

Non-profit spending policy options



Balance the needs of today with the desire to support the plans for tomorrow

Russell Investments Research



Mary Beth Lato, CFA, Senior Asset Allocation Strategist

Non-profit fiduciaries seek to balance the needs of their constituents 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, evolving markets. Creating a clear and well-defined spending policy not only helps ensure strategic alignment with an organization's mission—it is also an important means of creating fiscal discipline and consistency across diverse market environments.

In this paper, we unpack the spending policy, 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.



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

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 helping to ensure the stability of spending from year to year. For example, fiduciaries could use a 3- or 5-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 below.

Exhibit 1: Examples of spending policy components

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

Source: Russell Investments

Non-profit fiduciaries use the spending rate and spending methodology together to set an overall spending policy that dictates how the organization chooses to balance the interests of current beneficiaries with those of future beneficiaries. How much to spend today, how much to save for tomorrow, and how to ensure adequate, steady, and sustainable cash flows for both groups of beneficiaries are all dependent on the organization's desired time horizon. 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.

The spending rate needs to be coordinated with overall average portfolio returns to ensure that spending and growth are well balanced.

Once a decision about the desired time horizon has been made, fiduciaries must then determine whose interests they are prioritizing, as future and current beneficiaries have differing interests regarding sustainability. For example, future beneficiaries are primarily interested in growth of assets, but typically favour a narrower, rather than broader, range of possible future asset values. This is the classic “expected return versus volatility” trade-off faced by many long-term investors. The interests of current beneficiaries, however, 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 they seek to provide.

Spending rate

The spending rate needs to be coordinated with overall average portfolio returns to ensure that spending and growth are well balanced.

Once 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. Fiduciaries must continue to keep in mind the tug of war between the desires of current and future beneficiaries. 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—potentially at the expense of today's beneficiaries. Conforming to the desires of future beneficiaries increases the chances of significant asset appreciation over time. The job of the fiduciary is therefore to determine the balance of the competing needs of these two groups by aligning the spending rate with the organization's long-term funding and perpetuity goals.

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 provide their community 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.

Below, we illustrate examples of various spending rates and asset allocations. Exhibits 2 and 3, which are based on passive allocations to global equity and Canadian core fixed income, demonstrate that while it has been difficult for organizations to sustainably spend 5% or more in the past, it will be even more difficult to sustain similar spending rates and maintain the inflation-adjusted value of assets over the next 5-10 years. This is because returns for a variety of asset classes are projected to hit historic lows, with expected U.S. equity returns dampened by high valuations, and expected global fixed income returns dampened by low global interest rates.

Exhibit 2: Historical probability of maintaining the real asset base over rolling 10-year periods based on spending rate and asset allocation, 1900-2018¹

SPENDING RATE	100% EQUITY	80% EQUITY	60% EQUITY	40% EQUITY	20% EQUITY	100% BONDS
3%	71%	67%	63%	58%	50%	43%
4%	64	58	57	51	40	35
5%	51	50	48	42	31	29
6%	45	42	42	33	28	26

Source: Russell Investments

¹ Calculated with historical market data from FTSE TMX Canada Universe Bond Index, S&P TSX Composite Index, Russell Global Equity Index, Consumer Price Index and Dimson, Marsh and Staunton data. 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.

Exhibit 3: Forward-looking probability of maintaining the real asset base for the coming 10-year period based on spending rate and asset allocation, drawing from Russell Investments' December 2018 market conditional forecast assumptions²

SPENDING RATE	100% EQUITY	80% EQUITY	60% EQUITY	40% EQUITY	20% EQUITY	100% BONDS
3%	54%	51%	44%	32%	15%	3%
4%	46	41	32	18	4	>1
5%	38	31	21	9	>1	>1
6%	30	22	13	3	>1	>1

Source: Russell Investments

In Exhibit 3 above we have illustrated an organization's chances of investment success based on a variety of simple asset allocations and spending rates. All combinations indicate a success rate below 50%, favouring current beneficiaries relative to future beneficiaries. Why is this the case? As 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 were above 50%, then the real asset base would be expected to grow over time³ and favour future beneficiaries relative to current beneficiaries; this is because real spending amounts increase as the real asset base grows.

