Fundraising: the Missing Piece in Endowment Management

Each time a man stands up for an ideal, or acts to improve the lot of others, or strikes out against injustice, he sends forth a tiny ripple of hope, and crossing each other from a million different centers of energy and daring, those ripples build a current that can sweep down the mightiest walls of oppression and resistance.

– Robert F. Kennedy

Why does fundraising matter?

Nonprofits are unique. In addition to having the ability to generate earned income, they raise contributed income to support their organizational mission. The premise behind a nonprofit's tax exempt status is that the nonprofit exists for public benefit and therefore requires an accounting and capital structure that differs from standard business enterprises. In order to encourage individuals and organizations to support the nonprofit community's provision of public goods, monetary gifts to charitable organizations are tax deductible. Contributed income, for most nonprofits, is an essential component of the revenue mix. It is often proactively solicited through annual campaigns, capital campaigns, special events, sponsorships, and ongoing fundraising initiatives. The individual and institutional givers who make charitable contributions do not receive nor expect goods and services in return.

Types of Contributed Income

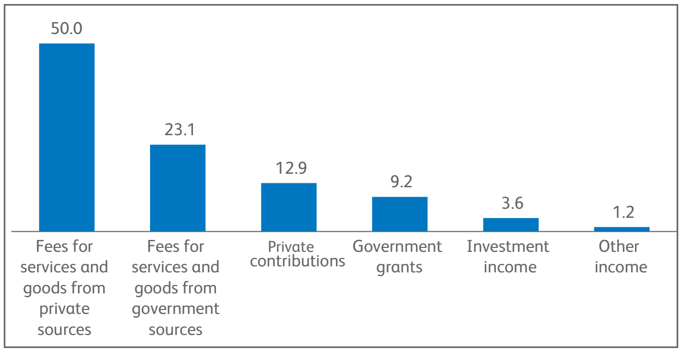
- **In kind** – cars, equipment, clothing, household items, real estate, etc.
- **Cash** – pledges, annual donations, sponsorships
- **Planned gifts** – bequests, gift annuities, charitable trusts

On the contrary, earned income represents all capital generated in exchange for goods or services. Today's nonprofits are increasingly developing sources of earned income. Well known examples are thrift stores, performing and visual arts ticket sales, Girl Scout cookie sales, gift shops, admission fees and contracts for services.

Types of Earned Income

- **Fees** – admission, services, tickets
- **Contracts** – services, government
- **Investment income** – interest
- **Rental income** – building, equipment, property, parking lots
- **Business income** – sale of donated items

Figure 1
Revenue Sources for Reporting Public Charities. 2012 (Percent)



Sources: NCCS calculations of IRS Statistics of Income Division Exempt Organizations Sample (2008); The Urban Institute, National Center for Charitable Statistics, Core Files (Public Charities, 2012); American Hospital Association 2010 survey; and National Health Accounts (Centers for Medicare and Medicaid Services).

According to the Urban Institute's 2014 brief on the nonprofit sector, approximately 50 percent of the total revenue for public charities came from fees for services and goods from private sources as indicated in Figure 1 (above). This figure includes tuition payments, ticket sales, and hospital patient revenues (but excludes Medicare and Medicaid) and is driven largely by hospitals and higher education nonprofits, both of which derive their funding primarily through fees for goods and services. Fees from government sources, such as government contracts and Medicare and Medicaid payments, accounted for almost one-quarter of public charities' revenues (23.1 percent) in 2012. Private charitable giving represented 12.9 percent of total revenues, and government grants represented another 9.2 percent. Combining government contracts and grants into a single category, the government provided nearly onethird (32.3 percent) of 2012 nonprofit revenues.

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Sustainability is a common nonprofit buzzword that addresses the organization's ability to operate over a long period of time. Oftentimes, income diversity is considered a driver of sustainability. Multiple income streams soften the cyclical impact of any single source of funds. For many social service nonprofit organizations, the end of the year is a significant period for individual gifts. Private independent schools often have two income spikes during the year when students register and then when they begin paying school tuition. A membership based association may use an annual membership drive once a year and a single annual conference as their two primary revenue sources. While income may follow a cyclical trend throughout the year, expenses are likely to be steadier. To ensure that organizations can meet their needs, multiple revenue sources can smooth the income stream and reduce the impact of income volatility on the organization's ability to deliver effective programs and services.

On the contrary, too much income diversity can dilute an organization's focus. The balance between earned and contributed revenue as well as the underlying sources is a strategic decision that varies by the type of organization and the method of program delivery. While there is no single solution for the earned to contributed revenue ratio, the chart below illustrates how some nonprofits resolve the dilemma.

