

How are spending
policies developed
and implemented?

PART
FOUR
—OF—
FOUR



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2016 SEI NONPROFIT SURVEY SERIES

Answers to Key Questions about Managing Nonprofits

Background

The SEI Nonprofit Management Research Panel completed a comprehensive survey of executives and investment committee members from nonprofits in the U.S. to gauge their views on a number of critical components of their organizations. The poll was completed by 253 participants, representing nonprofits with endowments ranging from \$25 million to more than \$5 billion. None of the respondents are current clients of SEI. We conducted the poll in January/February 2016 and are releasing a series of chapters focused on nonprofit spending, governance/board and committee management, investment management, and fundraising.

Summary

This perspective will provide an overview of the spending rates and methodologies that various types of nonprofits in the U.S. currently use, and the key considerations for investment committees in determining the spending strategy for the organization. The Uniform Prudent Management Institutional Funds Act (UPMIFA) clearly outlines the fiduciary responsibility of the stewards of these asset pools. Conducting relevant analysis, paired with risk-reducing diversification strategies and maintaining good decision records, are all part of complying with this act.

An unsteady market makes spending decisions more difficult.

Finding the right level of spending in the face of volatile investment markets and increasing demands for endowment assets is an ongoing challenge for nonprofits. Colleges and universities need to offset government budget cuts and face higher demand for scholarship support, while local community foundations have a perpetual need to help their causes.

Organizations of all types are asking:

- What sustainable level of spending can we realistically achieve from the supporting asset pools?
- How can the asset allocation be most effective in this volatile market environment?

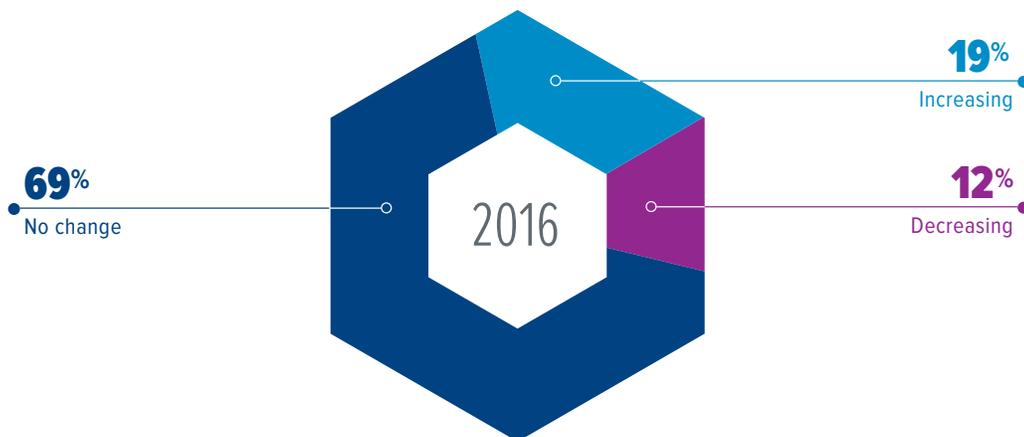
Our survey responses uncover your peers' spending strategies. Where do you fit in?

Spending levels are expected to hold steady.

According to nonprofits surveyed, most organizations (**69%**) do not plan on making spending changes.

In an effort to gauge the spending outlook, we asked each organization if they expected to increase, hold steady or reduce spending in 2016. Overall, most organizations (69%) do not plan on making spending changes. Notably, in our 2013 study, more than half of respondents had made a change in the five years following the 2008 market downturn. It seems many organizations made the necessary adjustments and plan to hold spending steady. Any potential expectations for increases could reflect higher market values.

