

Designing a Policy to Meet Your Long-term Mission

# Endowment Spending

During today's webinar, participants will

# Learning Objectives

**Explain** spending methodologies

**Assess** the impact of spending policy on endowments

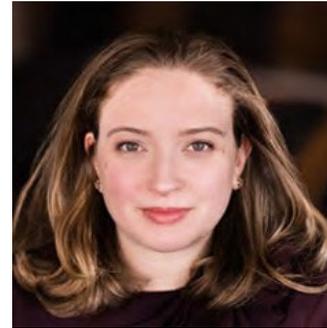
**Examine** the alignment of asset allocation and spending policy

Hirtle, Callaghan & Co.

# Presenters



**John Griffith**  
Director and  
Endowment Specialist



**Catherine Lee Clarke**  
Investment Officer



# Long-Term Partner with Independent Schools

## H I R T L E C A L L A G H A N

- Leading investment office for nonprofits and families
- National firm with offices in Texas, California, Philadelphia, Chicago, Cleveland, Denver, Pittsburgh
- 30+ years of experience – Since 1988
- Independent, employee-owned firm
- Conflict-free and client-aligned
- Over 200 client relationships
- Manage approximately \$17 billion
- 90+ professionals
- 95% client retention rate

Armanino & Ensworth School

# Presenters



**Bryan Vencill**

Partner

Armanino Advisory LLC



**Kathy Ferguson**

Senior Manager

Armanino Advisory LLC



**Whitney L. Johnson**

Director of Finance  
and Operations

Ensworth School

# Firm Overview

## ABOUT US

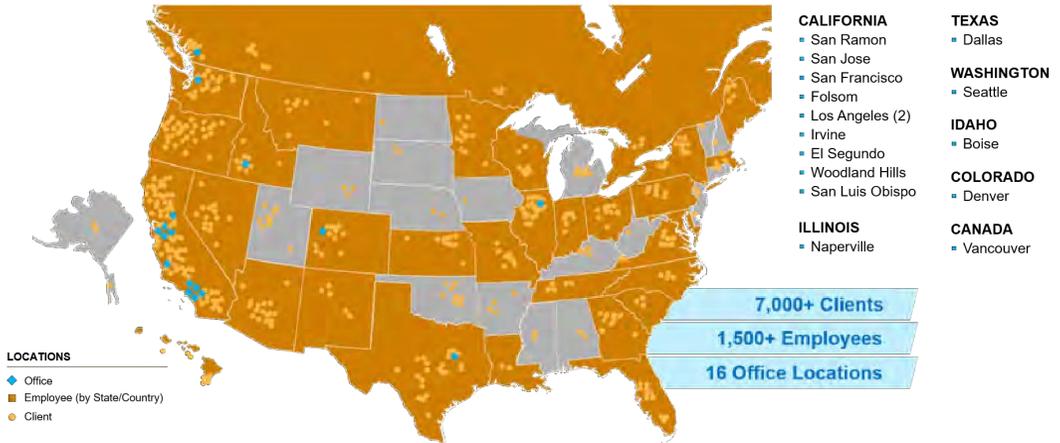
### Purpose

To be the **most innovative** and **entrepreneurial firm** that makes a **positive impact** on the lives and **our clients, people and our communities.**

### Snapshot

1500+ Employees  
Team Members in 22 States  
21st Largest CPA & Consulting  
Largest Industries:  
Technology / Nonprofits  
200+ Private Ed. Clients  
100+ Private Ed. Audits

### Locations



### AFFILIATE COMPANY



### RECOGNITION & AWARDS



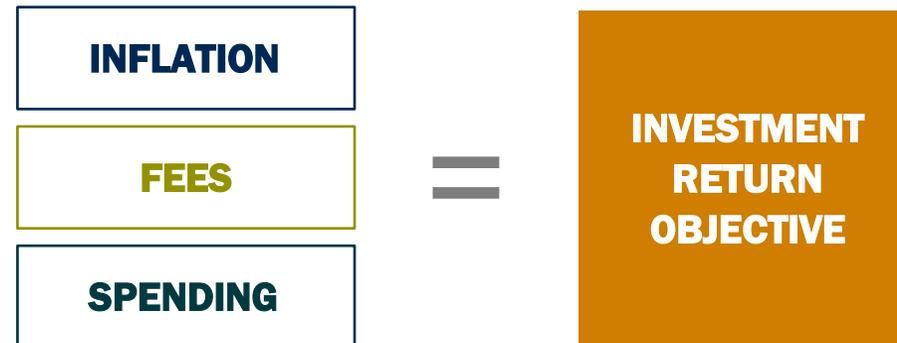
# Why Are We Talking About Spending Policy?

