A Sound

By Sandra R. Sabo

Investment

Believing in their missions, students, and academic programs, institutional leaders are steadily increasing endowment spending—despite lower returns—to fulfill priorities both current and future.

Many factors come into play when a finance committee or governing board looks at the endowment spending policy: institutional goals and priorities, enrollment trends, size and strength of various funding sources, amount of outstanding debt, availability of cash, and institutional appetite for risk, to name just a few. How the factors combine—and are weighed by committee members—varies from one institution to the next. One university, for example, might favor a conservative approach to all aspects of investing and spending. Another institution with a similar-sized endowment might prefer to take on higher risk in some investment areas while maintaining a conservative spending policy. Yet another might increase its endowment spending even when returns are lower.

"Every institution has unique circumstances that need to be taken into consideration when setting a spending policy and looking at investment approaches," says Nikki Kraus, global head of client development for Strategic Investment Group, a firm in Arlington, Va., that provides outsourced chief investment officer services to 30 institutions. That said, she identifies four general trends exerting influence on endowment decisions at all institutions:

Expectations of lower returns. Historically, investment committees became accustomed to annual returns in the range of 8 to 9 percent and used that figure in long-range planning forecasts. According to the *NACUBO-Commonfund Study of Endowments* (NCSE), however, the average return—regardless of endowment size—was 2.4 percent in FY15 and fell to –1.9 percent in FY16.

"Many people don't think they will get an 8 percent return again in the next five years, so they are researching a lower spending level," observes Kraus, one of the authors of *Endowment Management for Higher Education* (AGB Press, 2017). "If a committee thinks the endowment will have a 6 percent return and inflation is at 2 percent, then they know they can't spend 5 percent without eroding the corpus."

Need to stabilize operating budget support. Since the financial crisis in 2008, some institutions have experienced variability and uncertainty regarding their funding sources—particularly public institutions that have seen a significant erosion in state support. The need to help plug budget gaps can put pressure on institutions to increase, or at the least maintain, endowment spending for operations in dollar terms—enhancing the need to grow the endowment. The *NACUBO-Commonfund Study of Endowments* reports that, historically, participating institutions rely on their endowment to fund an average of 9.7 percent of their respective operating budgets.

Increased donor engagement. "Donors are more engaged than they've ever been, and they want to know that any gift they give will be well-handled," says Kraus. In addition to demonstrating how well your endowment is managed, she notes, "Communicate why you need the gift. Giving is a very emotional thing, and donors want to know what they're giving toward and for."

Desire for endowment growth. Fundraising for the endowment has not necessarily been ingrained in the culture of many institutions. Kraus observes, "They've been raising money, but it has usually been for buildings. Today, there's a tremendous recognition among institutions—often those with endowments under $500 million—that they must commit to growing their endowments in order to control their own destiny."

Here's a snapshot of how these trends are playing out at four institutions.

A Question of Balance

In FY16, the endowment pool managed by the University of Illinois Foundation on behalf of three institutions (Springfield, Chicago, and Urbana-Champaign) experienced a decrease in returns. Still, endowment spending increased that year. That's because the foundation bases its 4 percent distribution on a six-year rolling average of market value.

"We use a longer moving average to provide greater predictability to the budget. It tends to dampen the down, and it also dampens the up," explains Ellen Ellison, chief investment officer for the University of Illinois Foundation. For example, the $1.8 billion endowment was up 15.75 percent in FY17, "but that doesn't mean spending in dollar terms will go up 15.75 percent," adds Ellison, who is based in Chicago. "The moving average will include three good years, two bad years, and then another good year. It helps achieve some stability when the markets are volatile or the state budget situation is unpredictable."

That stability became particularly valuable during the past two years, as the Illinois legislature grappled with a financial crisis that suspended all funding to the three public universities in the University of Illinois system. The U of I System, which has total enrollment of about 83,000, weathered two years without state funding primarily by exercising sound fiscal management and tapping reserves. While the U of I System has since received $650 million in state funding for FY18—which represents about 10 percent of its overall annual budget—the legislature provided only $115 million in retroactive funding for each of the two previous fiscal years.

The funding delay and shortfall simply strengthened the resolve of the foundation's investment committee to build the endowment and make it a more meaningful source of funding. “We want to really focus on long-term fundraising and giving so we have a better balance among grants, state funding, the endowment, and tuition,” Ellison says. “Right now, the University of Illinois has committed to a tuition freeze, so we want as many diversified sources of income in the budget as possible.”

In October, each of the three universities launched campaigns with a combined $3.1 billion goal. Ellison expects that the funding priorities of these campaigns will emphasize gifts to support scholarships and endowed chairs, which will promote talent retention of students and faculty. In time, the foundation aims to continue growing the endowment so it reaches $8 billion. At the current spending rate of 4 percent, an $8 billion endowment would translate into future distributions of $320 million annually, or about 5 percent of the system’s total budget—up from the current level of 1.2 percent of the budget.

