



SEI's Nonprofit Spending Policy Research Series.

2023 Update



Spending policy is the biggest driver of a portfolio's return objective and the amount of risk to take.

Background

The SEI Nonprofit Management Research Panel surveyed executives and investment committee members from nonprofits in the U.S. and Canada on a number of key measures. Nearly 100 participants completed the poll, representing nonprofits with endowments ranging from \$5 million to more than \$5 billion. None of the respondents are current clients of SEI®. We conducted the poll from May through July 2023.

Summary.

Risk/Return tradeoff

Good governance includes strong, well-thought-out policies, and investment portfolio stewardship rightly gets significant attention.

The assets donated or earned in a nonprofit's portfolio are typically meant to last in perpetuity, with some regular distribution to support current operational functions, grantees, student support, etc. That distribution, or spending policy, is the largest factor in determining how much a portfolio needs to return over the long term, and it is directly correlated to how much risk should be taken when establishing the strategic asset allocation within the investment policy.

Consider these key risk factors when establishing the long-term asset allocation: inflation risk, which erodes purchasing power over the long term; return variability that can be tolerated over the short term; and the amount of illiquidity that can be taken in the portfolio. The long-term return side of the equation should cover the spending and the inflation aspects, as well as investment-related fees, while being attentive to the risks taken to reach the return objective.

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

Spending policy



Purchasing policy



Risk tolerance



Liquidity



Strategic asset allocation



For illustrative purposes only.

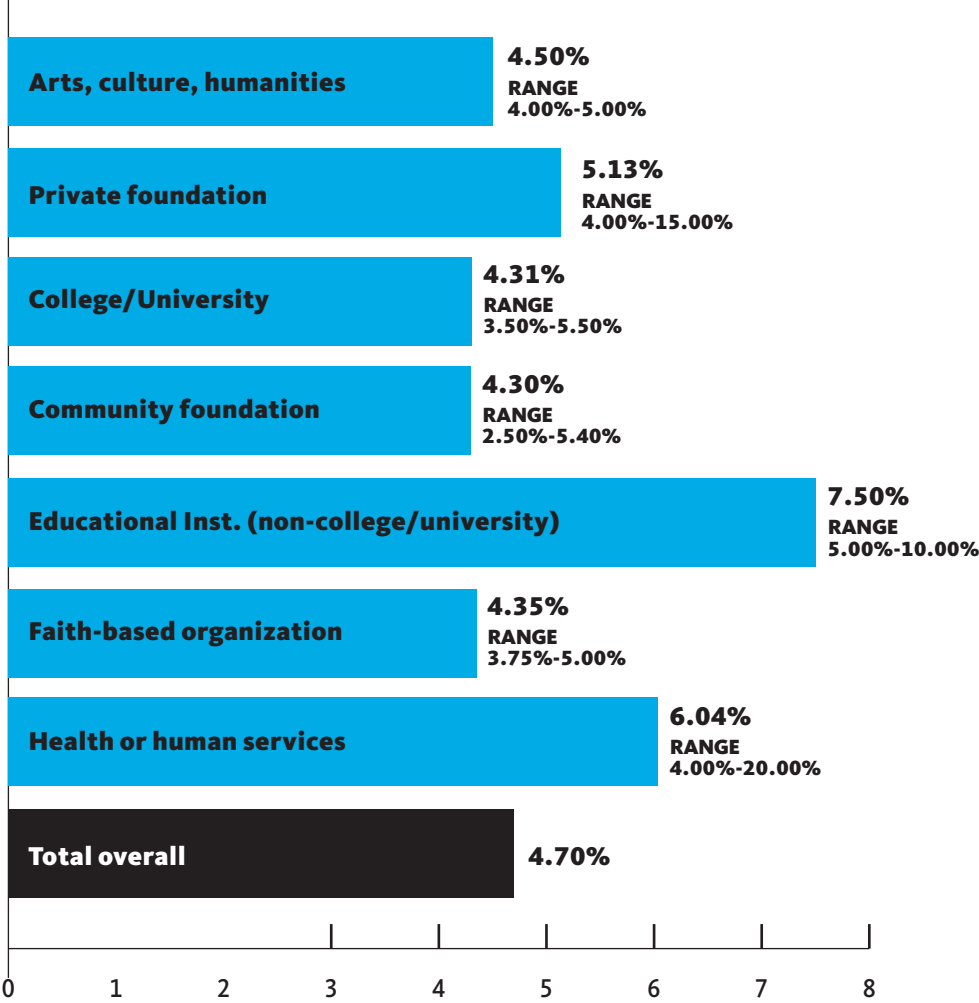
Integrating short-term cash flow needs is one key challenge for managing long-term portfolios. For example, the financial math may be as simple as withdrawing the annual spending rate of 4%, but the reality is that the funds may move in and out of a portfolio much more frequently. Subsequently, the timing of those short-term cash flows can impact both the short- and long-term returns of the portfolio. Integrating these custom cash flow considerations is also an important part of the asset allocation discussions with your investment team.

