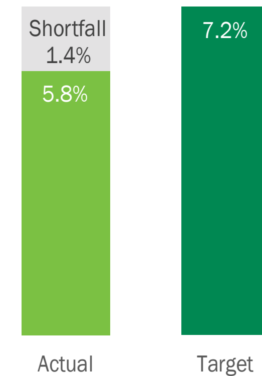
Institutions are increasingly challenged to meet their spending needs with investment gains from their endowment.

For decades, organizations have relied on their endowments to fund critical operational needs in their budgets, with targeted spending rates of 5% from the endowment serving as a common baseline. Prior to the Global Financial Crisis, institutions could safely meet a real 5% return target by investing in a traditional portfolio of 70% stocks and 30% bonds. However, this has been difficult for the past 10 years, and the market outlook makes it very unlikely that continued spending at 5% is fiscally responsible. With historically low interest rates and lower expectations for global growth, endowments have delivered inadequate investment returns to meet their spending rates. The average endowment returned a 10-year annualized nominal return of 5.8%, falling short of a targeted return (spending plus inflation) of 7.2%. This is a 13% decline in purchasing power! Faced with this return deficit, institutions are being forced to reconsider both their spending and investment policies.

10-Yr Average Annualized Endowment Return vs. Target

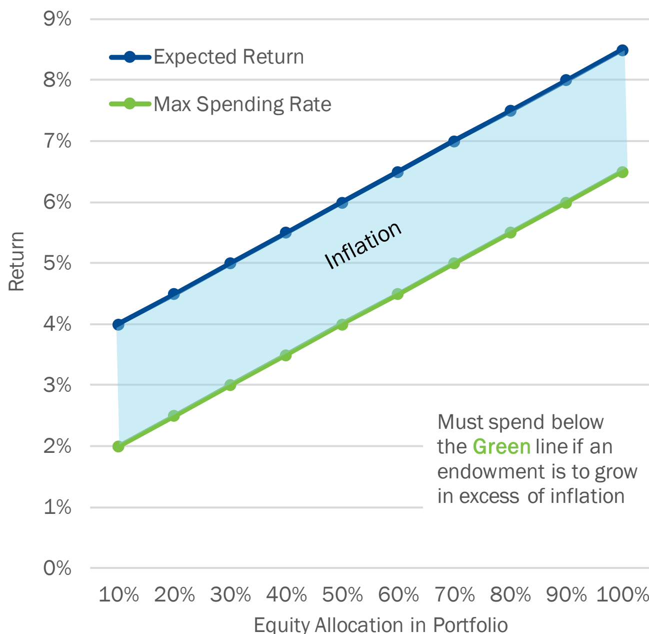


Source: 2018 NACUBO-TIAA Study of Endowments (NTSE)

Often spending policy takes a back seat to investment policy and asset allocation in investment committee discussions. When faced with a return shortfall, trustees tend to focus on investment strategies to grow their endowment. We believe spending policy is equally important, and possibly even more so. Reducing spending is a critical tool trustees can use to directly impact the long-term success of their organization. *It is vital for trustees to choose a spending policy that allows the organization to meet short-term obligations while maintaining purchasing power for future generations.* In this paper, we address the challenges committees face as well as the key considerations they should focus on as they address spending policies.

THE LINK BETWEEN SPENDING, RETURN EXPECTATION AND ASSET ALLOCATION

Spending Rate is Tied to the Return Expectation



There is an inherent trade-off between spending and return. To put it simply, an organization cannot spend more from the endowment than it makes, adjusted for inflation. The chart on the left highlights this relationship – an institution's maximum **spending rate** is constrained by an **expected return** minus inflation. To maintain purchasing power, institutions cannot spend above the green line, meaning spending cannot exceed the real return delivered from the investment portfolio. Trustees have an obligation to implement a disciplined spending policy, and in many cases, reduce their spending in order to meet return goals.

For institutions who cannot curtail spending, they must increase the endowment's expected return by adopting a more growth-oriented asset allocation. Increasing the portfolio's equity allocation (moving to the right on the x-axis) raises the probability of achieving higher returns over the long-term. However, trustees must be willing to accept greater levels of risk (and potential illiquidity) and the higher volatility associated with a more equity-oriented portfolio. The trade-off between spending and return is not an easy decision.