DEVELOPING AN EFFECTIVE SPENDING POLICY & SUSTAINABILITY

Philanthropy southeast

October 26, 2016

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Fund Evaluation Group

WHY DO WE CARE ABOUT SPENDING POLICY?

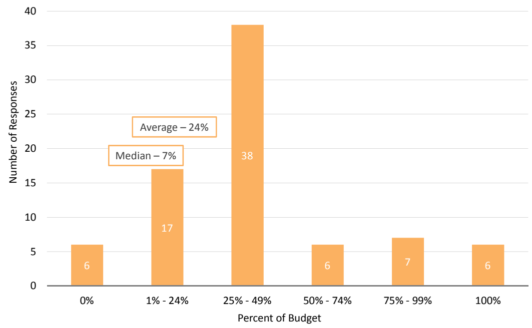
- Subtle change can have a major impact on the value of your portfolio and meeting your mission
- Fiduciary responsibility
- Balance the needs of today with those of the future
- It is something we have control over

SPENDING POLICY CONSIDERATIONS

ENTERPRISE MANAGEMENT

FEG-CF SURVEY: SPENDING DISTRIBUTIONS

OPERATING BUDGET % SUPPORTED BY FOUNDATION DISTRIBUTIONS



Source: FEG 2016 Community Foundation Survey
[1] Answers were grouped into ranges.

N= 80

CONSIDERATIONS FOR COMMUNITY FOUNDATIONS

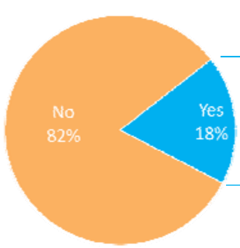
TOPICS ORDER OF IMPORTANCE

CATEGORY	VERY IMPORTANT	TOP TWO[1]
Asset Allocation	***84%***	***99%***
Spending Policy	77%	96%
Donor Advised Funds	66%	91%
Fundraising	55%	83%
Rebalancing	38%	90%
PRI / MRI	11%	22%
ESG / SRI	2%	18%

Source: FEG 2016 Community Foundation Survey
Asset Allocation N=86; Spending Policy N=86; Donor Advised Funds N=53; Fundraising N=88; Rebalancing N=88; PRI/MRI N=88; ESG/SRI N=77
[1] Top two includes if a participant selected Very Important or Important

FEG-CF SURVEY: NOT A LOT OF CHANGE

DID YOUR ORGANIZATION CHANGE THE SPENDING POLICY IN THE PAST THREE YEARS?



For those that changed the spending policy,~60% reduced spending

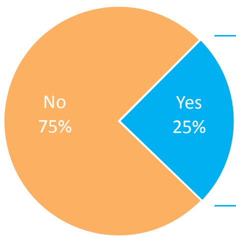
The remaining ~40% changed calculation method or increased fees

Source: FEG 2016 Community Foundation Survey

N= 87

FEG-CF SURVEY: FUTURE CHANGES?

DO YOU FORESEE CHANGING YOUR SPENDING POLICY IN THE NEAR FUTURE?



~75% said they plan to reduce the spending rate; ~5% plan to increase

What is prompting the future change?[1]

- Performance Returns
- Lowered Projected Returns
- Ability to Attain Targets / Hurdle Rate
- Volatile Market Conditions

Source: FEG 2016 Community Foundation Survey
[1] Answers were grouped

N= 85

SPENDING IS ONLY PART OF THE EQUATION

Long-Term Return > Target Spending Rate + Administrative Costs + Inflation

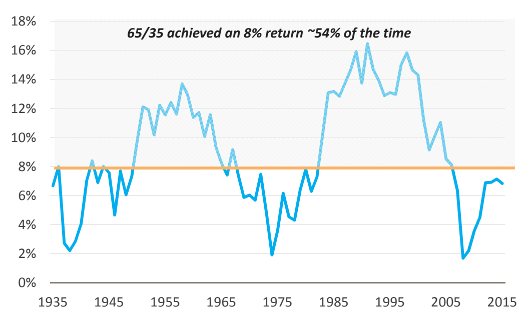
4.5% *Spending* + 1.5% *Fees* + 2.0% *Inflation* = **8.0% Primary Objective**

CONSIDERATIONS

- Spending needs should not unduly influence asset allocation decisions
- Higher spending needs could lead to overly aggressive asset allocation
- Lower spending needs could lead to overly conservative asset allocation

