DiMeo Schneider & Associates, Nonprofit Investment Stewards Podcast
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Your Guide to Endowment Spending Policy — With Devon Francis

[00:00:00] Welcome to Nonprofit Investments Stewards with Bob DiMeo and Devon Francis from DiMeo Schneider and Associates. Bob and Devon are passionate about helping Nonprofit Organizations prosper, whether you oversee endowment foundation or retirement plan investments, this podcast exists to help stewards, improve performance, reduce costs and discover strategies that enable your charitable organization to prosper and advance its mission.

Now onto the show. Hello and welcome back to the Non-profit Investment Stewards Podcast. I'm Bob DiMeo as always joined by co-host Devon Francis. But today we have a little twist for our listeners. My wonderfully talented colleague won't actually be the co-host. She is the guest on this episode.

Our topic is one that many endowment committee members and nonprofit leaders are grappling with and that is a spending policy. Devon has extensive experience with the ins and outs of [00:01:00] spending policies. But before we jump to specifics, Devin, how are you today? And I must ask. What does it feel like to be on the other side of the proverbial mic?

I'm not going to lie, Bob. I'm a little bit nervous. It's a bit daunting, but you know, I'm feeling pretty good. And, uh, usually we just get to sit back and ask the guests tough questions and we don't do any hard work. So today I'm on the hot seat, but I think I'm ready. I think you are ready as well.

And that's great. It's just wonderful to have you with all of your experience. And maybe we can begin by me asking you to just share with the listeners a bit about the types of nonprofit clients that we manage money for, especially any that might be wrestling with spending policies these days. Sure. You know, we really, our nonprofit client base runs the gamut.

So we're dealing with arts institutions, social service organizations, grant making institutions, hospitals, universities, secondary schools, religious [00:02:00] organizations, really every type of nonprofit organization you can think of. Uh, we probably serve as one, you know, I think, uh, in terms of wrestling with spending policy.

The current climate and the era of COVID, uh, these organizations are in all sorts of different places. So some organizations were relieved a lot, received a lot of help, um, from the government from PPP Funding and other types of government support. Um, so in some cases where, you know, they may have started the year thinking that it was going to be a really challenging year.

In some cases, they've been able to get the support from the government. I have one institution that, uh, was spending a very high percentage of their endowment. They had a monthly draw. They were frequently, um, Asking for, you know, disbursements above and beyond that draw because cashflow was such a problem.

And they actually haven't drawn from the endowment over the course of the last eight months because [00:03:00] they got so much governmental support. So you have that experience on the one hand. And then on the other hand, you have institutions that are really struggling in the face of COVID that haven't gotten as, as much support as they need, or, you know, perhaps the, the financial burden of the current environment is so.

Substantial that it, it can't, uh, you know, can't be counteracted by governmental support. So, you know, the COVID era is one factor and it's a big factor. Um, but longer term when we've been dealing with institutions and talking about their spending policies and thinking about spending practices. A lot of times we've seen really a societal shift that's reflective of this kind of new normal, where everyone's walking around with an entertainment device in their hand, which is their phone.

Uh, you know, you've got Netflix streaming and, um, so a lot of arts institutions like museums, theaters, [00:04:00] symphonies, I've been really struggling and trying to adapt to this new, um, you know, focus that, uh, that people have, and perhaps a lack of attention, perhaps, uh, a lack of interest in cultural institutions and that sort of thing.

So for some of those clients, we've seen more of a reliance on the spending draw from the endowment, um, and you know, really. These institutions are in some cases, more reliant than they'd like to be. Um, and it, you know, they just keep the doors open. Might. Make them have kind of an unsustainable spending drop.

So that's, that's a challenge. Another thing that we've seen in terms of trends is, um, a lot of our religious organizations, churches really across the country are seeing diminished membership, no matter what, uh, you know, Catholic Baptist, whatever the case may be, churches are struggling for membership and that's how they do their fundraising.

So therefore they have less revenue. [00:05:00] Um, the, the reliance on the spending draws more. For substantial. So we've seen a lot of challenges on the spending front, across our client base. And many of these are pandemic or sort of special circumstance related comments, a little bit on why nonprofits CFOs or investment committees.

