending a percentage of the BoY market value	2%	3%	5%

Source: NACUBO-TIAA Study of Endowments, 2022—percentages are based on 654 study participants. 2021 Council on Foundations-Common fund Study of Foundations—percentages based on 149 study participants for private foundations and 82 study participants for community foundations.
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 5, we often find that the **percentage of moving average assets** and **hybrid rule methodologies** serve to best balance the needs of current and future beneficiaries for many of the fiduciaries that we work with. Both methodologies allow organisations to maintain relatively predictable spending while allowing for some reduction in spending after market losses which helps to stabilise the asset base.

It is important to note that the volatility of spending is determined not only by the spending policy, but also by the asset allocation. A less volatile asset allocation will lead to less volatility in the asset base and therefore lower fluctuations in spending even if the spending policy is reactive to changes in the asset base. Whereas an asset allocation that allows for highly volatile returns will lead to greater fluctuations in the asset base, and therefore more volatile spending.

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 stabilise the asset base or stabilise spending in volatile markets. If there is a preference to protect the spending on current beneficiaries in a negative market environment then parameters should be chosen to stabilise the spending. If there is a desire to protect the ability to spend on future generations then a more reactive spending policy is appropriate.

Exhibit 6 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, and therefore how reactive the spending is changes in the market value of assets.

Exhibit 6 illustrates the weighting of current and past asset values based on chosen parameters for both methodologies.

Exhibit 6: 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 [5]	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%	. . .
6	Percentage of moving average	7 years	14%	14%	14%	14%	14%	14%	14%

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. The longer the averaging period, the more the spending is fixed year-over-year and less reactive to changes in the market of assets.

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 more the spending is fixed year-over-year and less reactive to changes in the market of assets.

In choosing a spending methodology and defining its parameters, an organisation must carefully weigh the trade-offs between predictable spending and protecting the asset base in down markets. The possibilities previously discussed by adjusting the parameters of the percentage of moving average assets and hybrid rule methodologies is how we typically see organisations weigh these trade-offs.

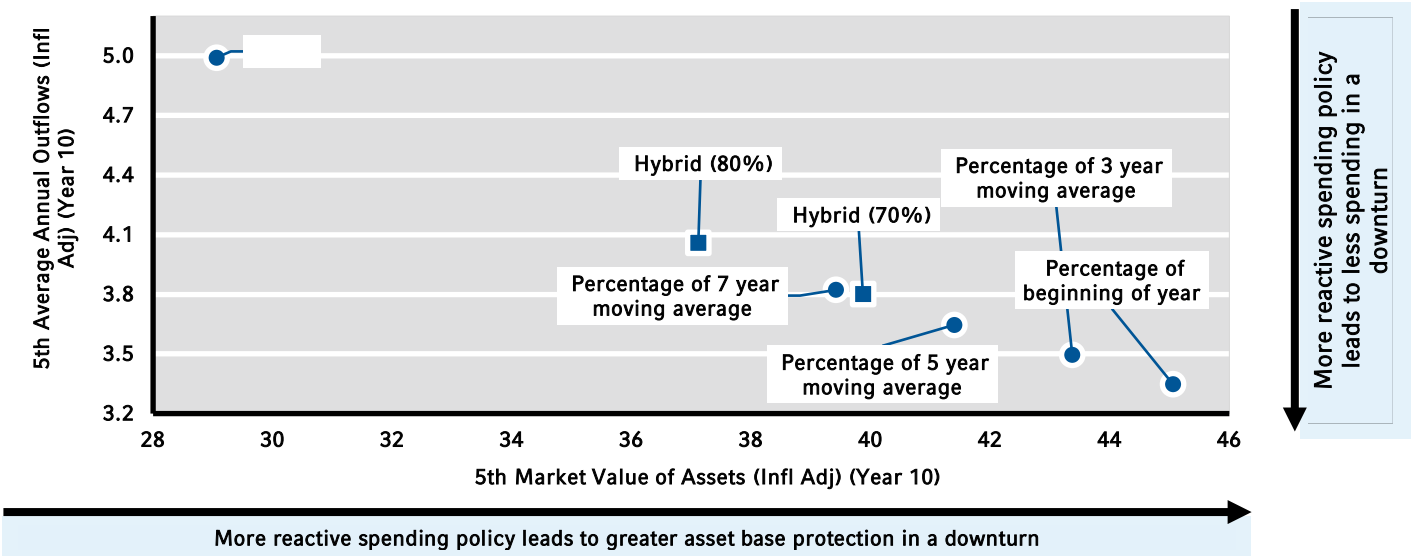
An extreme in terms of balancing this trade-off is **fixed spending.** Fixed spending is when the nominal or real spending dollars remain constant year over year, despite fluctuations in the asset base. We do not typically recommend fixed spending levels; however, organisation-specific circumstances, such as recurring fixed dollar grants or high mortgage payments and operating costs, which prevent year-on-year spending reductions, may require a fixed or hybrid spending methodology.