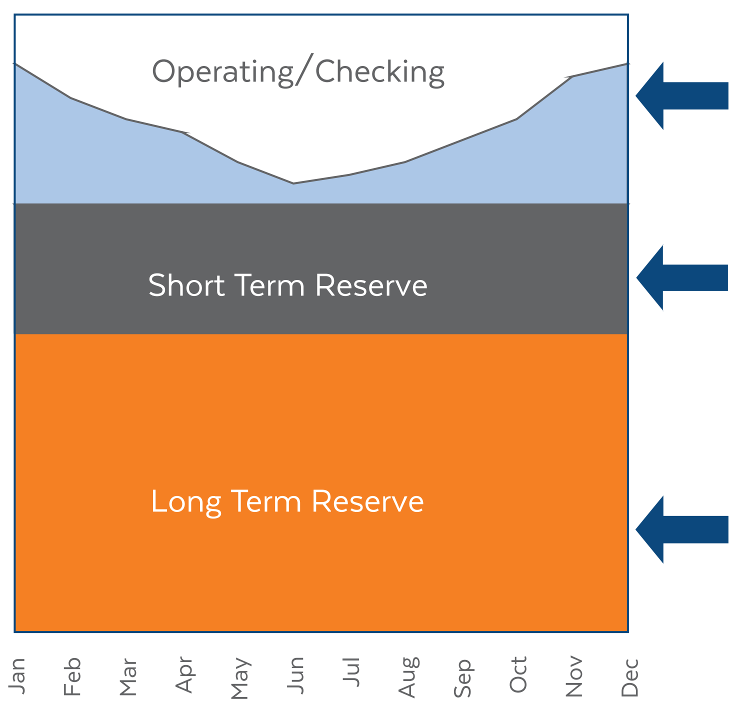
The 3 buckets

Integral to the role of fundraising in endowment management is a clear delineation between the different types of funds an organization has and how additions to each pool are determined. As new funds are raised, their purpose defines their classification. The graph below identifies the three primary pools of funds for nonprofits and their characteristics.

Typically, funds raised for an endowment or quasiendowment are categorized as long term reserves. Endowments can be defined as assets donated to an organization for its aid and support that are oftentimes long term, designated for a program or capital project, and restricted or partially restricted. Endowment gifts may include donated cash, stock, real estate and other assets that can be monetized. Quasi-endowments are defined almost exactly as endowments with the exception that they are generally unrestricted and established by the institution. For long term assets designed to support the organization over time, the funds are often pooled into an investment portfolio that is managed for total return using modern portfolio theory and governed by the Uniform Prudent Management of Investment Funds Act (UPMIFA). Due to its long investment time horizon, maximizing capital appreciation is typically the investment objective of endowment assets. Organizations with unrestricted endowments have the option of employing a spending policy that returns a portion of the assets back to the organization to be used at their discretion. Over the long term, this additional funding source can provide much needed

Figure 2

Sample Account Structures for Non Profits



Operating / Checking Account

Target: 2 - 6 months of operating expenses

10% - 30% of investable assets

- Operating funds as needed with daily liquidity
- Safety of principal

Short Term Reserve

Target: 3 - 6 months of operating expenses

10% - 30% of investable assets

- Reserve to augment operati ng cash flow volatility
- Incremental Income with relative stability of principal

Long Term Reserve

Target: excess of operating and short term reserves

40% - 70% of investable assets

- Reserve to maximize long term capital appreciation
- Long term time horizon with principal fluctuation

financial sustainability and greater flexibility for the organization to devote resources to mission related priorities. One example of leveraging an endowment to improve fundraising is a mid-sized social service agency in Coastal Georgia that uses endowed funds to pay for all administrative expenses so that all annual giving is passed through directly to member agencies or charitable programs. Because of their endowment, the organization is able to inform donors that 100% of their gift is directly impacting the community's needs.

Growing Your Endowment or Quasi-Endowment for Mission Success

Relying solely on an existing endowment or quasiendowment without the addition of new funds, is a missed opportunity for nonprofit organizations. While being careful to protect the organization from donor fatigue, large scale fundraising campaigns should not be viewed as a one-time endeavor. Fundraising campaigns can be used to attract new capital for purposes beyond the physical plant. Restricted and unrestricted funds for scholarships, programs, strategic growth, and innovation often excite donors to assist an organization in meeting its mission.

Endowments Defined

Restricted – funds restricted by donors as defined in the gift agreement that are classified as permanently restricted net assets

