

Definition and Management of Endowment

[Definitions, (historical) background and relevance, key issues, international perspectives, future directions, and recommended readings. 2000-3000 words]

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INTRODUCTION

Endowment, in the vernacular, can refer to any asset of substance that allows a person, organization or country to excel in their pursuits of business or leisure. For example, economists specializing in international trade describe a country as having an “endowment” of abundant land for agricultural crops. A man or woman can be described as “well-endowed”, but this implies a topic more risqué than a generous trust fund or accumulated retirement savings. Nonprofit sector “endowment” is analogous to a savings account. Organizations may have endowments of other types of assets (a beautiful campus, historic facilities, etc.), but their financial endowment is our primary focus.

DEFINITION

Nonprofit organizations and foundations – especially foundations – use endowment earnings as a source of income for their operations. Endowment is more than just savings, however. Nonprofit and for-profit firms alike use reserves, a form of savings, to survive temporary increases in cash needs when income receipts are insufficient to cover the shortfall. Another type of savings is capital project accounts, which accumulate funds over multiple years in order to finance larger purchases of equipment or buildings. Each of these can be spent down to zero as the situation dictates – to relieve a shortage of cash or to purchase a building. Endowment, however, is often restricted, whether by protocol, donor intention, or a binding legal contract, so that the original corpus of funds is never spent.

Note the very sharp difference with this type of savings. For-profit firms do not speak of endowment, nor do they face binding legal restrictions on how their savings must be spent. If a for-profit firm accumulated a significant amount of funds in savings, it would be a target for a takeover. Accumulation of cash reserves is a signal to others that the firm is not investing in itself properly. Accumulation of endowment for a nonprofit, on the other hand, is a sign of organizational maturity and acceptance by the donating public that the mission should endure over time.

The legal definition and practice of endowment establishment and spending differ by country, but elemental to the degree to which a nonprofit endowment fund is restricted is the donor intention of the original gift. Centuries upon centuries of gifts to the church or state illustrate the historical significance of donations establishing monasteries, parks, and universities. If the donor intended that his or her gift fund a specific purpose into

perpetuity, future caretakers of the endowment must direct funds toward that purpose only, and must steward and preserve the corpus of the endowment so that its growth allows perpetual payout for that purpose. This is often referred to as a “true” endowment.

Nonprofit organizations also have the option of establishing a “quasi”- endowment. That is, a variety of income sources – donations, fees, and bequests, for example – may be directed into a fund that is not a true and legally binding endowment. The funds may be spent down to zero if needed because the organization itself decided to put them aside as savings (they were not directed to do so by a donor, specifically). The organization calls this fund an endowment and pledges to pay out only a portion of the annual growth of the fund so that the fund may grow over time. Unless the donations going into this fund were specifically restricted for a certain purpose, the quasi-endowment’s earnings over time can be used to fund any organizational need. Unlike true endowment, quasi-endowment can be considered simply as savings with unusually conscientious practices governing withdrawals.

The reason why many nonprofit organizations place their savings in quasi-endowment instead of a true endowment account is to signal to all organizational stakeholders that these funds are not merely reserves, but assets set aside to preserve the organizational mission over time. The “endowment” label promotes prudence in future expenditure of the funds’ earnings. On the other hand, the quasi-endowment arrangement allows the organization some flexibility to spend the principal, not just annual earnings or capital gains, when the organization is facing a large operational deficit.

MANAGEMENT

Earnings and capital gains of endowment assets over time provide an attractive source of revenue for a nonprofit organization. Once the initial gift arrives, the stream of revenue from endowment assets arrives without virtually any labor expended, as would be necessary with commercial fees, annual donations, and grants. With a larger endowment, the organization can devote more of its time to program implementation and less time on fund raising activities. Furthermore, unrestricted endowments provide a revenue stream that can be used for whatever the nonprofit needs, such as ongoing program costs, a much needed roof repair, or updated accounting software. In contrast, revenues from other sources such as grants are difficult to obtain for these more prosaic needs. Will a foundation provide funds for the new accounting software, or for a program that extends service to a previously unmet segment of the population? The grant makers will gravitate toward the direct programmatic support, while the hidden operational support of the organization goes unfunded. Thus, revenue from unrestricted endowment can fulfill a critical need for the less newsworthy but vital supporting services in an organization.

