

The *Ambachtsheer* Letter

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REINVENTING ENDOWMENT FUND MANAGEMENT

“The rolling three-year spending method that most endowment funds use appears not to be the best rule for creating discipline in the spending processes of universities and other beneficiary institutions”.

From a **commonfund** paper
“Why Do We Feel So Poor?”
April 2003

The Endowment Fund Crisis

The pensions crisis gets a well-deserved break in this *Letter* as we turn our attention to what has been happening in the endowment fund sector. Arguably, the equity bull market of the 1990s distorted the finances of foundations and other endowed not-for-profit institutions even more profoundly than it did the finances of funded pension plans and their sponsors. Why? Because the vast majority of endowment funds have a hard-wired spending rule that is an accident waiting for a time to happen. That time turned out to be the 2000-2003 period. This *Letter* documents the ‘accident’ and explains how the risk of future accidents can be reduced.

It is probably the simplicity of the hard-wired endowment spending rule that explains its broad popularity: “pay out annually 5% of the rolling three-year average of fund market value”. It does not require rocket science to explain why such a spending rule, typically combined with a 65-35 equity-bond asset mix, is an accident waiting to happen. Even if it were reasonable to assume that such an investment policy could generate a net 5% real return over the long run, it is not (and never was) reasonable to assume that a three-year averaging period is of sufficient length to eliminate the shorter term return ‘noise’ that inevitably

accompanies any risk-taking investment policy devised to attain the 5% goal.

In the last half of the 1990s, the return ‘noise’ of a 65-35 asset mix policy took on a life of its own, lifting the market values of endowment funds to unprecedented heights. The hard-wired spending rule ensured that the dollar pay-outs from these funds would rise to unprecedented heights as well. These dollar windfalls were quickly converted into bigger university and hospital payrolls, into more ambitious research programs, and into new bricks and mortar. Then came the devastating stock market experiences of 2000, 2001, 2002, with the jury still out on 2003. As surely as night follows day, the hard-wired pay-out formula is now reclaiming the windfall dollars of the late 1990s.

Unfortunately, there is no equivalently simple formula to reclaim the increases in payroll, research commitments, and space that those 1990s windfall dollars spawned. As the commonfund paper cited above put it, it is this inability to undo the consequences of the faulty pay-out policies of the past, that makes most institutions dependent on endowment fund dollars “feel so poor” today. That is why the endowment fund community is now in crisis.