Spending Policy is Critical to Your School's Long-term Success

# Endowments Typically Have Three Fundamental Goals



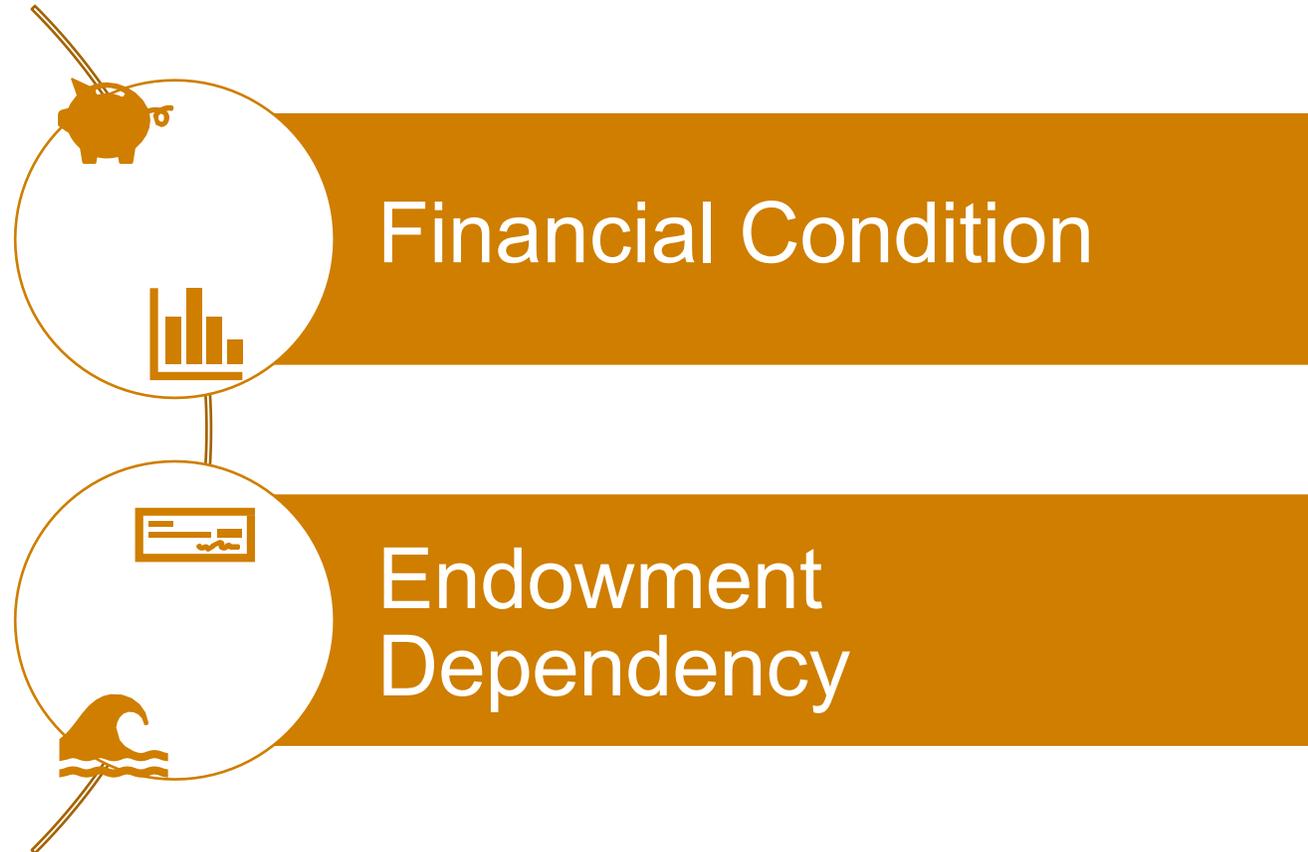
# Spending, Return Expectation and Risk are All Linked



*Aligning spending and asset allocation enables the endowment to keep pace with inflation*

# Aligning Your Spending Policy With Your Operational Model

# Spending Policy Must Account for Organization's Overall Health



## Financial Condition

# Spending Policy Considerations

### Schools in a Strong Financial Position

The stronger your financial condition, the lower your spending rate should be

Benefits of growing the endowment outweigh the upside of short-term spending

Although it may be tempting to spend more in good times, the prudent approach is to maintain a lower spending level - preserving the ability to spend more if the financial condition changes

### Schools in a Weak Financial Position

Curbing short-term spending may be more difficult

If spending less is not an option, the asset allocation should be more growth-oriented, aiming for higher returns to offset spending

Trustees must be willing to make trade-offs to ensure the long-term sustainability of their endowment and their institution

Endowment Dependency

# Spending Policy Considerations

## Low Endowment Dependency

Better position to prioritize long-term endowment growth

Should maintain the lowest spending rate that the institution can withstand

## High Endowment Dependency

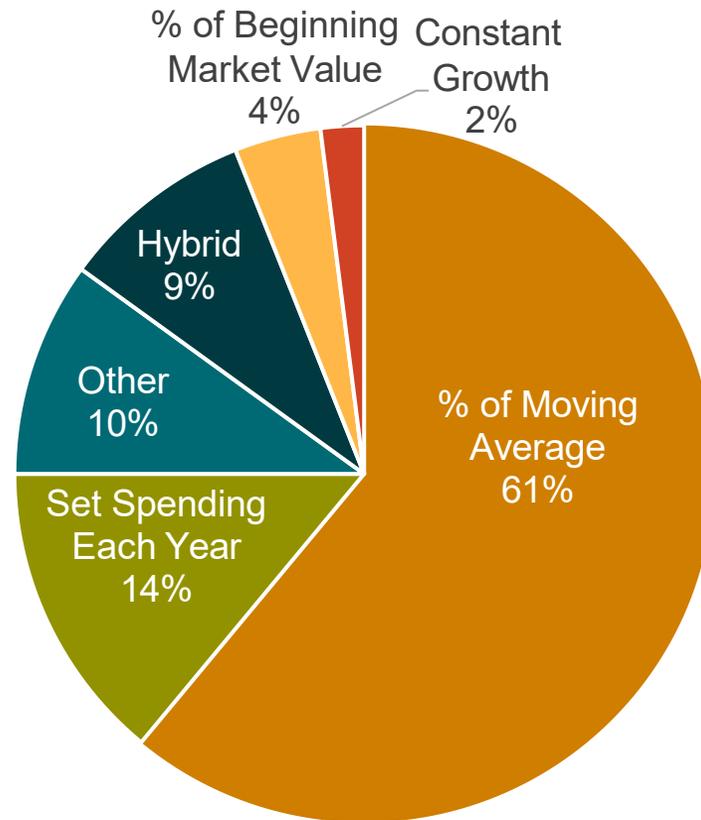
With less ability to reduce spending, focus should be on asset allocation

