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2021 UPDATE:

SEI's Nonprofit Spending Policy Research Series

Background

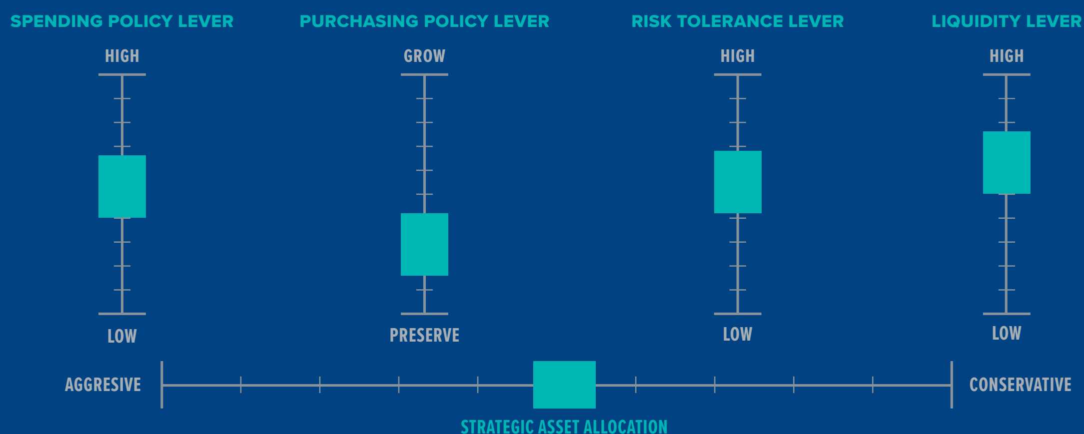
The SEI Nonprofit Management Research Panel completed a comprehensive survey of executives and investment committee members from nonprofits in the U.S. and Canada to gauge their views on a number of critical components of their organizations. The poll was completed by 102 participants, representing nonprofits 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 2020-2021 and are releasing a series of chapters focused on nonprofit spending, governance/board and committee management, investment management and fundraising.

Summary

Spending practices of nonprofit organizations dictate the cash outflows that are used for a variety of philanthropic purposes like scholarships and financial aid, grants to the community, operational support, capital improvements and professional development, but they need to be balanced with the long term nature of the assets to last in perpetuity and help future beneficiaries. Thus enters the challenge of deciding what spending policy is the right number, which then influences how high your return objective should be, and of course, there is no free lunch in investing, so the higher the return needs, the more risks investors take on. Consider the chart below, which identifies 4 key levers that influence that risk/return tradeoff, aka, the asset allocation.

FIGURE 1

Prioritize the levers to align with your desired risk and return goals



This chart shows how the levers might look if you prioritize a moderate spending rate. To take a balanced approach to achieving your target return, which implies a moderate risk tolerance and a balanced strategic asset allocation, you may also need to be prepared for capital erosion over the long-term. If you find you aren't willing to trade off one lever for another, then it may be necessary to reevaluate your priorities. For example, as shown in the chart, if you do not truly have a moderate risk tolerance, or you have a need to grow capital, then you may need to rethink your spending target.

Spending is by far the largest variable, and one that organizations can somewhat control, as opposed to inflation, which is a liability that increases as the time horizon increases, but still must be accounted for as part of the long-term return goal to maintain the purchasing power of the assets. Enter the risk side of the equation, and the short term liquidity needs, all of which are part of the asset allocation framework. It's not surprising that over the past decade as low interest rates drove down long-term return expectations, we have generally seen downward pressure on spending policies. With the impact of the COVID-19 pandemic last year, revenue streams were shut down overnight and caused a higher demand for liquidity to supplement the outflow and expense side of the nonprofit ledger. Some organizations benefited from having or initiating credit facilities and PPP loans. Donors graciously stepped up to the plate and we saw an increase in inflows from giving, and some organizations looked to their long-term investment pools and endowments. Even UPMIFA granted flexibility in what was considered prudent spending (normally a max of 7%).

Our survey responses uncover organization spending strategies.

