FEG Insight

GIVING SPENDING POLICY THE ATTENTION IT DESERVES

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Giving Spending Policy the Attention It Deserves

In the realm of decisions nonprofit fiduciaries must make, few decisions have as much impact as those related to spending policy—a set of guidelines determined by a nonprofit to inform how endowment funds should be spent. Why? Aside from being endorsed by the Uniform Prudent Management of Institutional Funds Act (UPMIFA), the regulatory act that governs endowment management, implementing an appropriate spending policy can greatly contribute to the success (or demise) of the following outcomes.

- The management of nonprofit funds into perpetuity
- Honor of donor intent
- Financial support for a nonprofit's mission
- Balance of current distributions with support for future generations
- Steady cash flow to supporting beneficiaries
- Operational support

Private foundations have less ability to deviate from a set spending policy mandated by the IRS. However, other nonprofits have the latitude to adjust their policies. Nevertheless, how much airtime does spending policy get in the boardroom? While appearing simple in nature, there are many facets that should be considered.

1. Effect on Portfolio Management
2. Policy versus Effective
3. Trends in Spending Rates
4. Spending Methodologies
5. Which Inflation Matters Most?
6. How to Evaluate Making a Change

Each consideration will be discussed in greater detail below.

EFFECT ON PORTFOLIO MANAGEMENT

Spending policy effects portfolio management through its direct relationship with the concept of intergenerational equity—the balance of current distributions, or spending, with ensuring the portfolio can also provide distributions for future generations. Board, committee, and staff members have a fiduciary responsibility to look to this concept as their north star when thinking about managing long-term investments. Since an endowment is set to last in perpetuity, the endowment's spend out should not exceed the long-term return of the organization's portfolio, net of inflation and investment and/or administrative fees. Combined, these three factors—spending rate, inflation, and fees—constitute an organization's "hurdle rate," which serves as an organization's long-term return objective.

SPENDING + INFLATION + FEES = LONG-TERM RETURN OBJECTIVE

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While the equation seems fairly straightforward, the challenge lies in the nonprofit's ability to set and govern the underlying variables. The spending rate is often the largest numerical contributor to the formula. While it tends to be more static, its constant nature does not come without complexity and often heavy decision-making. Inevitably, nonprofits are faced with addressing an endless list of demands through their spending policy. While it would be theoretically easier to aim high and utilize resources as much as possible to achieve all spending demands, if the spending rate is too high—or imprudent, as deemed by UPMIFA,[1]—the required rate of return needs to be higher, thus tempting the portfolio to take on more risk to meet higher return objectives. That, in turn, can put future generations at risk, which breaks the foundational principle of intergenerational equity mentioned before. Finding a balance, and therefore an appropriate spending rate, is essential as stewards of these important assets.

POLICY VERSUS EFFECTIVE

Digging deeper, it is important to differentiate between "policy" and "effective" spending rates. The "policy" spending rate is the stated rate, often mentioned in governing documents and used as the input for objective setting. The "effective" spending rate, also known as the "actual" rate, is the outcome after applying the organization's full spending distribution, which is calculated with a specific spending methodology. Since a spending policy may take into consideration multiple years or quarters of market values, the resulting effective rate for an organization may be higher or lower than the stated rate for that year.

A common example is a spending policy rate of 5% applied to a moving 12-quarter total portfolio market value average. In the example shown, the policy rate is 5%. The effective spend rate would be the result of the 5% applied to the 12-quarter moving average of the total portfolio market value divided by the current total portfolio market value.

The general rule-of-thumb is that in "up" periods the effective rate is lower than the policy rate because it is being applied to a larger base, while the reverse is true in "down" periods. As the market has generally risen over time, it is worth examining the difference between effective and policy spending rates to more accurately determine if purchasing power has been met.