FIGURE 1
Spending expectations

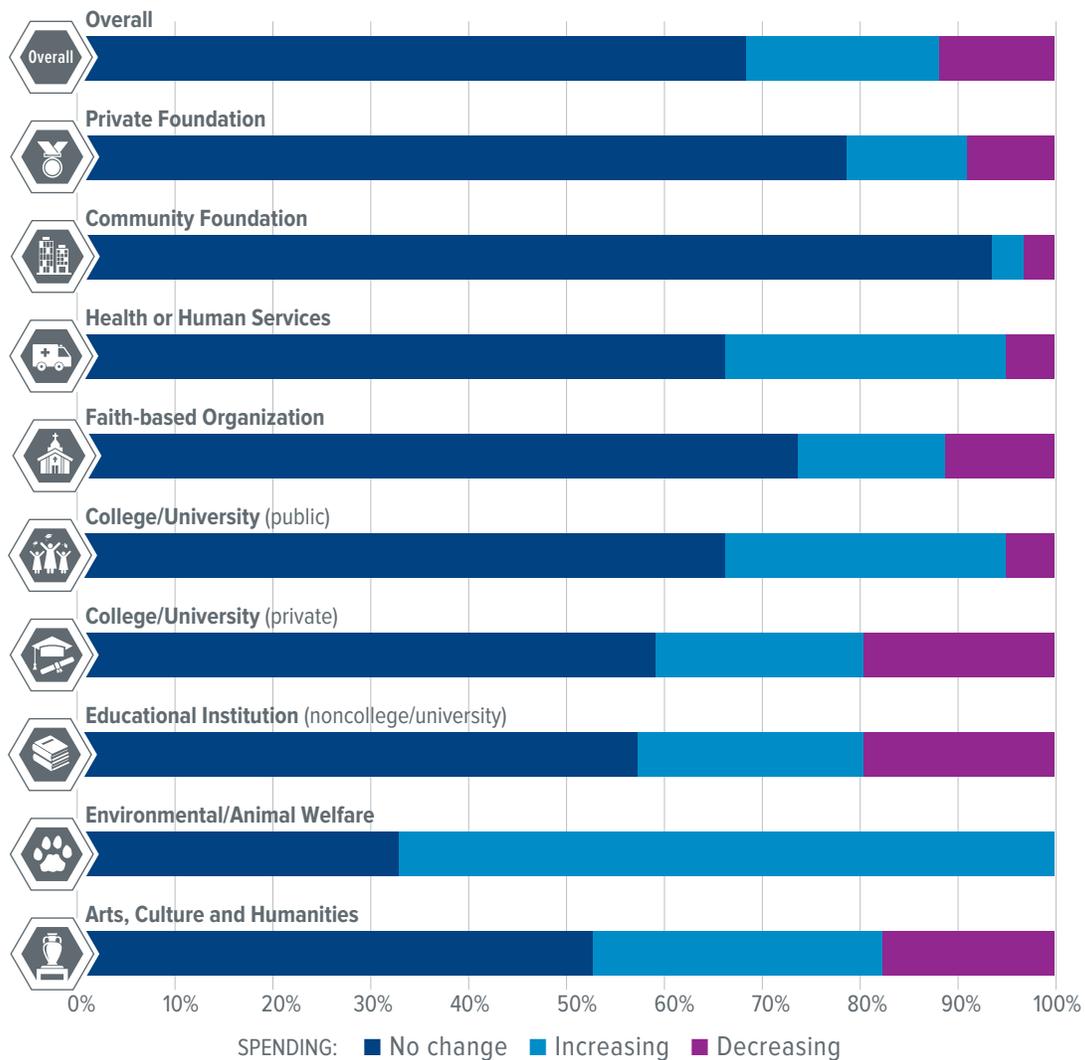


FAST FACT

Community foundations are the least likely to increase spending, with 94% maintaining or decreasing spending.

Figure 2 shows the spending projection by organization type. With a few exceptions, holding steady on spending was the most common response. Interestingly, for private colleges and universities, a similar percentage of organizations reported plans to decrease spending as reported plans to increase spending.

