

# Financial Modeling of Withdrawals From an Endowment Portfolio

Stephen L. Kessler, CIMA, CFP

**InvestmentHelp.org Note: This is an ideal article for trustees of endowments and foundations.**

## Overview

*The last bear market made directors and boards of endowment funds nervous about the sustainability of their spending policies. Many institutional portfolio values have been seriously impaired, donations of appreciated securities have slowed to a crawl, donors have become more cautious, and beneficiary needs continue to grow. Barring a dramatic and unexpected turn of events in the financial markets, endowment and foundation committees need to come to grips with the expectation of lowered real returns from their investment portfolios.*

Most charitable and educational institutions seek permanent endowment funds to gather large donations and further their ability to satisfy the annual funding needs of their beneficiaries. The political appeal of such endowments for donors is undeniable. Patrons can perpetuate their ability to make annual gifts beyond their own lifetimes; they can create advised funds in their own names and expand their influence in the community with the magnitude of their gifts. Implied in an institution's appeal is the idea that the value of each year's gifts will continue to increase as the underlying portfolio grows faster than inflation over time.

The last bear market, however, has made directors and boards of endowment funds nervous about the sustainability of their spending policies. Many institutional portfolio values have been seriously impaired, donations of appreciated securities have slowed to a crawl, donors have become more cautious, and beneficiary needs continue to grow.

## Spending Policies

Annual spending by endowments and foundations has been shaped by two major factors: donor expectations and minimum spending rules. Endowment funds have educated donors to believe that their gifts could be conservatively expected to result in distributions of at least 5% annually and that they could be expected to grow over time. Those expectations have been reinforced by federal government rules requiring minimum distributions of 5% annually for private foundations to maintain their tax-exempt status. This translates into a political problem for endowment fund development directors: How do they entice potential donors when past performance had been poor and the fund can't guarantee the growth of annual advised gifts in perpetuity?

## The Past as Prologue

Having enough money to last a lifetime might be the definition of success for an investment program designed for individual investor, but that is not good enough for an endowment. Ideally, the goal would be to retain the endowment's purchasing power over time and not lose too much in the interim. If, for example, an endowment started with a \$1 million portfolio, the goal would be to maintain its inflation-adjusted value at the end of a ten-year period, without losing more than 20% of the starting principal at any time during the ten-year period. The 20% loss was chosen because that generally is the point where endowment boards get nervous and consider abandoning diversification guidelines in favor of safety.

Based on simulations of a traditional 60/40 stock/bond mix over a 20 year period from 1973-2002, endowments no additional donor contributions, could only meet the above goal (maintain purchase power and don't drop more than 20%) by not making any disbursements. Of course, this is unrealistic. Who could have an endowment that didn't endow anything? Furthermore, the simulations assume no asset management fees or trading costs, both of which will detract from returns.

It appears that the fortunate history of endowment promises, until recently, was the result more of good luck than skill. Promises were made and kept because the market offered extraordinary returns over nearly a generation. Because the past offers us little hope of repeating that good fortune, maybe we can try projecting a different future.

## Now what do we do?

While increasing the traditional asset allocation from 60/40 to 70/30 resulted in an average return that was up slightly, the overall success rate for meeting the goal of not losing more than 20% of the starting principal declined. Few endowment boards would consider more than a 70% allocation to stocks, so it's clear that other strategies need to be considered.

Adding other asset classes to the portfolio is one such strategy. In simulations that maintain the 70/30 asset allocation mix, but add both international stocks and real estate to the equity portion of the mix to create an allocation composed of 50% U.S. stocks, 10% international stocks, 10% real estate investment trusts and 30% bonds, median returns rose on par with those of the more traditional 70/30 mix. The notable difference here was a marked improvement in the success rate of meeting the

overall goal of not losing more than 20% of the portfolio's principal. Unfortunately, the success rate is not quite high enough.

## Conclusion

Using multiple financial modeling techniques, the simulations demonstrate that it is very difficult to maintain purchasing power over a ten-year period with any degree of consistency when we introduce any reasonable withdrawal rate. While donors may be willing to go along, organizations have actually suffered a decline in the ability to meet funding needs. The alternative is to choose another definition of success.

Increasingly, it appears that donors and their endowed organizations must make some difficult decisions. Either the withdrawal rate must decline, or the promise of maintenance of purchasing power must be renegotiated. If politically acceptable, a 4% withdrawal rate is recommended. If not, perhaps a guarantee of two or three years at a 5% level might work, with future withdrawals dependent on market conditions. In the meantime, endowment and foundation committees must come to grips with the need to increase solicitation efforts to make up for lowered real returns.

## About the Author

***Stephen L. Kessler, CIMA®, CFP®, has been the director of research for S.R. Schill & Associates and Quantum Asset Management since 1991. He is a charter member of IMCA® and was in the first class to receive the Certified Investment Management Analyst (CIMA) designation. Mr. Kessler received a B.S. in engineering science from the University of Miami and a M.B.A. from Seattle University.***

---

Although information and opinions expressed reflect responsible points of view, they do not necessarily represent the opinions of the IMCA Board of Directors, the IMCA staff, or IMCA members.