A conservative asset allocation is actually riskier

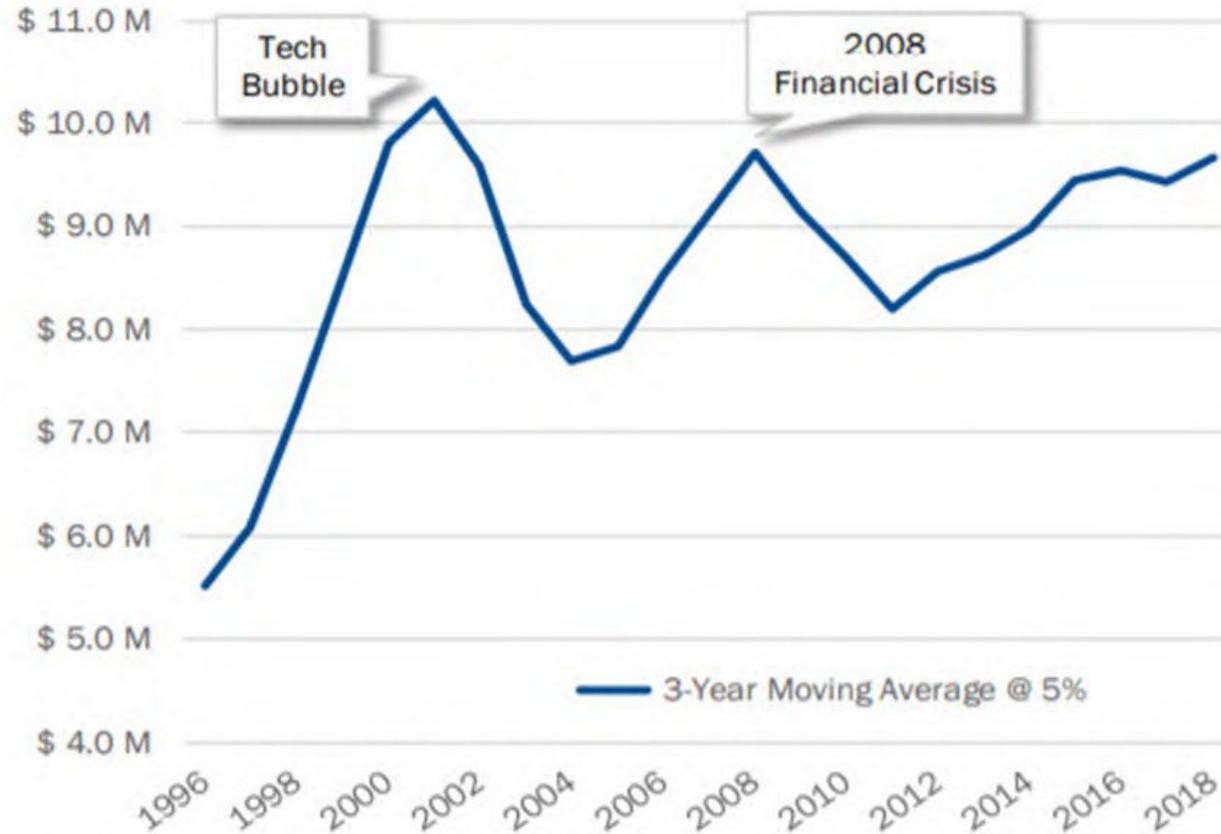
The primary concern should be failure to achieve the organization's mission if the endowment's purchasing power is eroded over time

# Does Your School Have the Right Spending Policy in Place?

# Most Schools Employ the Moving Average Spending Method



## Endowment Spending



Note: Assumes \$100 million endowment, no gifts, 70/30 asset allocation using historical returns, spending at 5%

## But the Moving Average Spending Policy Has Significant Flaws

1. Does not protect schools from market volatility which leads to excessive spending volatility.
2. Fails to provide revenue diversification. During a market crisis, net tuition, gifts and endowment spending all decline together.

What Spending Policy is Right for Your School?

Spending policy determines the annual flow of funds from the endowment to the operating budget