Other nonprofit stakeholders in general should be thinking about spending policy. Well, you know, Bob you've talked in the past about the three levers and that's one of the cornerstones of the work that we do on behalf of our nonprofit institutions. So that the three levers exercise is that an analysis of the inflows up to the organization, the outflows, and then the required return that is necessary to.

Help the institution kind of preserve the corpus. Um, so obviously spending policy represents the outflows. So it's really one of the three primary factors [00:06:00] that we're looking at. And it's one that institutions to a certain degree have some sort of control over. Um, you know, of course the environment may have an effect and an impact.

Um, but essentially the institution can set the spending policy. Generally speaking, our purpose at DiMeo Schneider is to help our clients achieve their overarching goals. And the primary goals of an endowment or a foundation asset pool are to exist in perpetuity and to create intergenerational equity.

So intergenerational equity is the concept of you don't spend too much now and rob future generations of the benefit of this asset pool, but you also don't spend too little now and Rob the current generation. So it's about balance. Obviously, if you have too high of a spending rate that will eat away at the corpus and will destroy the potential of [00:07:00] reaching that goal of existing and perpetuity, um, As you know, I have two daughters and you know, when I think about spending policy, I think about their practices, uh, and they, neither one of them is going to achieve it.

So be careful. Yeah, that's right. Well, it's a good lesson. Good. Okay. The way that they behave, neither one of them has any prayer of achieving intergenerational equity. So I have, on the one hand, uh, my penny pinchers, my younger daughter, every dollar she gets, she squirrels it away. She's never spent a dime.

So, you know, she. She will have plenty in the future, but she's not getting the benefit of those assets now. And then my other daughter, Oh boy. She is a spender. Um, and you know, I think back to the first time that she got some, some money for Christmas, you know, it probably was 50 bucks, which to, uh, at the time she was probably nine or 10 years old.

Um, that's an enormous amount of money, right. And then she started [00:08:00] earning an allowance. So she would get $5 a week to do her chores. And so, you know, she was building up a little bit of a nest egg, but then she started realizing, Oh, I have the ability to spend this money. So she asked me to take her out shopping.

And every time we went shopping, she'd spend $15, $20, you know, certainly more than the $5 she was taking in each week. And, you know, I keep warning her. Fiona, if you spend all this money, you're not going to have any left. And her response would always be, Oh, well, my birthday is coming up or Christmas is in a few months.

Or, you know, she had the ability to replenish that pot. Even if she had to go dry for a couple of months, she knew that there were inflows coming. But nonprofit organizations don't have that luxury of knowing that there are reliable inflows. So if they spend too much from the endowment and the markets don't keep pace, the future of the endowment is at stake.

So that's really why it's vitally [00:09:00] important for these institutions to be focused on spending policy. And I'm sure we'll chat about it later, but sometimes you can have sort of the perfect storm, right. With the inflows declining as the markets are declining. And we'll unpack that a little bit more later, but perhaps you can share a bit about spending policies.

There are various types. What are the most common that we see? And just a bit about the differences amongst the various spending policy approaches. So by far, the most popular approach is the percentage of a moving average policy. Um, probably three quarters of nonprofit institutions use that as the base of their spending policy.

And that's of course, where you just take a moving average of the endowment value and you have a certain percentage for four and a half, 5%, and you draw based on that calculation. Less commonly used, but still, you know, fairly rudimentary, um, [00:10:00] and, and, and widely known about, um, our, the inflation based policy where you take last year's spending amount in dollar terms and just increase it by the inflation rate.

And that's what you spend in the next year. Um, usually the inflation based approach has, uh, upper and lower bands. Because let's say you have, um, a period of time where you have high inflation and, uh, very weak markets. So you might have a negative market return, which will result in the endowment being a lower asset base.

But if you have high inflation, then that type of inflation based spending policy will require you to be spending more than what you said. Spent last year. So you're spending more in dollar terms. The, uh, the value of the endowment is lower. So usually there are upper and lower bands, a cap and a floor, let's say, uh, you know, you must spend a minimum of 3% of the endowment value or a maximum of [00:11:00] 6%.

