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# Are 5% distributions an achievable hurdle for foundations? Were they ever?

## An update

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At Russell Investments, we have long been interested in whether it is realistic for private, non-operating foundations to expect to be able to preserve real capital and simultaneously meet the IRS's minimum spending requirement of 5% per annum on qualifying distributions. We first explored this subject in 2004 in the research report "Are 5% distributions an achievable hurdle for foundations? Were they ever?" (Yuan-An Fan and Steve Murray, 2004) by focusing on the historical success of different spending rates. We revisited this topic in 2009 and again in 2012 to reflect then-prevailing market trends, including one of the most difficult recessionary periods in modern financial history.

In this report, we continue to find that sustainably supporting a 5% spending rate remains a challenge in today's low-return market environment. We consider the possibility that spending 5% while maintaining purchasing power may not be a realistic expectation going forward. We also discuss alternative actions that foundations can take to improve the likelihood of meeting their goals. These include investing in alternative strategies and dynamically managing those exposures, which can boost a portfolio's chances of success. We also look at the ability to fundraise, and propose re-examining a given foundation's stated goals in balancing the needs of tomorrow with those of today.


Although this report focuses on the sustainability of the IRS-mandated minimum spending rate of 5%, we recognize that many foundations actually spend more than 5%. This additional spending can be caused by pressure to support near-term projects that require additional funding, as well as to meet the IRS's requirement. This situation is further complicated by the fact that many private foundations have expenses and spending that do not count as qualifying distributions—which, in effect, increase their spending rate.

To complicate matters further, there are types of non-profit organizations that are able to spend less than 5%, but, for a variety of reasons, choose to spend closer to 5%. Because no two non-profit organizations approach their spending decisions in exactly the same way, we have included a wide range of spending levels in our analysis. This paper assumes that the current goal of the foundation is to exist in perpetuity and to preserve its real asset base in order to provide future beneficiaries with the same level of support that is provided to current beneficiaries.

## Sustainably spending 5%: A historical struggle

First, let's take a brief look at history. Using market data from 1900 to 2015, Exhibit A and Exhibit B examine a foundation's likelihood of successfully maintaining its real asset base while spending between 3% and 8%, with various asset allocations over five- and 10-year periods. In Exhibit A, you can see that a foundation with a 60% allocation to equity, 40% allocation to bonds and a 5% spending rate only would have had a 52% chance of maintaining its real asset base over rolling five-year periods.

Similarly, in Exhibit B, we find that the same foundation, with a 60% allocation to equity and a 5% spending rate, would have had a similar chance of maintaining its real asset base over rolling 10-year periods.

As you digest these numbers, you will recognize additional implications of the data. Foundations with equity allocations of 60% and higher were able to sustainably spend 5% over half of the time, which is a common target set in asset allocation and policy design. However, this also means that 40-50% of the time, committees would have failed to reach their goals over their likely planning horizons. For foundations that saw spending and expenses creep up to 6-7%, it would have become increasingly likely that the portfolio would not be able to maintain its real value. This has led many foundations to search for higher return opportunities through alternative investments. What this also tells us is that, historically, many committees have failed to meet these higher spending goals.

These sobering observations are, in fact, exactly what foundations should expect. If a foundation constructs a portfolio to support its spending goals, the only way to guarantee success would be to invest in an environment of steady and predictable, rather than volatile, returns in excess of inflation—but that capital market environment has not existed over long periods of time. Given the dynamic and volatile nature of today's capital markets, a portfolio with an expected average return of inflation plus 5% can only expect to outperform that target roughly half of the time, while underperforming it the other half. In order to expect success more frequently than half of the time, a foundation would have to undertake additional risk and target a return meaningfully higher than 5%. This propensity to set ambitious targets and experience disappointment is something committees must understand and fully accept when they design investment portfolios.

## Sustainably spending 5%: A continued struggle

A look at the historical sustainability of spending 5% demonstrates just how difficult a target it has been. Unfortunately, we don't believe it is going to get any easier over the next 10 years. Two harsh realities exist today that differ from the 116 years of history we have examined and used to calibrate our forward-looking assumptions.