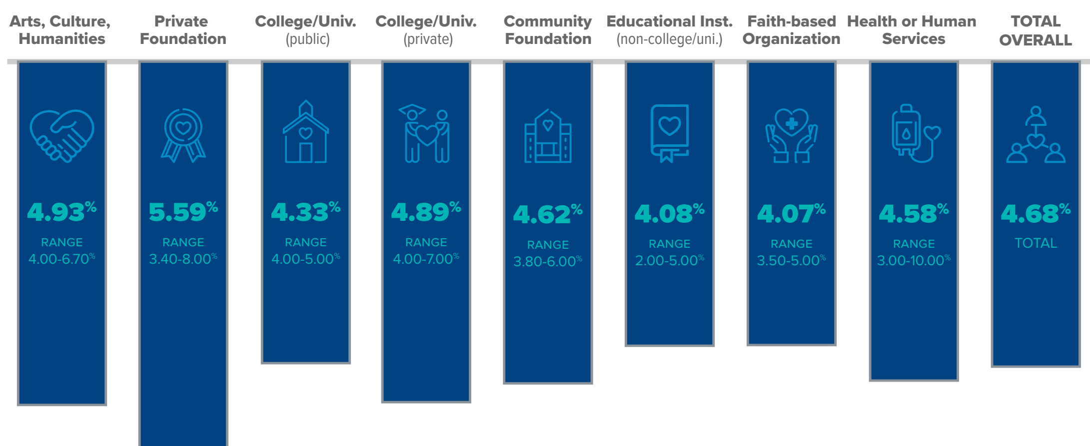
SECTION 1

Spending levels

The overall average for the FY20 data was 4.68%, slightly down from the SEI survey five years prior, which averaged 4.75%, and for FY12 the average was 4.8%. It may seem like a small incremental change but keep in mind that most spending calculations are smoothed by virtue of their rolling average calculation. That said, this year, when looking under the hood at the data by types of nonprofits, as shown in Exhibit A, half actually saw an increase relative to 2016. Private foundations, health and human services, community foundations and private universities all saw increases in the average spending policy rate. Private foundations, like community foundations, saw an increase in grant applications due to the pandemic, as resources plummeted and grantmaking increased, which is directly correlated to spending. Health and human services, who were clearly on the front line, and private colleges and universities, who do not receive state appropriations to supplement their revenue drop from falling enrollment, had more operational needs that had to be met to keep afloat during this turbulent time.

FIGURE 2

Spending rates by organization type



FAST FACT:

Per the NACUBO FY20 study, the spending rate average for private colleges and universities is 4.92%, compared to 4.1% for public colleges and universities, both fairly consistent with SEI's survey.