Spending levels.

Key takeaway: Spending increased over the past two years on average, but levels were very specific to organization types.

After spending elevated amounts during the COVID-19 pandemic, community foundations and the arts, culture, and humanities sector decreased spending, while other sectors increased. Higher education remained fairly stable with 65% of institutions keeping the same spending policy, while another 20% decreased their spending.

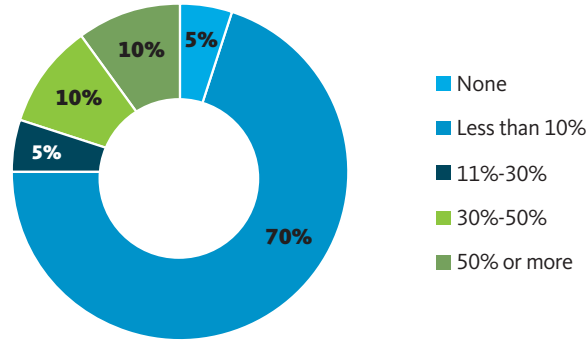
Spending rates by organization type



Operating budget and reserves.

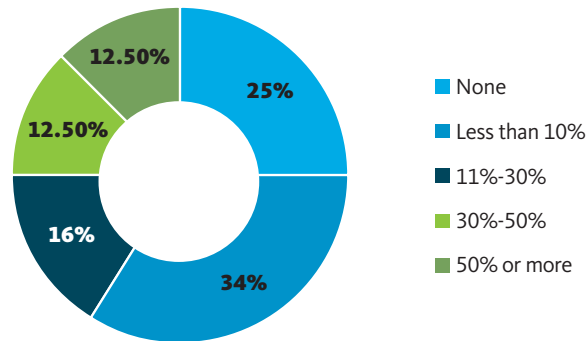
Percent of operating budget supported by endowment spend

Education



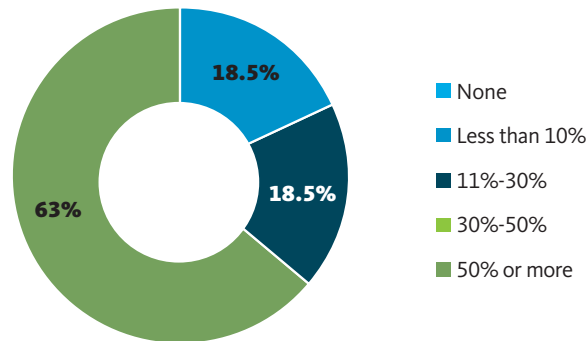
Consistent with NACUBO and other higher-ed surveys, most colleges and universities have well-diversified revenue streams. So, the the annual spending draw is not significantly supporting the operating budget, but primarily used for financial aid and scholarships.

Community foundations



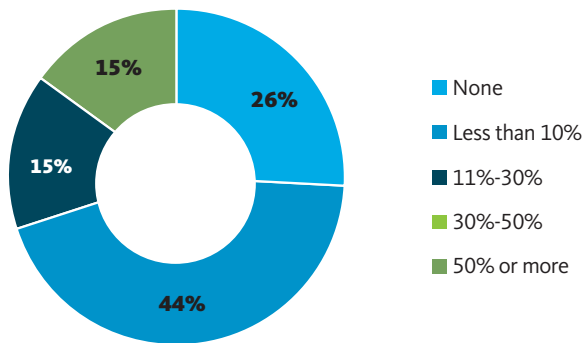
There is a fairly divergent split between the spending having a minimum, if any, level of support versus those with endowments supporting 50% or more of the operating budget, indicating many different models for community foundations.

Private foundations



As expected, private foundations, which typically have minimal sources of revenue, rely heavily on their annual draw for operating support.

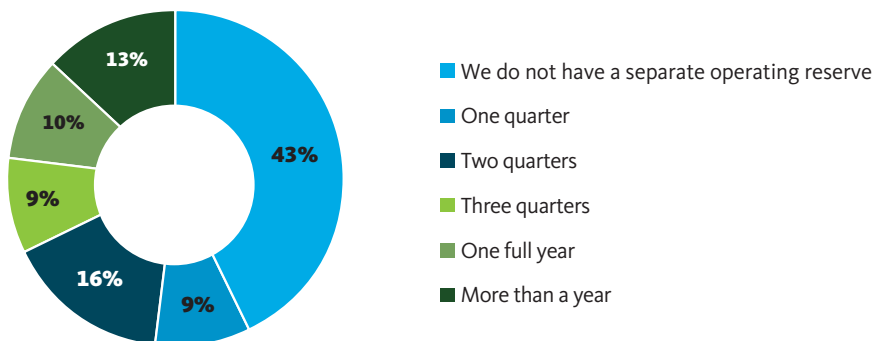
Other



The remaining types of nonprofits also tend to have less reliance on their annual spending distribution to support their operating budget; although, a meaningful amount (15%), did have a 50% dependency rate.

