Spend Policy 101

For nonprofit organizations, the endowment/foundation's ultimate purpose is to support the organization and its activities. The performance and size of the endowment are intended to serve as a current and future source of financial means for the institution. This is most frequently accomplished through recurring annual withdrawals, commonly referred to as "the spend". The Spend Policy is the agreed-upon formal policy that governs how much is taken from the endowment and how the amount will be calculated.

The Spend Policy is a fundamental governance tool for nonprofit organizations. It ensures that endowment funds are managed effectively to support both current operations and future needs. By adhering to best practices and regularly reviewing the policy, institutions can maintain financial stability, achieve long-term investment goals, and fulfill their mission.

For over 30 years, TIFF has been working with nonprofit organizations to manage their investment programs, including support on spending policies. Reviewing the institution's financials, including endowment draw and how much it supports the operating budget, is a key component of our Strategic Asset Allocation process, as detailed in this related paper.

Given the importance of the Spend Policy, this paper will review the fundamental principles and recommended guidelines for effective Spend Policies.

Spend Policy Best Practices

Every institution should have both an Investment Policy Statement and a Spend Policy. While Investment Policy Statements often receive the most attention, the Spend Policy is equally important. Here are key recommendations for creating a strong Spend Policy:

1. **Have a documented policy.** This can be a standalone document, though certain organizations include it in the Investment Policy Statement.

2. **Outline the objective and purpose of the spending policy and how it supports the mission.** This is often a philosophical section that identifies the goals of the funds once received by the organization. It can be as broad as "supporting the mission" or as specific as a singular need, such as financial aid for an educational institution.

3. **Clearly define the calculation methodology.** A policy with a clear calculation will help avoid miscommunication on potential spending each year and keep stakeholders aligned on how to determine the spending size.

4. **Include the relevant Uniform Prudent Management of Institutional Funds Act (UPMIFA)**, if applicable. Most donor-endowed assets are governed by the UPMIFA, and, with the exception of Pennsylvania, each state has their own version. It is important to understand any regulatory requirements that may impact your spending. For example, some states, such as New York, have incorporated a maximum spend of 7% of the value of an endowment in any one year; above 7% is considered imprudent.

5. **Have formal approval.** Spend Policy is often recommended by the Investment Committee for full Board approval to ensure buy-in from key stakeholders. This promotes dialogue with key constituents around the conflicting goals of (1) sufficient current support of the organization and (2) long-term maintenance of purchasing power through investment performance that exceeds the combined impact of inflation and spend rate (commonly CPI+5%).

6. **Review the policy annually** to ensure it is still meeting the goals of your organization.

The segments that follow will cover the fundamentals of what is inside of the Spend Policy and how to put that in context of budget support.

Spend Methodology: How to Calculate the Spend

A key component of the Spend Policy is the methodology by which the withdrawal will be calculated. There are three broad approaches to calculating the spending amount:

1. **Endowment Market Value:** A predetermined percent of endowment market value,
2. **Inflation-Based:** Last year's spending increased by inflation, and
3. **Hybrid:** A combination of market value and inflation.

While there are other methodologies (e.g., no set calculation – determine the appropriate amount each year; spend all current income), these categories cover the most commonly used and discussed approaches.

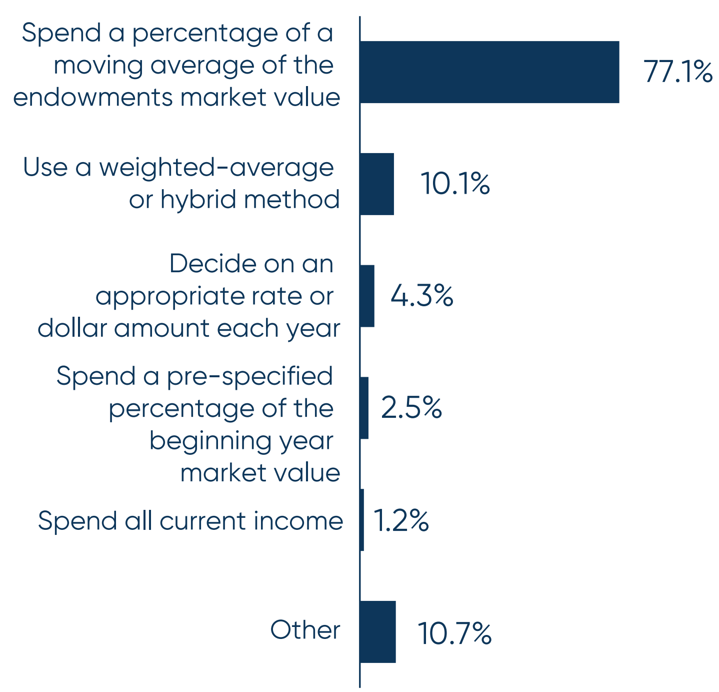
The chart below provides a description of each approach:

