PROVIDING A STEADY AND GROWING STREAM OF FINANCIAL SUPPORT

Most endowment and foundation managers have adopted total return investment and spending policies. The goal of these policies is to provide a steady and growing stream of financial support for beneficiaries while maintaining the purchasing power (inflation-adjusted balance) of the invested assets over the long-term. Maintaining purchasing power assures that future generations benefit as much as the current generation. The widespread adoption of these policies is supported by the legislation governing the management of endowments. This includes the Uniform Prudent Management of Institutional Funds Act, which specifically permits the adoption of total return investment and spending policies, even when a donor has specified in a gift instrument that only income may be spent.

WHAT DOES “TOTAL RETURN” MEAN?

When you own securities (stocks and bonds are the most common types), your returns include:
• Any interest or dividend payments received; and
• The change in the market value of the security.

Total return includes both kinds of return. Investors should evaluate net returns –returns after deducting investment expenses.

WHAT IS TOTAL RETURN INVESTING?

Total return investing seeks to maximize the risk-adjusted net returns. A tax-exempt total return investor is indifferent to whether the source of returns is interest and dividend payments or the change in the market value of the security. The concept of risk-adjustment is important. Investors expect higher returns for greater risks. Another way of articulating this approach is that total return investment seeks to maximize total returns for any given level of risk. Different investors will have different appetites for risk.

WHAT IS TOTAL RETURN SPENDING?

Total return spending uses a formula to determine spending that is independent of the source of returns. Often this means spending more than interest and dividends received and “harvesting” a portion of the appreciation – the increase in the market value of securities. This is based on the assumption, well grounded in the history of investment markets, that securities increase in value in the long-term. In high-interest, low growth markets the spending may go the other way and a portion of interest may be retained to compensate for low growth.

WHAT IS A TOTAL RETURN SPENDING FORMULA?

While there are many approaches, the Connecticut Conference has adopted a common formula for determining annual spending from an endowment fund. The formula is the product of three variables:
• The number of investment units held by the fund on the determination date;
• The 20-quarter average of net asset value per unit (the quarter-end net asset value per unit), and
• The spending rate, currently 4.5%

After multiplying the variables, the resulting annual amount is divided by 12 to determine the monthly distribution rate.

It is essential that the spending rate reflect the investment policy. Risk-averse investors will need to adopt lower spending rates.

‘The NACUBO-Commonfund Study of Endowments reports that 97% of over 800 colleges and universities have adopted total return spending policies. The Commonfund Benmarks Study of Operating Charities reports that 95% of over 100 charities have adopted total return spending policies. In the Connecticut Conference, over 60% of congregations participating in the Consolidated Trust Funds have adopted total return spending policies.
ARE THERE ALTERNATIVES TO TOTAL RETURN INVESTING AND SPENDING POLICIES?
It is difficult to identify prudent alternatives to this approach. Investing to maximize income while preserving asset value typically fails to consider the impact of inflation, as required by law. This strategy provides limited opportunity for the growth of assets, if any. Even at moderate rates of inflation, the purchasing power of any given dollar amount will be cut in half over 25 to 30 years.

IS IT REALLY OKAY TO SPEND A PORTION OF ASSET APPRECIATION WHEN A DONOR EXPLICITLY STATED TO SPEND INCOME ONLY?
Yes. Governing law permits the reclassification of a portion of asset appreciation as income. Reclassification is governed by the guidelines for prudence set forth in the laws governing endowments. Note that legally, with the reclassification, the adjusted amount IS income. There is an exception if a donor specifically states that the governing laws shall not supersede their specific instructions.