So that's the inflation based approach. To check in. Pardon me too, to check in on those two, the first one, the percentage of a moving average. A hundred million dollar portfolio as an illustration, 5% spending policy for a round number, probably a high number today, but 5% spending policy they're spending $5 million.

And if the portfolio next year, because of outflows or market performance or what have you. Is that 105 million or 95 million, they would spend 5% of that new number, or maybe it's an average over three years. Something like that. The inflation based on the other hand is the institution or organization is sort of spending what they spend.

And then depending on what inflation does, uh, in this case, let's say they spent 5 million last year. If inflation is up very, very modestly, then the spending. And the following year would be up very modestly as well. Correct? Correct. You've got it exactly right. Yep. And then there's the hybrid [00:12:00] approach, which is a combination of the two.

Um, sometimes that's called either the Yale or the Stanford rule because both of those universities use the hybrid approach. So that's where a portion of the calculation will come from an inflation based. Calculation. Um, usually that's 60 to 80% of the calculation comes from the inflation based model.

And then the remainder comes from a percentage of the moving average. So it is more closely tied to the endowment value than the straight inflation based approach. Um, but. It's not quite as volatile as the percentage of a moving average rule. And then there are a few other types of, um, spending policies that not very many institutions use.

One is to spend all of the current income from the portfolio. That's a pretty old fashioned approach. Um, we don't typically see that these days. And then of course, there's the, what I call this. CD or pants approach the institution to just decide each year. [00:13:00] Okay. What are we going to take from the endowment?

Um, that is more common than we would like, but, you know, certainly, um, not have a formal policy that we see very often. And we've certainly taken over client relationships where seat of the pants was the, uh, sort of default spending policy. The real problem we've seen there is that it's so easy to have the human element.

Takeover. Right. And extrapolate if markets are doing poorly or markets are doing well, or the organization is doing poorly or doing well to extrapolate. And the lack of discipline is a real issue as you've pointed out to many clients over the years. So yeah, you're absolutely right. And you know, another thing is plenty of institutions have a formally stated spending policy and they just don't pay attention to it.

So they might have a PR you know, 4% of a moving average. But nine times out of 10, they spend more than that because that's what the budget requires [00:14:00] or because it's hard times or whatever the case may be. Um, so there is no use in having a spending policy, if you're not going to adhere to it so true. And it gets back to discipline and intentionality and, and that sort of thing.

So you've talked about various spending policy methodologies, talk a little bit about the benefits or maybe even the drawbacks of the various policies. And what should investment committee members and nonprofit leaders in general consider when deciding which type of policy or methodology to approach to adopt.

Yeah. So, as I mentioned, the moving average rule is by far, the most commonly used, that is the policy that is most closely tied to the market value of the endowment. And because we know that markets are volatile, it tends to be the most volatile in terms of the spending allowance. So the dollar amount that you are able to spend, if you use that moving average rule, um, it will fluctuate from year to year.

[00:15:00] You can make it a bit more smooth, um, by using more data points. So what do I mean by that? Well, if you are using a percentage of a moving average rule, you can say, okay, we're going to take an average of the last three years of the market value. When you're doing that, three-year calculation. You can do it at a, at the year end.

So you'd be looking at three data points or you could do it over the course of 12 quarters. It's the same timeframe, but the 12 quarter data points will lead to a smoother spending stream. And you could do five years or 20 quarters. So typically the more data points we see, the more, or the less volatile that spending allowance will be.

One of the things that I think is important to realize about the moving average rule is that in times of stress and you already alluded to this Bob, um, in times of stress, when the markets are negative [00:16:00] and that spending calculation would, uh, Result in a lower spending allowance. Um, so a dollar amount that is lower than it was perhaps the year before that tends to be the same type of time period, where it's going to be difficult to fundraise.

Because typically when you have weak markets, you also have a weak economy. Your donors may not be as generous. Um, As they, you know, are in, in good times. So it's, it's a tough situation that a lot of institutions find themselves in when at the very same time that they're spending policy, um, would tell them to spend less, that they're also not able to fundraise successfully.