Methodology	Description	Example
Endowment Market Value	▪ A predetermined percent of endowment market value ▪ Market value most commonly a moving average of 3-5 years, using quarterly or annual value points ▪ Most common approach for spend policies	4% * 12 quarter moving average of ending quarter value
Inflation-Based	▪ Last year's withdrawal ($) increased by an inflation factor (e.g., CPI, HEPI for higher education) ▪ Most commonly banded (e.g., inflation factor must be between 4% - 6%)	Last year's spending * (1+CPI), banded between 4% and 6%
Hybrid	▪ A weighted average of inflation-based and market valued-based ▪ Often referred to as "Yale/Harvard Approach" ▪ Most common for large endowments	70% of last year's spending + 30% of 5.0% of the endowment's audited 2-year values

What methodology do endowments use?

Based on the FY23 NACUBO Study of Endowments, 77% use a percent of the trailing moving average of market value. The most popular spend policy by a significant margin is a 12-quarter moving average of market value approach. Quarterly trail is more popular than annual regardless of trail length. Three years is by far the most popular length of trail regardless of annual or quarterly data periods. The larger the endowment, the more likely they are to use a hybrid method. Smaller endowments are more likely to have no set calculation and to determine the amount year to year. These trends have not changed significantly over the past 5 years.

FY23 NACUBO Spending Methodology Usage by All Institutions



CASE STUDY
Yale University & Brown University

Let's put this methodology discussion into context of two real institutions.

Yale University - Hybrid

Yale's Spend Policy is well known, so much so that the hybrid approach is often called the "Yale Approach". Yale's policy is 80% of last year's spending + 20% of 5.25% of the endowment's audited 2-year values, with a target payout of 5.25%.[1]

Brown University – Market Value

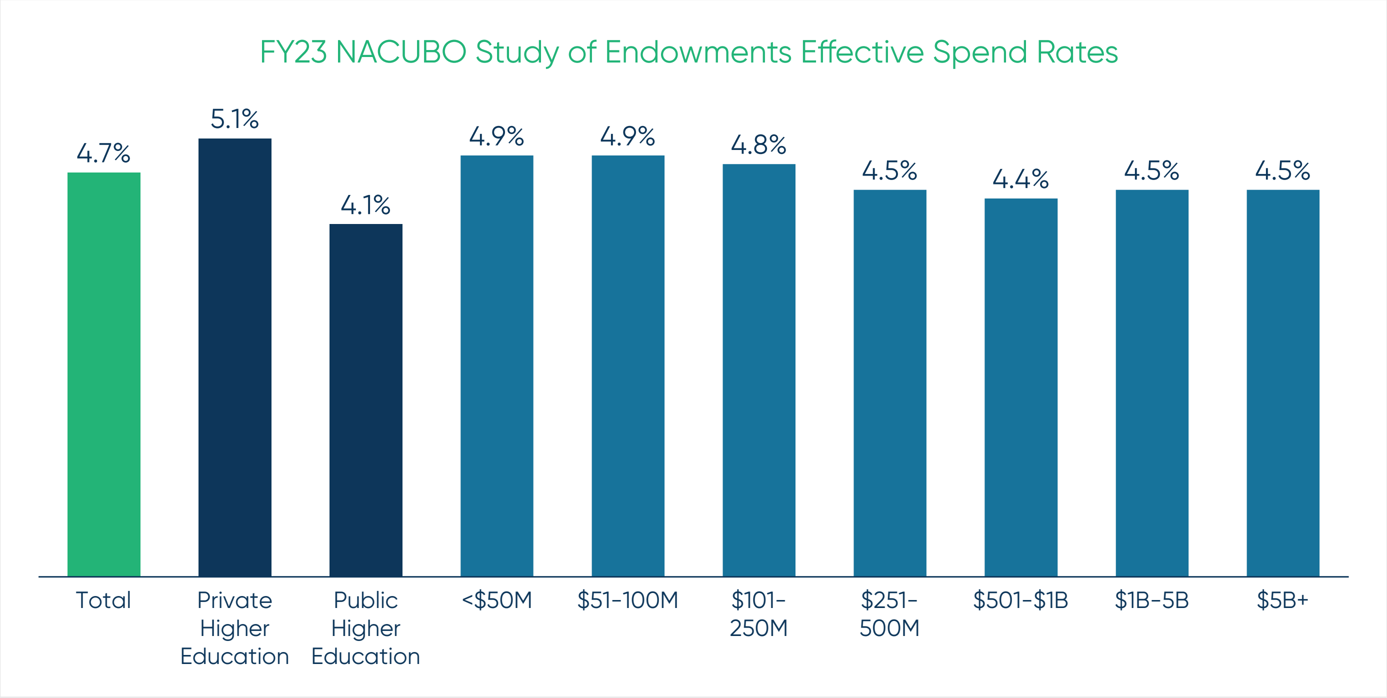
Brown falls into the 77% of institutions that use a moving average calculation. Brown sets the payout between 4.5% and 5.5% of the average of the total endowment market value for the 12 prior quarters (3 years with quarterly data points).[2]

