INSTITUTIONAL GROUP

Endowment strategy under pressure.

Managing spending, allocation, and sustainability for long-term growth.

Amid market volatility and cash flow uncertainty, institutions should reassess spending policies and asset allocations to balance risk and stability.

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Introduction.

Meeting spending requirements is a fundamental long-term objective for any institutional endowment or foundation.

While all foundations strive to offset spending over time, they must also maintain purchasing power in the face of inflationary pressures. This white paper explores the complexities of reviewing or potentially revising endowment spending policies when markets are experiencing downside volatility, the impact of planned spending on asset allocation, and the critical considerations institutions must evaluate when managing their financial sustainability.

Why revisit spending policy today?

Colleges and universities are currently facing several significant challenges directly impacting their revenue. For starters, some schools are experiencing declining enrollment and the corresponding decrease in tuition collection, partly because of changing American demographics. The government's oversight over student visas will likely also impact student enrollment. International students are generally more likely to pay full-fare tuition and not rely on student financial aid. Moreover, the price for attending colleges has increased dramatically over the last several decades. With costs at some schools nearing $100,000 per year, potential students are reevaluating the return on investment for a traditional four-year degree.

From a fundraising standpoint, some headwinds persist as well. Donors now have more options for self-directed giving, often desiring more immediate and directed impact within institutions. At the same time, institutions face growing demands to address inclusivity and diversity while navigating resistance from some stakeholders. This has led to donors placing conditions on contributions or withdrawing financial support, adding to financial unpredictability.

At the federal level, colleges and universities are facing new concerns about the future of their federal funding. Most schools use federal grants for 10%-15% of their operating budgets, but for large research institutions, it could be as high as 40%-50%. Potential changes to federal funding will have a disparate impact unique to each institution. Also, the 2017 Tax Cuts and Jobs Act created financial challenges with the excise tax on the largest private college and university endowments, as well as the repeal of advance refunding bonds. Spending challenges could grow if some of the existing proposals—expansion of the excise tax and the elimination of tax-exempt bonds or tax-exempt status—are approved and become policy.

Unfortunately, at a time of significant revenue challenges, operating costs have also increased, as colleges and universities have pursued capital improvement projects and expanded their offerings to attract more students and faculty. Consequently, these factors are increasing pressure on institutions to spend more from their endowments, leading many to wonder if now is a good time to review and potentially modify their spending policy.

Fundamentals of endowment and foundation spending.

The primary purpose of endowment funds is to support institutional goals.

Endowments are typically meant to last in perpetuity, with some regular distribution to support current operational functions, grantees, student support, etc. That distribution, or spending target, is an integral factor in setting a return target for the endowment, and together will directly inform the strategic asset allocation. **Exhibit 1** presents the average annual effective spending rate by endowment size, highlighting how institutions with varying asset levels approach spending in support of their missions.

The ultimate goal is to balance portfolio growth and effective spending to ensure the institution benefits from the endowment's financial resources.

Exhibit 1. Average annual effective spending rates by endowment size

	Total Institutions	Under $50M	$51M-$100M	$101M-$250M	$251M-$500M	$501M-$1B	$1B-$5B	Over $5B
Total Institutions	658	82	104	149	108	71	115	29
Responded Institutions	626	78	98	142	104	70	106	28
FY24 Spending	4.8%	4.9%	5.0%	4.9%	5.0%	4.3%	4.5%	4.9%
FY23 Spending	4.6%	4.8%	4.7%	4.8%	4.7%	4.3%	4.4%	4.5%

Source: 2024 NACUBO-Commonfund Study of Endowments

As endowments and foundations review their spending policies, there are several important factors to keep in mind.

Spending is a drag on portfolio growth

Withdrawals from the portfolio reduce its value and hinder compounding over time. The timing and amount of draws should be strategically considered in the context of overall portfolio and endowment goals. For example, a one-time draw from the portfolio may make sense to fund a new capital project or fill a budget hole, but without a plan to replenish those funds in the future, that draw will impact the endowment's future spending power.