The debate over how much of the operating budget should be held in reserves is elevated now that interest rates have risen, and cash or short-term bonds have return potential of 3%-5%, compared to close to 0% over the past two decades. Creating an operating reserve allows more flexibility around the timing of cash withdrawals from the long-term portfolio, which can meaningfully impact long-term returns. The question often becomes: How much should be held in the long-term growth portfolio, and how much in short-term reserves? The answer, of course, is unique to each organization and their specific cash flow needs, inflows, risk tolerance, and revenue sources.

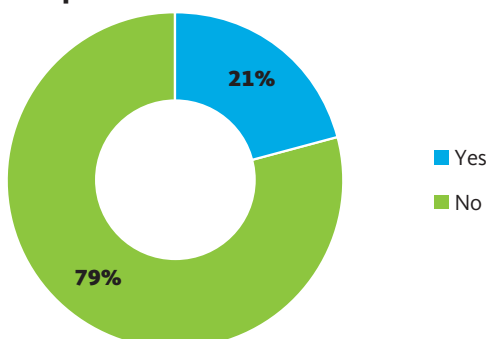
Quarters of operating budget put into a separate operating reserve



Almost 60% of nonprofits have an operating reserve. Of those that do not, which was surprisingly high, the distribution was fairly even across types of nonprofits. Of the 57% that do have a reserve, the amount of quarters held in reserve was well dispersed.

Separate spending policy for non-endowed or unrestricted assets

All respondents



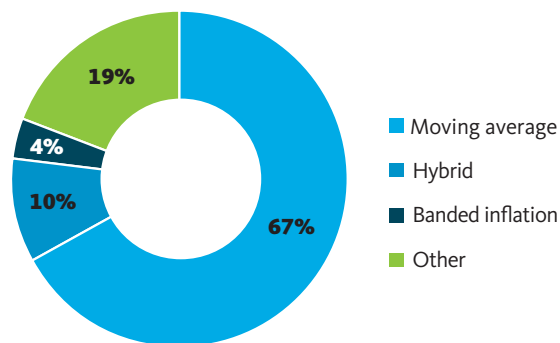
Most meaningful for larger pools of non-endowed or unrestricted assets, only 21% have a separate spending policy for these pools.

Spending methodologies.

Consistent with prior studies, the moving average methodology is most often used to calculate spending. Of that 67%, about two-thirds use 12-quarter/three-year rolling averages, while about a third use 20-quarter/five-year averages. Banded inflation decreased from our 2021* study, as inflation increased significantly over the past two years. Meanwhile, the "Other" category increased from 15% to 19%.

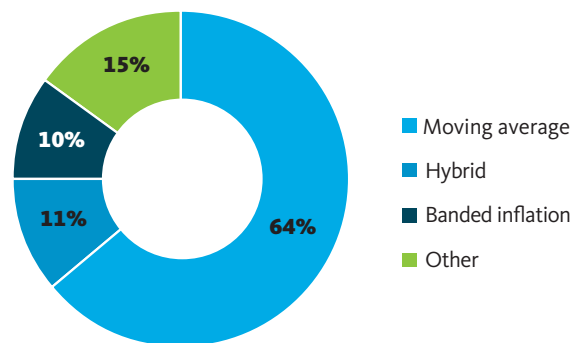
2023

Spending methodologies being used



2021

Spending methodologies being used



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 typically 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 the Higher Education Price Index (HEPI) 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 are poor. This methodology has increased in usage, but is often accompanied with guardrails for some control.

Hybrid model

This approach combines the two previously mentioned 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 can be more predictable (moving average).

*The 2021 poll was conducted in 2020-2021 by SEI, included 102 participants, representing nonprofits with endowments ranging from \$25 million to more than \$5 billion. None of the respondents were clients of SEI.

Case study: Comparing spending methodologies.

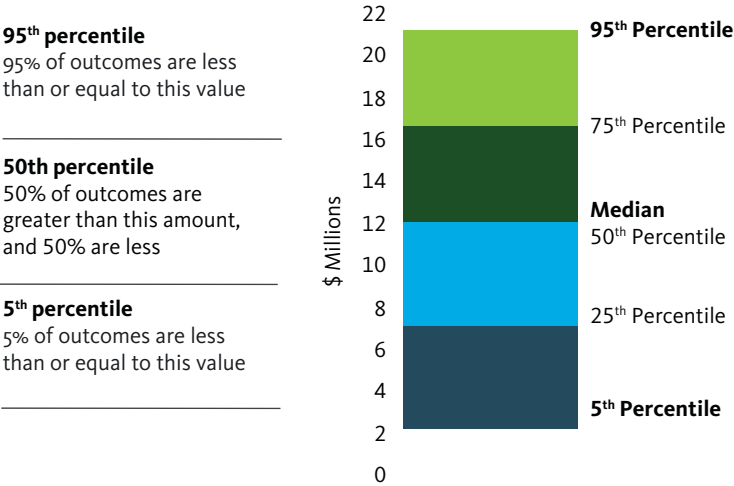
Consider an example of a \$100 million portfolio that has a spending policy of 4.5%, and assume no inflows. The profitability distribution (shown below) estimates the range of values of the \$100 million after the 4.5% spend over the next five years, assuming the expected return distribution, gross of fees, and inflation. The median value in year five would be \$125.4 million.