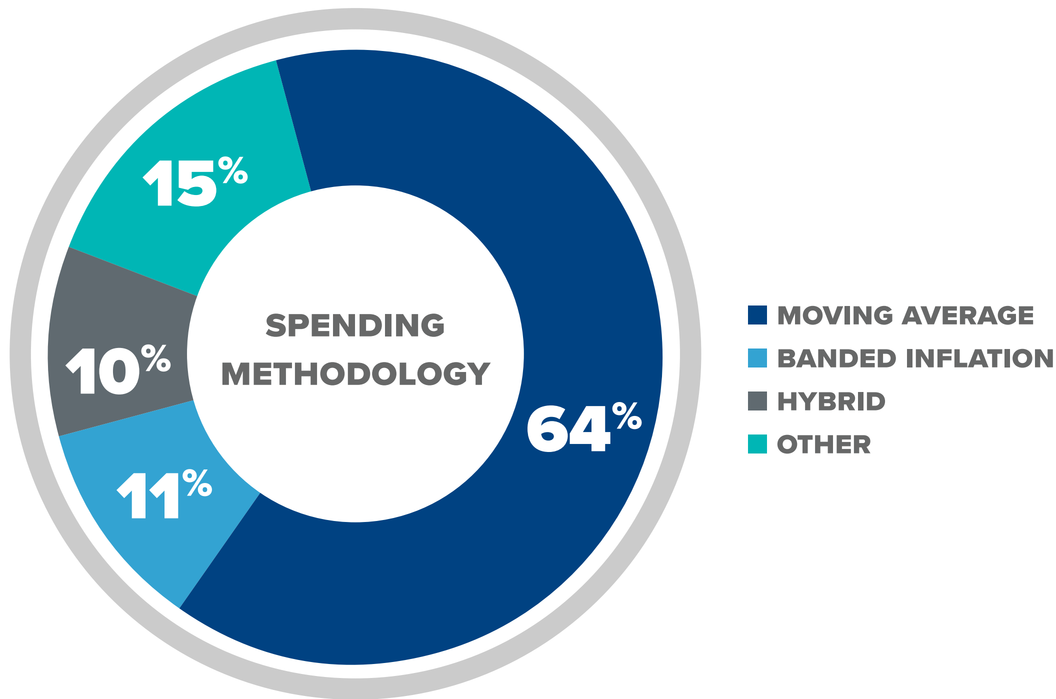
SECTION 2

Nonprofit annual spending rate methodologies

According to the poll, 64% of participants use the moving average method, 16% use other methodologies, 11% use a banded inflation methodology and 10% use a hybrid methodology. 70% of those that use a moving average use a 12 quarter or 3-year rolling average, up from 52% in 2016; 22% use a 20 quarter or 5-year moving average; 8% use over a 6-year rolling average.

FIGURE 3

Spending methodologies being used



FAST FACT:

The banded inflation method has grown in usage since 2016, which tells us nonprofit organizations were looking for a better predictability factor in 2020. Banded inflation allows for guard rails to help manage volatility and distributions year to year, while incorporating incremental increases and expenses.

Different types of spending rate methodologies and what they mean

- **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 and are more correlated to an increasing or decreasing market value.

- **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 if there is no adjustment for spending downward when market returns have been poor. This methodology has increased in usage, but is often accompanied with guard rails for some control.

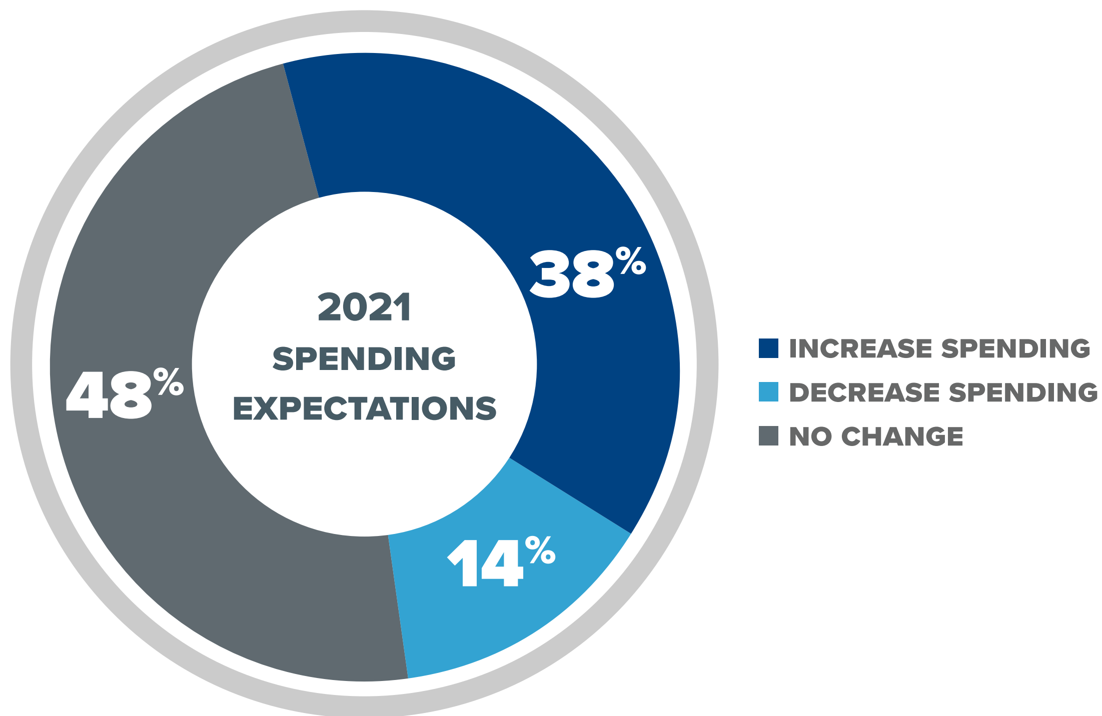
- **Hybrid or Yale model:** This approach combines the above two strategies. The level of annual spending is determined by combining a fixed amount using the banded inflation model and a fixed percentage using a moving average formula with three- or five-year smoothing. As a result, a portion of the spending varies based on the markets (inflation formula), and a portion is more predictable (moving average).

SECTION 3

Spending expectations and impacts on spending from 2020

The percentage of organizations that are expecting to increase spending has doubled in the last five years.