Even as the endowment grows, the UI Foundation wants to keep its spending rate between 4 and 5 percent and re-invest excess earnings for future growth. “Certainly, there’s always pressure from today’s generation to spend more,” says Ellison. “But the board’s responsibility is to be balanced, knowing that spending too much today could permanently impair the endowment’s ability to grow sufficiently and produce the same distribution in the future.”

Pulling Back on Risk

In 2007, with what seems like remarkable foresight, Muskingum University decided to reduce its spending rate and thus reduce its risk. “We were at 5 percent of a three-year rolling average but thought that rate was just too high. Over the next few years, we transitioned to 4.5 percent over a 20-quarter average,” explains Philip Laube, vice president for finance and operations at the New Concord, Ohio, institution.

Although making that move kept the 2008 recession in the calculation longer and suppressed spending, Laube appreciates the consistency provided by the extended trailing average. Before switching to quarterly averages, Muskingum used end-of-the-year calculations. “The more data points used, the better you’ll be able to avoid shock to the institution at any given time,” says Laube. “For example, if you had a big correction hit in the month of December one year, that could be a big shock to spending. Now, that kind of correction would represent only one-twentieth of our calculation, versus one-fifth.”

Of the $2.9 million distributed annually from Muskingum’s endowment, the greatest portion—nearly half—goes to student scholarships. Other allocations go toward deferred maintenance and about a half-dozen endowed chairs. One portion is designated by the board for operations. Muskingum constructed $75 million in new projects over the past 15 years, and each project included allocations to the endowment to cover future maintenance costs.

In the 20 years that he has been at Muskingum, Laube has seen the university’s endowment double to its current value of $70 million. He anticipates that Muskingum’s next capital campaign will include a goal of growing the endowment, particularly as a means of providing long-term support to new campus initiatives related to student success and experiential learning. “The board has always been very concerned about the contribution the endowment makes to the budget. But it’s just as concerned with not just maintaining but enhancing intergenerational equity, especially as the university embarks on a new strategic plan,” says Laube.

One way Muskingum maximizes its endowment is by relying on investment committee members to perform many duties typical of an outsourced CIO. Although the university contracts with a firm to provide advice on asset allocations and assistance on reporting, the committee—chaired by a former investment professional—does the lion’s share of

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the decision making. Laube estimates the members' active involvement saves Muskingum about $200,000 annually.

For example, the committee recently undertook a comprehensive review of the endowment's allocation classes, repeating an exercise done five years earlier. "We are continuing down the path of making our endowment look more like the bigger endowments, to be less risky yet have similar returns," Laube explains. "In going through the review process," he adds, "it was interesting to see how expected returns across asset allocation classes are shrinking together. Some asset classes, like traditional equities, don't have any greater returns but give you almost twice the risk of other asset classes."

In addition to revising the asset classes in its portfolio, Muskingum updated its gift acceptance policy. If, for example, a planned gift includes the value of a charitable trust, the policy now clarifies that the net expected value of the charitable trust be counted toward gift levels for naming or similar considerations.

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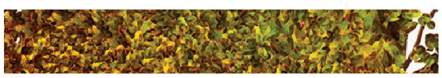
—Laura Block, University of North Dakota Foundation



Success at the Statehouse

When Laura Block arrived at the University of North Dakota (UND) Foundation, Grand Forks, as its chief financial officer, the endowment sat at $75 million. Now, 10 years later, the endowment is at the $268 million mark. Although the endowment benefited from good returns, usually around 8 percent, the bulk of the growth came from an all-out effort to pursue gifts that would support sustainable endowment growth.

The effort began in 2006, with UND's first all-campus campaign to include significant endowment goals. "In seven years, we raised $324 million, with about a third of the campaign total going into the endowment. Another third will come in the future, through deferred gifts, and much of that will also go into the endowment," says Block. Before the campaign ended, UND's fundraising got a big boost from two actions by the state legislature.

First, legislators approved a 40 percent tax credit for any endowment gift of $5,000 or more to a North Dakota–based charity. In other words, giving $50,000 to an endowment would zero out $20,000 worth of North Dakota taxes.

Then in 2012, when the state was flush with revenues from oil drilling, legislators enacted a state match. For every $1 a North Dakota donor put into a North Dakota educational institution's endowment, the state would put in 50 cents.

"The state gave its contribution all at once, even if the donor had committed to pledge over time. So even if a donor gave $10,000 per year for five years, the state put $25,000 into the endowment from Day One," Block explains. The match applied to all 11 higher education institutions within North Dakota, although UND and the state's other research institution each had a higher cap of $10 million on the state's contributions. "When the match became available, we saw many people who had always been on the sidelines—maybe waiting until they retired—give a gift," reports Block. Younger as well as older donors took advantage of the matching opportunity, with the university also seeing increased giving among many people who had given smaller amounts in the past.

