

Spending Policy

“We define organic order as the kind of order that is achieved when there is a perfect balance between the needs of the parts and the needs of the whole” -Christopher Alexander

Institutional Best Practices: Spending Policy

Most institutional portfolios are established in support of some long-term objective, such as funding an educational scholarship into perpetuity or providing ongoing funds in support of a local community. The central concept in a thoughtful spending policy is balance; for the institution, for the portfolio, for the beneficiaries, for the present, and for the future. It was James

Tobin who said: “the trustees of endowed institutions are guardians of the future against the claims of the present.” The leaders of institutional portfolios must not only consider the claims of the future and present, but also the risks.

There is no single “right” spending policy and formula. The best approach toward providing

distributions from a portfolio to the institution that it supports will be specific to the needs and constraints of the organization. There are a handful of approaches commonly used across institutional investing, each with benefits and drawbacks, and their effectiveness may differ depending on the market environment and performance of the underlying portfolio.

For most institutional portfolios, an annual draw in support of the underlying organization is required in order to maintain favorable tax status, and these typically range from 3-5% per year. Some institutions simply withdraw a percentage of their portfolio each year, though most chose to employ a “spending formula” in order to smooth the impact of investment volatility on the underlying organization’s budget to allow for more stability of income and planning. The spending formula can be thought of as a risk-sharing mechanism between the

institutional portfolio and the underlying organization. An organization with greater tolerance for income volatility and budget flexibility may choose a spending formula that transfers more investment volatility to the budget. An organization heavily reliant on the income generated from the portfolio to fund its operations may elect to keep as much volatility within the institutional portfolio as possible. As we’ll see in the examples below, this decision will have long-term impacts on the compounding of wealth in the portfolio.

For example, an organization that requires very stable and predictable income from the institutional portfolio may elect a spending formula that holds spending nearly constant during a market decline or takes multiple quarters or years to adjust downward with the portfolio value. The result is an “effective spending rate” from the portfolio

that is higher than the target spending rate during a period when the portfolio value is stressed. If, hypothetically, an organization begins the year with \$100 in its institutional portfolio with a target spending rate of 5% per year (\$5), but a significant market event causes the portfolio value to decline to \$70, then the effective spending rate jumps to 7% ($=\$5 / \70). In this example, the institutional portfolio is bearing all market volatility in the short-term, and the increased spending draw as a percentage of the portfolio more-quickly exhausts liquidity for future draws and opportunistic capital for portfolio rebalancing into attractive assets.

The two most commonly used spending formulas are a smoothed market-based approach and an inflation-based approach, with many institutions choosing to incorporate elements of both into their specific spending policy.

The *market-based approach* to

spending typically is structured with a target spending rate (e.g., 4%) multiplied by a long-term smoothing of the portfolio value, such as over a rolling 3-5 year period measured quarterly or annually. This approach is typically used by organizations that can accept greater income volatility to the budget, often because income generated from the institutional portfolio may represent a relatively small portion of total income.

Advantages: Offers stability in spending by diluting the impact of any single year's strong performance or downturn. Institutions can predict their spending reasonably well.

Drawbacks: In prolonged bull or bear markets, the adjustment to the dollars distributed from the portfolio may change relatively slowly, either depriving the institution of potential additional cash flow or not cutting spending quickly enough in downturns

(putting more stress on the portfolio).

The *inflation-based approach* typically increases the annual spending amount by a fixed percentage or at the rate of some measure of inflation, such as the Consumer Price Index. This approach may be more appropriate for organizations for which income from the institutional portfolio represents a larger portion of total revenue, so more stable and predictable income from portfolio distributions may be more desirable for budget planning. The inflation-based approach often incorporates caps and floors on annual spending (such as a banded range of 3-6%).

Advantages: Provides a direct link to inflation, ensuring that spending maintains its purchasing power. The bands allow for some flexibility without drastic changes in year-to-year spending.



Drawbacks: If inflation is consistently high or low, spending might hit the bands frequently, leading to more volatile spending.

In addition to these basic approaches, spending formulas may have nuances that are meant to limit spending volatility, and many institutions utilize a hybrid approach to spending that incorporates elements of the market-based and inflation-based approaches to best fit the organization's specific needs. For example, an institution may choose a spending policy that provides 4% of a 12-quarter rolling

average of the portfolio's market value with a 3% minimum spending "floor" in order to keep up with growth in a bull market, a 6% "cap" on spending to limit the potential for over-spending and impairment during a significant portfolio value decline, and a 2% required annual dollar spending increase to keep pace with inflation during periods when the portfolio value is flat year-over-year.

Examples:

Imagine a university endowment beginning with \$100 million at the start of the 1990s. Let's make a few assumptions:

- Target spending rate is 5%
- Spending floors and caps are set at 3% and 6% respectively.
- Moving average uses a 3-year period.
- For the hybrid model, 70% of the spending is based on prior year spending adjusted for inflation, and 30% is based on

a 5% target spending rate applied to a 3-year moving average of the portfolio.

- The portfolio's total return is approximately 13% per year in this scenario

The banded inflation approach results in the lowest spending amount but highest portfolio value as growth significantly outpaces inflation. The basic approach of spending 5% annually results in the highest spending amount but lowest portfolio value.

Now, let's utilize the same assumptions but consider the decade that began in the year 2000 as the "tech bubble" was bursting. This scenario utilizes the actual returns of the MSCI All-Country World Index and assumes that the portfolio has a 0.75 beta (sensitivity) to this market index. We assume a 10% linear market return after 2002. The results being that the banded inflation approach provides the least decline in spending but also the

lowest ending portfolio value as a larger share of the portfolio is provided back to the organization when asset values are in decline. In other words, the portfolio bore a greater share of market volatility than other spending approaches during this bear market.

	1990s			2000s		
	Ending Portfolio Value	Total Spending Rate	Total Portfolio & Spending	Ending Portfolio Value	Total Spending Rate	Total Portfolio & Spending
Basic 5% Spending Rule	\$208.0	\$71.1	\$279.1	\$76.8	\$35.5	\$112.3
Market-Based Approach	\$221.8	\$63.9	\$285.7	\$75.6	\$35.8	\$111.4
Inflation-Based Approach	\$228.7	\$57.3	\$286.0	\$70.1	\$39.9	\$110.0
Hybrid Model Approach	\$226.6	\$59.3	\$285.9	\$71.8	\$38.7	\$110.4

Even the “best” spending policy will have benefits, drawbacks, and periods when it feels it could have been more effective in hindsight. The spending policy should be constructed as part of a discussion with investment fiduciaries and the organization’s administration and budget officials in order to achieve an approach that best balances the long-term objectives of both the organization and the institutional portfolio. For a real-world endowment or foundation, these spending levels and shifts can have significant impacts on operational activities, emphasizing the importance of the chosen spending policy and its alignment with the institution's objectives and risk tolerance.



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