How we create probability distributions and what they mean

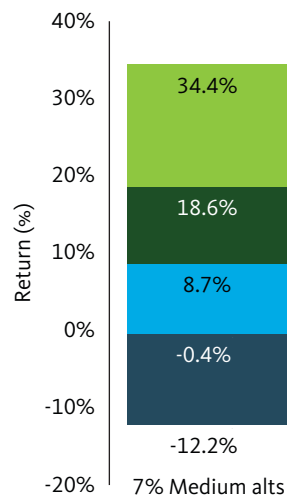
- The probability distribution graphs and/or tables that follow are meant to provide an overview of the range of possible outcomes for a given variable (e.g., returns, expense) for a given asset allocation.
- The probability distributions are generated using SEI's proprietary modeling tool and simulated capital market behavior.
- Capital market behavior is simulated for 1,000 possible scenarios based on expected performance of each asset class and reflecting 2023 economic conditions. Capital market assumptions such as return, standard deviation, and covariances are inputs into this process, combining with model parameters to create market scenarios.
- We use these 1,000 capital market scenarios to create 1,000 output scenarios for each variable being considered.
- A 90% confidence interval should be interpreted as 90% of the projected output variables, falling between the 5% and 95% results, based on SEI Capital Market Assumptions.
- This projection is hypothetical, does not reflect actual investment results, and is not a guarantee of future results.

About capital market assumptions

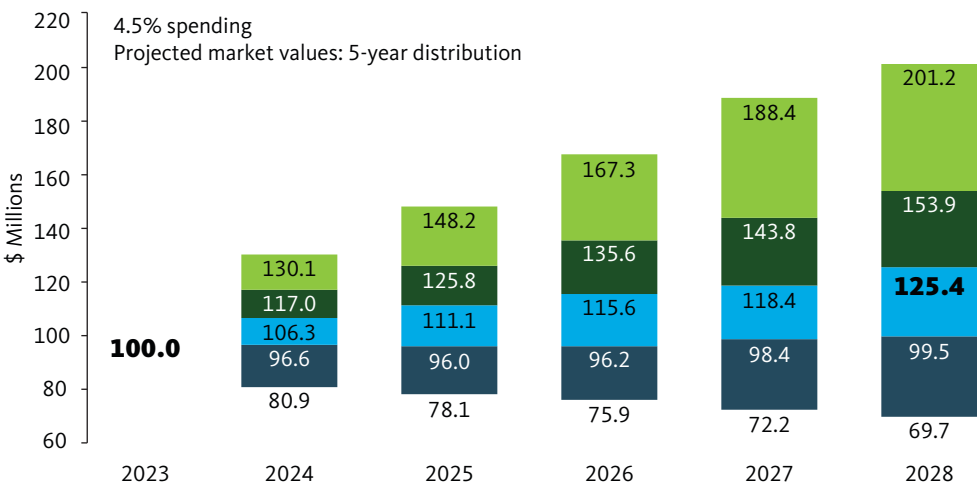
- SEI Investments Management Corporation develops forward-looking, long-term capital market assumptions for risk, return, and correlations for a variety of global asset classes, currencies, interest rates, and inflation.
- These assumptions are created using a combination of historical analysis, future market environment expectations, and by applying our own judgment. In certain cases, alpha and tracking error estimates for a particular asset class are also factored into the assumptions.
- We believe this approach is less biased than using pure historical data, which may be affected by unsustainable trends or permanent material shifts in market conditions.



