CLEARPOINT

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BRIAN WUNDERLE, ASSOCIATE

THE ROLE OF SPENDING RULES

BY BRIAN WUNDERLE, ASSOCIATE

Spending rules are implemented by endowments and foundations to achieve their primary investment objective: to meet current spending needs while maintaining the real or inflation-adjusted value of investment assets for future spending needs. The concept of spending rules came from both financial theory and experience with markets. The idea is that a balanced portfolio of equities, fixed income, and alternative investments should, over time, return about five percent annually above the rate of inflation. An institution, in theory, should be able to spend about five percent of its funds, and have the value of its investments increase by the rate of inflation, preserving purchasing power to meet future spending requirements. This concept historically has worked over long periods of time, despite the ups and downs and uncertainties of markets. Spending rules have been refined by lowering draws from endowments, lengthening the time used to calculate spending rules, and requiring that cultural, risk, and organizational considerations be included in the calculation, but the concept has remained the same.

No single spending rule is suitable for every institution. The approach used should be determined by an institution's mission, objectives, and specific needs. Institutions that are heavily dependent on high current endowment draws may strive to minimize volatility, as volatility could disrupt essential ongoing initiatives. Conversely, if an institution is more focused on growth, and less on income, a longer-term investment approach with a lower spending rule may be

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client and Reporting and Operations teams with Andrew Burger and Claudia Colon, respectively.

Andrew Burger has joined Clearstead as a Portfolio Manager. Prior to joining Clearstead, Andrew was a Private Banking Advisor at PNC and most recently, Associate Investment Advisor. Andrew is a graduate of The Ohio State University.

Claudia Colon has joined Clearstead as a Performance Analyst. Claudia is a recent graduate of John Carroll University where she majored in Finance. While at John Carroll University, she completed a finance internship at Howard Hanna and participated in the Meaden & Moore Leadership Series.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

implemented, as the institution can accept higher volatility of returns. The following sections describe regulatory guidelines that govern spending rules, various types of spending rules, and how an organization can determine the best spending rule to meet its needs.

UPMIFA AND IRS

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) is a law adopted by most states that provides rules regarding how much of an endowment can be spent, for what purpose, and how endowment funds should be invested. UPMIFA stipulates that institutions consider the purpose of the funds, the length of time the funds are expected to support the objective, current market conditions, capital market expectations, inflation, and other resources of the organization when defining a spending rule. As fiduciaries, trustees must understand the implications of UPMIFA.

The Internal Revenue Service (IRS) separates nonprofits (501(c)(3)) into two types—private foundations and public charities—each with different rules their spending policies must follow. Private nonprofits typically represent funds from a single or specific source, such as a family or corporation, instead of funding from the general public. Private nonprofits typically are family or corporate foundations. The IRS requires that private nonprofits spend, at minimum, five percent of the value of investments on grants or eligible administrative expenses to remain a 501(c)(3) organization. If a foundation spends less than five percent, it will be subject to a 30% excise tax on the undistributed income.[1]

Public charities—endowments or foundations supporting public nonprofits such as churches, hospitals, schools, colleges, or community foundations—usually have been built with funds from public sources and have on-going fundraising activities. Public charities have more flexibility in determining what amounts can be distributed. Under IRS rules, a charity is assumed to be a private foundation unless it can otherwise prove it is a public charity.

SPENDING RULE TYPES

A spending rule has two components: a spending rate or amount, and a rule to control the volatility of that rate or amount. Common methods to mitigate volatility in spending include moving averages, caps or floors on spending, or an adjustment for inflation. Four common spending rules include:

- Income-Only
- Prior Year Spending Plus Inflation
- Percentage of Moving Average
- Hybrid

Below is a summary of spending rules.

METHOD	DESCRIPTION	SPENDING FORMULA
Income-Only	Distribute the income produced from the portfolio	Current yield
Prior Year Spending Plus Inflation	Distribute prior year spending increased by rate of inflation	Distribution from previous year x inflation rate
Percentage of Moving Average	Distribute a percentage of the market value over a number of years	Percentage of market value x average market value of number of years
Hybrid	Many types, but some distribute a high percentage of prior year spending adjusted for inflation plus a smaller percentage based on a Percentage of Moving Average spending rule	Prior year spending x inflation plus percentage of market value average of number of years