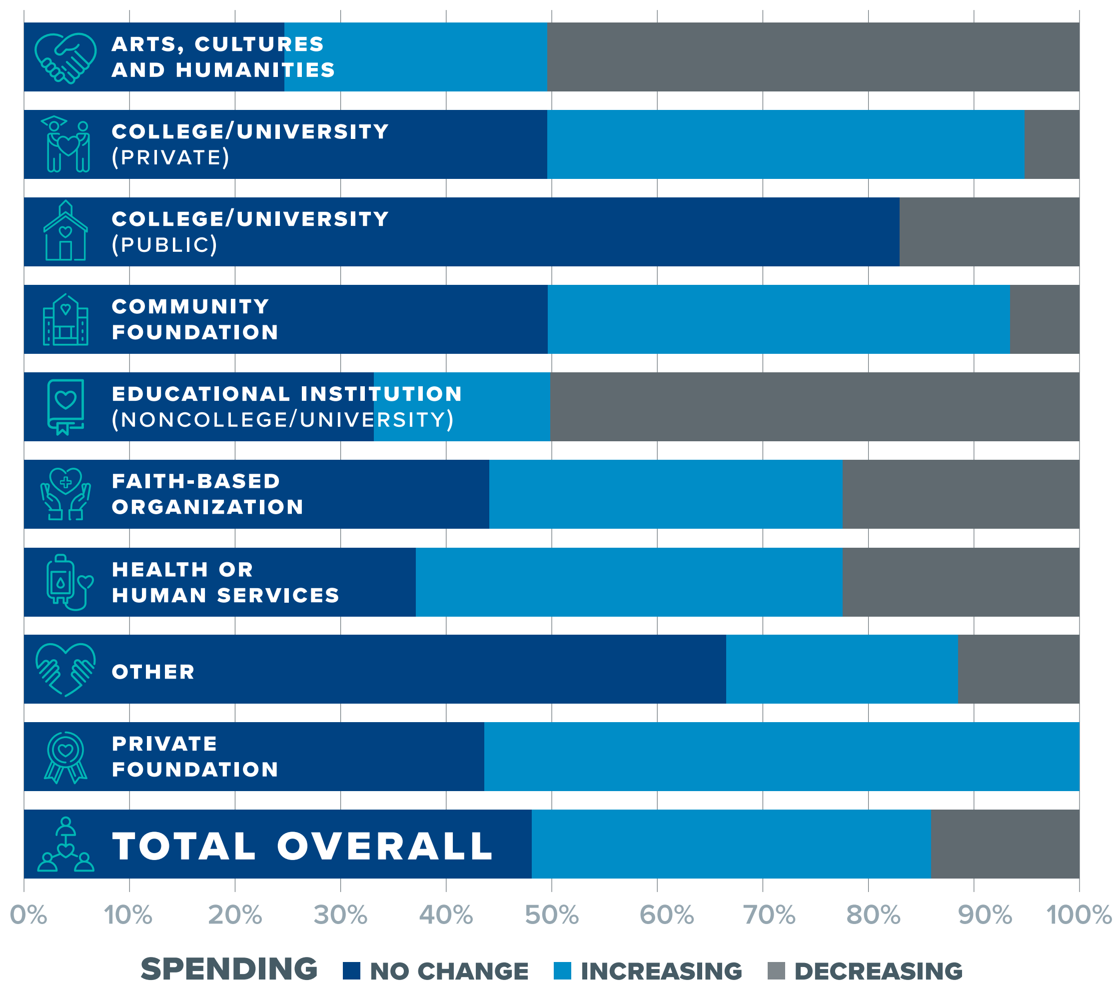
FIGURE 4
Spending expectations (increasing, decreasing or same for all nonprofits)



In an effort to gauge the spending outlook, we asked each organization if they expected to increase, hold steady or reduce spending in 2021. According to the nonprofits surveyed, most organizations (48%) do not plan on making spending changes. There was a significant increase, however, in the percentage that are evaluating whether the spend rate should be higher, now 38% of the respondents, up from 19% in 2016. Arts and culture, healthcare and human services and public higher education were the biggest drivers of this increase, per Figure 5.

FIGURE 5

Spending expectations broken down by NFP type



When asked specifically how the COVID-19 pandemic impacted spending, 68% responded "No Impact." There may be additional revenue sources to offset operational strains for some organizations, or a distinct separation between short-term liquidity needs and the long-term nature of the endowment pools. However, of those that DID experience an impact:

- 11% said their organization is considering an allocation (or increased allocation) to illiquid investments as a source of return.
- 10% said their organization is considering changing the methodology used to calculate spending.
- 3% said their organization did not meet their spending target.