FIGURE 2
Spending projection by type



Like most budgets, there are a limited number of resources to reconcile inflows and outflows. On the positive side, there is fundraising (where relevant) and investments. However, many nonprofits are asking themselves what portion of annual donations are expected to actually flow to the endowment? And are investments best positioned to earn enough to meet long-term return objectives without taking on too much risk? If the long-term return objective (sometimes referred to as a “hurdle rate”) includes the spending rate, long-term growth and/or inflation assumptions, and possible fees, then what can actually be controlled to keep the numbers in check? The answer often lies on the outflow side of the ledger—the institution’s spending.

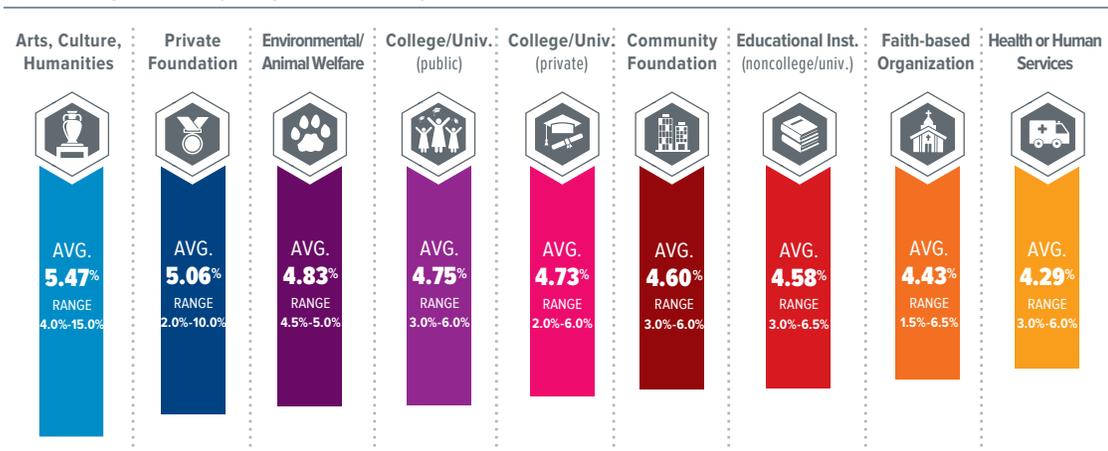
SECTION **2**

Nonprofits report a broad range of current spending rates.

The average spending rate among all nonprofits surveyed was **4.75%** for year-end 2015, down just slightly from **4.8%** average in 2013.

The range of averages varies by type of organization. Arts, culture and humanities organizations show the highest average spending rate of 5.47%. Other organizations have average spending rates between 4.33% and 5.06%.

FIGURE 3
Spending rates by organization type



Some organizations have been able to curb expenses, tighten payouts or benefit from new sources of inflows or higher asset values. In the latter case, it is not uncommon for nonprofits to actually lower spending rates as market values increase. This yields a consistent dollar payout and minimizes the volatility in the grant-making process, while putting more funds back to work in the asset pool to help with future years when markets may not be so rewarding and/or fundraising efforts may not be as successful. Many institutions will therefore use a rolling average of three to five years of market value to smooth the spending dollars each year.

FAST FACT

Overall college and university spending increased from 4.08% in 2013 to 4.72% at the end of 2015.