To further illustrate the difference, consider the following case study which examines an organization's *actual* dollars spent each fiscal year for 30 years, using a starting value of $5.62 million. With a calculated average effective rate of ~4.5% compared to the policy rate of 5.5%, the ending value was an astonishing $108.19 million, after net cashflows and market appreciation. The average effective spend rate was ~1% lower than the policy rate due primarily to strong market appreciation and gifts slightly exceeding spending over time, both of which assisted in the strong and steady growth of the portfolio (i.e. denominator in the spending formulas). To note, there were individual years the effective rate slightly exceeded the policy rate, but they were few and far between (and when intuitively one might think so – e.g. Dot.com tech bubble in early 2000s, Great Financial Crisis in '08/09 and COVID in 2020). On average however, over three decades, the effective rate was ~1% lower than the policy rate, and that difference is meaningful. As the endowment analysis charts demonstrate, the portfolio value would have been $136.87 million if it had been earning the policy spend rate of 5.5% plus inflation. In other words, it is showing purchasing power has not been met (since $108.19 million is less than $136.87 million). Alternatively, had the portfolio earned the average effective rate of ~4.5% plus inflation, the overall value would have been only $106.97

[1] In some states UPMIFA defines spending over 7% as imprudent.

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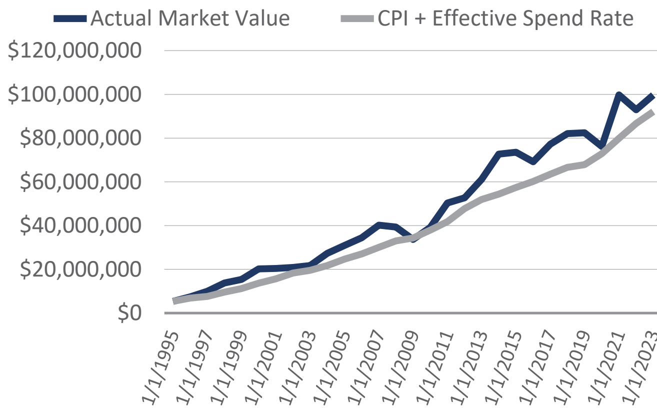
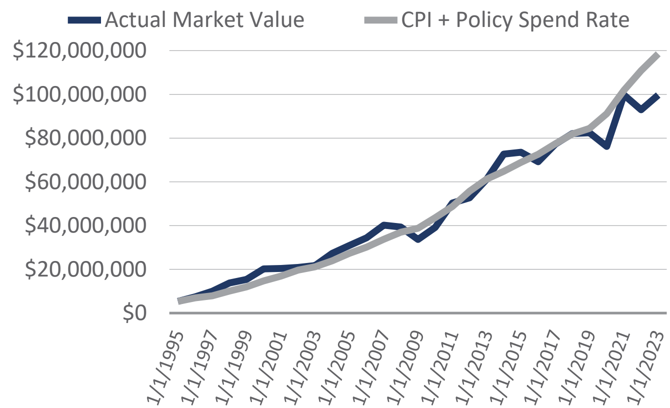
million. Thus, the purchasing power has been met (with a little cushion). This analysis is unique to this specific organization's actual experiences over a long period of time, but it highlights the differences in assessing whether goals were met.

ENDOWMENT ANALYSIS





Data source: FEG

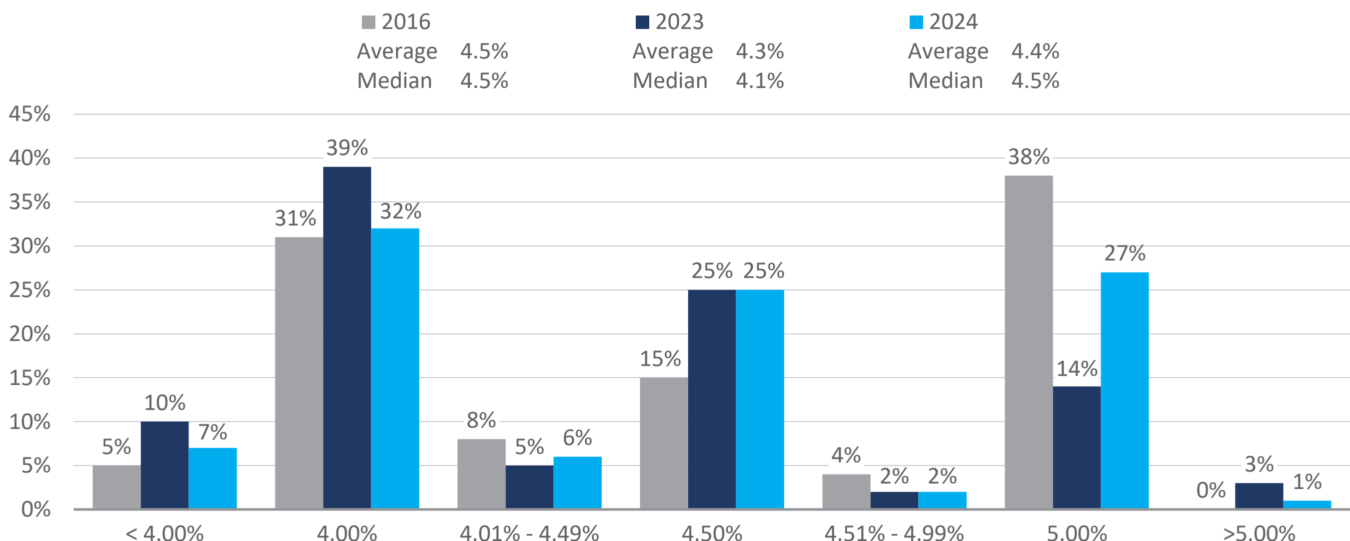
Spending methodologies, a key component of this example, is one of the important facets discussed shortly.