Block credits UND's key donors and alumni for leading the charge and, with support from the university's leadership team, for persistently pursuing the endowment tax credit and state match over the course of several legislative sessions. "These ideas didn't come from the legislators but from our donors sharing statistics and testifying about the importance of driving philanthropy," says Block. "Our donors really emphasized the need to build a rainy day fund for institutions to draw on when times are tough and gifts aren't as great."

The rainy day arrived in 2015, when activity in North Dakota's oil fields came to a near standstill and UND's investment returns plummeted. The state stood by its commitment to match 50 percent of endowment gifts but lowered the cap on its contributions to $200,000 annually. For its part, the UND Foundation maintained its spending rate at 4 percent, although it adopted an underwater endowment policy to reduce the payout on endowments falling below 85 percent of the original gift's value. About 90 percent of UND's endowment spending is dictated by donor restrictions, primarily for student scholarships and faculty enhancement programs. UND often uses unrestricted funds for special initiatives, such as the petroleum engineering program it launched a few years ago.

During the last decade, UND has received fewer unrestricted major gifts—a trend Block expects will continue as a new generation of donors steps up. "Donors are really cognizant about where a major gift is going, and younger demographics in particular want to be integrally involved and know what exactly they are impacting," says Block. "They don't look at sustainable funds in the same way as our older donors. Our younger donors like their money to be spent, which will present some challenges when they move into the position of being our major donors."

Endowment Update

For the latest information on investment trends, economic forecasts, and asset allocations, join other chief financial officers and institutional treasurers at NACUBO's 2018 Endowment and Debt Management Forum (EDMF), to be held February 7–9, at the New York Marriott Marquis. Advance registration for NACUBO members is $795 per person; this early-bird registration fee is available until Jan. 10, 2018. For more information about EDMF or to register, visit www.nacubo.org and click on the "Events and Programs" tab.

Back on Track

After the financial crisis in 2008, the foundation of Valencia College in Orlando, noticed a decrease in contributions. Formerly known as Valencia Community College, the primarily two-year institution that serves 74,000 students had been actively fundraising for its endowment when the drop-off occurred.

"We had a lot of donors who questioned the value of donating to an endowment as they saw market values crash below corpus values. They wanted to know why we had the endowment and only spent a small percentage," recalls Michelle Matis, vice president and chief financial officer of the Valencia College Foundation. "These donors still believed in the college and its purpose but were more interested in giving for immediate need, such as scholarships, or to directly support a specific academic program."

With fewer contributions, the endowment increased slowly, averaging 4 percent growth annually over 10 years. Still, the foundation continued to disperse about 4 percent annually. Valencia, which does not use any endowment spending to cover operational expenses, applies the bulk of its spending (55 percent) to student scholarships. Each year, the foundation sets aside some unrestricted dollars for Save Our Students (SOS), an emergency hardship fund available for disbursement by frontline staff, administrators, counselors, and career advisers at Valencia's eight campuses. "They are the people who see students with issues such as not being able to buy books because a car needs repairing. By making funds available through SOS, we're trying to prevent the stop-outs," Matis explains.

In 2012, donations to Valencia's endowment began a marked climb, and the endowment's value now stands at $70.3 million. Along the way, the foundation's finance committee benchmarked other institutions' spending policies and made a major adjustment: To even out the effect on students who rely heavily on scholarships, the foundation moved from using a rolling three-year average in its spending calculation to a seven-year average. Valencia, which uses an outsourced CIO, also increased the minimum balances required to establish an endowment, setting scholarships at $25,000 and endowed faculty chairs at $50,000.

Rather than using the endowed chairs to bring in visiting faculty, the college offers them as an incentive for faculty to undertake research and other special projects—and the professors must apply for the privilege every year. "Only tenured faculty can apply for an endowed chair, and it's quite a competitive program," says Matis. "They have to make a case for how they'd use the funds, what they want to accomplish, and how they might incorporate students into their plans. The faculty association administers the program and comes up with the procedures for selecting recipients."

Adding more endowed chairs and scholarships will be a focus of Valencia's upcoming campaign to add $30 million to its overall net assets, although not all the funds raised will go into the endowment. Matis operates on the principle that she can look any endowment donor in the eye and honestly say, "This is what we did with your money." To that end, Valencia issues a state-of-the-foundation annual report, encourages donors to review audits and prior-year Form 990s on its website, sends each scholarship donor a personalized report on how much was awarded and to whom, and forwards thank-you notes from scholarship recipients.

Matis also welcomes questions from donors, along with requests to review meeting minutes and investment reports. "Donors may not always agree with the decisions the foundation makes," she says, "but if we can show them the process we followed—the statistics we looked at, the information we considered—they'll realize we can't and don't make a decision based on just one factor."

SANDRA R. SABO, Mendota Heights, Minn., covers higher education business issues for *Business Officer.*
sandysabo@comcast.net