Balancing spending and market performance

Actual market performance will play a significant role in determining financial stability. How you build your spending policy should align with your target asset allocation, and the two must support each other. A balanced spending rate will be commensurate with the portfolio's return potential. A spending rate above your actual portfolio return is obviously not sustainable.

Better cash flow management

The sustainability of spending can be influenced by the net draws, which include both withdrawals and new contributions. Higher spending is more sustainable when offset by strong inflows. However, institutions are challenged to forecast contributions due to uncertainty, making liquidity management more complex.

Advanced considerations for spending policy and asset allocation.

Relative portfolio size

Assessing portfolio size in relation to institutional expenses is critical. For example, a $40 million endowment supporting an institution with $300 million in annual expenses has limited financial impact. If you were to dramatically increase the portfolio's risk in order increase your expected return, the resulting financial impact would likely be modest. In this hypothetical, every additional 1% of earnings would offset only 0.13% of total expenses while adding more risk in the form of either more portfolio volatility or illiquidity.

Volatility considerations

Portfolio volatility affects spending sustainability and budgeting consistency. Drawing funds from a depressed portfolio complicates recovery. Drawn funds are unavailable to experience a market rebound, making protecting the principal and creating real growth especially challenging.

Many endowments use smoothing strategies to protect the integrity of the portfolio during down markets. **Exhibit 2** indicates how spending less from an endowment when the portfolio is down makes for an easier recovery. Unfortunately, this may mean spending less from the endowment when times are tight and the additional spending would be most impactful.

Exhibit 2.

	Starting portfolio value	Value Yr 1, 10% decline	Value Yr 2, after 10% rebound
4% spend, no draw (contributions offset spending)	$200 million	$180 million	$198 million
4% spend, 4% draw	$200 million	$172 million	$182 million

For Illustrative Purposes Only

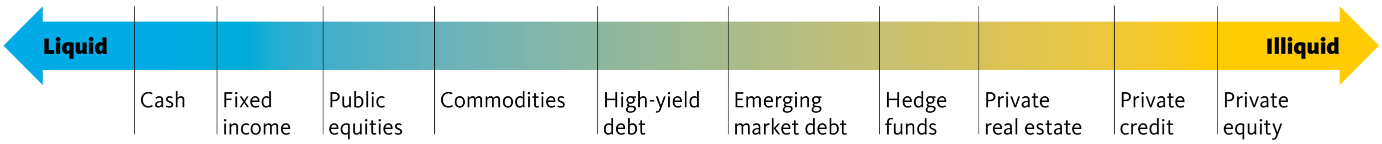
Short-term liquidity buffers, such as cash reserves or credit lines, can help institutions manage spending needs during market downturns. However, such measures provide only limited support and cannot replace sound risk management strategies. Cash and short-term investments have also historically not been able to generate significant earnings and can act as a drag to overall performance.

A higher spending rate may necessitate a more aggressive investment approach that could statistically improve the likelihood of reaching the higher return target. However, market inconsistencies can undermine high-risk portfolios, making them unsuitable for institutions with significant financial commitments. Effective portfolio management must balance risk, return expectations, and spending constraints.

Liquidity constraints

Many investment models assume portfolio withdrawals can be made evenly across asset classes, but asset classes such as private assets often lack liquidity, especially in market downturns. Institutions with high allocations to private investments must ensure sufficient portfolio liquidity to support spending needs. As **Exhibit 3** represents, asset classes vary considerably in liquidity, especially in periods of market stress.