Expected return distribution (10-year)

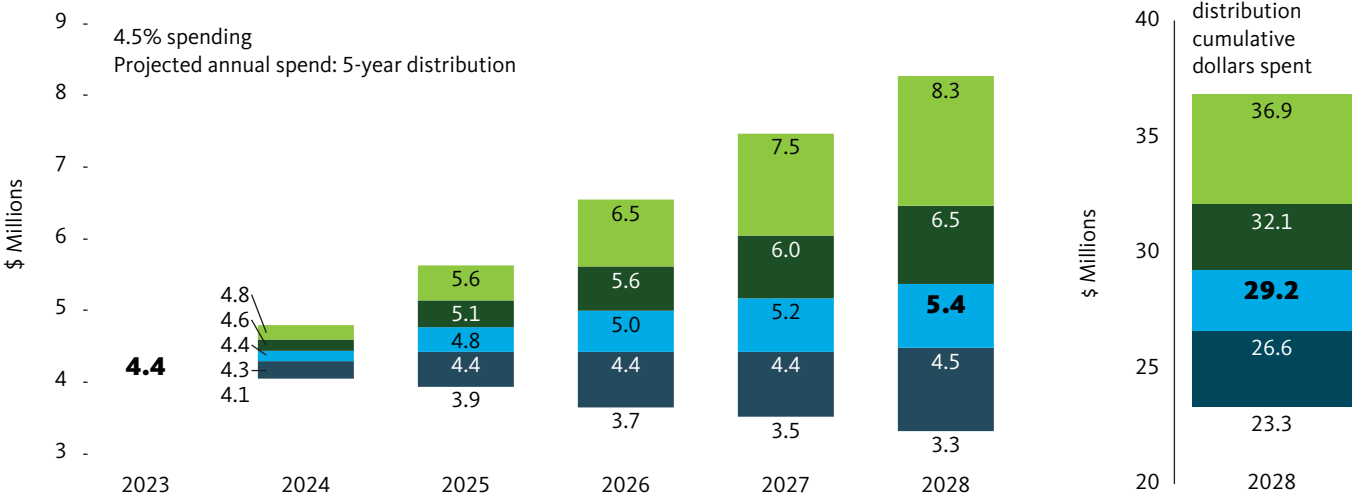


3-year moving average spending policy

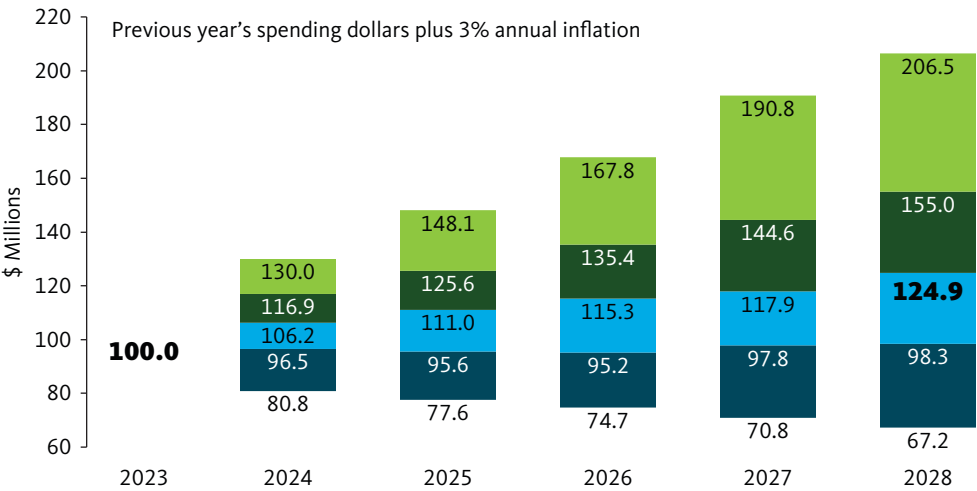


The annual spending distribution of this hypothetical portfolio would start at \$4.4 million and grow to \$5.4 million over five years, with a median cumulative spend over the five years of \$29.2 million.

