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The Steward

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An Overview of Spending Policy

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With lower return expectations, many nonprofits question their current spending rates. A related question may also be whether the current spending policy methodology is appropriate in volatile markets.

Most foundations/endowments choose to spend a percentage of assets. However, there are other approaches. One possibility is to designate a fixed dollar amount. When returns are high, this method will build principal; however you may eat into principal when returns are low. Alternately, withdrawals may be based on a percentage of return, for example, "75% of last year's gain." This method ensures that you will not invade principal, but will result in years in which there is no spending. This method is unacceptable for most funds.

As stated, the most common method is a fixed percentage of assets, for example, "5% of three-year average year end balances." The three-year average provides a smoothing effect. Of course, you must set spending policy below the expected return on your assets.

The bear market of 2000-2002 revealed flaws in each of these approaches. Spending a fixed percentage of assets when fund balances declined resulted in fewer dollars to meet rising costs. The smoothing techniques resulted in overstated *average* balances even though the *actual* fund balances had decreased. For example, if your year end balances were $100 million, $90 million and $80 million for each of the past three years the average balance is $90 million. 5% of that number equals $4.5 million – 5.6% of the actual balance. During periods of high returns like the 1990s, these policies result in higher spending. Unfortunately, once you increase spending it is difficult to lower it again. People rapidly come to depend on those funds.

Many institutions are exploring alternative spending policies. One such method is to choose a nominal dollar amount of spending and then adjust it upward by the inflation rate. For example, an initial dollar amount equal to 4% of current asset value is adjusted annually for inflation. The underlying principle is to tie spending to cost increases rather than investment returns. A spending band, such as 3% to 6%, ensures a minimum and maximum annual expenditure. Research suggests that this approach helps smooth spending amounts, and increases the likelihood of principal growth over time. Some organizations take the inflation-based method a step further by using a more relevant price index than the consumer price index (CPI). For example, colleges might use the higher education price index (HEPI).

A very simple approach is to use the current nominal level of spending as a fixed target. The finance or investment committee can then readjust the target every few years based on the circumstances. If fund returns are generally positive, this simplistic spending approach should allow the pool to grow, although, in real terms, spending will actually decline.

Another approach, devised more than twenty years ago by members of the economics department of Yale, seeks to combine two methods. The “Yale Rule” considers both investment gains (or losses) and the impact of inflation.

The Yale formula consists of:

- 70% of the allowable spending from the prior fiscal year, increased by the rate of inflation (CPI).
- 30% of the long term spending rate of 4.5% (1.35%) applied to the four quarter market average of the endowment.

Because the formula has a 70% weighting on current spending, increased by inflation, volatility is reduced significantly and usually results in spending increases. With a 30% weight to the current market value, the impact of good investment performance and new gifts are also factored into the spending. Also, spending becomes less dependent on prior year’s market values – 30% on the current year and progressively less on previous years’ values.

Please contact us if you would like to model the impact of these various approaches.