So that's one of the things that I think folks need to be aware of when they are deciding which policy they want to use. Um, in terms of predictability. The inflation based model is by far the most predictable, because you're just [00:17:00] looking at that last year spending dollar amount and projecting that plus the inflation rate.

So it's pretty easy to forecast, but it's highly reliant on the starting point. So let's say an institution right now wants to move away from a moving average rule and move towards an inflation based rule. We are coming off a period of very strong market returns, where the spending allowance is probably the highest it's ever been for an institution.

And so they are using that as the starting point and then building on it from there. So like you said, if this year's spending was 5 million, next years would be 5 million plus inflation and it would keep on going up, up, up, of course, usually with those upper and lower bands, but generally you would see an increase in the dollar amount that's allowed each year.

And. You know, I just think that institutions [00:18:00] need to be aware if they're starting from a perspective of very high spending that, you know, over time that may not be sustainable. Um, It's funny. One time we were talking about a spending policy with one of our clients and they were trying to decide which calculation would be, or which type of policy would be best for them.

And the finance director said, well, which one is going to allow us to spend the most, this year? Uh, you're kinda missing the point. That's, that's exactly how you should not go about making the decision of what's the right policy. It's such a great point though, right? Because you have sort of competing stakeholders and, if you get in a room and you work through this and you have intentionality around it, you can actually produce, I guess you can select.

Uh, the appropriate methodology, unique to your organization, and then produce a really good outcome. But if it's just folks sort of independently coming [00:19:00] at this, it could be a mess. Yeah, absolutely. And you know, I think it's important to know your institution. So if you have, uh, one of the big factors when it comes to deciding what the right spending policy is, is how reliant are you on the endowment draw.

If a really significant portion of your operating budget comes from the endowment draw, you're probably going to want a policy that is not very volatile. So that you don't, you know, you, you want budgetary stability from year to year, so that's something important. And that's something that we talk about with our clients.

We have one institution that I'm thinking of where 80% of their annual budget is. Comes from the endowment draw 80%. That's huge. I think the average, according to surveys, is about 7%. So 80% is a really big number. And if that institution is using a moving average rule, well, that's [00:20:00] going to be very volatile and you might have to have severe budget cuts from, from year to year.

So I think that's something to keep in mind. Um, And what kind of organization is that? What sort of institution? Um, it's a kind of a museum type institution versus maybe a school, a university that might be 5% of budget comes from the endowment spender. Exactly. Yup. Yup. Uh, and one of the things that I think is important, you know, you mentioned, um, a lot of voices in the room and, and conflicting, um, Goals and objectives and desires.

Um, I think the importance of consistency is, is. We cannot be understated. Um, so it's really interesting when you compare these different spending approaches over a very long period of time, they typically result in a very similar ending endowment value [00:21:00] and very similar spending, cumulative spending over time.

So what I mean by that is if we compare an endowment over a 30 year period. And we look at, uh, the endowment using a percentage of a moving average rule using the inflation based rule with bands, using the hybrid approach with a combination, the ending value after that 30 year period, regardless of the policy that's used is very, very close in many cases, within a few thousand dollars of each other.

Um, and the cumulative spending that has. Ben allowed, but you know, based on the policy over that 30 year timeframe is also remarkably similar. So it's really staggering to see those numbers, but that's over a very long-term period. If you have an organization that. [00:22:00] Changes its spending policy based on the environment.

Hey, we've had great market returns. Let's switch to a moving average based rule. Oh, okay. Now we, uh, we don't have such good market returns. Let's go to the inflation based rules so that we can take last year spending plus inflation. If you have an institution that is, that keeps on changing horses, midstream, they're not going to reap benefits of, um, you know, kind of building up the coffers and bad times or, or vice versa reigning in spending in the good times.

Um, and those practices of switching the spending policy will ultimately eat away at the corpus. And again, eliminate the possibility of achieving that goal of perpetuity. So you're doling out some pearls now, Devin, and this is super helpful. You've prompted a thought about a client of ours many years ago, a religious institution, and one of their investment committee members, sister Rita.