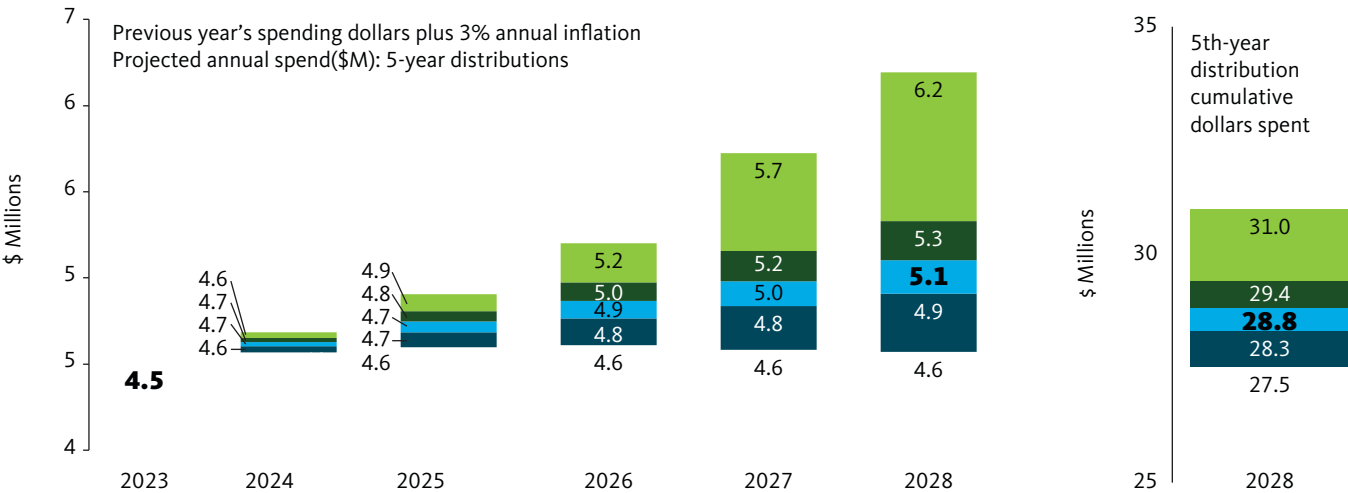
3-year moving average spending policy



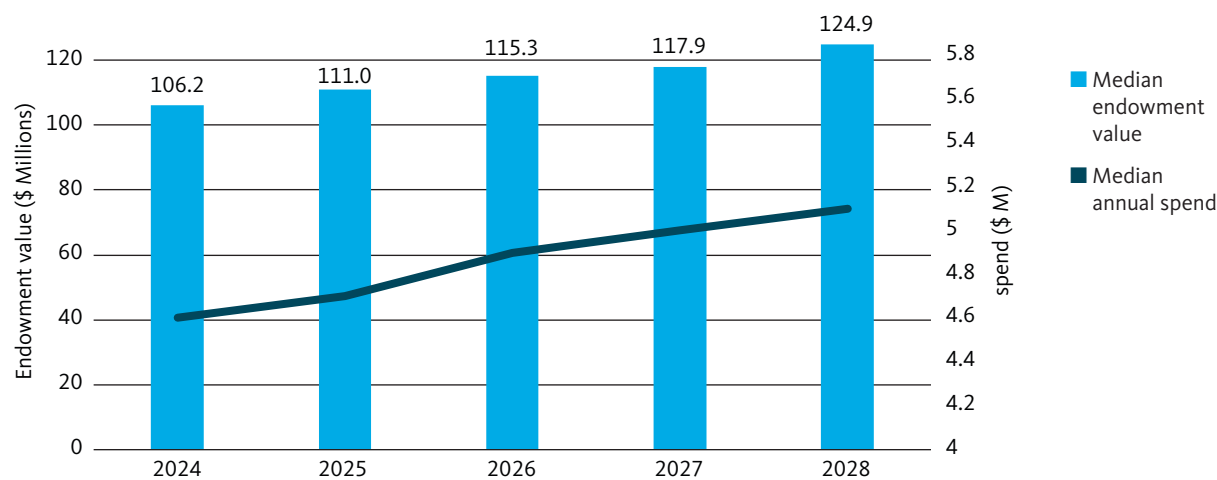
Banded inflation spending policy



Banded inflation spending policy



Median projected market value and annual spending



The chart above summarizes the median values year by year of the hypothetical portfolio, overlayed with the annual spending in dollars, which continue to grow due to the added inflation adjustment every year. There are many ways to customize this type of work. For example, shocking this analysis in the event of a down market would be a prudent risk exercise.

Finally, consider a hybrid methodology, in this case a 50/50 blend of the two scenarios above. This method has about the same median value in year five but has spent over \$1 million more over the course of the time period, and \$700K more than the 3-year moving average method. Analyzing the tradeoffs of the different calulations may be a worthwhile exercise to understand how up and down markets may impact the annual spending distributions and offer ideas on how you might have tigher controls around the cash flows.

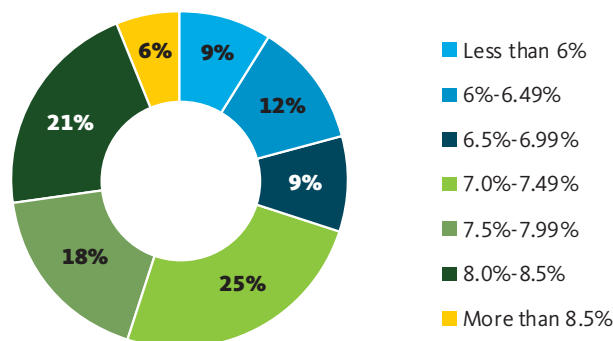
Comparing results of different median spending methodologies

Spending methodology	12-qtr./3-year moving average	Banded inflation	50/50 blended hybrid
Median market value year 5	\$125.4 M	\$129.4 M	\$124.8 mm
Median cumulative spending total year 5	\$29.2 M	\$28.8 M	\$29.9 M

Return objectives.