**MOVING  
AVERAGE**

**CONSTANT  
GROWTH**

**HYBRID**

**% OF MARKET  
VALUE**

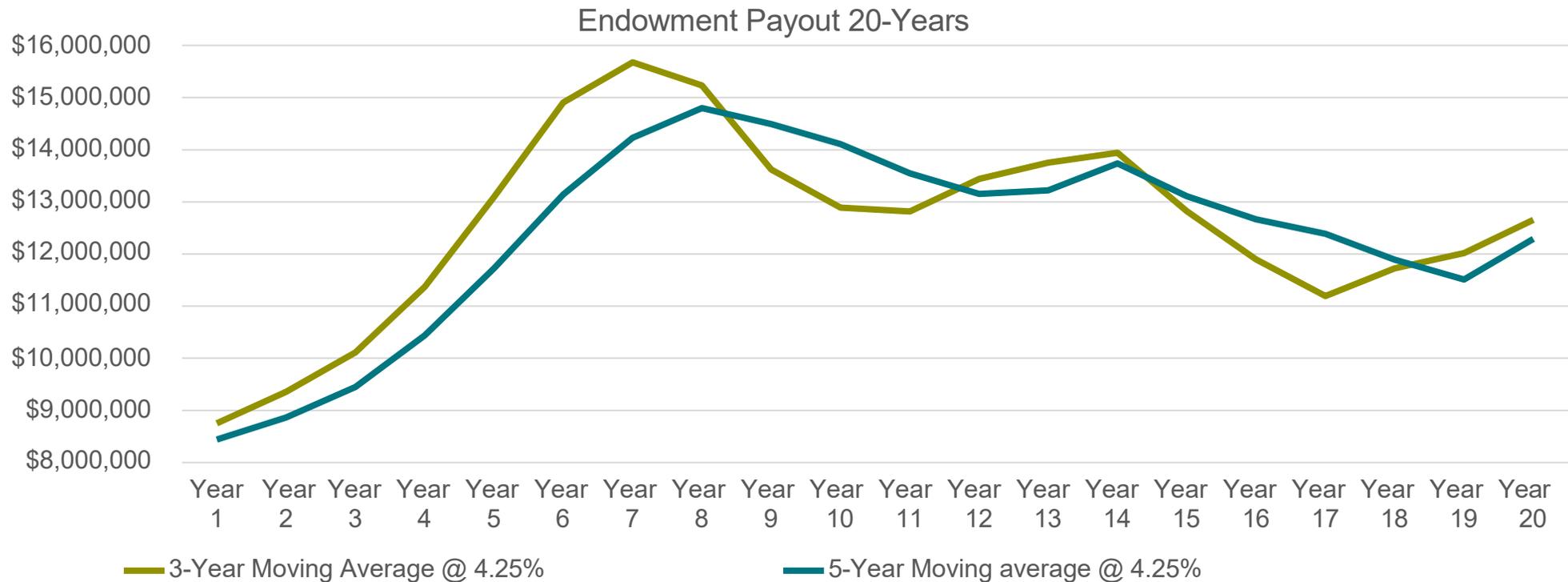
**SET POLICY  
EACH YEAR**

**OTHER**

# Different Spending Methods Explained

	3-Year Moving Average <i>(Most Popular Method)</i>	5-Year Moving Average
<b>How it Works</b>	Spending rate using a 3-year (12-quarter) moving average	Spending rate using a 5-year (20-quarter) moving average
<b>Advantages</b>	<ul style="list-style-type: none"> <li>Smooths spending to ease market highs and lows</li> <li>Simple to implement and explain</li> <li>Familiar</li> </ul>	<ul style="list-style-type: none"> <li>More closely aligns spending policy time horizon with investments</li> <li>Lowers volatility</li> </ul>
<b>Disadvantages</b>	<ul style="list-style-type: none"> <li>Spending is still highly correlated to market value fluctuations</li> </ul>	<ul style="list-style-type: none"> <li>Long tail of reduced spending</li> </ul>

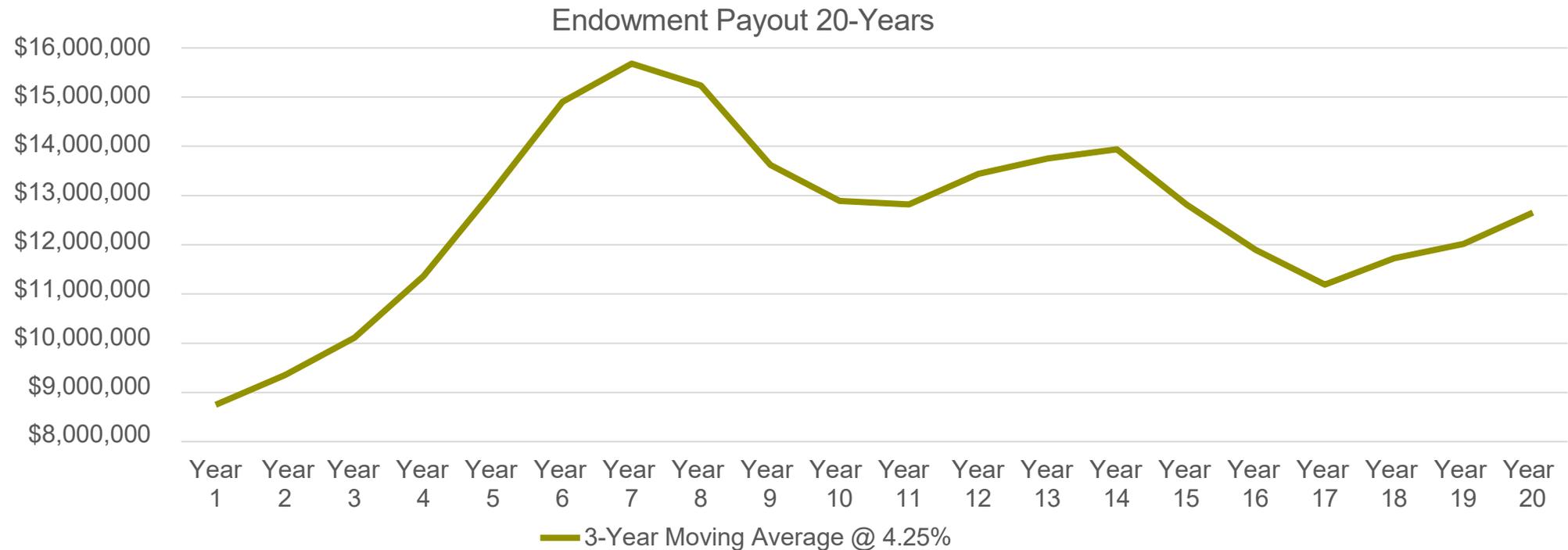
# 5-Year Moving Average Approach Modestly Reduces Spending Volatility