TRENDS IN SPENDING RATES

Understanding how spending rates have changed over time can help the board, committee, and staff members govern and manage an organization's spending rate. There are many industry studies on trends in nonprofit spending available to tap into. The annual FEG Community Foundation Survey (CFS) and the National Association of College and University Business Officers (NACUBO) Study of Endowments survey are two notable studies that consistently demonstrate spending trends across the industry.

HISTORICALLY, FEG's CFS SURVEY HAS DEMONSTRATED A CONTINUAL DECREASE IN SPENDING RATE, HOWEVER THIS YEAR WE SEE MORE ORGANIZATIONS INCREASING THEIR SPENDING RATE

Spending Policy Rates (Excluding Any Administration Fees)



Note: Answers were grouped. Answers may have been excluded that were more than 20% off the average (2016 N=70 / 2023 N=100 / 2024 N=107).
Source: 2024 FEG Community Foundation Survey

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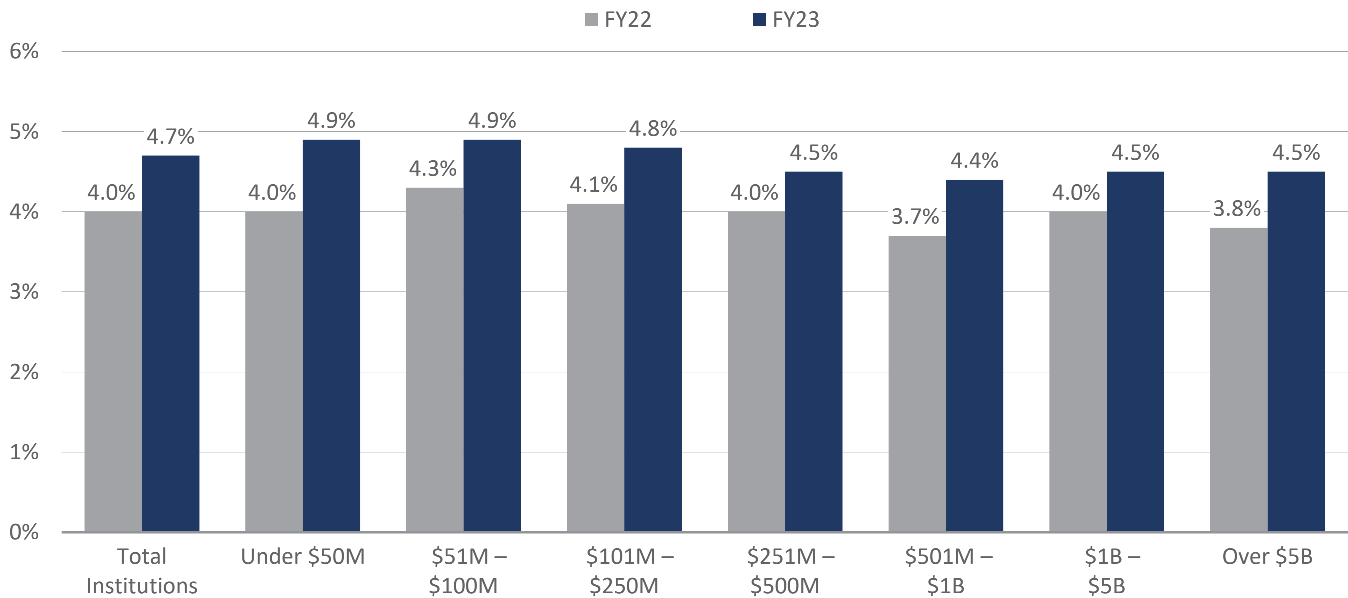
The aggregate data from FEG's 2024 Community Foundation Survey demonstrates the average spending policy rate for community foundations is 4.4%,[2] with responses primarily distributed between 4.0%, 4.5% and 5.0%. Since FEG's survey began in 2017, the average spending policy rate has come down from 5%.