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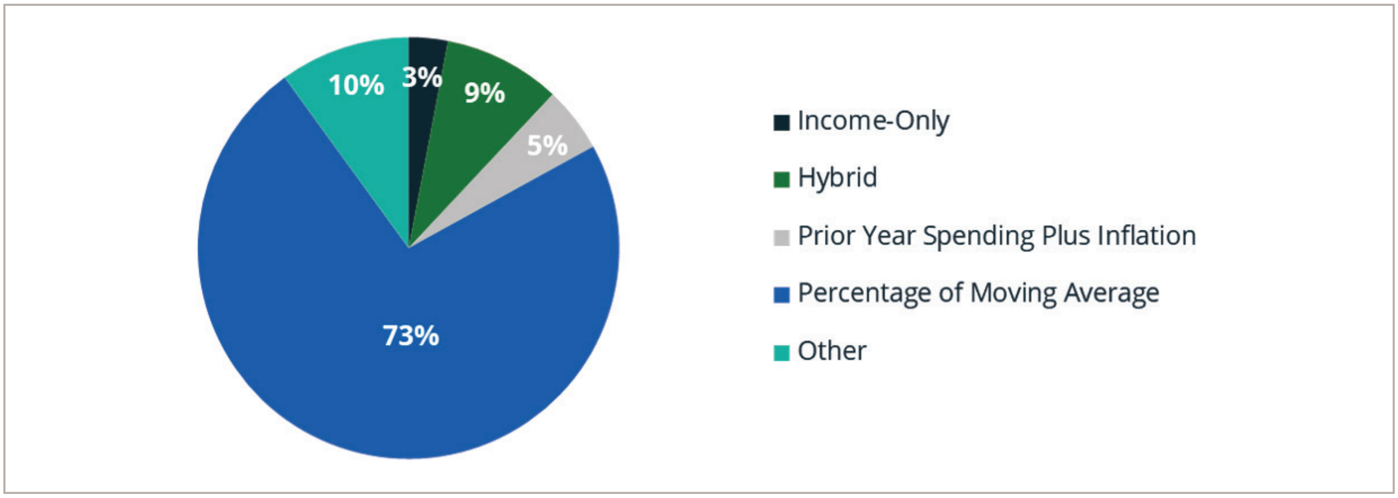
SPENDING RULE PREVALENCE

The chart below shows the spending rules used by organizations surveyed in the 2017 NACUBO-Commonfund Study of Endowments (NCSE), a survey of over 800 nonprofit colleges and universities.

Spending Rule Usage



Source: 2017 NACUBO-Commonfund Study of Endowments. Study of 809 institutions ranging from <$25 MM to >$1 billion.

Income-Only

The Income-Only method was used by three percent of organizations, even though UPMIFA encourages organizations to focus on total return—income plus realized and unrealized capital gains—in calculating annual distributions. Organizations using an income-based rule may be what UPMIFA defines as “underwater funds” or from Pennsylvania or Puerto Rico, neither of which has fully adopted UPMIFA.

Prior Year Spending Plus Inflation

Prior Year Spending Plus Inflation allows nonprofit organizations to maintain spending at current levels and adjust that spending by inflation. Institutions can set caps and floors on inflation or deflation amounts to prevent drastic changes in spending amounts. In low inflation periods, such as currently, the Prior Year Spending Plus Inflation results in smooth spending patterns for endowments. About five percent of institutions follow a Prior Year Spending Plus Inflation rule.

Percent of Moving Average

Seventy-three percent of the organizations surveyed use a Percentage of Moving Average approach. This method establishes an amount to be spent, such as five percent, and usually applies it to the average of a three- or five-year period. As noted earlier in this article, the Percentage of Moving Average approach aligns with financial theory and market experience: an endowment can expect to earn about five percent plus the rate of inflation, over time, with a balanced portfolio of equities, fixed income, and alternative investments. This method smooths market fluctuations and leads to more stable spending than the Prior Year Spending Plus Inflation approach, which does not apply a moving average. This is important for nonprofits, as spending volatility is reduced and institutions such as hospitals and schools with multi-year commitments are better funded with lower volatility approaches.

Distributions may become more stable by increasing the amount of time over which spending rules are based. For example, distributions based on a five-year moving average may have lower spending volatility than three-year moving averages. Further, because of increases in markets over the past ten years, many institutions are reducing spending percentages to less than five percent to build long-term purchasing power.

Hybrid Rules

Hybrid Rules, pioneered by universities such as Yale and Stanford, have become more prevalent in recent years. Twenty-one percent of endowments above $1 billion used some type of hybrid rule. Hybrid rules assign weightings to specific yearly distributions, which provides more spending stability. For example, eighty percent might be based on prior year spending adjusted for inflation, and twenty percent to a percentage of moving average. With Hybrid Rules, spending is less sensitive to market fluctuations than other approaches. Compared to Percentage of Moving Average, Hybrid Rules lead to lower spending in upward trending markets and higher spending in downward trending markets. Lower sensitivity to market movements leads to lower cumulative spending, making Hybrid Rules the most effective method for preserving the real value of endowments.

DETERMINING FIT

Below is a chart that shows outcomes for various spending rule approaches.

