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OCIOs, Consultants Call on Endowments to Re-Examine Spending Policies

The way a nonprofit spends their funds has implications for asset allocation, outsourced chief investment officers say.

By Justin Mitchell | May 2, 2022

Outsourced chief investment officers and consultants are nudging their endowment and foundation clients to re-examine their spending policies on a regular basis to make sure they are aligned with asset allocation targets.

Spending policy is the “most overlooked” part of managing an endowment, and it plays a key role in figuring out an institution’s asset allocation, according to Commonfund, an OCIO firm that serves nonprofits, and endowments.

“As the only permanent link between the endowment and the institution it supports, the spending, or distribution, policy … should be revisited just as frequently as an asset allocation,” write Commonfund Managing Director Anthony Peretore and Associate Rachel Clivaz in a recent paper. “The investment committee should ensure that the endowment has adopted the optimal calculation for its institution by considering key aspects such as the operating budget’s reliance on the endowment and sensitivity to distribution volatility.”

Commonfund said it has designed a set of questions to help guide investment committees and staff to select a spending policy most appropriate for a particular investor, and has found many institutions have adjusted their policy after going through the exercise.

But the answer is different for each institution. The most important thing for OCIOs and consultants to do is get their clients to focus on what is unique about their own institution, instead of focusing on what others are doing, said Matt Bank, a principal at Global Endowment Management, an OCIO.

“There really isn't a one-size-fits-all approach. It has to be customized. It has to be tailored. And so it can't be done in batches or at scale,” he said.

In general, nonprofits have less tolerance for variability in the amount of money they plan to spend each year, said Elizabeth Warren, director of the member strategy group at TIFF Investment Management, another OCIO that works with nonprofits.

“They just want more predictability about what they’re going to get and when,” she said.

Asset allocation comes first, Warren said. An institution can figure out their spending policy based on what their asset mix is, she added.

“I do think spending volatility has really come to the forefront for most of the nonprofits we've worked with,” she said. “But return volatility is the primary input of spending volatility.”

Some big questions that come up include the level of risk an institution is willing to take on, what sort of agreements it has with donors, the institution’s operational stresses and what other sources of capital it may have, Bank said.

Spending policy is also critical to asset allocation because it plays a role in how the institution figures out what to target for its returns, said M.J. Bobyock, a managing director in the OCIO program at SEI.

“When you think about your asset allocation, you think about your risk-return profile – how much do you need to make, and how much risk are you willing to take to make that much,” she said.

The spending policy most commonly used by nonprofits is based on the moving average of the endowment’s market value over the last 12 quarters, the paper states, citing numbers from the National Association of College and University Business Officers and TIAA’s 2021 endowment study.

A separate study SEI released recently in tandem with the Association of Governing Boards of Universities and Colleges, based on a survey of 130 public university endowments between July to September of last year, found that 23% were planning to increase the amount they spend. More than a quarter of those that were planning an increase said it was due to a change in spending policy.

The vast majority, 82% of all survey respondents, used some sort of moving average for their spending policies, the SEI study said.

“[The moving average is] a simple calculation. It's easier explained to donors,” Bobyock said. “But then, you miss the benefit of spending more in an upmarket and sometimes that's not aligned with the institution or the donors’ ideal.”

Bobyock suggested institutions could use a “hybrid” spending policy, one that mixes a moving average with a calculation for inflation. The Commonfund study also suggested two different possible hybrid models, and stated that using just a moving average creates a "feast or famine" scenario where a market drawdown could seriously impede the endowment's ability to support operations.

Some nonprofits did find themselves having to support their attached institutions more in recent years as they reacted to the market fallout from the coronavirus pandemic, as reported.

However, very few clients changed their spending policy just because of the pandemic, although they did talk about it more, Bobyock said.

"The market corrected so quickly that it's sort of masked any challenges people might have," Bank, from Global Endowment Management, said. "We generally had very few clients who overdrew from their foundations or endowments that year at most up to relatively consistent policy and kept their eyes on the long term."