First Comes Spending, Then Come Investments—or Is It Vice Versa?

When it comes to spending and investment policies, it's a bit of a chicken-and-egg scenario for nonprofits. How a nonprofit chooses to invest portfolio assets and the amount of grants it plans to award are complimentary decisions, so it's basically impossible to say which of these decisions comes first.

What we can say with certainty is that endowments and foundations need both an investment policy that documents how portfolio assets are deployed and a spending policy that outlines how much of the portfolio is earmarked for grants. We also know that stakeholders who do not tie spending to investments create significant potential for a decline in portfolio assets and the financial means to award grants in the future.

It should, therefore, come as no surprise that organizations that craft incompatible spending and investment policies may jeopardize a nonprofit's future and may violate their fiduciary duties under the Uniform Prudent Management of Institutional Funds Act (UPMIFA). In fact, UPMIFA specifically indicates that organizations must factor in the investment policy of the institution and the expected total return from income and the appreciation of investments when determining spending rates.

Successfully fulfilling the mission of a nonprofit depends on careful control and planning around both spending policy and investment strategy.

The Role of a Spending Policy

An organization's spending policy is a tool that guides the charitable spending and investment trade-off. Spending rules are ultimately designed to advance the mission of an organization and its multiple goals. "A nonprofit institution's spending approach should be unique to the goals, financials, and risk profile of the organization; it’s not a one-size-fits-all approach,” says CAPTRUST Senior Manager James Stenstrom.

“Our experience has shown us that having clearly defined spending rules instills a higher level of accountability into the budgeting and financial oversight process,” says Stenstrom.

Developing an appropriate spending policy is one of the more challenging steps in the nonprofit planning process. “The institution’s spending policy is usually one of the most important investment strategy inputs,” says Stenstrom. Interestingly, as shown in Figure One, 12 percent of CAPTRUST’s 2018 Endowment and Foundation Survey respondents do not have a formal documented spending policy.

Figure One: Endowments and Foundations with a Documented Spending Policy

Source: CAPTRUST’s 2018 Endowment and Foundation Survey results.

However, a poorly understood or implemented spending policy may be worse than not having one at all. It is important to have an established spending policy in good order and accessible to key decision makers. Furthermore, decisions about implementing a spending policy should be formally documented so context is maintained as stakeholders change over time.

A formal spending policy is an important component of any audit trail. It provides the context necessary to understand drivers of past success or failure. Lastly, a formal policy accompanied by documented compliance may be the best defense against the potential for declined ability to award grants for future generations.

The Big Balance

For key decision makers, balancing current and future spending can involve difficult, even painful, trade-offs. Officials must balance the expected life of the programs to be funded against the desired life of the organization and the intent of the original charitable gift. This involves the management of three broad trade-offs: spending, investment risk, and investment return.

There are no easy answers.

“Nonprofits must carefully orchestrate the trade-offs between sustainability and predictability in the present and the future. The more a spending policy varies with fluctuations in asset values, the more sustainable—but less predictable—it is,” says CAPTRUST’s Stenstrom.

A high rate of spending requires a relatively aggressive and riskier portfolio or more fundraising to support that spending. Conversely, committees that prefer more conservative investment approaches may need to reduce spending. Stenstrom explains that the spending rate should be coordinated with overall average portfolio returns to ensure spending and investment returns are well balanced.

“Spending more than generated returns on an ongoing basis is a recipe for a decline in assets, regardless of other features of the spending rule," says Stenstrom. "The perpetual struggle is to decide how much of the available assets should go to those worthy causes currently knocking at the door and what should be invested for future needs."

When endowments and foundations invest too aggressively, their portfolios may be decimated by both spending and portfolio declines. But if they invest too conservatively, their portfolios may not provide enough growth to keep up with inflation. High levels of spending may require aggressive investment strategies, but these strategies may lead to greater uncertainty in returns, making a spending policy less sustainable.

Given these uncertainties, it's in the best interest of nonprofits to carefully coordinate overall fund goals with spending and investment decisions. Further, it is critical that decision makers understand the impact that spending decisions can have on their investment portfolio.

Different Types of Spending Policies

An endowment or foundation's spending policy might be based on current asset value, trailing-average asset value, past spending, income from assets, portfolio returns, or some combination of these. But the right spending policy plays a significant role in an institutions' ability to achieve its objectives.

A well-thought-out spending policy should balance the current and future needs of the organization while creating a practical and predictable level of spending. A sound policy must also consider the organization's other sources of funds, such as fundraising, grants, and government support, and how they correlate to the financial markets and spending needs. And finally, a good spending policy maintains the original donor's intent where applicable.

Evaluating strategies across multiyear market scenarios allows more flexibility in the types of spending policies that can be considered and provides the ability to emphasize different goals over different investment horizons.

"Most often, we see moving-average-based spending policies—where an organization spends a fixed percentage of its portfolio's average market value over a set time period," says CAPTRUST Senior Director Grant Verhaeghe. "12 or 20 quarters are commonly used periods."

But while moving average policies tend to strike a good balance between preserving portfolios and sustaining future spending, we see nonprofits using a variety of spending policy types as shown in Figure Two.

Figure Two: Spending Policy Usage Among Nonprofits

Source: CAPTRUST's 2018 Endowment and Foundation Survey results.

There is no way to conclude if one policy is superior to any other policy on a general basis, sinceeach has its merits in different situations.

A thorough review of a nonprofit's goals, objectives, and needs is a staple in both the initial and ongoing part of establishing your nonprofits spending policy. As the decisions made around spending help drive asset allocation and investment manager selection decisions, establishing these rules can be one of the most important and pressing choices a nonprofit board, spending, or investment committee will make.

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