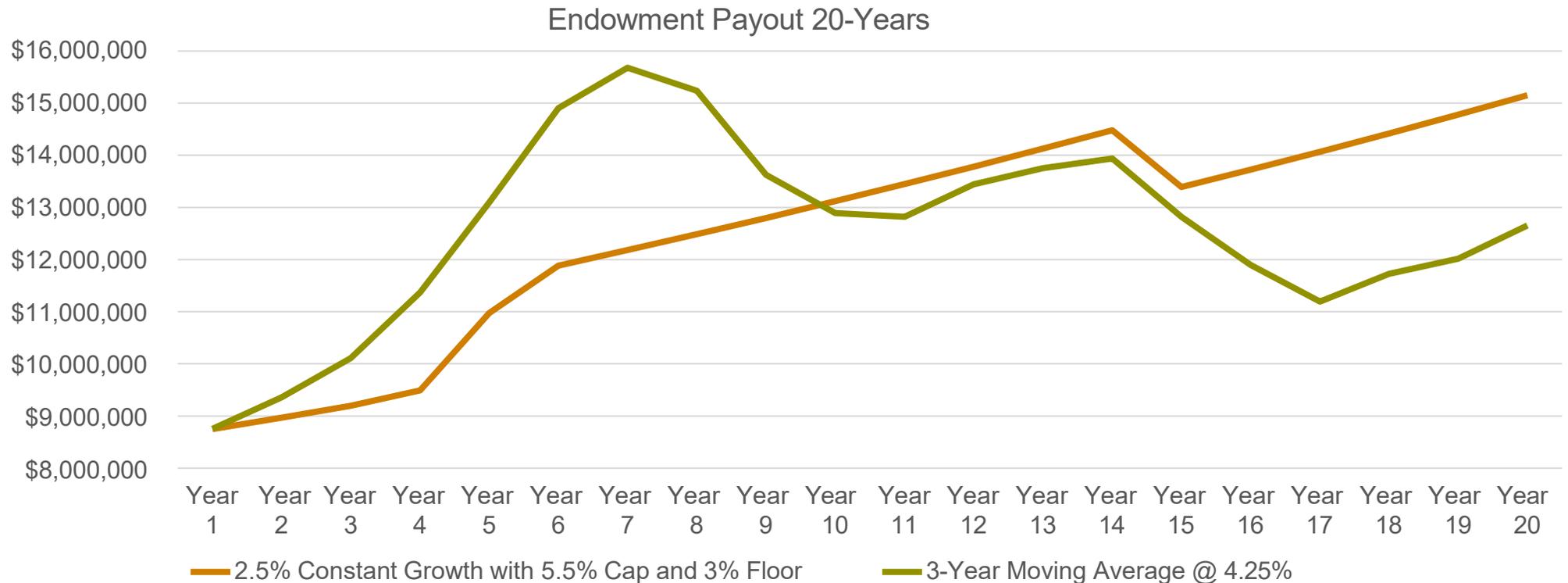
# Different Spending Methods Explained

	Constant Growth	Hybrid (Yale Model)
<b>How it Works</b>	Prior Spending x (1 + growth rate or CPI) + (Prior year gifts x spending rate)	(70-80%) Constant Growth + (20-30%) Moving Average
<b>Advantages</b>	<ul style="list-style-type: none"> <li>Smooths spending</li> <li>Spending is more predictable</li> <li>Flexibility in setting growth rate</li> <li>Fits with donor intent</li> <li>Provides protection when markets decline</li> </ul>	<ul style="list-style-type: none"> <li>Enables stable distributions and maintains purchasing power</li> <li>Spending rules can be customized to fit unique needs</li> </ul>
<b>Disadvantages</b>	<ul style="list-style-type: none"> <li>Not as responsive to changes in endowment market value</li> <li>Spending can be higher during prolonged bear markets, and moderated during strong markets</li> </ul>	<ul style="list-style-type: none"> <li>Finding and maintaining the right combination of spending rules requires judgment</li> <li>More complex than other methods</li> </ul>

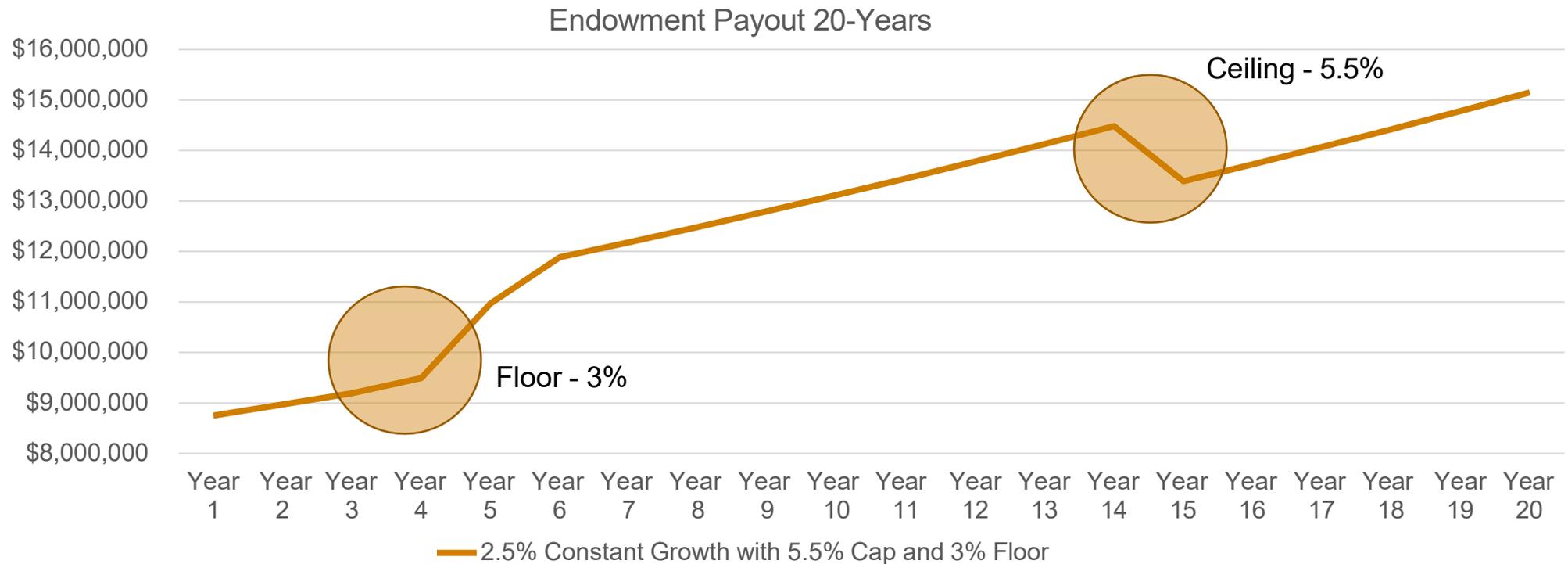
# Spending with the Moving Average Approach is Volatile



