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Reconsidering the Endowment Spending Policy

A spending policy based on Total Return means more money for ministry

For generations, investors were taught to "invest the principal, spend only the income." And back in the old days, that advice made sense. But times have changed, and the standards for prudent investment management have changed as well. In recent years, many corporations have shifted their focus away from paying shareholder dividends, focusing instead on increasing the value of the stock itself.

Investing for Total Return

As a result, today's diversified investors look for overall portfolio growth rather than concentrating on income potential — a concept known as investing for Total Return. Rather than withdrawing the dividend income from their portfolios, institutional investors — from the Ford Foundation to Harvard University to historic churches — reinvest their dividends and evaluate performance by considering the overall growth in the value of their portfolio from both reinvested earnings and capital gains.

Technology company Microsoft offers a good example of the wisdom of the Total Return approach. Microsoft made its initial public offering in 1986, but didn't begin paying dividends until 2003. If you had purchased 100 shares of Microsoft 10 years ago when the market opened on June 1, 1998 ($20.97/share), and sold those shares — which had now grown to 400 shares thanks to stock splits — at the same time five years later ($24.98/share), you would have gained $7,895 or an average annual return of 75% — but you would have enjoyed no cash benefit until you sold your shares. Had you held your shares for another five years, you would have received total cash dividends of $1,800, but your shares would have been worth more than $11,000 — an average annual total return of 44% from your initial investment of $2,097.

An individual investing for retirement might not have minded receiving a relatively small sum from Microsoft dividends over those years. But church endowments generally have different requirements. Donors to endowments intend for their gifts to be used continuously to advance the mission and ministry of the church over generations. Consequently, endowment funds need to be invested so that the long-term power of the financial markets can grow the portfolio, protect its value from the eroding effect of inflation, and generate an income stream to fund mission and ministry programs.

KEY POINTS

- **Prudent spending policies no longer distinguish between principal and income. Dividend earnings are all reinvested, and the value of the entire portfolio is considered as an integrated whole.**
- **By "cashing in" 3-6% of the portfolio each year, a spending policy based on Total Return permits investors to benefit from growth in stock value, making more money available for ministry.**
- **Even with a small percentage of the portfolio sold each year, a well-diversified endowment fund should continue to grow over the long term.**

Spending Policy Based on Total Return

With the shift to investing for Total Return, institutional investors have established spending policies that ignore the distinctions between principal and income. Instead, a modest percentage of the portfolio's value is "cashed in" each year to create the revenue used for the organization's mission.

For many who are new to the idea of a spending policy based on Total Return, the notion of selling part of the portfolio sounds a lot like 'dipping into principal.' But investing for Total Return requires a new way of thinking about the portfolio: instead of defining principal (or the corpus), the portfolio is seen as an integrated whole from which both income and capital gains become available to support the organization.

Take the Microsoft example above. Prior to the company's distribution of dividends, no cash was available even though the portfolio was growing rapidly. Even after Microsoft began paying dividends, income totaled only $1,800 from 2003 to 2008; but a spending policy based on Total Return would have provided over $3,600 for ministry — twice as much — while the portfolio value still realized a 10-year gain of $8,500 or an average annual return of over 40%.

For most institutions and local churches, a spending policy based on total return is determined in a way that permits adjustment as circumstances require —

1. The value of the portfolio is determined at a given point in each of the last three to five years.
   A three-year range is typical, while a five-year range is more conservative. Because the range considers values from prior years, church budget managers know in advance how much money will be available from the endowment.
2. An average value is calculated from the values in the range.
   This value is known as a rolling average, as the three- to five-year range shifts by one year each year.
3. A percentage of the resulting average portfolio value is sold.
   Most spending policies establish 3-6% spending range, with most organizations spending in the 4-5% range.
4. The proceeds are spent as permitted by the terms of the endowment or organizational policy.

Although the overall value of the portfolio is reduced by a small percentage each year, the value of a well-diversified portfolio should continue to grow over the long term. The chart illustrates the performance of a $10,000 church endowment invested on January 1, 1978 in United Church Funds' Moderate Balanced Fund, which offers a prudent mix of both stocks and bonds. Even with a policy permitting a 5% spending rate each year, the value of this $10,000 investment grew by an average of 20.3% each year for 30 years, to a total value of $70,924. Even more exciting, however, is the fact that a spending policy based on total return would have permitted this church to invest more than $57,000 in ministry over the last 27 years — funds earned from the total return on the initial $10,000 investment!