SPENDING AND ASSET ALLOCATION POLICY SHOULD ALIGN

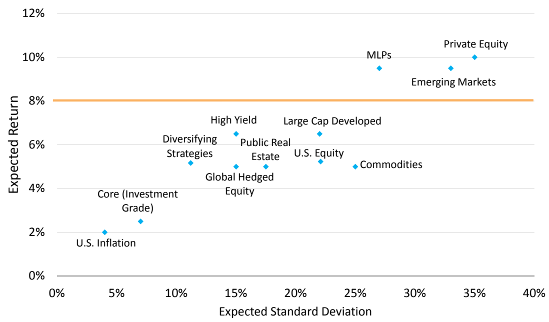
RETURNS VS. OBJECTIVE
65/35 Equity/Bond Portfolio, 10-Year Rolling Return



Data Sources: Ibbotson Associates and Lipper; Data as of 12/31/2015.

2016 FEG 10-YEAR (STRATEGIC) CAPITAL MARKET ASSUMPTIONS

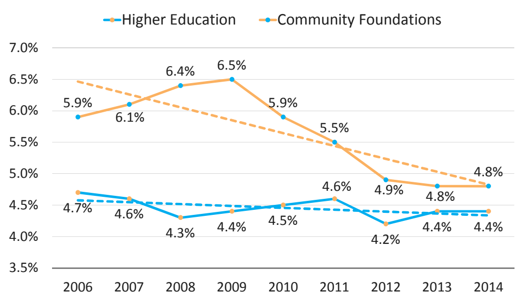
FEG 10-YEAR CAPITAL MARKET ASSUMPTIONS



Source: FEG Data as of 12/31/2015. FEG Capital Market Assumptions are hypothetical based on asset category. Please refer to the Appendix for full disclosures.

LOWERING SPENDING RATE

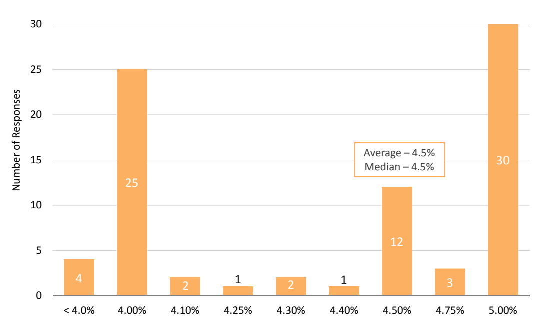
AVERAGE ANNUAL EFFECTIVE SPENDING RATE
2006-2014



Data Source: NACUBO-Commonfund Study of Endowments 2014; 2014 Council on Foundations – Commonfund Study of Investment of Endowments for Private and Community Foundations

FEG-CF SURVEY: SPENDING POLICIES A BACTRIAN CAMEL

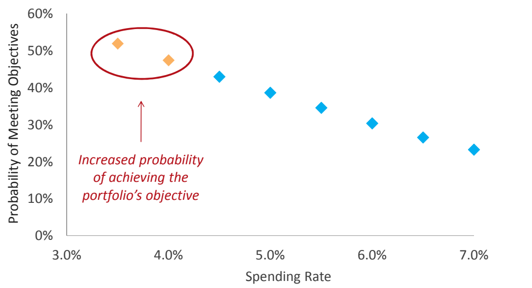
SPENDING POLICY RATE[1]



Source: 2016 proprietary FEG-Community Foundation Survey preliminary results as of March 22 2016. Sample size equals 78 U.S. community foundations.
[1] Answers below 4.0% were grouped.
N= 80

SPENDING POLICY CONSIDERATIONS

IMPACT OF CHANGE IN SPENDING RATES



Source: FEG modeling 10 year projection, assuming a global 65/35 stock/bond split and a 20-quarter moving average spending policy. Created with mpi Stylus. © 2009 Markov Processes International LLC. All Rights Reserved. Data provided by Morningstar, Inc. The information contained herein: (1) is proprietary to MPI and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. MPI is not responsible for any damages or losses arising from any use of this.