With the above spending rates potentially higher than forward-looking return expectations, the real value of assets is expected to depreciate over time, and organizations are at risk of providing a diminished level of support to their future beneficiaries' needs. We recommend that organizations enhance returns in a risk-controlled manner through active management and alternative investments to achieve returns greater than expected by these simplistic asset allocations. Organizations should also consider ways to support their future beneficiaries through fundraising. Those organizations who have more flexibility in their spending, and who 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. Those organizations that don't have flexibility in their spending, may need to re-consider their objective of perpetuity and if full intergenerational equity is likely. These ideas are further explored in the paper "How sustainable is your spending?" [Kaake, Lato, 2017].

Spending methodology

What we see time and again is that many organizations focus primarily on designing their strategic asset allocation around their long-term average spending rate while not setting a formal spending policy to abide by annually.⁴ Despite its relatively lower impact, the spending methodology is quite relevant when 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.

According to the 2018 NACUBO-Commonfund 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 percentage of moving average assets methodology. This is shown in Exhibit 4.

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

SPENDING METHODOLOGY	DESCRIPTION	PERCENTAGE USING RULE
Percentage of moving average assets	Spending a fixed percentage of the average asset value over a determined number of years	75%
Select spending rate each year	Annually determining the percentage of assets to spend	7%
Hybrid rule	Spending based on a blended weighting of last year's spending and a percentage of the current assets	9%
Spend all current income	Spending all income generated from your investment program in a given year	3%
Percentage of beginning of year (BoY) market value	Spending a percentage of the BoY market value	2%

Source: NACUBO-Commonfund Study of Endowments, 2017. Percentages are based on 809 study participants. Please note that multiple responses to this question were allowed, resulting in total responses in excess of 100%.

² 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.

³ 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.

⁴ According to the latest NACUBO-TIAA Study of Endowments and Council on Foundations-Commonfund Study of Foundations, 24% of private foundations, 4% of community foundations and 7% of endowments state that they decide on an appropriate spending rate each year.

Of the methodologies listed above, 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.

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

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 below 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.

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 to apply the spending rate to. 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, by dictating the percentage of the current year’s spending that is based on the spending in the prior year, with the remainder being calculated as a percent 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.

“Asset averaging can lend meaningful smoothing to payouts but smoothing beyond five years has limited effect.”

Exhibit 5: Weighting of current and past asset values for hybrid and percentage of moving average

ROW	METHODOLOGY	PARAMETERS	CURRENT ASSETS	1 YEAR AGO	2 YEARS AGO	3 YEARS AGO	4 YEARS AGO	5 YEARS AGO	6 YEARS AGO
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%	...

Source: Russell Investments

A percentage of moving average assets methodology with either no or a shorter averaging period (rows 1 and 2) or 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. 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. The percentage of moving average assets methodology with a short averaging period will provide greater protection to the asset base in periods of market distress, given that it has a higher weight to current assets and reacts quickly to changes in asset values. 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.

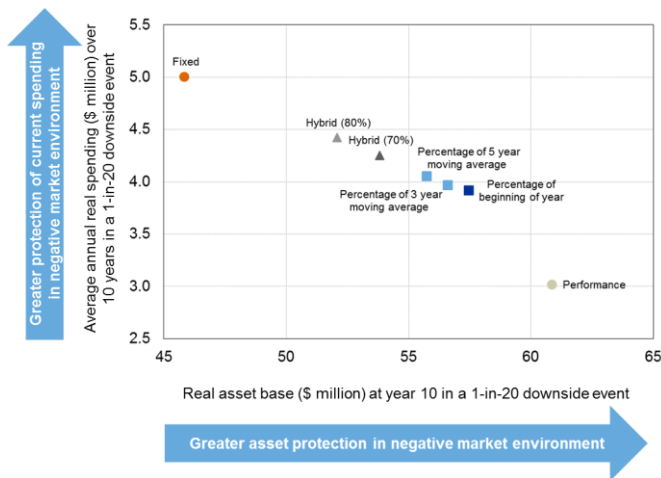
On the other hand, the hybrid methodology with a high weighting to the prior year’s spending (which does not immediately react to changes in asset values), or a fixed spending methodology, could lead to permanent asset base impairment after market downturns. On the plus side, these methodologies offer current beneficiaries more predictable spending and support.