The 2023 NACUBO study showcases "effective" spending rates for the higher education sector.[3] The results of this study highlight a year-over-year increase in the overall average in the effective spending rate from 4.0% in 2022 to 4.7% in 2023. Because the study is measuring effective spending, the policy rate is applied using the respondents' spending methodology; then, the resulting dollars spent are divided by the beginning of the fiscal year (FYE) asset value to arrive at an effective rate. One must consider the markets to fully understand and appreciate what the 2023 NACUBO study tells us. In the 2023 study, the respondents submit results for FYE 2023 per instructions to do so. Beginning year values were lower because of low investment returns for FYE 2022; according to NACUBO, the average return for FYE 2022 was -8.0%. Thus, the divisor was lower, making the outcome higher. The math principles are fundamental in nature and may not seem significant in the short-term. However, they may be worth tracking over the long-term to help ensure awareness of any trends.

AVERAGE ANNUAL EFFECTIVE SPENDING RATE BY SIZE (FY22-FY23)



Data source: NACUBO Commonfund

Again, it is important to note the difference between measuring policy versus effective rates when looking for peer data. The NACUBO study is measuring effective/actual rates, whereas FEG's survey is measuring policy rates.

[2] The 2024 survey included responses from 107 foundations representing almost $41 billion in assets across multiple size cohorts.

[3] As represented annually since 1974 by the NACUBO study. The 2023 survey included responses from 688 public and private institutions representing endowments totaling $839 billion.

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SPENDING METHODOLIGIES

The calculation of spending distribution is an important consideration, especially when considering the impacts it could have in the examples discussed thus far. Varying types of methodologies focus on different aspects and pain points, including smoothing spending distributions, limiting volatility in annual spending, and providing more consistency and transparency for budget planning.

The majority of nonprofit organizations use the moving average method. It is generally recognized as the most intuitive methodology and can be easy to maintain. The approach varies between three-year, or 12-quarter, and five-year, or 20-quarter methods. Typically, the longer the time period, the less volatile the spending. The table below outlines the methodologies and the advantages and disadvantages of each.

METHODOLOGY	ADVANTAGES	DISADVANTAGES
MOVING AVERAGE Spend a fixed percentage of a rolling average of the market value over a specific time period.	• Smooths the amount of the spending distributions year over year • Simple to implement and easy to explain	• All market values are given the same weight, which may matter depending on market shocks or substantial cash flows • Spending is highly-correlated to market value fluctuations
CONSTANT GROWTH Increase the spend each year by a constant growth rate or inflation.	• Smooths spending • Higher probability the spending increases year over year	• Judgement used in setting the annual increase • Does not consider market value changes
CONSTANT GROWTH WITH BANDS Spending is contained within a range of +/- a percentage of the previous year's market value.	• Increases market value during strong markets • More predictable spending	• Moderated spending amount during strong markets • Spending higher during prolonged bear markets
GEOMETRIC Weight average is given to inflation-adjusted spending and target spending rate of market value.	• Accounts for inflation and market movements • Balance between spending and market value can customize the smoothing rate	• Slightly lower endowment values • Complex and difficult to explain
HYBRID Custom combination of spending rules to meet the specific needs of an institution. For example, spending totals 80% of the previous year's spending and 20% of the targeted long-term spending rate. Another example might be spending is adjusted for inflation and constrained between 4% and 6% of the inflation-adjusted market value two years prior.	• Can favor either stable distributions or maintaining purchasing power • Spending rules can be customized to fit the specific needs of an organization	• Identifying and maintaining the right combination of spending rules • Complex and difficult to explain

It is worth exploring which methodology works best for each organization. Consider looking to a financial partner to help quantify potential options.