Exhibit 7 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.

Fixed spending is when the nominal or real spending dollars remain constant year over year, despite fluctuations in the asset base.

Exhibit 7[6,7]: 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[8]



For illustrative purposes only.

While the analysis in Exhibit 7 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. However, in periods of prolonged strong market performance, the expectations of both current and future beneficiaries will be met and therefore the tension between their needs is not as concerning.

In periods of strong asset performance, a spending policy that leads to stabilised spending will allow the gains to accumulate for future generations while still maintaining the expected support to current beneficiaries. At the same time, a reactive spending methodology will spend more of the gains on the current generation, leaving fewer additional gains to accrue to future generations, but as long as real returns are higher than spending the future beneficiaries will not be negatively impacted.

Organisations also need to consider the impact of their spending policy, the combination of spending level and methodology, on their ability to tolerate market drawdowns. Typically, organisations with higher levels of spending seek to offset the impact of the high spending with aggressive portfolios, but when growth-oriented portfolios experience drawdowns, the higher spending rate makes it more difficult to recover from a drawdown. Exhibit 8 demonstrates the length of time expected to recover from a 10% loss depending on the spending level and rule.

Exhibit 8: Length of time required to recover nominal asset base from a 10% drawdown

More difficult to recover from market drawdowns

LEVEL METHODOLOGY	4%	5%	6%
BOY Market Value	8.9yrs	10.4yrs	12.3yrs
3 Year Average	8.9yrs	10.7yrs	12.3yrs
7 Year Average	9.1yrs	11.0yrs	12.6yrs
Fixed Real	10.8yrs	13.2yrs	14.4yrs

More difficult to recover from market drawdowns

Based on an 80/20 portfolio, from Russell Investments' December 2023 strategic planning forwards forecast assumptions

This demonstrates that higher spending levels make it more difficult to recover from market drawdowns, but so do policies where the methodology leaves annual spending less reactive to changes in the market value of assets.

Governance considerations

An important element of spending through time that cannot be looked at analytically is the tendency for an organisation to actually follow the spending policy that it has agreed to. We know it is not always the case—especially if the final annual spend is determined by a vote of the board. All the analysis presented in this paper assumes that the spending policy is followed through all market environments.

If an organisation adopts a reactive spending policy but then doesn't reduce spending as much as the policy dictates in a negative market environment or an organisation adopts a stable spending policy but then desires to increase spending more than the spending policy dictates in a positive market environment, the desired long-term impacts of the spending policy will not be realised. The extent to which the spending policy balances the interests of current and future beneficiaries will only be realised if the spending policy is followed through all market environments. When organisations stray from the agreed upon spending policy, it is typically in the favour of current beneficiaries as they are the ones that currently have a voice in the room. One of the most important ways in which the interests of future beneficiaries can be protected is to not stray from the spending policy in order to increase near-term spending beyond what the spending policy calculates for the annual spending level.

The other consideration is the timing of the spending relative to when it is set. Some organisations may have more drawn-out governance processes that lead to the spending based on the results at the end of fiscal year 2021 being spent in fiscal year 2023, not 2022. If this is the case, no matter how reactive the spending policy is, the actual spending will not be nearly as reactive to short-term changes in the market value of assets due to the lag in spending.

> *One of the most important ways in which the interests of future beneficiaries can be protected is to not stray from the spending policy to increase near-term spending beyond what the spending policy calculates for the annual spending level.*

Conclusions

The spending policy can be structured in ways that seek to ensure intergenerational fairness, to maximise 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 organisation and its spending program. Spending policies that are unsustainable in unfavourable 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 favour one group of beneficiaries over the other. And then importantly, whatever you choose, follow it!

This will allow not-for-profit fiduciaries to balance their more immediate objectives while also supporting their communities going forward.

[1] According to the latest NACUBO-TIAA and Council on Foundations-Common fund Studies, 28% of private foundations, 10% of community foundations and 5% of endowments state that they decide on an appropriate spending rate each year.
[2] Assumes equities are allocated to US equities from 1900-1990 and to world equities from 1990-2023.
[3] The analysis uses forecasts that assume no valuation reversion to impact expected equity returns.
[4] Forecasting represents predictions of market prices and/or volume patterns utilising varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.
[5] 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.
[6] 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-, five- or seven-year average asset value. 'Percentage of beginning of year' – based on 5% of the asset value at the start of each year.
[7] 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."
[8] 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, 2023 Strategic Planning Forwards capital market assumptions.

QUESTIONS?

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