GREENLEAF TRUST

Perspectives

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Topics for your Nonprofit Committee Meetings

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Volatility in the financial markets has increased, and the returns that we expect from equity and fixed income markets globally are lower than over the recent market cycles. What are the topics that should be on the meeting agenda for the Finance and Investment Committees for nonprofits?

Sustainable Spending Rates

One of the more difficult decisions facing a non-profit: What amount is required annually from the investment portfolio to support operations and does this withdrawal rate allow for the long-term growth of portfolio assets?

Private foundations have a particular challenge versus endowments held by public charities. Private foundations are required to distribute at least 5% annually or face penalties and may have fewer capital raising opportunities. Endowments for public charities have more flexibility to adjust spending rates, may have a longer, or even perpetual, time horizon and may have opportunities to raise additional endowment dollars.

> "The question we often hear is whether a non-profit should focus on income generation to support a spending rate…"

The question we often hear is whether or not a non-profit should focus on income generation to support a spending rate, rather than referencing a long-term, total return on the invested assets. Our view is that by focusing solely on income, the growth of the portfolio may be constrained and this may reduce the long-term growth of the assets and the potential, sustainable withdrawal rate from the portfolio. Set the spending rate too high and cutbacks may be required during market downturns. Set the rate too low and mission critical spending and programs may not receive all of the dollars needed.

Typical spending rate formulas include the following:

- Set a dollar amount of withdrawal and adjust this amount annually for inflation. This is a simple calculation but does not take into consideration the performance of the financial markets and the impact on the sustainability of the portfolio during a prolonged period of lower market returns.
- Set the withdrawal rate as a percent of the portfolio value and adjust the amount annually for inflation, with a maximum and minimum withdrawal rate defined, also adjusted for inflation. An annual decision is whether to use the spending amount defined by the formula or an amount defined by the maximum or minimum distribution to account for market performance.
- Set a withdrawal rate as a percent of the portfolio value over a rolling period, for example, three or five years. This smooths the withdrawals and allows for consistent withdrawals during periods when the market is rising or falling.

Our research team's capital market assumptions for the next 10 years project annual returns for US equities of 5.0%, developed international equity market returns of 6.5%, emerging market returns of 8.5%, fixed income returns of 2.5% and returns from cash equivalents of 2.1%. The annual returns from non-core fixed income and alternatives are in line with these estimates. Inflation will likely return to 2% or more per year. The typical asset allocation for a non-profit may lead to a projected annual return of 5.0%. If the investment objective for the non-profit is for the portfolio value to grow on an inflation-adjusted basis after considering the withdrawal rate and expenses, there could be a shortfall. A tool for quantifying this shortfall is a Monte Carlo analysis.

While beyond the scope of this article, an advantage to the Monte Carlo simulations is that in addition to budgeted withdrawals, projections for additional capital contributions, both amounts and timing, are included in the analysis. If withdrawals are forecast for specific projects or expenditures, or if differently budgeted annual withdrawals are considered, those amounts are also included in the analysis. The objective is to determine the ability of the investment portfolio to support a sustainable level of annual distributions.

Investment Policy Statements

Spending policies and investment strategies are connected. A portfolio withdrawal rate may define a required return for a portfolio but it also sets the time horizon for the portfolio. For example, if a non-profit expects to have higher withdrawals and distributions over the short term, the time horizon for the portfolio may be shorter and the ability to tolerate market volatility may be lower.

The investment policy statement, or IPS, is the document that connects the spending policy with the investment strategies. The IPS is ideally reviewed annually and includes the non-profit's mission, investment objectives and constraints. It should include references to the spending rate, the need for inflation protection, the non-profit's risk tolerance, the time horizon for the portfolio, tax considerations, liquidity needs and any unique needs and circumstances. The methods and time frame for measuring the success of the investment strategies are included and in addition to financial market benchmarks, include measurements against the spending objectives. For example, a common benchmark related to spending objectives is a return in excess of the spending rate, plus inflation and expenses. Another spending objectives benchmark is a future portfolio value equal to or in excess of the amount needed to sustainably support a given dollar amount of withdrawals.

> "… asset allocation targets and ranges are included in the IPS, along with the permitted asset classes."

Over the life of the investment portfolio for a non-profit entity, the asset allocation or amount invested in equities, fixed income, cash and other investments, determines the success of the investment strategies and is more important than the individual security selections. The asset allocation targets and ranges are included in the IPS, along with the permitted asset classes. A typical asset allocation may be 70% equities, 25% fixed income and 5% cash. However, with near-term market volatility expected to remain high and future asset returns lower than those recently experienced, non-profit fiduciaries are debating whether to change the allocation to riskier assets such as equities. This decision should be made in conjunction with the expected portfolio withdrawal rate and the ability to control those withdrawal rates. The Monte Carlo analysis, including potential portfolio performance using a range of asset allocations, will help with the decision.

At Greenleaf Trust, we assist with development of the investment policy statement, spending rate recommendations and tracking, we develop spending and asset value simulations to assist with the long-term asset sustainability question and we provide data for 990 filings with the IRS.