Year	Total Return	$10,000 Investment	3-Yr Rolling Average	5% Spending Policy	CPI	Inflation-adjusted value
1978	4.52%	$10,452.00			7.6%	$9,657.65
1979	13.21%	$11,832.71			11.3%	$10,495.61
1980	15.60%	$13,678.61			13.5%	$11,832.00
1981	4.96%	$14,357.07	$11,987.77	$599.39	10.3%	$12,878.29
1982	21.32%	$16,818.61	$13,289.46	$664.47	6.2%	$15,775.86
1983	14.64%	$18,616.38	$14,951.43	$747.57	3.2%	$18,020.66
1984	5.33%	$18,861.06	$16,597.35	$829.87	4.3%	$18,050.04
1985	30.72%	$23,825.31	$18,098.68	$904.93	3.6%	$22,967.60
1986	12.80%	$25,970.02	$20,434.25	$1,021.71	1.9%	$25,476.59
1987	0.39%	$25,049.59	$22,885.47	$1,144.27	3.6%	$24,147.80
1988	13.87%	$27,379.69	$24,948.31	$1,247.42	4.1%	$26,257.13
1989	25.08%	$32,999.11	$26,133.10	$1,306.66	4.8%	$31,415.15
1990	-0.07%	$31,669.35	$28,476.13	$1,423.81	5.4%	$29,959.21
1991	26.27%	$38,565.08	$30,682.72	$1,534.14	4.2%	$36,945.35
1992	10.83%	$41,207.55	$34,411.18	$1,720.56	3.0%	$39,971.32
1993	10.90%	$43,978.61	$37,147.33	$1,857.37	3.0%	$42,659.25
1994	-3.48%	$40,590.79	$41,250.41	$2,062.52	2.6%	$39,535.43
1995	26.99%	$49,483.72	$41,925.65	$2,096.28	2.8%	$48,098.18
1996	13.76%	$54,196.40	$44,684.37	$2,234.22	3.0%	$52,570.51
1997	21.79%	$63,771.58	$48,090.30	$2,404.52	2.3%	$62,304.83
1998	19.64%	$73,891.80	$55,817.23	$2,790.86	1.6%	$72,709.53
1999	11.36%	$79,495.05	$63,953.26	$3,197.66	2.2%	$77,746.15
2000	-0.22%	$76,122.49	$72,386.14	$3,619.31	3.4%	$73,534.33
2001	-5.91%	$68,004.35	$76,503.11	$3,825.16	2.8%	$66,100.23
2002	-11.22%	$56,549.10	$74,540.63	$3,727.03	1.6%	$55,644.32
2003	19.08%	$63,611.64	$66,891.98	$3,344.60	2.3%	$62,148.57
2004	8.42%	$65,623.14	$62,721.70	$3,136.08	2.7%	$63,851.32
2005	4.66%	$65,545.10	$61,927.96	$3,096.40	3.4%	$63,316.56
2006	10.59%	$69,389.92	$64,926.63	$3,246.33	3.2%	$67,169.45
2007	6.89%	$70,924.56	$66,852.72	$3,342.64	2.8%	$68,938.67
				$57,125.76	4.2%	

This table illustrates a $10,000 investment in the Moderate Balanced Fund, adjusted for inflation as represented by the Consumer Price Index (CPI), which offsets the actual total return each year. Past performance is not indicative of future performance, and an investment made in this fund today may gain or lose value in the future.

When faithful members and donors entrust future generations with legacies and gifts intended to serve the church for decades to come, each group of trustees bears a sacred responsibility to manage both the investment and expenditure of those funds in a wise manner — faithful both to the intent of the donor and informed by an understanding of the financial markets and prudent investment management.

United Church Funds stands ready to assist churches and UCC-related organizations with guidance in developing updated investment and spending policies, offering professional investment management services, and helping build endowments that provide more money for ministry.

DISCUSSION QUESTIONS

1. How should we establish a spending policy based on total return to benefit from the long-term growth in value of our investment portfolio?
2. How much should our spending policy allow us to "cash in" each year?
3. Should we use a 3-year rolling average balance or a 5-year rolling average balance?

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