**Exhibit A: Historical success rates over rolling five-year periods, 1900-2015[1]**

| | 100% EQUITY | 90% EQUITY | 80% EQUITY | 70% EQUITY | 60% EQUITY | 50% EQUITY | 40% EQUITY | 30% EQUITY | 20% EQUITY | 10% EQUITY | 100% BONDS |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **3%** | 66% | 65% | 65% | 61% | 62% | 59% | 56% | 57% | 55% | 43% | 38% |
| **4%** | 61 | 59 | 58 | 56 | 55 | 53 | 50 | 45 | 37 | 33 | 34 |
| **5%** | 58 | 56 | 56 | 54 | 52 | 47 | 43 | 37 | 30 | 25 | 25 |
| **6%** | 55 | 55 | 54 | 50 | 45 | 40 | 33 | 25 | 21 | 19 | 16 |
| **7%** | 51 | 51 | 47 | 41 | 37 | 28 | 24 | 19 | 17 | 15 | 13 |
| **8%** | 43 | 40 | 36 | 30 | 27 | 21 | 16 | 14 | 13 | 11 | 11 |

**Exhibit B: Historical success rates over rolling 10-year periods, 1900-2015[2]**

| | 100% EQUITY | 90% EQUITY | 80% EQUITY | 70% EQUITY | 60% EQUITY | 50% EQUITY | 40% EQUITY | 30% EQUITY | 20% EQUITY | 10% EQUITY | 100% BONDS |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **3%** | 74% | 72% | 72% | 71% | 69% | 67% | 64% | 58% | 48% | 39% | 38% |
| **4%** | 67 | 67 | 66 | 64 | 62 | 57 | 52 | 43 | 35 | 33 | 29 |
| **5%** | 60 | 58 | 57 | 52 | 51 | 46 | 41 | 34 | 30 | 27 | 23 |
| **6%** | 48 | 49 | 48 | 46 | 40 | 36 | 32 | 24 | 24 | 20 | 15 |
| **7%** | 44 | 44 | 41 | 35 | 32 | 27 | 20 | 18 | 14 | 11 | 10 |
| **8%** | 37 | 35 | 30 | 27 | 23 | 18 | 14 | 11 | 10 | 6 | 2 |

**Exhibit C: Chance of success in coming 10-year period based on Russell Investments' June 2016 forecast assumptions[3]**

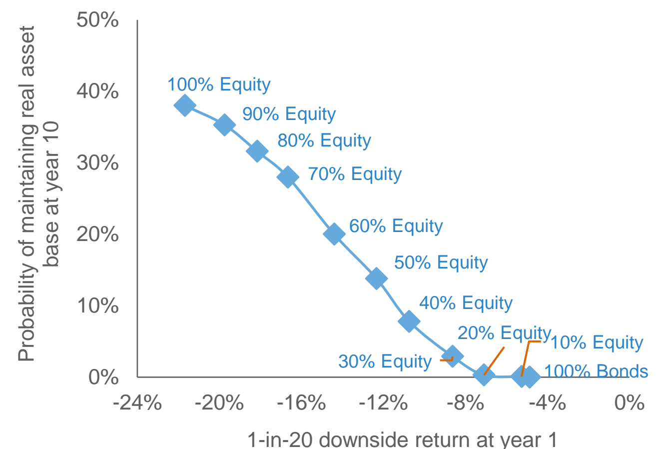
| | 100% EQUITY | 90% EQUITY | 80% EQUITY | 70% EQUITY | 60% EQUITY | 50% EQUITY | 40% EQUITY | 30% EQUITY | 20% EQUITY | 10% EQUITY | 100% BONDS |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **3%** | 55% | 53% | 51% | 47% | 43% | 37% | 30% | 19% | 10% | 3% | <1% |
| **4%** | 48 | 44 | 41 | 36 | 31 | 24 | 15 | 9 | 2 | <1 | <1 |
| **5%** | 38 | 35 | 32 | 28 | 20 | 14 | 8 | 3 | <1 | <1 | <1 |
| **6%** | 31 | 28 | 22 | 18 | 12 | 8 | 3 | <1 | <1 | <1 | <1 |
| **7%** | 25 | 20 | 16 | 12 | 7 | 4 | <1 | <1 | <1 | <1 | <1 |
| **8%** | 19 | 14 | 10 | 7 | 4 | 2 | <1 | <1 | <1 | <1 | <1 |