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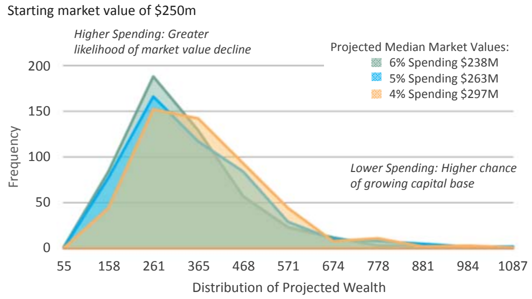
SPENDING DECAY

IMPACT OF CHANGE IN SPENDING RATES

Starting market value of $250m



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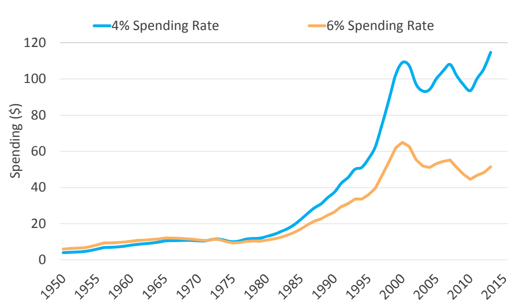
LOWERING SPENDING RATE: IMPACT ON GROWTH

SPENDING GROWTH

4% vs. 6% Spending Rates



Data Source: Lipper; Data as of 12/31/2015. Based on starting market value of $100 and a portfolio comprised of 65% S&P 500 Index and 35% Barclays U.S. Aggregate Bond Index. Assumes a 3-year moving average spending policy.

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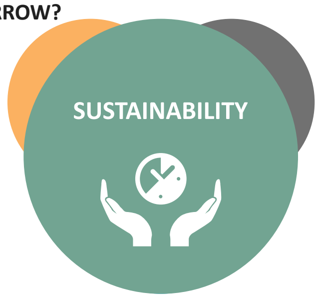
SUSTAINABILITY

TODAY… OR TOMORROW?

CONSISTENCY OF SPENDING



MAINTAINING REAL VALUE

SPENDING POLICY METHODOLOGIES

- **Moving Average**
- **Constant Growth**
- **Constant Growth With Bands**
- **Geometric**
- **Hybrid**

> *"Never think that lack of variability is stability. Don't confuse lack of volatility with stability, ever."*
>
> **- Nassim Nicolas Taleb**

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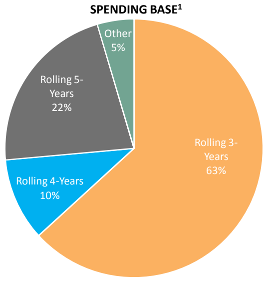
https://manage.eventmobi.com/en/ars/results/question/11381/207637/48d7c65fb34bc6a040c620f1bb4efbcc/

FEG- CF SURVEY: ROLLING QUARTERS AND A MOVING AVERAGE

~90% of organizations answered that their spending methodology is a moving average

TIME PERIOD USED TO DETERMINE SPENDING BASE[1]



Source: FEG 2016 Community Foundation Survey
[1] Answers were grouped.

N= 87

SPENDING POLICY METHODOLOGIES

MOVING AVERAGE
5% spending rate using a 3-year moving average

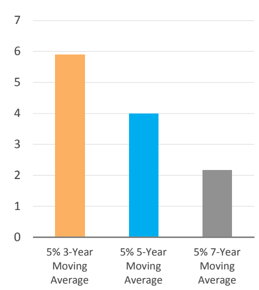
ADVANTAGES	DISADVANTAGES
✓ Smooths spending more than if ending market value used	x All market values are given same level of significance
✓ Simple to implement and explain	x Spending is highly correlated to market value fluctuations

Spend a fixed percentage of the average market value over a set time period

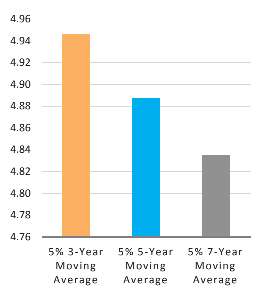
5% x (1/3) [Ending market value$_t$ + Ending market value$_{t-1}$ + Ending market value$_{t-2}$]

SPENDING METHODOLOGY COMPARISON

YoY CHANGE IN SPENDING ($)
1994-2015, Standard Deviations



AVERAGE SPENDING (%)
1994-2015



YoY: Year-over-Year.
Data Source: Lipper; Data as of 12/31/2015. Based on starting market value of $100 and a portfolio comprised of 65% S&P 500 Index and 35% Barclays U.S. Aggregate Bond Index.