FAST FACT:

44% of community foundations increased spending in 2021.

SECTION 4

Nonprofits expect an increase in inflation

When we look back at the levers chart in the introduction, inflation is another metric that must be included in the return hurdle. The “inflation wind” has most certainly been at our back for well over a decade, generally not hitting the Federal Reserve long-term target of 2% during that time, as measured by the PCE deflator and considering CPI ex-food and energy (the more volatile sectors). However, recent fiscal and monetary stimulus, which has helped keep the economy moving during this pandemic, may influence that trend moving forward. The question will be whether it’s transitory, or temporary, as the Fed is suggesting, as we exit the pandemic and see pent up demand released, or is it a more secular change in long-term supply and demand? The consensus among economists seems to be the former, and the market is trying to figure out if it agrees with the transitory projections.

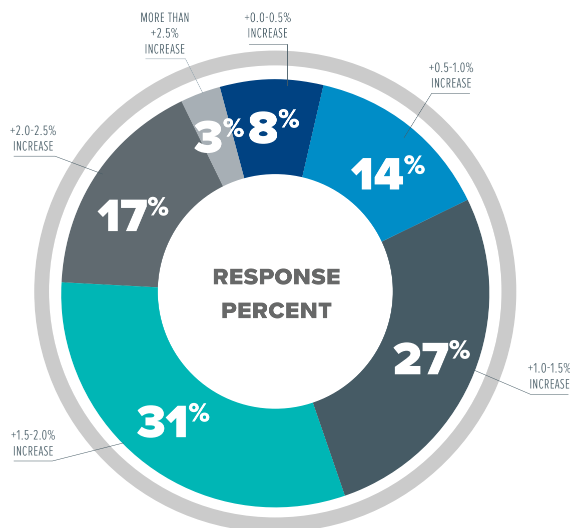
There was a 55% increase in nonprofit respondents that believe 2021 inflation will increase to **2-2.5%.**

This was the biggest increase overall, showcasing the impact of COVID-19 inflation rates. This is significant because the Fed’s threshold has been steady at 2%, but last year they noted it wouldn’t be an absolute 2% and would be more of a floating, relative rate.

The number of nonprofit respondents that believe there will be a 1.5-2.0% increase in inflation jumped from 25% to 30% in 2021.

FIGURE 6

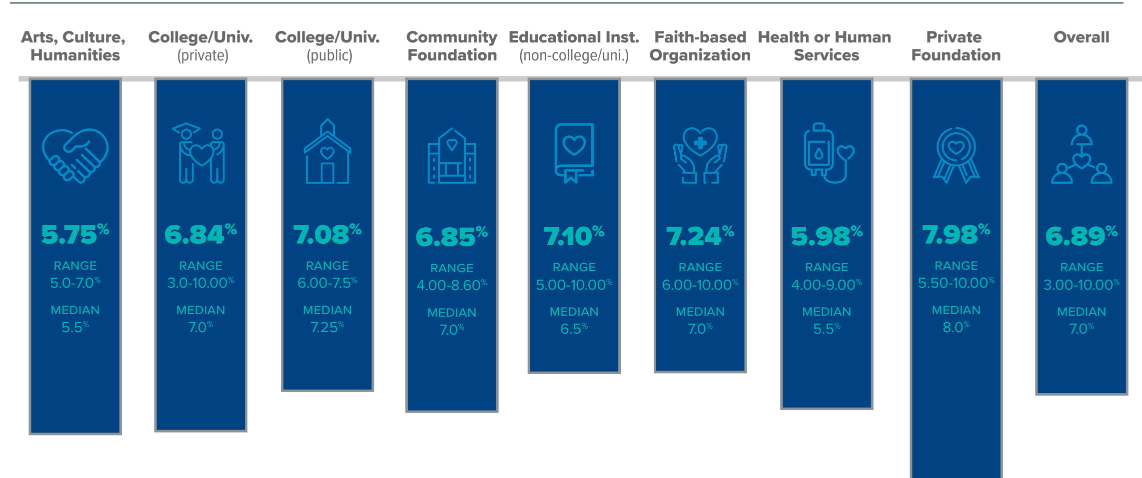
Inflation expectations for 2021



Increasing spending pressures and inflation expectations points to increasing expected return targets. The chart below shows expected returns by nonprofit type. The overall return target was 6.91%, almost identical to the average in 2016, but in this year's survey we saw less returns in excess of 10% so the median was closer to the average, which was 7%.