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WHICH INFLATION MATTERS MOST?

Recall inflation being one of three key inputs into setting the long-term hurdle rate that drives the management of an endowment's portfolio strategy. Inflation, as measured in its most basic form as Consumer Price Index (CPI), can fluctuate up or down in short-term periods. By way of example, CPI has fluctuated between 2.5% and 5.6% over a recent 10-year period, a difference in percentage terms of over 100%. This volatility can be difficult to manage, which has caused some to question whether there is a more appropriate metric. As an alternative, some education institutions use the Higher Education Price Index (HEPI), which more closely tracks operational cost changes year over year and historically is higher than the CPI. Given that these are long-term assets, another option is using a less volatile long-term inflationary measure that aligns with capital market assumptions used in the strategic asset allocation process. That number is typically closer to the Federal Reserve's long-term target of 2% and tracks closer to the PCE Index (Personal Consumption Expenditures).

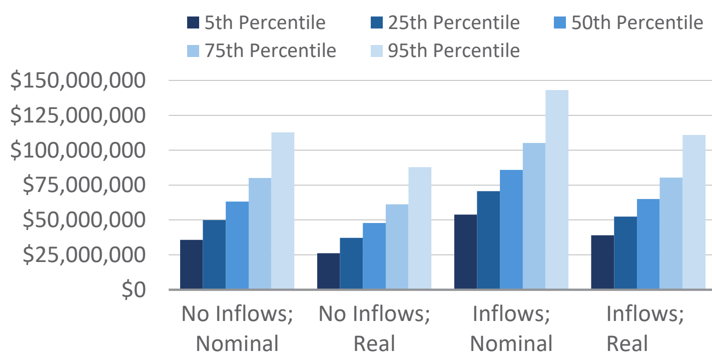
What is the right metric to use, or which matters most? The answer varies depending on each organization's risk tolerance and portfolio objectives. Regardless of choice, it is important to document it within the investment policy Statement so there is no confusion when measuring results.

HOW TO EVALUATE MAKING A CHANGE

If an organization is contemplating making a change to the spending policy, it is important to quantify how the change could impact future asset values and spending distributions. The following case study walks through an example analysis. The process can be cumbersome; lean on an investment partner for help during the planning process and throughout execution.

COMPARING A 3.5% VS. 4.0% SPENDING RATE

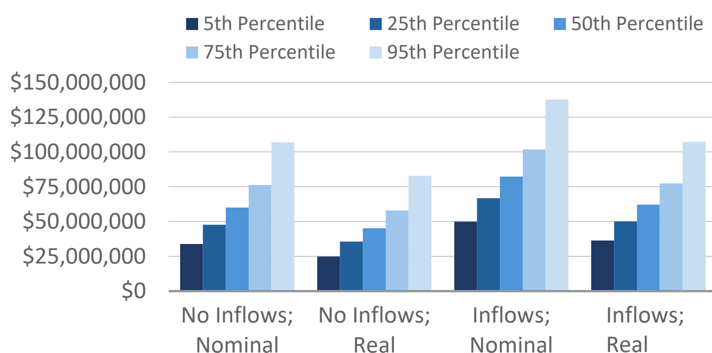
10-Year Market Value: 3.5% Spend Rate



10-Year Total Spend: 3.5% Spend Rate

	3.5% NOMINAL	3.5% REAL
5th Percentile	$13,905,327	$11,668,989
25th Percentile	$16,071,882	$13,673,080
50th Percentile	$17,893,602	$15,311,339
75th Percentile	$19,978,137	$17,208,805
95th Percentile	$23,608,788	$20,446,867

10-Year Market Value: 4.0% Spend Rate



10-Year Total Spend: 4.0% Spend Rate

	4.0% NOMINAL	4.0% REAL
5th Percentile	$15,696,879	$13,221,684
25th Percentile	$18,121,928	$15,389,363
50th Percentile	$20,138,814	$17,186,142
75th Percentile	$22,482,638	$19,305,978
95th Percentile	$26,457,206	$22,847,321

Data sources: FEG, Marcov Processes International

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This exercise utilizes a probability distribution, or Monte Carlo analysis, to understand the impact of an increase in spending policy rate. The sample spending analysis exhibit demonstrates that a change in spending policy from 3.5% to 4.0% yields about $2.25 million more in median spending over a 10-year time period, but the portfolio market value declines by over $3 million in the higher spend scenario. All else being equal, the 4% spend will erode more corpus over time, eventually yielding in less distributions. This is a simplified analysis, and actual results will depend on the timing of the cash flows.