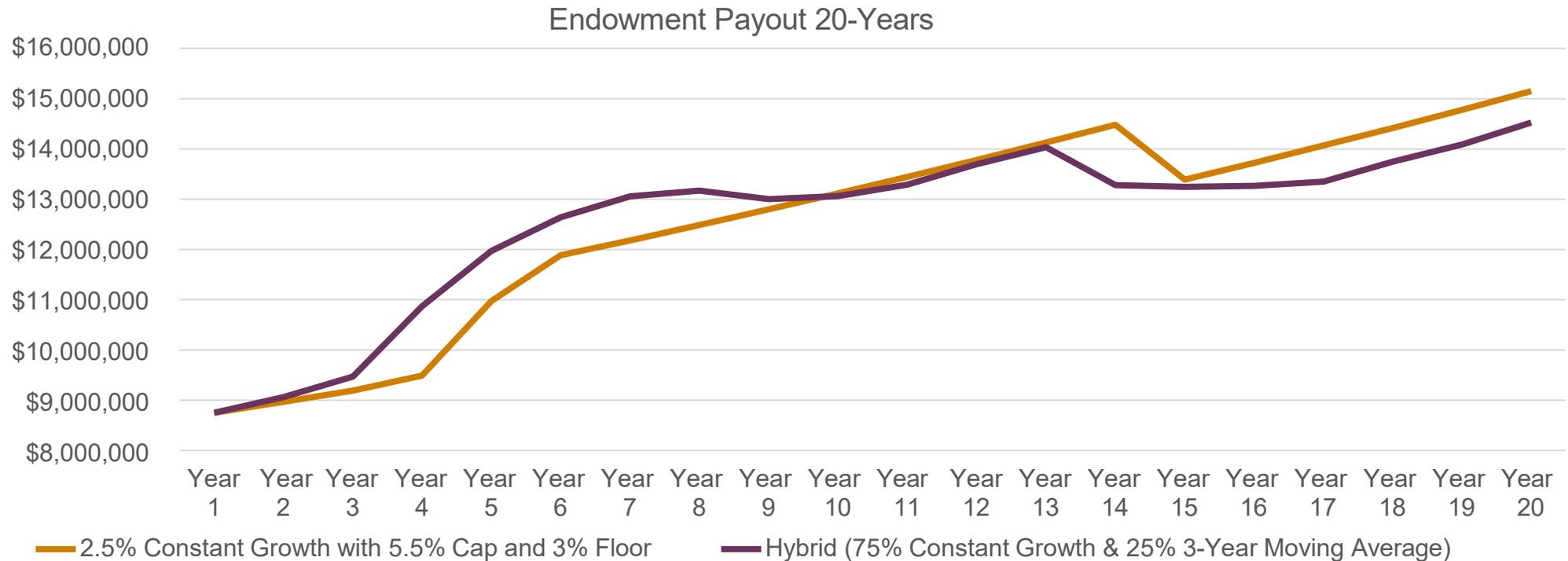
# Constant Growth Method Smooths Spending to Ease Market Highs and Lows



# Floors & Ceilings Prevent Disconnect Between Endowment Spending and Market Value



# Constant Growth and Hybrid Models Both Produce More Predictable Spending

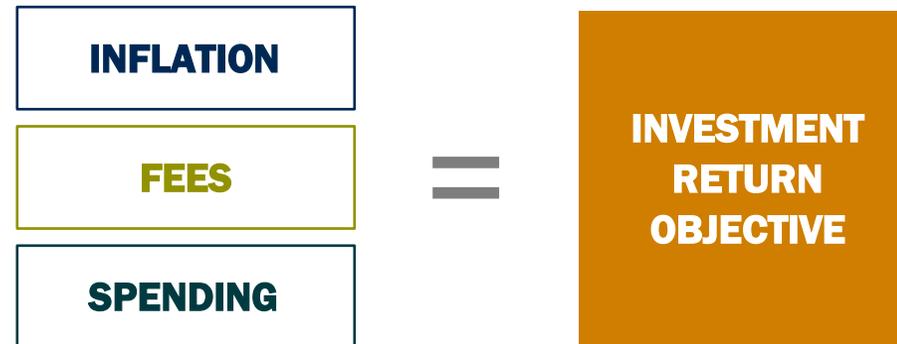


# Constant Growth is the Best Fit For Most Endowments

- Creates more control over spending
- Makes spending more predictable, facilitating budgeting and financial planning
- Separates the growth in endowment spending from market volatility
- Can add floor and ceiling to keep spending % within a corridor
- Acts as a revenue diversifier
  - Lower spending during boom times
  - Higher spending during bad times