SPENDING POLICY METHODOLOGIES

CONSTANT GROWTH

ADVANTAGES	DISADVANTAGES
✓ Smooths spending	x Judgment in setting annual increase
✓ Simplistic	x Does not consider market value
✓ Higher probability spending increases over previous year	

Increase spending each year by a constant growth rate or inflation

Example: Spending$_{t-1}$ x (1 + Consumer Price Index YoY % change) = Spending$_t$

SPENDING POLICY METHODOLOGIES

CONSTANT GROWTH WITH BANDS

ADVANTAGES	DISADVANTAGES
✓ Increases endowment value during strong markets	x Moderated spending amount during strong markets
✓ More predictable spending	x Spending higher during prolonged bear markets

Spending is contained within a range +/- a percentage of previous year's market value

SPENDING POLICY METHODOLOGIES

GEOMETRIC

ADVANTAGES	DISADVANTAGES
✓ Accounts for inflation and market movements	x Slightly lower endowment values
✓ Good balance between spending and market value – can customize smoothing rate	x Complex

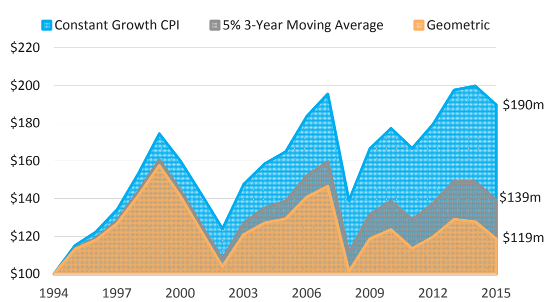
Weight given to inflation adjusted spending and target spending of market value

Example: Smoothing rate x [Spending$_{t-1}$ x (1+inflation$_{t-1}$)] + (1- smoothing rate) x (target spending rate x beginning market value)

SPENDING METHODOLOGY COMPARISON

IMPACT ON MARKET VALUE

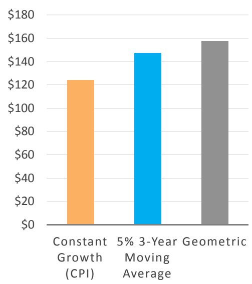
1994-2015, 65/35 Equity/Bond Portfolio



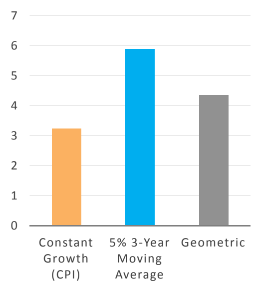
Data Source: Lipper; Data as of 12/31/2015. Based on starting market value of $100 and a portfolio comprised of 65% S&P 500 Index and 35% Barclays U.S. Aggregate Bond Index. Geometric policy is 70% of last year's distribution adjusted for inflation and 30% of a 5.5% target spending rate based on prior year's ending market value.

SPENDING METHODOLOGY COMPARISON

CUMULATIVE SPENDING
1994-2015



VOLATILITY OF SPENDING
1994-2015, Standard Deviations



Data Source: Lipper; Data as of 12/31/2015. Based on starting market value of $100 and a portfolio comprised of 65% S&P 500 Index and 35% Barclays U.S. Aggregate Bond Index. Geometric policy is 70% of last year's distribution adjusted for inflation and 30% of a 5.5% target spending rate based on prior year's ending market value.

SPENDING POLICY METHODOLOGIES

HYBRID

ADVANTAGES	DISADVANTAGES
✓ Can favor either stable distributions or maintaining purchasing power	x Finding and maintaining the right combination of spending rules
✓ Spending rules can be customized to fit the specific needs of the institution	x Complex

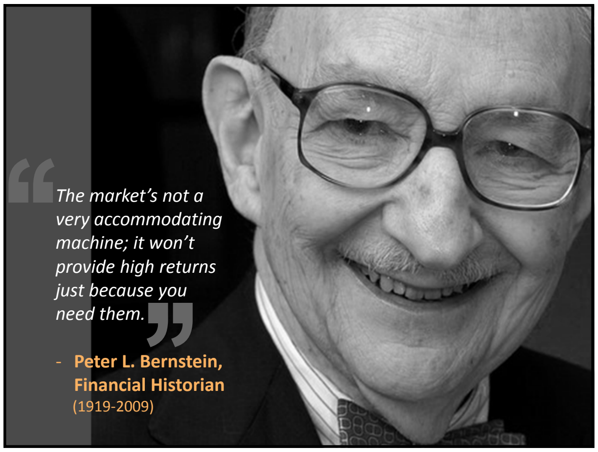
Custom combination of spending rules to meet the specific needs of an institution

FINDING BALANCE

A rational spending policy should be identified and implemented consistently to balance between the competing needs of stable outlays and the preservation of assets for future generations

INCREASE INTERGENERATIONAL EQUITY	MORE CONSISTENT PAYOUT
Increase # of years in moving average	Increase # of years in moving average
Move to banded constant growth	Implement bands with moving average
Reduce payout percent	Use geometric rule

A hybrid approach may meet both goals, but will also increase complexity.