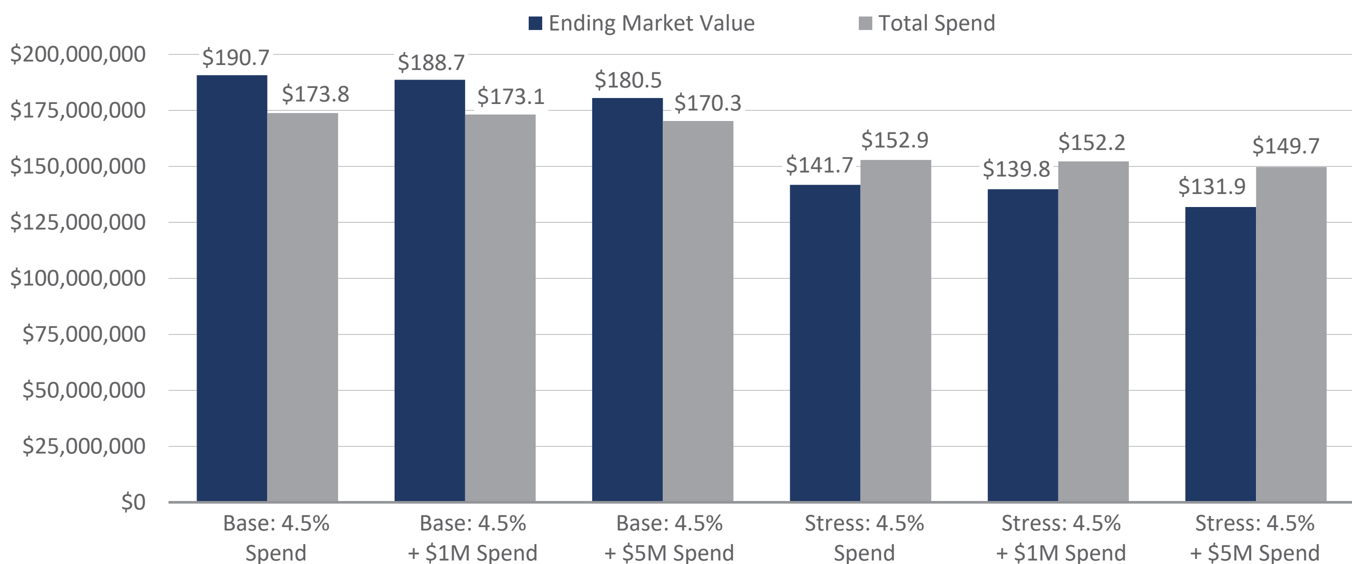
This example includes two other important factors. The first is a fundraising inflow assumption of $1.8 million annually—which can be customized year by year—and the second is a "real" result reflecting a 2.75% inflation assumption, which erodes about 24% of the organization's purchasing power over the 10 years. Just as important as the spending rate change, it is critical to consider these factors when analyzing a change.

STRESS-TESTING THE POLICY

While the above analysis shows various probabilities of different return scenarios over a 10-year period, it is also worth quantifying what a near-term market shock may do to a portfolio's short- and long-term spending outcomes. Additionally, one might consider how a one-time need for additional distributions could impact the assets in the portfolio. One example would be to start with a market value of $95 million, assuming a 7% median return and a 4.5% spend rate using a five-year rolling average. Over a 27-year period, the median or base case outcome is a portfolio value of $190.7 million and a cumulative spend of $173.8 million. To stress-test a large withdrawal, $1 million and $5 million one-time withdrawals are introduced in year one. Then, the portfolio is stressed for unexpected market environments, applying a -12.5% return in year one, a flat return in year two, and a 7% return thereafter. Considering the $1 million and $5 million withdrawals, the median impact is a hit to the end portfolio value between $49 million and $59 million, as well as a reduction in the cumulative amount spent over the 27 years.