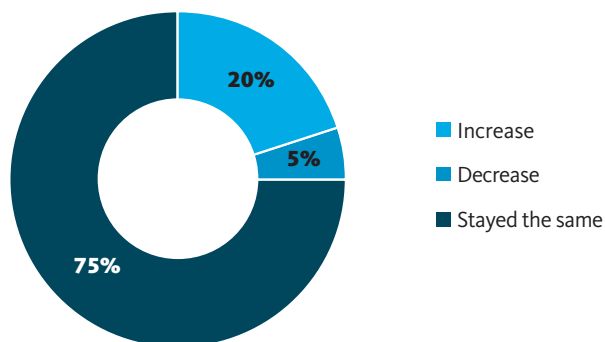
Total return objectives are typically stated in the investment policy and usually described as covering the spending, inflation, and fees. Fees can include both investment and administrative fees, depending on the type of organization.

Total return objectives



The overall average of the return objective of all survey respondents was 7.2%, an increase compared to our surveys in 2021 and 2016,* when the return objective average was closer to 7%. The majority of those with higher return objectives were larger educational endowments and private foundations. Over 50% of public higher educational institutions had return objectives between 8%-8.5%, and 83% of those had over \$500 million in assets.

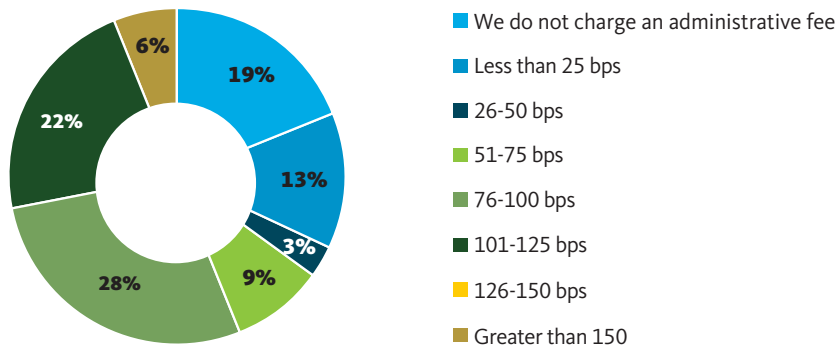
Investment return objective for 2023



Consistent with the unchanged spending policy, 75% of the survey respondents did not change their return objective. However, a meaningful 20% did, with higher inflation expectations cited as the primary reason.

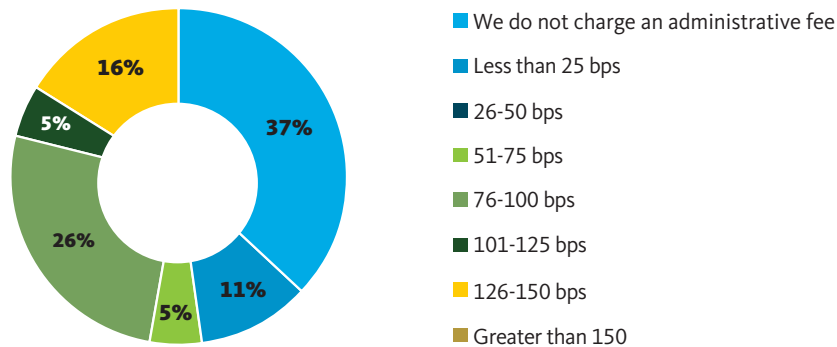
*The 2016 poll was conducted in Q1 2016 by SEI, included 253 participants, representing nonprofits with endowments ranging from \$25 million to more than \$5 billion. None of the respondents were clients of SEI.

Endowment administration fee: Community foundations



Community foundations and higher education institutions may charge an endowment administrative fee to manage the donor accounts and investment process. About 1 in 5 community foundations do not charge a fee, but a comparable amount charge between 101-125 basis points (i.e., 1%-1.25%). The highest weight was 76-100 basis points. With higher education institutions, 76-100 basis points was also the most often cited fee, but a comparable amount charged over 1.25%.

Endowment administration fee: Higher education



Use of illiquid assets.

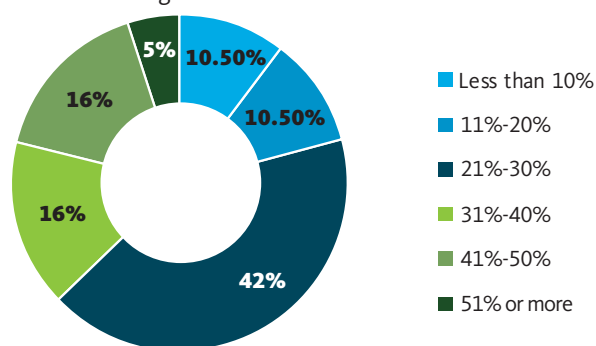
As return objectives have grown over the past few years, so too has the use of illiquid assets. These assets are expected to earn a higher return because of the premium an investor should be paid to give up daily access to their funds.

Interestingly, higher education shows more weight in illiquid asset classes as their portfolio size increases, which is consistent with historical studies. But that is not the case with community foundations, which have less sources of funds and more need for liquidity. Private foundations also tend to have higher allocations to illiquid asset classes due to the higher return objective driven by the IRS-required 5% spending distribution.