SECTION
3

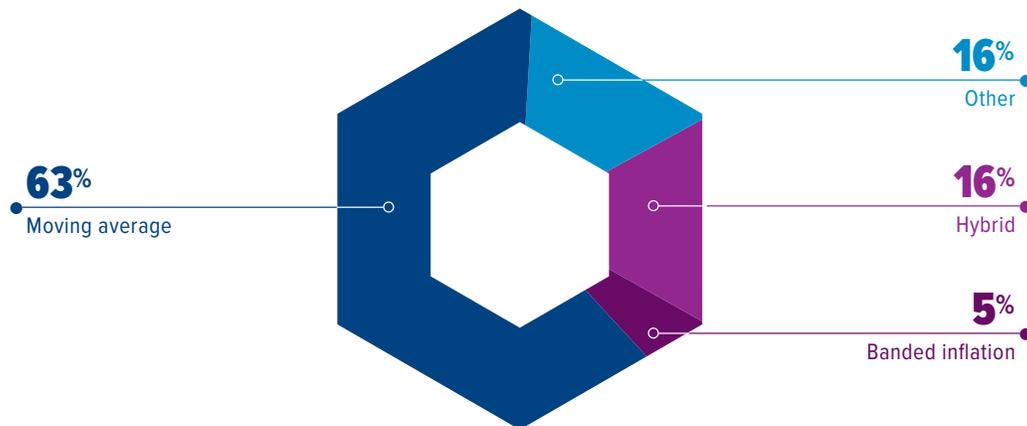
Most nonprofit organizations use one of three strategies to determine their annual spending rate.

According to the poll, **63%** of participants use the moving average method; of this group, **52%** use a three-year smoothing average and **19%** use a five-year smoothing average formula.

- ▶ **Moving average:** The most common formula used by poll participants to calculate spending is based on a stated portion of the portfolio value at the end of the prior year. A smoothing calculation is then applied using the average ending portfolio balances over a number of previous years or quarters. Using this moving average methodology, spending levels have less variability from year to year.
- ▶ **Banded inflation:** A dollar amount of spending is calculated in the initial year that the spending policy is created, based on the needs of the organization. The spending amount for each subsequent year is then determined by multiplying the prior year's spending by an inflation factor, such as the Consumer Price Index, or HEPI (Higher Education Price Index) in the case of colleges and universities. This type of policy typically provides stable year-to-year spending dollars in the short-term, but challenges arise in the long-term as there is no adjustment for spending downward when market returns have been poor.
- ▶ **Hybrid or Yale model:** This approach combines the above two strategies. The level of annual spending is determined by combining a fixed amount using the banded inflation model and a fixed percentage using a moving average formula with three- or five-year smoothing. As a result, a portion of the spending varies based on the markets (inflation formula), and a portion is more predictable (moving average).

Because markets, portfolios, financials and goals change frequently, investment committees should consider re-evaluating their spending policies at least once per year to ensure that they are spending enough to meet their short- and long-term goals, but also not spending in excess and compromising the financial health of the endowment.

FIGURE 4
Spending methodologies being used



The most popular methodology may not be the best one for you. But how do you know?

A moving average methodology with three-year smoothing formula is the most popular among survey respondents, but does it mean that it's the right spending approach for your nonprofit? If your organization reviews its spending policy annually, but hasn't made a change in more than five years, how do you know when the time is right to adjust your spending? Often, you can answer these questions through an analysis of past and future spending scenarios.

A nonprofit's endowment portfolio and spending approach should be unique to the goals, financials and risk profile of the organization; there is no one-size-fits-all approach. One way to be sure your organization has chosen the best methodology moving forward is to take a look at past performance and spending to project future outcomes.

Another strategy to consider in addition to the spending methodology is immunization of a portion of the portfolio, which can provide protection against downside losses in the short term. Since liquidations are made from the immunized account, which in effect operates like a saving account, there is less need to sell securities in down markets to meet liquidity needs. The immunization accounts need to be replenished from the main pool, but the time horizon is more flexible.

To determine whether an immunization strategy would be a valuable addition to your organization's investment strategy, try testing different scenarios with an extreme drop in markets to see what the spending results are over the subsequent few years and what the impact could be to the long-term health of the asset pool.

Do we have the hurdle rate and portfolio to support spending?

A critical consequence of the selected spending policy is how aggressive the portfolio's long-term return objective needs to be. Also referred to as hurdle rates, these long-term return objectives need to not only cover spending, but should include an assumption for inflation to maintain purchasing (or spending) power into perpetuity, or at least 20-30 years (which is a reasonable proxy for analysis).