SAMPLE SPENDING ANALYSIS AND STRESS TEST

Ending Market Value and Total Spend



Data source: FEG

OTHER CONSIDERATIONS

Nonprofits have different sources of revenue depending on the needs of the organization, which can affect how an organization leans on its spending policy. If an organization is relying on the annual spending distribution to support operational needs, such as payroll, revenue needs will be different than an organization that has substantial cash flows from sources such as government support, grants, and donations. The more reliant an organization is on the revenue of the portfolio, the greater the risk of shorter-term fluctuations impacting day-to-day business. One possible solution is to separate the asset pools into different risk and return profiles: establishing a long-term growth pool can allow a nonprofit to take on more risk in search of higher return while maintaining shorter-term liquidity in a separate, more risk-averse portfolio.

Similarly, different spending policies may make sense for different types of pools—e.g., endowed vs. non-endowed, or restricted vs. unrestricted. Since the pandemic, there has been a recognized need for more unrestricted assets for emergency or operational purposes. As these types of assets increase, they may warrant being managed separately with different investment and spending policies.

Lastly, administrative fees are important to consider. Recall that "fees" is the third variable in the hurdle rate discussed earlier. Administrative fees vary greatly depending on the type of organization and the options made available to donors. An organization may also consider investment expenses as similar types of fees. Regardless of an organization's choice in what is captured with respect to the hurdle rate, it is important to document in this step in the investment policy statement.

KEY TAKEAWAYS

Spending policy is the largest component of an endowment's return objective and should be understood and routinely examined by nonprofit boards and committees. Most nonprofit organizations have spending policies between 4-5%, as shown in various industry studies. There is a difference though, between an organization's spending policy and its actual or effective spending rate, which is a worthwhile comparison to measure to ensure long-term goals are on track. Spending methodology is an important decision to consider to alleviate pain points, such as smoothing spending or limiting volatility. It may also be worth reviewing which inflation measure is being used in the long-term return hurdle, and if it aligns with the assumptions used in the strategic asset allocation decisions.

Fiduciaries have other types of analyses that can help make informed decisions, like a comparison of future outcomes using varied methodologies and inputs, such as cash flows and near-term market shocks. There may be a reason to add guardrails or create a hybrid calculation that better suits an organization. Finally, other considerations like an organization's dependency on spending distribution to support operational needs, other sources of inflows, or types of assets in various investment pools may cause a need for different spending policies.

In the end, giving attention to an organization's spending policy is a smart fiduciary exercise that should be done as a regular part of the governance process. It is a challenge to stay focused on both short-term and long-term goals simultaneously, but having supporting analyses to document reviews and decisions will inevitably serve future constituents.

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The National Association of College and University Business Officers (NACUBO) is a membership organization representing more than 1900 colleges, universities and higher education service providers across the country. The NACUBO data was obtained from the 2023 NACUBO-TIAA Study of Endowments (NTSE), an independent third-party. The study includes a survey of 688 U.S. colleges and universities. The study divided the data into seven categories according to size of endowment, ranging from institutions with endowment assets under $25 million to those with assets in excess of $1 billion. The study data is for the 2023 fiscal year (July 1, 2022 - June 30, 2022) and based on the responses provided by the participants and is meant for illustration and educational purposes only. The average and median returns presented in this presentation are taken directly from the NACUBO study and were not calculated by or achieved by FEG or its clients. FEG is not affiliated with the organization and did not pay for the survey results.

The Community Foundations data is obtained from the proprietary FEG 2024 Community Foundation Survey. The study includes a survey of 107 U.S. Community Foundations. The survey was open for responses online from January 16 - March 8, 2024. Participants also had the option to complete as a word document and email the results back to FEG. The data from this survey is in preliminary stages and not yet finalized. Participants include community foundations with assets ranging from less than $25 million to greater than $1 billion. The information in this study is based on the responses provided by the participants and is meant for illustration and educational purposes only.

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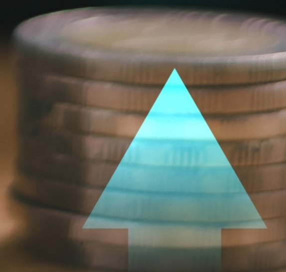

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