The Rate - What % is Taken Out of Endowments Annually?

The first portion of this paper defined how to calculate what would be taken out of the endowment. This second provides context for what percent organizations are taking from the endowment annually and what impact that has on the institution's operating budgets.

Due to the varying methodologies, we will use the effective rate for the comparison. The effective rate is calculated as the spend withdrawn over the past fiscal year, divided by the most recent endowment value (end of fiscal year). The effective spend rate is a way to disregard what methodology each school is using and provide a clean comparison of the spending withdrawn as a percentage of current fiscal year ending value.

The 22-year average effective rate was 4.5%, maximum 5.1%, and minimum 4.2%. In FY23, the average effective rate across all endowments in NACUBO was 4.7%. Private higher education had a higher effective spend than public higher education, which is a trend that has persisted for 15 years. In FY23, smaller institutions took out more than larger institutions. However, over 22 years of data, large institutions took out slightly more, on average. This difference occurs from (1) different spend policies, (2) different investment returns, and (3) different actions institutions took in response to economic shocks (e.g., GFC, Covid – either actively increasing or decreasing the dollar withdrawn) or school-specific matters (e.g., new building purchase).

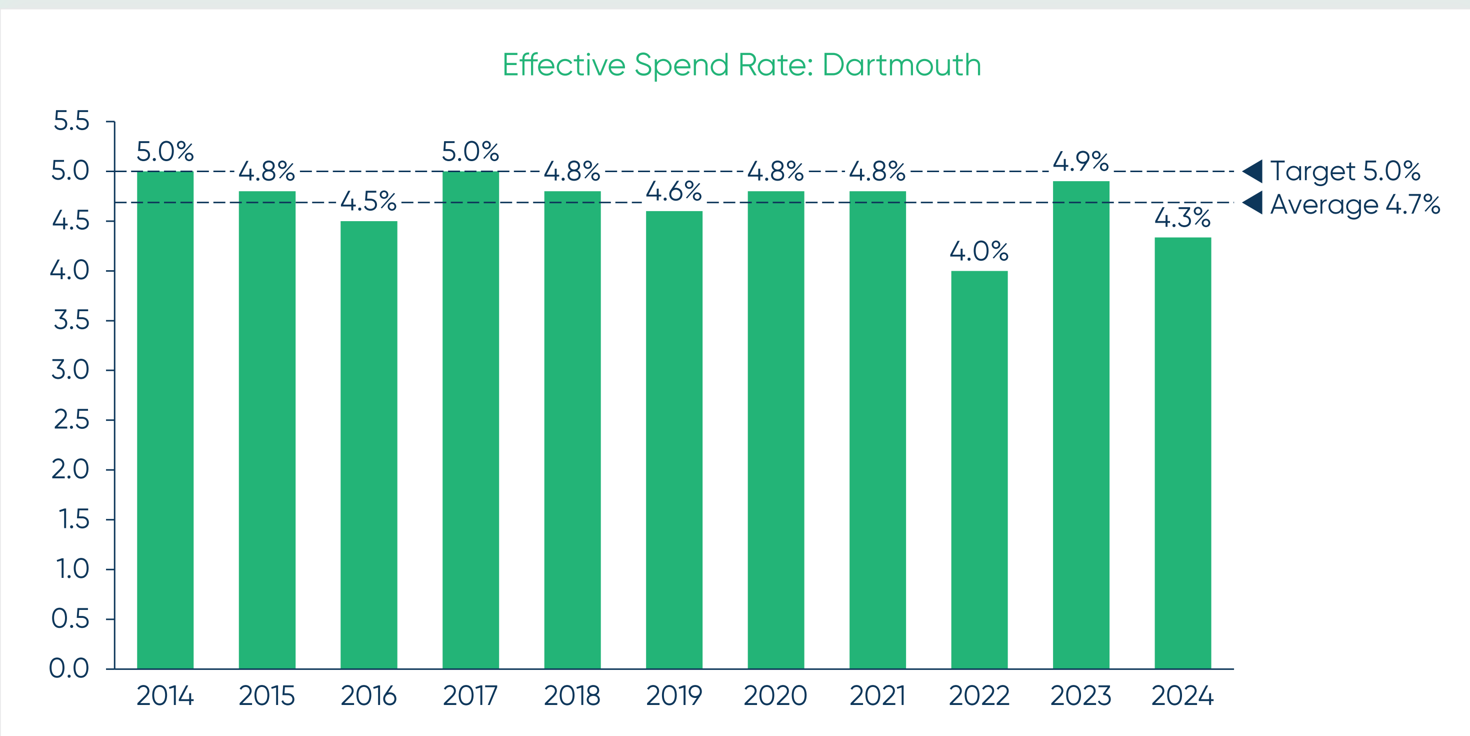


Why use an effective spend rate? It is important to look at the effective rate because each methodology has an impact on the resulting amount in dollars that is withdrawn. Two institutions both with a "4.5%" spend rate could have entirely different effective rates because one uses a 3 year annual trail on market value and the other uses 20 quarter moving average. In addition, certain institutions cannot quote an absolute "spend rate" because they use a hybrid or inflation-based approach.

CASE STUDY
Effective Spend in Practice – Dartmouth College

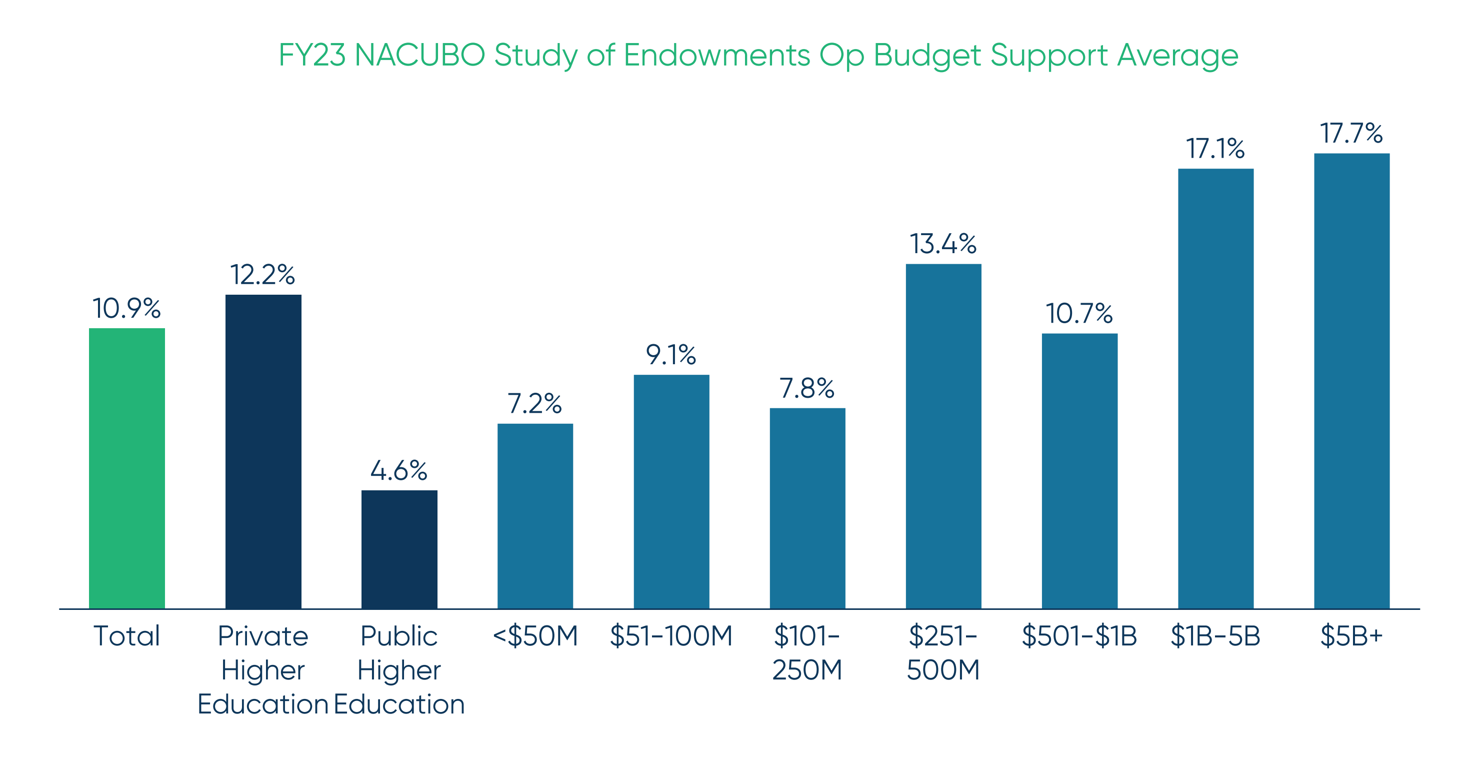
Dartmouth has a 5% spend rate target and employs a 70/30 hybrid - 70% of the current year distribution is based on the prior year's distribution, times an inflation factor, and the remaining 30% is based on the 4 quarter average calendar year market value times the long term payout goal of 5%.[3]