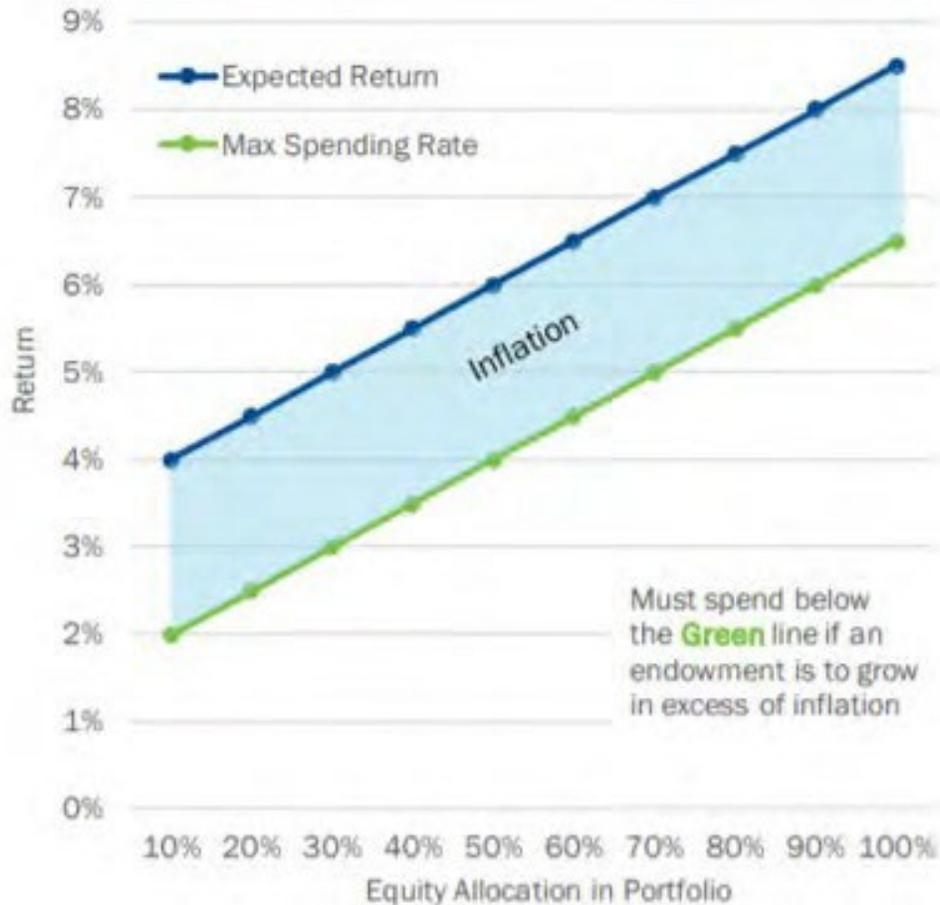
# Aligning Your Asset Allocation With Your Spending Policy

# Spending, Return Expectation and Risk are All Linked



*Aligning spending and asset allocation enables the endowment to keep pace with inflation*

### Spending Rate is Tied to the Return Expectation



# Spending Rates Impact an Endowment's Required Return

\* Equity allocation includes private equity and alternative assets

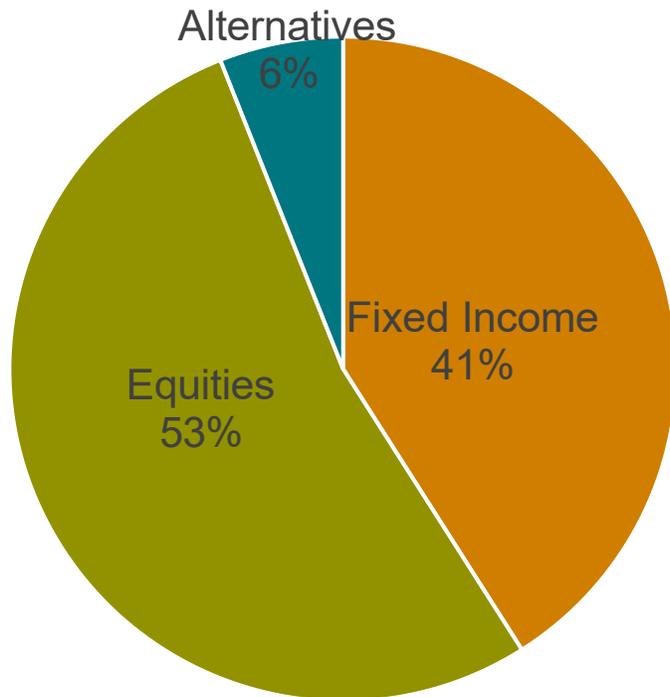
# The Endowment's Primary Goal is to Maintain Purchasing Power