I remember she was a professor on the West coast at a [00:23:00] West coast university, but she actually developed a model on not so much as you're saying. The approach selected or methodology is at one method versus another, but the amount and, and she actually developed a software program, it was kind of neat where if you spend less today sort of the message we're giving to your daughter, if you spend less today, You can actually spend more tomorrow.

And it's interesting just the way the math works. Oftentimes it might be 17 to 19 years off and I'm just for round numbers. I'm saying if an institution is spending at 4%, instead of 5% over the long, long haul, they actually have the ability to spend a lot more. Which leads to a question on, if it's not so much over the long term, did we use method a or method B uh, in terms of our spending methodology, what about the spending approach here?

We've got investment returns, [00:24:00] potentially very likely muted over the coming years. And then we have many organizations as you've pointed out charitable organizations where spending is up. So what are the trends in terms of spending policy and the actual digit or amount being spent from the portfolio?

Yeah, the trend is definitely moving lower. And we've seen that over the course of the last 10 years or so, where it used to be very common. Um, kind of the default rate was 5%. Now the average rate is closer to four and a half percent, but, uh, you know, that includes the outliers on the high side as well.

So we've seen a lot of institutions. Move away from a 5% spend to a four and a half or a 4%. In some cases I work with a client that has a three and a half percent spending policy. Um, so we've definitely seen the trend move lower, and I think you're exactly right. And it [00:25:00] marries with the conversation that we had with Matt rice.

Um, when we interviewed him about our new capital market assumptions, um, And for folks who might be listening, if you want to go back and listen to that episode, it was released on January 13th. Um, and Matt explained about how our forward-looking return expectations are muted compared to what they were last year, the year before, or the year before that.

Um, you know, we've got a very low interest rate environment on the fixed income side. So you have 20 to. 30, maybe even 40% of, of portfolio invested in fixed income. That's really not likely to generate much of a return at all. And then equity returns, um, or equity return expectations are muted as well because valuations are so high and we're coming off a period of such strong market.

Growth and activity, um, that the likelihood of that robust growth [00:26:00] continuing is somewhat diminished. So, you know, I think that institutions are being more realistic and more reasonable in looking forward. And, um, taking a look at those expected returns that their portfolio is likely to generate and saying, okay, well, our spending needs to be below that.

Um, so that's, that's the trend that we've seen. Excellent. Anything else you want to offer on that concept of marrying the spending policy to the construction of the actual portfolio? When we're advising clients and endowment and foundation committee members. Yeah, it goes back to that three levers exercise.

So we take a look at inflows. We take a look at outflows, which are the spending, uh, practices, and that gives you the required return. And so it's that required return that we use as kind of the linchpin for building our portfolios. So we can [00:27:00] have the best manager research group in the world. If we don't have the right asset allocation.

It doesn't matter if we choose the right managers. Um, so really asset allocation is the primary driver of investment returns. So we need to make sure that the underlying profile of the portfolio in terms of asset class construction is going to get an institution. That return that it needs in order to help preserve the Corpus.

Um, you know, typically it, it's, it's pretty simple math, the higher a spending rate, the more aggressive a portfolio needs to be. It needs to have less in conservative assets, like traditional fixed income and it needs to have more in growth seeking assets. Um, I think one of the most important things that we do for our clients is.

So to, to really inform our clients about what [00:28:00] they can and should expect from their portfolio. One of the ways that we do that is through our fiduciary governance calendar. Um, and each year, in fact, we'll be talking about this with clients this quarter. Um, we. When we have those revised capital market assumptions, we do asset allocation modeling.

So we take a look at their target portfolio and see what the expected return is, uh, that is going is likely to be generated from the portfolio. And that may result in having to tweak the portfolio. Let's say you have a spending policy of 5% and the expected return for a portfolio shows that we're only.

Coming out at, you know, 5.5%. Well, when you have a 5% spend what you are really looking at, that's a 5% real return that you need to achieve. So if you tack on, let's say 2% for inflation, really you're looking at a 7% [00:29:00] nominal return that needs to be achieved. So if our asset allocation modeling. Shows that, or a portfolio should only expect a five and a half percent nominal return.

