Wespath

Our Fiduciary Focus educational series is your resource for information about not-for-profit institutional investing, board governance, OCIO services and more. Learn best practices and industry trends that improve your operations and advance your organization's mission!

Spending Policies for Endowments and Foundations

Most endowments and foundations seek to exist in perpetuity and therefore rely on the proceeds from their investment assets to sustain their missions. Naturally, organizations must consider risk and reward in the management of these assets.

Endowments and foundations typically seek to generate returns that can fulfill their spending needs, while also protecting principal over the long-term. Understanding these factors helps an organization strike a balance between its investment objectives and its spending policy.

Spending Policy

A ***spending policy*** is a set of guidelines adopted by an organization that outline how that organization can spend from their investments to help fund their business operations and mission.

Key Factors to Consider

With this in mind, organizations should keep the following in mind when developing a spending policy:

- What is the organization's core mission? What will investment returns help fund?
- What are the organization's cash flow needs, risk tolerances and time horizons?
- Are current spending needs balanced with the desire to maintain the long-term value of principal?
- How much year-to-year variance in spending does the organization have?
- Is the spending policy reviewed annually?

Every organization will have unique answers to these questions, so there is no "one size fits all" solution to developing a spending policy.

There are also regulatory factors to consider. For instance, the IRS requires that private foundations adhere to a "5% rule," meaning that on an annual basis, they must spend 5% of the net value of their assets on qualified distributions such as grants, operating expenses and program-related necessities.[1]

Many endowments and foundations are also subject to the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which provides guidance on investment and spending decisions.

UPMIFA rules state that investing and spending must be at a rate that preserves the purchasing power of an organization's principal over the long-term.[2]

Managing Spending Tensions

In thinking about regulatory factors and individual considerations, we start to notice that there is often a tension between organizational goals and spending needs. This tension is best managed through a clearly defined spending policy, of which there are many models to work from.

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[1] https://pro.bloombergtax.com/portfolio/private-foundations-distributions-section-4942-portfolio-880/
[2] https://www.uniformlaws.org/committees/community-home?CommunityKey=043b9067-bc2c-46b7-8436-07c9054064a3

The Most Common Spending Models

SIMPLE	Flat spending amount or spending rate tied to the annual market value of the investment portfolio
INFLATION-BASED	Similar to a Simple policy, but with an adjustment for possible, or actual, inflation
SMOOTHING	A moving average method used to calculate the spending amount over a particular time period. Using this method, an organization would typically take the average market value of its investment portfolio over the last three years and multiply it by the spending rate (e.g., 4%) to find its annual spending target.
HYBRID	Combines two spending policies and weights the importance of each spending consideration based on the overall goals of the organization. This model typically considers the prior year's spending amount more heavily than earlier years, seeking to deliver better year-over-year consistency. However, the weighting formula can become complex.

This is just a snapshot of the many models foundations and endowments use to form spending policies, but it helps illustrate the variety of options available. Nevertheless, these concepts are probably better visualized with an example.

Spending Policy in Action

The Steeple Endowment has a $100 million investment portfolio. It adopted a simple spending policy and requires a 5% annual spend. The organization has $2 million in annual expenses. Here is what a particularly volatile year in the markets, either to the upside or downside, could mean for its ability to spend on its mission:

	Year prior	Account 20% gain	Account 20% loss
AUM at start of the year	$ 100,000,000.00	$ 120,000,000.00	$ 80,000,000.00
5% spend	$ 5,000,000.00	$ 6,000,000.00	$ 4,000,000.00
Operating expense	$ 2,000,000.00	$ 2,000,000.00	$ 2,000,000.00
Amount available to spend	$ 3,000,000.00	$ 4,000,000.00	$ 2,000,000.00
Difference YOY		33%	-33%

As we can see, a major fluctuation in investment returns can create an even greater discrepancy in the amount available to spend. Using a smoothing model based on three-year averages would provide less disruption in program funding, while a hybrid model would allow for adjustments based on upcoming priorities. It is possible that an organization may still opt for a simple spending model as well—as we have implied, there is no one correct answer.

Learn More

Wespath and Wespath Institutional Investments have experience working with endowments and foundations to help them develop and execute investment and spending policies. If your United Methodist-related organization would like to learn more about our services, please visit our website or contact:

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