FIGURE 7

Expected returns by nonprofit type



FAST FACT:

Overall, 71% of higher education institutions kept their return target the same for 2021, while the other 29% of respondents increased their return goals.

The role of alternative asset classes

With upward pressure on the quest for return, some nonprofits are turning to illiquid asset classes like private equity, venture capital, distressed debt and private real assets to get paid a illiquidity premium, the incrementally higher return an investor expects to get paid for giving up liquidity. The chart below shows how nonprofits are thinking about increasing their allocation to these illiquid asset classes, even at a time when liquidity, as previously discussed, is in dire need in the short term. Overall, 28% plan to increase their allocation to alternative asset classes. It is important to work with your investment partner and committees to understand how much illiquidity risk the organizations can take and how the liquidity profile can change in the event of a market shock.

FIGURE 8

Approximately, what percentage of your endowments' investments would be classified as illiquid?

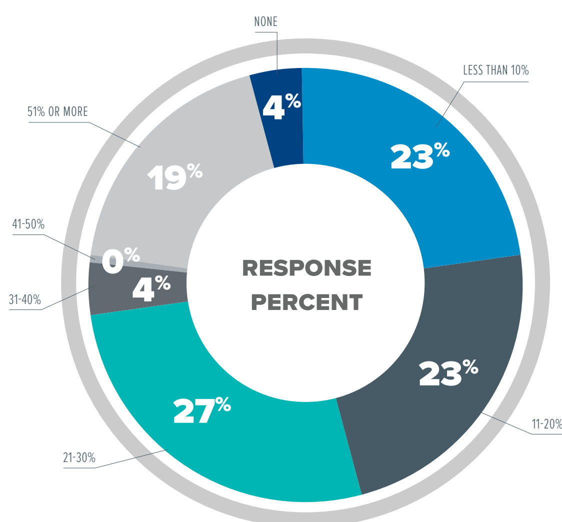
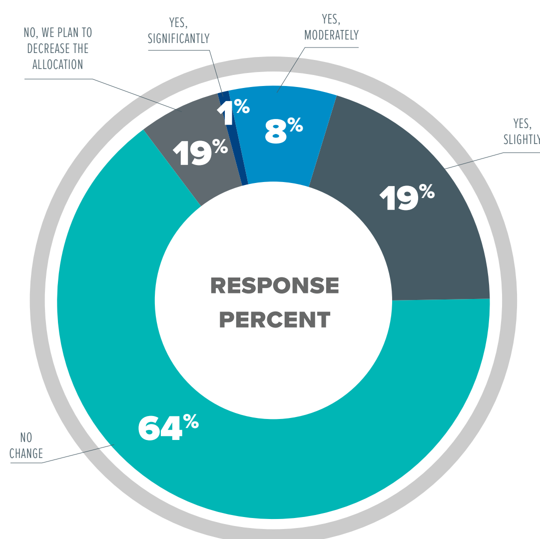


FIGURE 9

Do you plan to increase your allocation to alternatives in 2021?



SECTION 5

Spending on non-endowed vs endowed assets

Endowments, which often make up the majority of a nonprofit's investable assets, are typically what the spending rate is applied to. If there are non-endowed assets, or unrestricted assets, which tend to have a more flexible purpose than those with donor restrictions, then they are either excluded for a specific purpose or included in the overall calculation. But some organizations, almost a third (29%) of those responding, have a separate spending policy on these non-endowed assets, which can more often be called on for operational support, especially in times of liquidity crunches. Community foundations in particular represented almost half of those organizations that do have a separate policy. When surveying higher education in particular, 12% actually have a separate asset allocation for these assets, which may be because there are different investment pools and/or governance structures.

Conclusion

Evaluating your Spending Policy is an on-going fiduciary exercise. Since spending needs drive return objectives, and balancing return and risk drives strategic asset allocation decisions, it's imperative that the spending policy be periodically reviewed in conjunction with the organization's current needs. As stewards of these important assets, being attentive to the changing conditions—be they market driven or some other external or internal events—is a fiduciary responsibility. Working alongside your investment provider, it is important to integrate this analysis into your board and finance/ investment committee agendas and regularly monitor your progress towards helping your organization achieve its long term mission.

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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