Restricted Endowments

Major donors often designate their largest gifts to fund a specific purpose (for example, a university might receive a gift for scholarships for students from a certain area of the country). The nonprofit or foundation must comply with these restrictions forever, unless the court agrees that the purpose for which the funds were intended no longer exists. In that case, the funds would be directed to a purpose that is close to the donor’s original intent. It should be noted that a nonprofit may have a large endowment or total endowments, but if the funds are restricted to selected purposes, the organization has less managerial flexibility than an organization holding unrestricted endowment funds. Statistics listing total

endowments held by nonprofit organizations rarely describe the extent to which these funds are restricted or unrestricted, and thus do not provide a complete picture of comparative fiscal health.

Building the Endowment

Building a strong endowment is a high priority for most nonprofit organizations and many foundations (not private foundations, but those receiving donations from the broad public). How is this achieved? If the organization builds a quasi-endowment, it may gather revenue and follow its own managerial guidelines to pay into the endowment. For example, a nonprofit may put all bequest gifts or a certain percentage of annual giving revenue toward endowment. For a more formal emphasis on building endowment, especially true endowment, nonprofits and public foundations concentrate their efforts on obtaining gifts from major donors. Universities in particular are adept at staging multi-year endowment campaigns with very large campaign goals of a billion dollars or more. Thus, endowment funds overwhelmingly originate from high-wealth individuals, not from the small gifts received in broad-based campaigns (such as direct mail).

Nonprofits concentrate their endowment efforts on fund raising from major donors, because it usually takes less managerial effort to obtain one \$1,000,000 gift than ten thousand \$100 gifts. Also, a large gift to endowment is a gesture that suggests a deep dedication to the mission. “Endowment” is difficult to explain to a neophyte donor (after all, it isn’t all immediately spent on the cause), but begins to make sense to a donor who is nearing his or her life’s end and hoping to bestow a lasting gift to a beloved organization. Nonprofits with planned (estate) giving programs, therefore, usually direct those gifts toward the permanency of an endowed fund.

An optimal size of endowment is an elusive concept. Some human service organizations are reluctant to build a large endowment, for fear of losing grant contracts or even annual gifts from donors. Grant makers may view a large endowment as an indication that the organization is not devoting enough expenditure directly to the mission. Not only appearances, but also compelling current needs – such as hunger, or the need to save an animal species before it goes extinct – motivate agencies to limit their endowment-building efforts. In the end, the optimally sized endowment from a societal perspective depends on the organization’s mission and the existence of its alternative revenue streams now and in the future.

Stewardship

In the course of an endowment campaign, a nonprofit may establish an endowment advisory committee to set policy and supervise investment and payout policies. This committee reassures potential donors that the nonprofit will steward the assets properly with prudent investment choices, and select a payout strategy that is neither too generous, resulting in loss or inadequate growth of the endowment, nor too miserly, resulting in a suboptimal level of program services produced.

Prudent endowment investment choices are difficult to define, but more evident in contrast to imprudent investment choices, where the endowment’s corpus is threatened by losses from risky investments. In the 2001-02 recession, one U.S. foundation lost over forty percent of its fund balance because the assets were held in just one stock. The decision to

hold the assets in one company's stock was specified by the original donor, so no imprudence is implied, but for other foundations or nonprofits, diversification of asset holdings is one of many important ways to reduce portfolio risk. Some nonprofits and foundations may choose to limit their investment holdings to stock in those companies whose activities do not conflict with the nonprofits' missions.

Payout Practices

Payout strategies can differ widely. In the U.S., nonprofit organizations are not required to pay out any of their endowment in any given year. This allows organizations to undergo an endowment-building phase. Private foundations, on the other hand, are required to pay out at least five percent of their asset base annually. Growing the foundation's endowment is easily done if the investment returns are robust, but the five percent payout requirement for private foundations leaves little room for growth during lean years. To reduce the variation in their annual payout, nonprofits and foundations may adopt a rolling average model whereby they pay out a set percentage of a multi-year average of their assets. Payout also depends, of course, on the original donor stipulations. If the donor preferred a true endowment into perpetuity, the payout policy will seek to protect the corpus of the endowment over time. If the fund is a quasi-endowment, the organization may draw down the endowment substantially in times of extreme financial distress.

ISSUES

From the nonprofit or foundation's point of view, more endowment is always better, unless the gift is unduly restricted to a purpose that is difficult to carry out. A broader societal benefit is also evident. Endowment serves a role in smoothing out public service expenditures over time. Through recessions or even depressions, when commercial revenues, donations and grants may fall, endowment assets can provide the steady revenue stream that allows our favored cultural artifacts and services to survive (Irvin 2007).