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 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.

In choosing a spending methodology and defining its parameters, an organization must carefully weigh the trade-off between predictable spending and a strong asset base in down markets. 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 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 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^{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-looking⁸:



Source: Russell Investments

Large variations in year-over-year spending can be disruptive to the programs and services they seek to provide.

While the analysis above 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 applies a low weight to the current value of assets, or a fixed spending level, 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.

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 or five-year average asset value. 'Percentage of beginning of year' is 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).

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." And Kaake and Lato in the 2013 Russell Investments Research Report, "Understanding the effects of spending policies – A guide for non-profit organizations in Canada"

⁸ X-axis shows the inflation-adjusted asset base (\$ million) at 10 years in a 1-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.

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 unfavourable markets are unlikely to serve either group's interests. In addition to current and future beneficiaries who 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 effectively design a policy that does not unintentionally favour 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.

Contributing authors:

Kendra Kaake, CFA, Director, Non-Profit OCIO Solutions

Angie Santo-Walter, Director, Sales Enablement, US Institutional

Sophia Wang, Non-Profit Associate

Sources

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

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

Fan, Yuan-An, and Murray, Steve. (August 2004). Understanding the effects of spending policies for endowments and foundations. Russell Investments Research.

Kaake, Kendra, and Lato, Mary Beth. (February 2017). How sustainable is your spending? Russell Investments Research.

Kaake, Kendra, and Lato, Mary Beth. (December 2013). Understanding the effects of spending policies – A guide for non-profit organizations in Canada. Russell Investments Research.

Murray, Steve. (October 2011). Non-profit spending rules. Russell Investments Research.

The Non-Profit fiduciaries' handbook

As a non-profit fiduciary, you have a difficult job. You need to ensure that your organization has the money, talent, experience, and resources to fund your non-profit's mission. And you need to do this in an ever-changing market environment.

We know it's a lot to take on, which is why we have created **The Non-profit Fiduciaries' Handbook**. The handbook is designed to provide practical advice, planning tools, and best practices to help you successfully fulfill your responsibilities.

If you are interested in obtaining a copy of the handbook or would like to arrange a workshop for your committee, please go to: russellinvestments.com/ca/solutions-for/non-profits.

For more information

Contact Russell Investments at **1-866-737-2228** or visit russellinvestments.com/ca

Important information

Nothing in this publication is intended to constitute legal, tax, securities or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. This information is made available on an "as is" basis. Russell Investments Canada Limited does not make any warranty or representation regarding the information.

This publication may contain forward-looking statements. Forward-looking statements are statements that are predictive in nature, that depend upon or refer to future events or conditions, or that include words such as or similar to, "expects", "anticipates", "believes" or negative versions thereof. Any statement that may be made concerning future performance, strategies or prospects, and possible future fund action, is also a forward-looking statement. Forward looking statements are based on current expectations and projections about future events and are inherently subject to, among other things, risk, uncertainties and assumptions about economic factors that could cause actual results and events to differ materially from what is contemplated. We encourage you to consider these and other factors carefully before making any investment decisions and we urge you to avoid placing undue reliance on forward-looking statements. Russell Investments has no specific intention of updating any forward looking statements whether as a result of new information, future events or otherwise.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an event rate of return and may experience negative growth. As with any type of portfolio structuring attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Russell Investments is the operating name of a group of companies under common management, including Russell Investments Canada Limited.

Russell Investments' ownership is composed of a majority stake held by funds managed by TA Associates with minority stakes held by funds managed by Reverence Capital Partners and Russell Investments' management.

Copyright © Russell Investments Canada Limited 2019. All rights reserved.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the "FTSE RUSSELL" brand.

Date of first publication: October 2019

INST-01011 [EXP 10-2021]