	CUMULATIVE SPENDING	ENDING MARKET VALUE	TOTAL RETURN (CUMULATIVE SPENDING PLUS ENDING MARKET VALUE)	SLOPE (MARKET VALUE RELATIVE TO SPENDING)
Income-Only	$169,936,304	$117,702,293	$287,638,597	0.052631579
Prior Year Spending Plus Inflation	$181,201,186	$110,916,478	$292,117,663	-0.004993325
Percentage of Moving Average	$170,067,910	$117,823,816	$287,891,726	0.04250879
Hybrid Rule	$160,987,553	$150,674,664	$311,662,218	0.026736203

Source: Zephyr Style Advisor

Based on annual returns of a 60% S&P 500 index and a 40% Barclay's Intermediate/Government Credit Bond Index from January 1, 1990-December 31, 2017. Assumes initial portfolio is $100 million and quarterly rebalancing.

For informational purposes only and should not be construed as an advertisement. The hypothetical results shown represent past performance. Past performance is not indicative of future results. Current performance may be lower or higher than the performance data presented and produce different results. The investment information used in this example is intended to demonstrate how the historic performance of indices described could have impacted the spending of organizations and is not suggesting that the different spending methods will produce similar results in the future. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Assumptions and Slope

The analysis in the previous chart is based on a $100 million portfolio invested in a 60/40 mix of the S&P 500 Index and the Barclay's Intermediate Government Credit Bond Index from 1990 to 2017. The analysis compares cumulative spending, ending market value, total return (cumulative spending plus ending market value), and slope (stability of market value relative to changes in spending amounts) for each of the spending rule methods.

The Income-Only approach assumes a spending amount based on portfolio yields over the time period. The Prior Year Plus Inflation is calculated using spending during the prior year adjusted for inflation. The Percentage of Moving Average is calculated based on five percent spending on three-year moving averages. The Hybrid Rule is calculated using eighty percent of prior year spending adjusted for inflation plus twenty percent of the three-year trailing average of market values times five percent.

The slope of spending illustrates the sensitivity of market value changes relative to changes in yearly spending. A lower slope means that the rate of change in market value is less sensitive to the change in spending and should indicate greater forecasting clarity as the spending amounts have less effect on the overall market value.

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Observations

An organization that emphasizes long-term growth of capital, relatively high cash flows, and predictability of spending would use the Hybrid Rule. The Hybrid Rule, as indicated on the previous page, resulted in the greatest total return—income plus capital appreciation. Its cumulative spending was marginally below the Percentage of Moving Average, due mainly to the 80% weight on prior year spending. Its ending market value was substantially higher than the other methods and its slope compares well to other methods. The Hybrid Rule increasingly has been followed by nonprofits, especially larger institutions with ample endowments that can afford marginally lower annual spending. In this example, the Hybrid Rule is the best approach to build principal and deliver a high amount of cumulative spending in a predictable manner.

Smaller organizations and smaller endowments that need to maximize cumulative distributions might implement the Prior Year Spending Plus Inflation or Percentage of Moving Average approaches. Our example shows that both resulted in higher cumulative spending than the Hybrid Rule, and enabled endowments to grow at a rate ahead of inflation. These institutions could reduce volatility further by putting caps and floors on spending, for example a five percent cap and a floor based on prior year distribution.

THE CLEARSTEAD APPROACH

Clearstead advises approximately $20 billion for its clients, including nonprofits—educational, cultural, faith-based, and health care organizations—and has done so for over thirty years. Clearstead has expertise in educating trustees and finance staff professionals on spending policy; helping them define short- and long-term goals, and select appropriate spending rules achieve their objectives. Clearstead further works with clients to build financial models that integrate organizational and financial priorities with spending rules. As co-fiduciaries of client endowments and foundations, Clearstead reviews clients' asset allocation and spending method annually to ensure they are appropriate and effective.

Sources:

(1) Internal Revenue Service (IRS), 2019, https://www.irs.gov/charities-non-profits/private-foundations/taxes-on-failure-to-distribute-income-private-foundation.

MARKET BENCHMARK RETURNS

June 30, 2019		1M	3M	12M	YTD
US Large Cap	S&P 500	7.0%	4.3%	10.4%	18.5%
US Small Cap	Russell 2000	7.1%	2.1%	-3.3%	17.0%
Developed Intl	MSCI EAFE	5.9%	3.7%	1.1%	14.0%
Emerging Intl	MSCI Em Mkt	6.2%	0.6%	1.2%	10.6%
Real Estate	NAREIT	0.9%	1.1%	11.5%	18.0%
Core Fixed	BarCap Agg	1.3%	3.1%	7.9%	6.1%
Short Fixed	BarCap 1-3Yr	0.6%	1.5%	4.3%	2.7%
Long Fixed	BarCap LT G/C	2.8%	6.6%	13.8%	13.5%
Corp Debt	BarCap Corp	2.3%	4.3%	10.3%	9.4%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.