First, in our current situation of historically low yields, fixed income assets cannot be expected to generate returns as high as they have in the past. If expectations for inflation were to decrease by the same amount as expected returns for fixed-income assets, low yields would not be any more problematic than in the past. However, inflation expectations have not declined by the same amount as yields have. Second, we believe that the forward-looking equity risk premium will be lower than the realized risk premium from the past. This belief is based partly on the fact that the re-pricing of risk, seen through an increasing price-dividend ratio, drove much of the historically high level of returns to equities. That is not expected to continue. The combination of these market realities—lower yields and a lower forward-looking equity risk premium than in the past—means that the high returns of the past are not expected to repeat themselves in the future.

Exhibit C demonstrates a foundation's probability of successfully maintaining its real asset base over the coming 10 years based on Russell Investments' current market outlook. Using the earlier historical example of a foundation with a 60% equity allocation and a 5% spending rate, you will see that on a forward-looking basis, its probability of success is only 20%. Compare this with the approximately 50% chance of success a similar hypothetical foundation had in the past, and you can imagine the impact these unfavorable odds will have on a foundation's ability to spend 5% over the foreseeable future.

As you look at Exhibit D, you will notice a trend. The higher the probability for success, the greater the potential for losses. The portfolio with a 60% equity allocation has a 20% probability of success, but it also has a 5% probability of a loss greater than 14% in one year. Increasing the probability of success to 35% requires a portfolio that is 90% allocated to equity. With that, the foundation must also accept a 5% probability that the portfolio will experience losses greater than 20% in one year. Depending on your organizational and investment needs, the potential increase in losses may or may not be tolerable.

**Exhibit D: Likelihood of success versus downside returns with 5% spending[4]**




## What can be done?

Clearly, there is no magic bullet that can solve this conundrum. However, we believe that foundations can still make adjustments to better position themselves for success.

From an investment perspective, it is clear that foundations will have to undertake some level of investment risk to aim for the level of asset growth that can support a 5% spending rate. This will inevitably include a significant allocation to listed equities as a driver of return. To mitigate the risk and potential drawdowns associated with a high equity allocation, diversification into real assets and alternatives should complement the equity exposure. Many foundations have already diversified their portfolios, but we believe it is increasingly important for those who have not yet done so to embrace diversification. Once a diversified portfolio is in place, those exposures should be dynamically managed. In today's low-return environment, no investor can afford to overlook investment strategies that may offer incremental returns, take risks for which you do not expect to get paid, or ignore implementation efficiency.

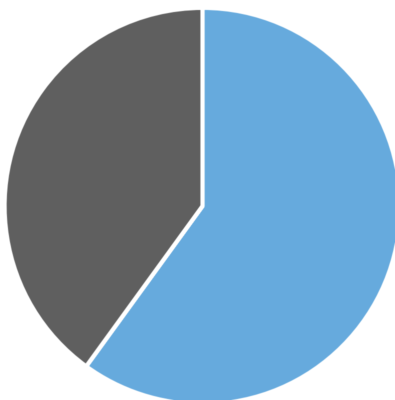
Dynamically managing diversified exposures can allow you to more quickly and nimbly take advantage of market insights to pursue higher returns and opportunistically seek to protect against market drawdowns. This approach helps tackle the issue of responding to rapidly changing markets. That way, investors can keep up with the accelerating pace of change and adapt quickly to capture new opportunities.

Constantly monitoring market and economic conditions and developing an appropriate response requires dedicated resources and specialized skills. To effectively undertake a dynamic approach, foundations are wise to partner with an investment management firm that will help them construct a portfolio to pursue their goals in an efficient manner. In Exhibit E, we show one approach that we have designed with this goal in mind. This approach includes a broader array of asset classes (such as alternative and illiquid investments), dynamic management of the allocations and looks to add value through active management within individual asset classes.