That's a one and a half percent shortfall in year over year. That's going to make a big difference. So it's our job to talk to our clients about. Okay, something's got to give here. If you need to spend that 5%, if that's, you know, not a negotiable, then you need to restructure the portfolio. So we have more in those growth seeking assets and less in those conservative assets.

Um, so I think that that. You know, putting the data together and letting our clients see the numbers and, you know, looking at a page and saying, Oh, wow, okay. My portfolio is only going to get me to X percent and I need Y percent. Uh, we need to rethink this. I think [00:30:00] that's important. Um, another thing that we do, which I think has been very beneficial is, um, What we call scenario analysis.

So in that way we can be in a number of different ways we can do cash flow modeling. So a lot of times, um, you know, a client may have a stated spending policy, but then there may be a year where they want to take a special appropriation from the endowment. We can do cash flow modeling. To show what the impact of that special appropriation might be.

And in fact, we have done that for clients in the past, and they've decided not to make that special appropriation because the, um, the long-term impact on the preservation of the Corpus is just so significant that it's not justifiable. Um, so that work has been helpful and we can also do, um, different, uh, analysis, uh, of different scenarios where we'll show a 4% spend a four and a half percent, spend a 5% [00:31:00] spend and show the long term impact of those different calculations on the endowment.

Um, and again, just, you know, putting a fine point on it, to see what the likely ending value of the endowment is. Based on those different scenarios it's going to be, that's been really helpful for our clients. So really, and I've talked about this before, about the importance of our role as educator. I think that's one of the most crucial things that we can do for our clients is to give them all the information they need in order to make a well-informed decision that that's going to result in the sustainability of not only the endowment pool, but also the organization over time.

So helpful Devin and you're actually touching on probably my favorite part of working with clients. And that is being in that boardroom or zoom call as it would be now, and really having what I'll call [00:32:00] the eyes wide open discussion. Right. And I love how you say, I said, listen, something has to give when we lay it out in clinical fashion and, and warm-hearted, but, but.

Clinical fashion. So people are armed with good information so they could make good decisions. I love when we get into that dialogue and folks start to realize, wait a minute, we either need to make this portfolio construction a lot more aggressive, or we need to reduce our spending. Or we've got to talk to the development team.

We need to bring more dollars in and it's just such a healthy approach to it. So Devin, this is awesome. So absolutely grateful for you sharing so many wonderful insights in terms of spending policy and the great work you do there. As you know, a number of our listeners probably already are aware. That you are an avid reader.

So before I let you go, I'm going to ask if you can share, if it's even possible, you read so many books. If you can share what is an all-time [00:33:00] favorite book of yours? Oh, it is too hard. So I'm going to kind of cheat. I'm going to give a trifecta. So I am a huge fan of dystopian literature, which, you know, over the course of the past year, we've kind of been in a real life dystopia.

So, you know, maybe not the best genre to be, uh, focused on. Um, but so probably the. The top three of my all time, favorite books are kind of a dystopian trifecta, 1984 by George Orwell, a brave new world by Aldous Huxley, and then Handmaid's tale by Margaret Atwood. So that combination very depressing. Yes.

Riveting. So, so perhaps. In the pandemic. Let's not, uh, let's space, our reading interval for those books, right? Yes, exactly. Wonderful. Well, Devin, just terrific to have you on the show in this capacity and for you to share so many wonderful [00:34:00] insights with our listeners. Thank you for having me. It's been a pleasure.

Outstanding. Well, listeners, please remember to subscribe and rate the show. If you haven't already go back and listen to the episode that Devin referenced, it's actually episode number nine, where our chief investment officer lays out both return and risk forecasts that were just updated. And then Devin and myself and another colleague.

We created something called the nonprofit guide to investing and it's chock full of all sorts of useful information. And Devin, no surprise wrote the section on the spending policy. So definitely feel free to check that out. We'll include it in the show notes and you can always reach out to me and Devin on LinkedIn.

So to all you good stewards. Thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for listening to the nonprofit investment stewards podcast. Click the subscribe button below to be notified of new episodes and visit DeMayo schneider.com for more information.

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