Even though Dartmouth targets a 5% payout, the effective rate changes from year to year. The graph below highlights the variability in effective spend within a single institution.[4]

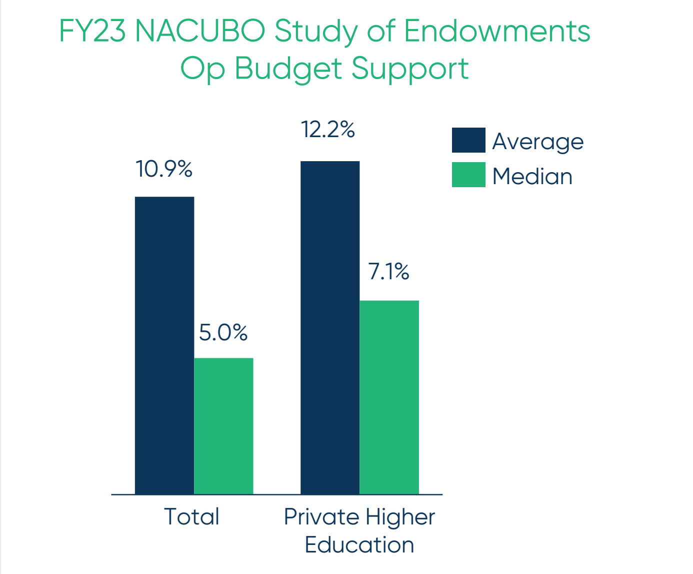


How Does This Amount Support Institutions' Operating Budgets?

Beyond good governance, the Spend Policy outlines how the endowment will support the institution. On average, 10.9% of operating budgets are supported by the endowment. Smaller endowments support less of the operating budget on average than larger institutions. Private higher education support more of the operating budget than public higher education.