**Exhibit E: Sample of portfolio adjustments**

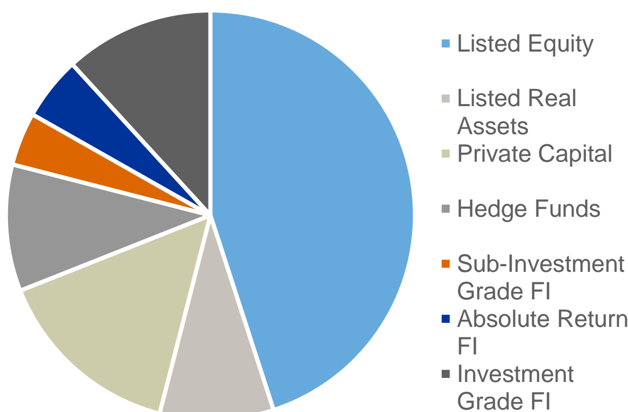
**Old portfolio: 60% equity, 40% fixed income**

60 / 40



**New, diversified portfolio**

Sample

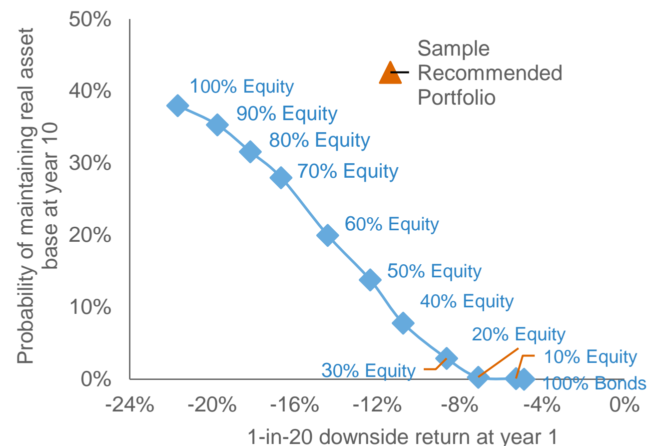



For illustrative purposes only.

The expected improvements can help increase the likelihood of success for a given level of expected risk, as demonstrated by the sample Russell Investments portfolio in Exhibit F.

As you can see in Exhibit F, the revised portfolio has a 5% probability of a loss of more than 11%, in line with the 50% equity portfolio, while increasing the likelihood of success to over 40%. This represents a significant improvement in the expected result without an increase in the potential downside losses.

**Exhibit F: Likelihood of success versus downside returns with 5% spending using a sample Russell Investments portfolio[5]**




However, the probability of success still falls under 50% for this sample portfolio over the next 10 years. While it provides an improvement in expected outcomes, it does not solve all of the problems currently faced by foundations. For the majority of private foundations that don't have the ability to fundraise, or choose not to fundraise, investment decisions alone cannot guarantee success or even make it the most likely outcome. Therefore, it is important for these foundations to monitor their spending and ensure that their total outflows remain as close to 5% as possible (or lower, if not a private, non-operating foundation).

Changing the asset allocation can help a foundation retain or improve its asset base, but this change does not guarantee success. However, with reductions to spending and expenses, we *can* guarantee benefits to the asset base, as every dollar that isn't spent is a guaranteed additional dollar in the asset base. Reducing spending is not an easy decision to make, and it ultimately comes down to the committee deciding how it will balance the support it provides current beneficiaries with the support it can expect to provide future beneficiaries.

Foundations face a difficult challenge as they attempt to operate in perpetuity while spending 5%. Along with considering a reduction in spending, it is in a foundation's interest to reconsider whether or not perpetuity is, or should be, the end goal. There is no right or wrong answer to the question of how to balance the needs of today with those of tomorrow, but it is increasingly no longer the case that perpetuity has to be the default goal for foundations. Any change to long-term goals should not, however, be taken lightly—Russell Investments recommends that foundations carefully review the implications of current spending and clearly articulate whether or not perpetuity is the most appropriate goal. With that being said, it is better to be proactive in adjusting expectations based on current realities than to slowly realize that current spending and market returns have fallen out of sync with stated long-term goals.

For those foundations that have the ability to raise funds, it will be important to maintain those inflows to help counterbalance the impact of spending in a low-return environment. Ideally, future inflows would be used to grow the asset base and not subsidize spending; however, that is not always possible. The ability to raise new funds offers foundations greater flexibility in deciding how to spend current assets when returns alone are not enough to offset spending and inflation.

A strong, dynamic investment framework and control of total spending can help navigate these difficult times and position your organization for success. At the end of the day, of course, a little bit of luck will always help!

[1] 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.

[2] 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.

[3] 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.

[4] See endnote 3

[5] See endnote 3

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