Some institutions have a strategic goal to reach a certain asset target and so additional growth may need to be built into the long-term return objectives. Others may include fees associated with running the investment portfolio (e.g., asset management and consulting fees) or may charge a fee at the donor level for administrative purposes. Some examples of different hurdle rates and their various components are shown below:

FIGURE 5
Hurdle rates

4.5% spending policy 2.0% long-term inflation assumption 1.0% additional growth objective + 1.0% fees	5.0% spending policy + 2.5% long-term inflation assumption	4.0% spending policy 2.0% long-term inflation assumption + 1.0% fees
8.5% hurdle rate	7.5% hurdle rate	7.0% hurdle rate

SECTION **4**

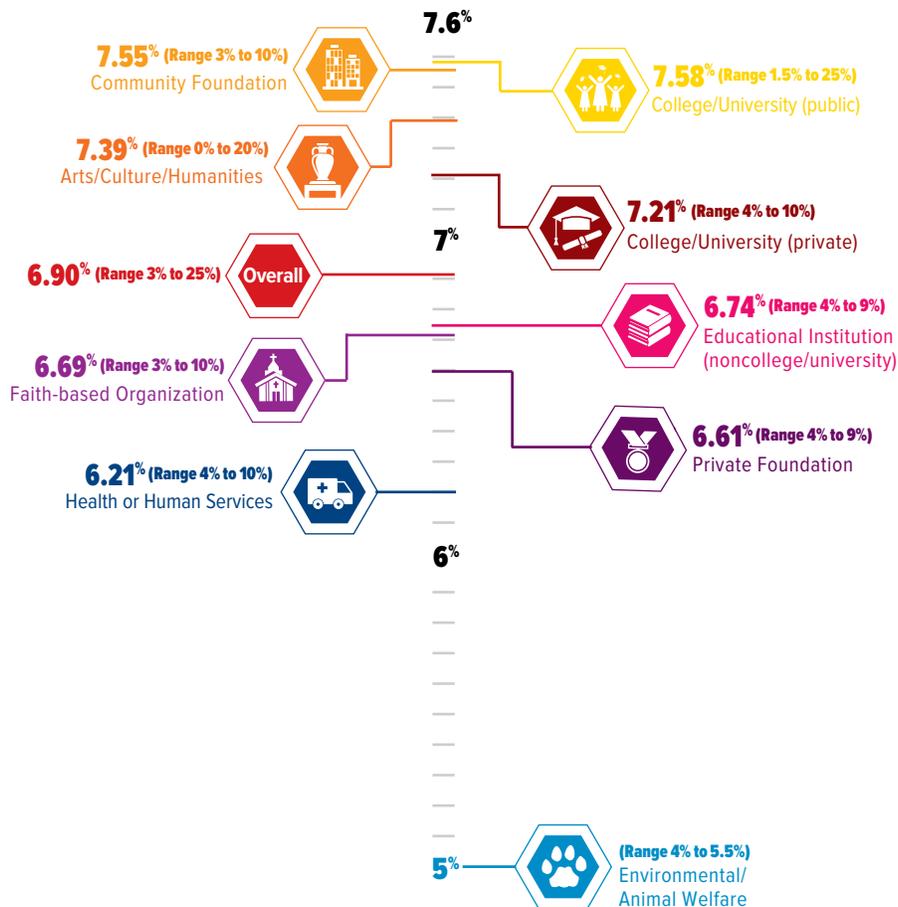
Return objectives also remain stable.

The overall average return objective for nonprofits participating in this survey was **6.9%**.

As nonprofit organizations face extreme pressure to do more with less, investment returns and funding the organization’s mission continue to be paramount to the organization’s success. While equity market performance over the past three years should have provided gains for many nonprofits, return objectives appear to remain stable and reasonable.

