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ENDOWMENT SPENDING IN A LOW RETURN ENVIRONMENT

For most organizations fortunate enough to possess an endowment, the funds are intended to be perpetual and to provide a stable and growing source of financial support to the organization well into the future. But in the here and now, budgets are typically tight; so boards and investment committees must address the creative tension between meeting today's spending needs while considering spending needs in the future. Arguably the most important endowment management consideration is determining a spending level that is truly sustainable, which means the buying power of the current endowment drawdown will be the same or higher in the future as it is today.

In practice, no spending rule is perfect. Rather, an endowment spending formula should serve as a guideline. In real life, investment and budget circumstances change, which means boards will always need to use their best judgment around portfolio and spending issues. We spend a great deal of time with our institutional clients on investment policy considerations directly related to portfolio spending, such as asset allocation and liquidity needs.

The most commonly used spending formula applies a fixed percentage, usually codified in the organization's Investment Policy Statement, to the market value of the endowment assets. This spending rate varies by organization based on each situation, but typically it ranges between 3.5% - 5.5%. Since annual market volatility can be high, organizations often apply their spending rate to a rolling-average of the value of the portfolio, usually over the trailing three years. This helps dampen the volatility of what the spending formula suggests the organization can spend; but large market moves in either direction over longer periods of time can impart volatility into the prescribed endowment drawdown.

Of course, the key variable in this calculation is the percentage spending rate the organization uses. To achieve true sustainability, over the long-term an endowment's investment return has to be high enough to cover the payouts, but also keep up with inflation and cover all fees and expenses. Naturally, spending less permits the endowment to grow faster and reduces the possibility of having to take large principal drawdowns during periods of market duress. We think a good working sustainable spending rate is 3.5% - 4.0%, which is a conservative spending allocation of about half the portfolio income and real growth from an equity-oriented endowment portfolio.

Today, the asset allocation decision is complicated by the steep decline in interest rates since the Great Recession. Investment-grade bond yields have fallen sharply. For the last five years, yields on intermediate maturity, investment-grade bonds have remained below the yield available on stocks. Indeed, today the yield available in stocks exceeds even the yield on the 10-year US Treasury note by a significant 0.5%. Going all the way back to 1954 stocks had not yielded more than bonds until 2011. Additionally, real economic growth in the developed world and in corporate earnings has been slowing.

	Annual Growth of Earnings for Stocks	Annual "Real" Growth of Earnings	Annual Inflation
Last 30 Years	6.1%	3.5%	2.6%
Last 20 Years	4.8%	2.6%	2.2%

Many non-profit boards are working hard to make budget adjustments to reduce endowment spending in the face of this lower-return environment. For organizations with stubbornly high endowment spending rates, or who are highly dependent on their endowment, we are recommending they consider putting one or two years' worth of spending in low-risk, liquid investments to drawdown while maintaining a full allocation to high-quality, dividend paying equities yielding more than investment-grade bonds.

Seemingly small adjustments to the spending rate can have a big impact on an endowment's ability to weather market volatility. Chronic overspending can permanently impair the sustainability of an endowment's purchasing power, which becomes a greater risk when investment returns are low and market valuations are high, as they are today.

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