Percentage of endowments' investments classified as illiquid

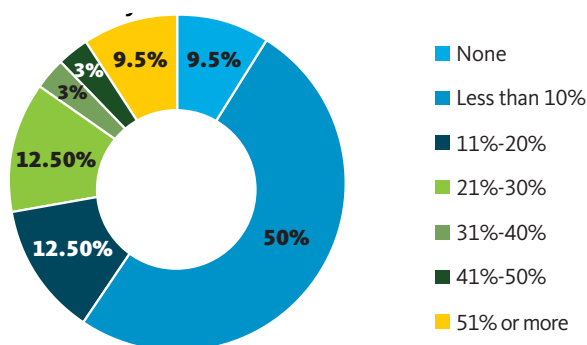
Higher education

Almost half of higher ed institutions have between 21%-30% in illiquid assets and an additional



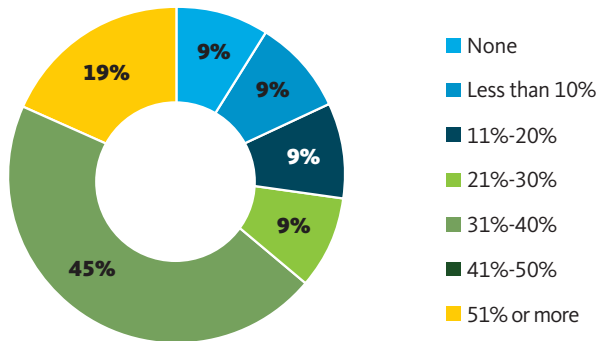
37% have even more. This is consistent with what we saw in the increased return objective, as higher expected returns are often associated with the illiquidity premium.

Community foundations



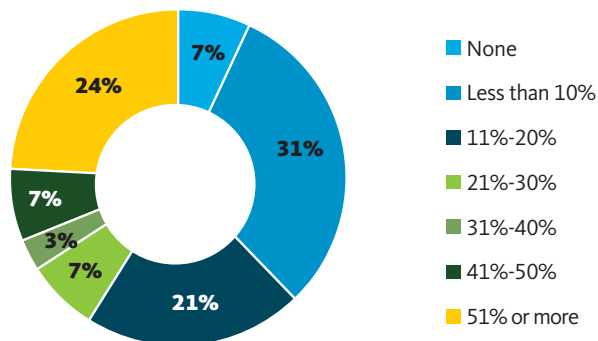
Community foundations have a smaller exposure to illiquid assets, with 50% citing less than a 10% allocation and an additional 9.5% having none. Keep in mind that relative to higher ed, community foundations have less revenue sources and higher demand for liquidity. Larger asset pools tend to have slightly higher weights.

Private foundations



Again, driven by higher return objectives and a higher mandated spending rate, private foundations tend to have higher allocations to illiquid assets.

Other



The remaining breakdown had pretty disparate allocations, with nearly one-quarter having over 50% in illiquid assets, and about one-third having less than 10%.

Conclusion.

A nonprofit organization's spending policy is the largest driver of its investment return objective, which in turn dictates how much risk a portfolio must take on in search of that return.

This research provides insight into spending policy trends, the directional changes of those policies, and the way the spending is calculated. For fiduciaries and stewards of these important assets, it is vital to routinely analyze whether the spending policy is appropriate for the nonprofit organization's current needs, overlaying with the long-term objective of maintaining the purchasing power of the assets in perpetuity.



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SEI develops forward-looking, long-term capital market assumptions for risk, return, and correlations for a variety of global asset classes, interest rates, and inflation. These assumptions are created using a combination of historical analysis, current market environment assessment and by applying our own judgment. In certain cases, alpha and tracking error estimates for a particular asset class are also factored into the assumptions. We

believe this approach is less biased than using pure historical data, which is often biased by a particular time period or event.

The asset class assumptions are aggregated into a diversified portfolio, so that each portfolio can then be simulated through time using a monte-carlo simulation approach. This approach enables us to develop scenarios across a wide variety of market environments so that we can educate our clients with regard to the potential impact of market variability over time. Ultimately, the value of these assumptions is not in their accuracy as point estimates, but in their ability to capture relevant relationships and changes in those relationships as a function of economic and market influences.

The projections or other scenarios in this presentation are purely hypothetical and do not represent all possible outcomes. They do not reflect actual investment results and are not guarantees of future results. All opinions and estimates provided herein, including forecast of returns, reflect our judgment on the date of this report and are subject to change without notice. These opinions and analyses involve a number of assumptions which may not prove valid. The performance numbers are not necessarily indicative of the results you would obtain as a client of SEI.

We believe our approach enables our clients to make more informed decisions related to the selection of their investment strategies.

For more information on how SEI develops capital market assumptions or the actual assumptions utilized, please contact your SEI representative.