Exhibit 3. Asset class liquidity



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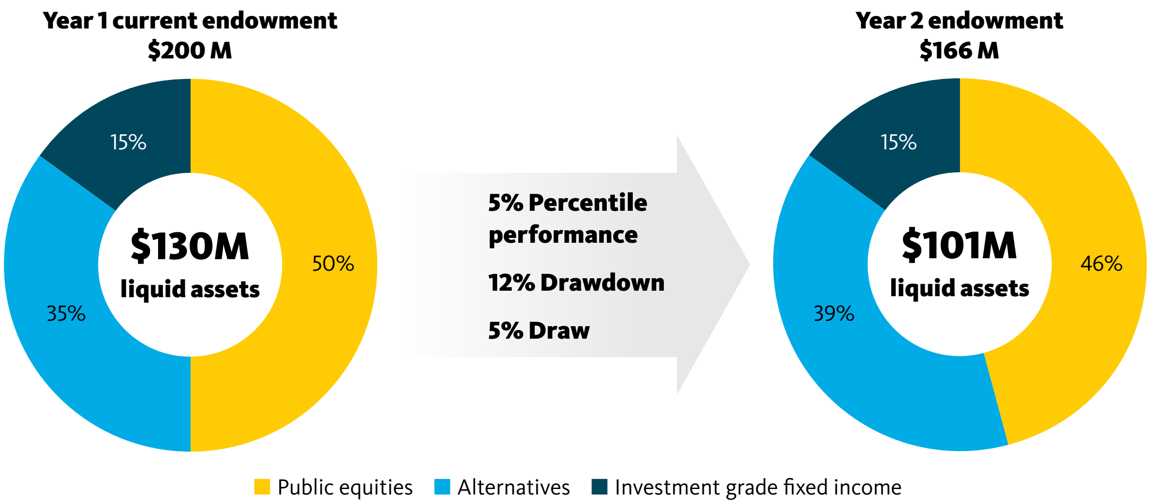
Private assets could have reduced distributions and redemptions in periods of market stress. For example, **Exhibit 4** illustrates how a relatively large annual endowment draw of 5% during a period of market stress—represented by a 12% drawdown—can place considerable demand on an endowment's more liquid assets, generally publicly traded stocks and bonds. Unfortunately, those asset classes tend to have quicker and more dramatic market value changes in market downturns as compared to private assets.

Exhibit 4.



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Drawing only from the more volatile but available liquid assets could distort the portfolio allocation and negatively impact the compounding benefit of a market reversion. Constrained liquidity in effect maximizes the damage of a portfolio draw during a down market.

While private assets introduce liquidity constraints, they frequently make sense in an asset allocation because they can offer return enhancement and diversification benefits. Institutions with higher spending needs must carefully balance their private asset allocations to avoid liquidity mismatches during financial stress.

Concluding notes.

Long-term strategy considerations

Given the current cash flow uncertainties for colleges and universities, it is a reasonable time to review your existing spending policy and associated asset allocation. Institutions must weigh the risks and rewards of a more aggressive investment approach against their financial stability. As you go through this exercise, there are several things to keep in mind:

Private asset allocation and liquidity planning

Institutions should carefully evaluate liquidity constraints when allocating to private assets. Factors to consider include:

- Whether spending policies allow for high private asset allocations.
- The degree of overweighting in private assets relative to institutional financial constraints.
- The institution's financial stability and ability to commit to long-term investments.
- The liquidity terms of all existing and potential new alternative investments.

Risk management in asset allocation

Investment decisions should be guided by institutional risk constraints and tolerance rather than spending needs alone. Key considerations include:

- The size and variability of spending draws.
- The institution's ability to forecast financial needs.
- The presence of liquidity buffers and new capital inflows.
- Acceptable levels of portfolio volatility and drawdown risk.

By implementing a disciplined spending policy and aligning it with a well-structured asset allocation strategy, institutions can achieve long-term financial sustainability while meeting their immediate funding needs.

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Contact us.

For insight on how SEI can assist your college or university in navigating the intricacies of endowment spending policies amid market volatility, understand asset allocation impacts, and help ensure financial sustainability, reach out to us today at **seic.com/contact-institutional**.

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