Generational Welfare

From a societal point of view, however, endowment growth at both foundations and nonprofit organizations is not entirely beneficial. Taking assets away from the free-flowing market economy and restricting them – permanently – to a specified function could, in theory, introduce drag on a macroeconomy. Generational equity is also a concern. If we allow endowment to be kept untouched or carefully stewarded over the ages, we shift consumption patterns (“consumption” referring to any benefit the nonprofit sector produces) from the current generation to future generations. This is a positive development if future generations are indeed going to be worse off than the current generation. Are they going to be worse off? The evidence is mixed. Every generation seems to have its version of the “in my day, we had it much worse than you” admonishment, as well as a fond remembrance of “the good old days.” Rising consumption rates of modern conveniences and advances in health care over time support the argument that each generation is a little better off than the previous. Considering this apparently advancing quality of life, the intergenerational shift of endowment from current to future generations is unwise.

Depending on the sector, we can craft opposing arguments to the need for savings over time. Environmental protection organizations may benefit from either a sharp infusion of

assets now, in a last-ditch effort to forestall climate change or preserve wild spaces and species. Similarly, an immediate investment in vaccines and other health-related innovations can eradicate diseases...forever, we hope.

Irrelevance Over Time

Often, donors specify that their gift endow a specific service. Though well-intentioned, these restricted endowments pose awkward dilemmas for future generations. The need for the service may no longer exist, the selected beneficiaries may no longer exist, or the service which it funds may no longer be perceived as beneficial to current society. Rich (1961, 86) remarked, "Perpetuity, like eternity, is a very long time and offers abundant opportunities for bad guesses regarding the charitable needs of future generations." Almost a century prior to Rich's lament, Kenny expressed similar disapproval of perpetual charities; "[W]hilst charity tends to do good, perpetual Charities tend to do evil. Too often...they bless neither him that gives nor him that takes...[I]t is utterly expedient to narrow (endowed charities') resources during their youth, for the purpose of augmenting their superfluities in their decrepitude" (quoted in Brody 1997, 919). In these cases, the courts are sometimes asked to intervene to release the endowment funds for a purpose which has a similar mission to which the original donor preferred.

Exchange of Tax Advantages for Public Benefits

Different countries have a range of tax advantages provided in exchange for charitable donations, including matching funds for donations, tax deductions, and credits. Usually, a gift for endowment is treated like any other donation provided to a nonprofit organization. For example, a donation may reduce the amount that the taxpayer must report as income. Assume the income tax rate is forty percent. The taxpayer saves forty percent of the cost of the donation via a reduction in his or her tax bill. In exchange for forgoing the taxes, the government receives the public benefits that the nonprofit organization produces (and indirectly, via the nonprofits that a foundation funds).

If the endowment gift went directly to a nonprofit, the organization may wait several years before spending any of its endowment proceeds. If the endowment gift went to a private foundation, the government may see an immediate return, because the foundation is required to pay out a certain percentage of the endowment, in the form of expenditures on public benefit goods and services. That annual expenditure may be small; less than five percent of the endowment's balance. Therefore, the government may have to wait an awfully long time for its tax exemptions to show up in the form of public benefits.

Decision Making Control of the Assets

The individual donor, when restricting an endowment to fund a specific purpose, retains the most decision making control over the assets, even after the donor is deceased. Even if the endowment is not specified for a specific purpose, control of the assets rests with a small group of decision makers. Although the assets in endowment have been ostensibly earmarked for the benefit of the public, the decision making regarding the investment and payout of endowment funds is made by the respected community members who serve as foundation or nonprofit stakeholders (board members and trustees). These stakeholders are, as a rule, high-income or high-wealth, well-educated community elders (Abzug and Galaskiewicz 2001). This point is not to imply that community elite are directing resources to self-serving interests, but to reveal an inherently paternalistic decision making structure.

Community elites determine what community needs are, and use endowment resources to pay for those identified needs.

Nonprofit sector decision making differs with respect to endowment expenditure radically from the use of government funds collected with taxes. Government decision making depends at least partially on the voting public to select the decision makers (politicians and the judiciary) to carry out voters' broad preferences. Thus, while an individual community member can be highly involved in the nonprofit sector, the broad public is uninvolved with the big decisions directing the use of nonprofit and foundation funds. Is this a concern? Perhaps to an academic audience only, at this point, and it is probably not a concern if the decision makers in place have good ideas that yield benefits for society. Yet, as the accumulation of society's assets in endowment rapidly accelerates, public scrutiny of endowment and accountability of stakeholders involved in its stewardship will surely increase.