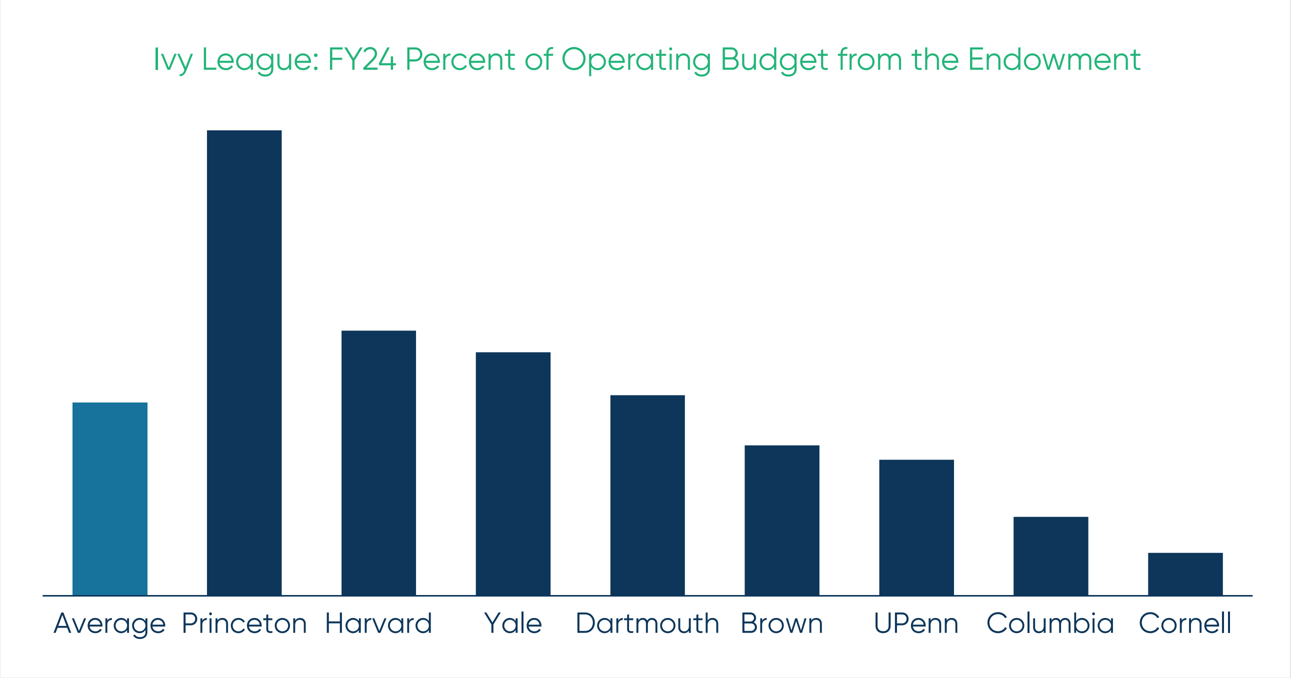


NACUBO also provides the median support, which is almost 50% lower than the average. The spread between the average and the median indicates that there is a long right tail or large outliers providing large budget support, pulling the average above the median. It is important to keep the median in context to understand what is "normal."



CASE STUDY
Ivy Operating Budget Support[5]

NACUBO's operating budget support provides averages and medians, which doesn't capture the wide range the endowment support can provide. Using the Ivy League as an example, we can see a very wide range from two-thirds (Princeton) to 6% (Cornell), with an average of 27%.



Conclusion

The Spend Policy is not merely a procedural requirement but a cornerstone of effective endowment management. Beyond being a hallmark of good governance, it is imperative for stewards of capital to grasp the intricacies of the Spend Policy and its impact on the institution's financial health and mission fulfillment. A well-constructed and diligently maintained Spend Policy empowers nonprofit organizations to strike a critical balance between providing immediate financial support and preserving the endowment's purchasing power for future generations. By adhering to best practices and engaging in regular policy reviews, institutions can ensure their investment programs are robust and aligned with long-term strategic objectives. With over three decades of dedicated service to the nonprofit sector, TIFF stands ready to offer expert guidance and collaboration in the development and refinement of your Spend Policy, helping you to secure a sustainable and prosperous future for your organization.

[1] Yale University Investment Office, "Overview of Yale's Endowment," accessed January 2025, https://www.yale.edu/funding-yale-home/overview-yales-endowment.

[2] Brown University Investment Office, "Understanding the Endowment," accessed January 2025, https://investment.brown.edu/endowment/understanding-endowment.

[3] Dartmouth College, "Endowment Utilization Policy," Dartmouth Policies, accessed January 2025, https://policies.dartmouth.edu/policy/endowment-utilization-policy.

[4] Dartmouth College Investment Office, "Dartmouth Endowment Report 2023," https://www.dartmouth.edu/investments/docs/dartmouthendowmentreport2023.pdf; FY24 data from Dartmouth College Financial Statements.

[5] Analysis based on FY24 financial statements from each Ivy League institution, except Dartmouth where FY24 summary data was used.