SPENDING POLICY CONSIDERATIONS

- Subtle changes can have major impacts
- No correct answer, rather a "best-fit" solution – Customize!
  - What are your priorities? Maximizing spending, minimizing volatility, maximizing market value
- Coordinate asset allocation and spending policies to ensure the long-term spending rate is consistent with the investment approach and the enterprise's risk tolerance
- Spending policy can be designed to "smooth" amount distributed from year-to-year
- Expected returns today are lower than historically—consider reducing absolute spending level

Appendix

EXAMPLE: CONSTANT GROWTH WITH BANDS

CONSTANT GROWTH WITH BANDS
Hypothetical 3-Year Scenario

- Beginning Market Value Y0=$100m, Y1=$125m, Y2=$150m
- Spending Y0=5%
- Inflation Y2=2.0%, Y3=3.5%
- 4-7% Band

Steps:
1. Calculate the Bands
2. Calculate the $ Spending
3. Verify Spending Falls within Band

For illustrative purposes only.

EXAMPLE: CONSTANT GROWTH WITH BANDS

1. Calculate the Bands

Floor = Market Value x 4%
Cap = Market Value x 7%

	BEG. MV	FLOOR (4%)	CAP (7%)
Year 0	$100m	$100m x 4% = $4.0m	$100m x 7% = $7.0m
Year 1	$125m	$125m x 4% = $5.0m	$125m x 7% = $8.8m
Year 2	$150m	$150m x 4% = $6.0m	$150m x 7% = $10.5m

For illustrative purposes only.

EXAMPLE: CONSTANT GROWTH WITH BANDS

2. Calculate the $ Spending

$\text{Spending}_t = \text{Spending}_{t-1} \times (1 + \text{Consumer Price Index}_{\text{YoY \% change}})$

	BEGINNING SPENDING ($)	CPI YoY % CHANGE	CONSTANT GROWTH	ENDING SPENDING ($)
Year 0				$5.0m
Year 1	$5.0m	2%	=$5.0m x 1.02	$5.1m
Year 2	$5.1m	3.5%	=5.1m x 1.035	$5.3m

For illustrative purposes only.

EXAMPLE: CONSTANT GROWTH WITH BANDS

3. Verify Spending Falls within Band

Floor < Spending < Cap

	FLOOR (4%)	ENDING SPENDING	CAP (7%)	ADJUSTED SPENDING
Year 0	$4.0m	$5.0m	$7.0m	$5.0m
Year 1	$5.0m	$5.1m	$8.8m	$5.1m
Year 2	$6.0m	$5.3m	$10.5m	$6.0m

For illustrative purposes only.

DISCLOSURES

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Any return expectations provided are not intended as, and must not be regarded as, a representation, warranty or predication that the investment will achieve any particular rate of return over any particular time-period or those investors will not incur losses.

The data on page 11 was obtained from the 2014 NACUBO-Commonfund Study of Endowments (NCSE). The study includes a survey of 828 U.S. colleges and universities. The study divided the data into six categories according to size of endowment, ranging from institutions with endowment assets under $25 million to those with assets in excess of $1 billion. Data is for the 2014 fiscal year (July 1, 2013 - June 30, 2014). The National Association of College and University Business Officers (NACUBO) is a membership organization representing more than 25,000 colleges, universities and higher education service providers across the country and around the world. The Commonfund Institute houses the education and research activities of Commonfund and provides the entire community of long-term investors with investment information and professional development programs. NCSE returns are presented net of fees and expenses.

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Results on pages 10 and 13-15 are based on hypothetical projections and may differ from actual results. Spending policy projections shown are hypothetical projections constructed under assumption of various constraints, market values and liquidity and spending rates, and projections may not be appropriate for all investment objectives. The results do not necessarily represent the actual results of any client portfolio and may not reflect the impact that material economic and market factors might have had on investment decisions. Investment results achieved by actual client accounts may differ from the results portrayed

The data on pages 4-7, and 12 are obtained from the proprietary FEG 2016 Community Foundation Survey. The study includes a survey of 88 U.S. Community Foundations as of March 31, 2016. The data from this survey was divided into five categories based on assets of the Community Foundation with assets ranging from less than $25 million to over $250 million. The information in this study is based on the responses provided by the participants and is meant for illustration and educational purposes only.

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Standard Deviation – A measure of variability in returns. The annual standard deviation measures the dispersion of annual returns around the average annualized return.

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