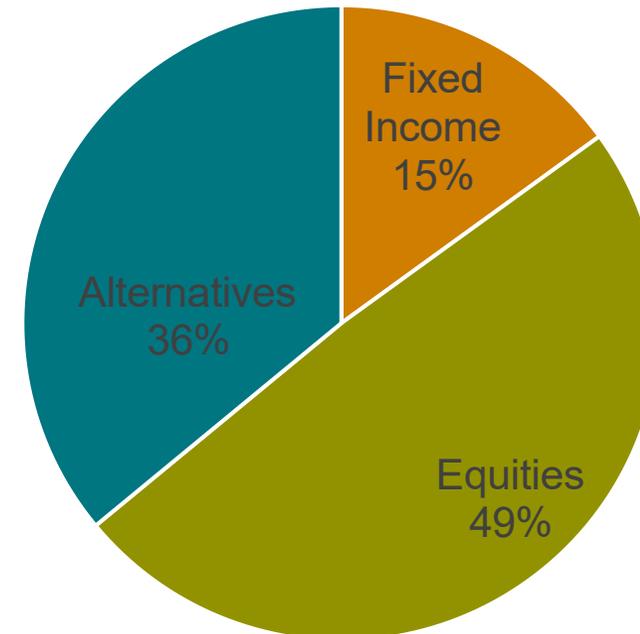
Tradeoff of current spending vs endowment growth for future generations

# Endowment Size Tends to Influence Asset Allocation

Asset Allocation  
Endowments \$5 to \$25 Million



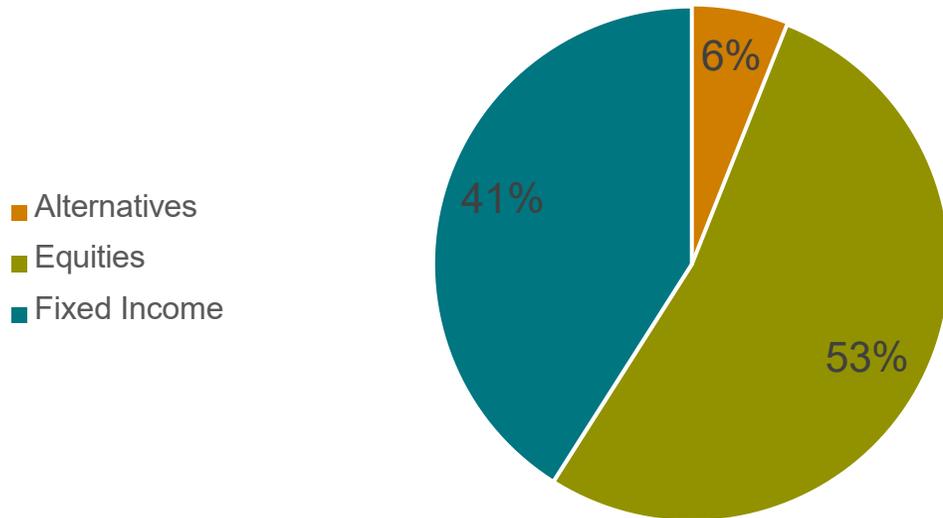
Asset Allocation  
Endowments \$25+ Million



Asset Allocation

# Keeping Pace with Inflation

Asset Allocation  
Armanino Clients with Endowments of \$5-\$25M

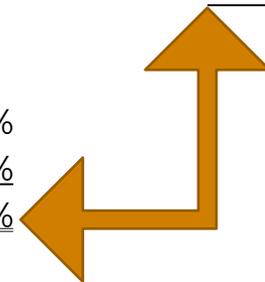


Portfolio Return

	Asset Allocation	Estimated Return	Weighted Return
Fixed Income	41%	2.5%	1.0%
Equities	53%	7.0%	3.7%
Alternatives	6%	4.0%	0.2%
Estimated Return			<u>5.0%</u>

Required Return

Spending	4.0%
Inflation	<u>2.0%</u>
total	<u><u>6.0%</u></u>

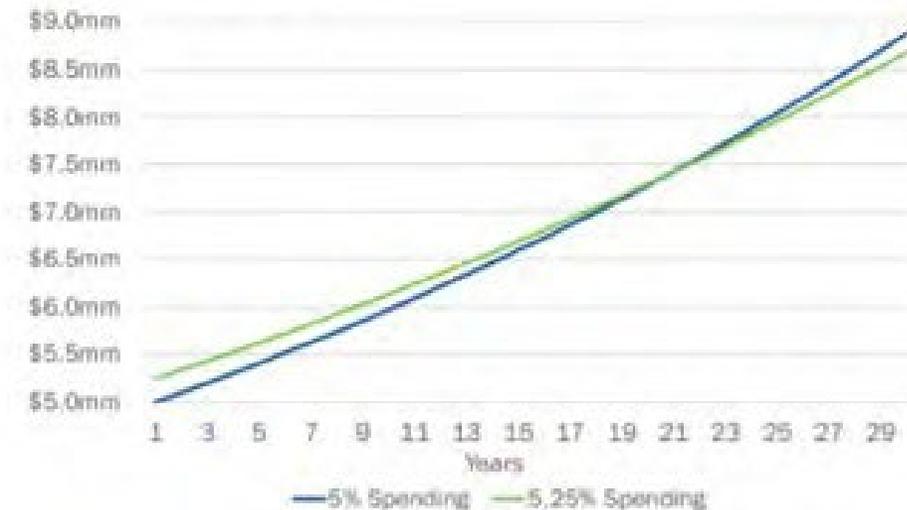


# Lower Spending Rates Can Generate Higher Spending Dollars

20 Years of a 0.25% Increase in Annual Spending



Endowment Spending



**Over 20 years the endowment spending will be higher using a 5% rate than a 5.25% rate because of compounding returns.**

# Investment Objective

1. Return objective – Two options
  - I. Preserve the purchasing power of the endowment in perpetuity
  - II. Grow the purchasing power of the endowment at a rate in excess of inflation
2. Provide a reasonably predictable and stable stream of annual cash distributions to assist in funding the School's operating budget
3. Attain such return objectives without the assumption of inappropriate risk

Thank You

# Continue The Conversation



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