Return objectives will vary based on the type of the organization and the way returns fund the overall mission. Figure 6 shows average investment return objectives based on type of nonprofit. Average return objective ranged from as low as 5% to as high as 7.6%. The nonprofits surveyed were asked if the return objectives included their investment management fees, and more than three quarters (76%) said this was the case.

FIGURE 6
Return objective by organization type



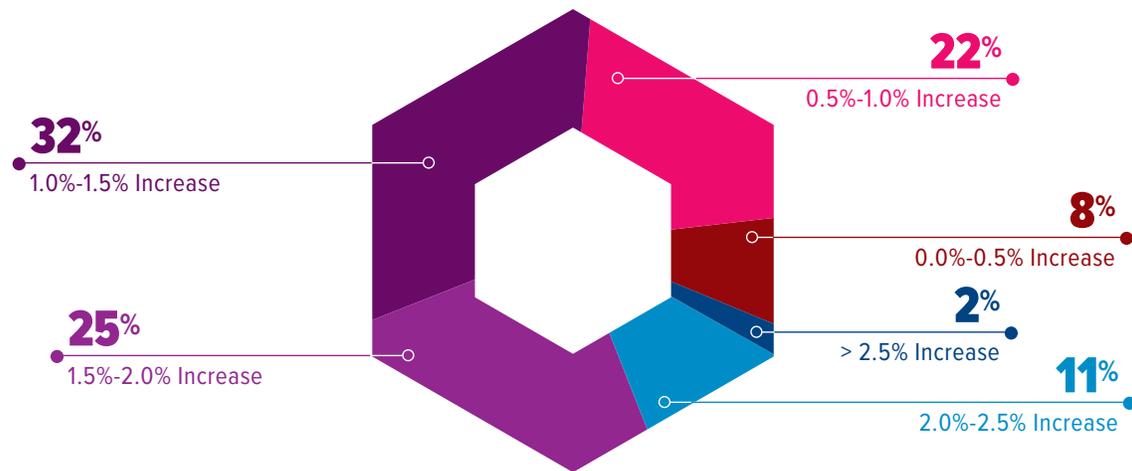
FAST FACT

More than half (53%) of the community foundations surveyed had a return objective of 8% or higher.

What do you expect from inflation?

The third component of a hurdle rate, in addition to spending and fees, is inflation. For 2016, 32% of nonprofits polled felt inflation would increase between 1% and 1.5%, with only 13% expecting an increase of more than 2%.

FIGURE 3
Inflation expectations



Once a hurdle rate is determined, it drives the strategic asset allocation decision, balanced by the risk objectives of the organization. Generally, a more aggressive policy will be required for higher hurdle rates and vice versa. The less-liquid alternatives bucket, however, can offer some return-enhancing and risk-reducing characteristics that can mitigate the volatility of the overall portfolio if liquidity conditions are flexible. This might explain why the use of alternative asset classes has grown in recent years. More details are provided in Part 2 of our study: "How are endowment assets overseen and invested?"

Conclusion

Identifying a sustainable spending strategy is more critical than ever. Since spending needs drive hurdle rates, and hurdle rates drive strategic asset allocation decisions, it's no wonder that the spending question is a top focus for investment committees. It is imperative to partner with your investment provider to integrate your specific needs as you build out your portfolio and monitor the progress on a regular basis.

To learn more about our services for nonprofits, visit us online at **seic.com/OCIO** or email **institutions@seic.com**.

2016 SEI Nonprofit Survey Series

Answers to Key Questions about Managing Nonprofits

Part 1: Are boards and investment committees supporting their nonprofits most efficiently?

Part 2: How are endowment assets overseen and invested?

Part 3: Are fundraising efforts supported and as efficient as possible?

Part 4: How are spending policies developed and implemented?

The Nonprofit Management Research Panel, sponsored by the SEI Institutional Group, conducts industry research in an effort to provide members with current best practices and strategies for the investment management of nonprofit foundations and endowments.

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