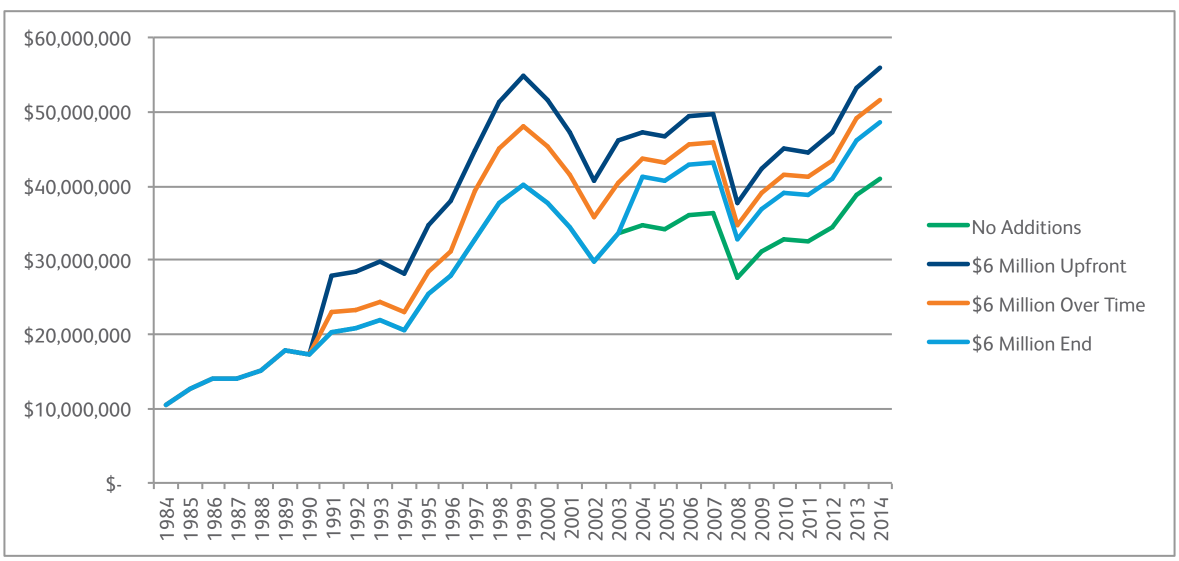
Quasi or Board Designated – funds designated by the institution or its board for a specific purpose that are classified as unrestricted net asset

Term – funds set aside for a specific period of time or until a certain event occurs that are classified as temporarily restricted net assets

Once an investment policy statement is established, the key investment decision makers often grapple with questions that impact how the funds are to be invested. What is the purpose of the funds? How do they support the mission? What is the time horizon for investing? How risk averse is the organization? What would happen if we were unable to meet our spending needs? What is the impact of a real loss?

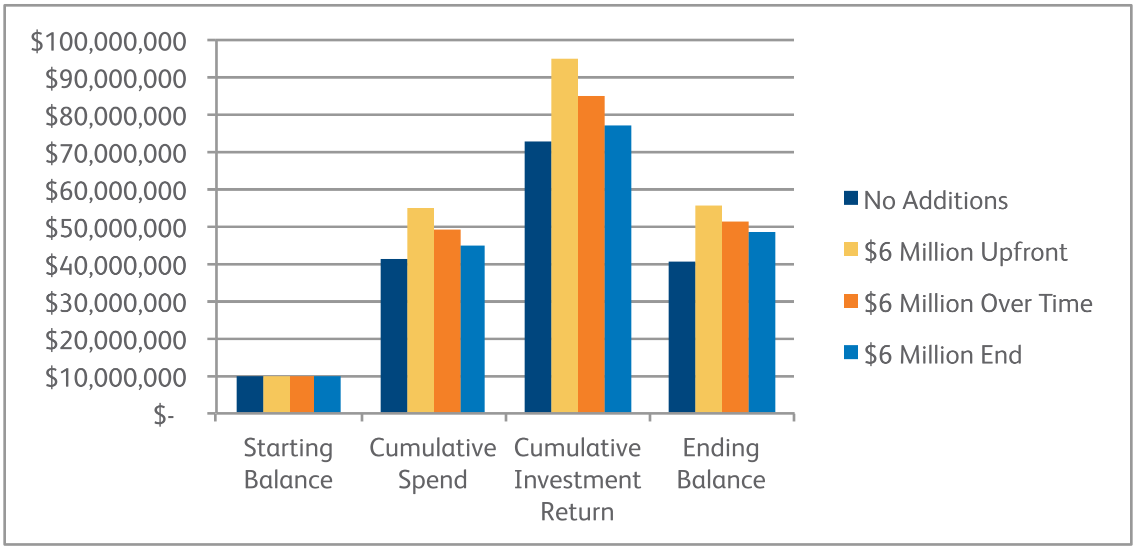
The graph below shows the power of making additional contributions to an existing endowment. It uses a baseline of $10 million as the endowment's starting market value.

Graph 1 and 2
Market Value of a $10 million endowment over 20 years



Then, three scenarios illustrate a single $6 million addition near the beginning of the endowment (year 7), three $2 million additions over a three year period (years 7, 13 and 20), and a single $6 million addition at the endowment at the end (year 23). The purpose of this illustration is to very simply demonstrate the power of compounding interest over time and the significant impact that additional contributions can make on the cumulative spending and ending market value of an endowment.

Graph 2 of 2



Comparative analysis of the impact of endowment additions assumes an asset allocation of 60% equity and 40% fixed income, a fixed time horizon of 30 years, and a spending rate of 5%

Fundraising: An important piece of the puzzle

Compounding the challenge of managing an existing endowment, organizations must decide when is the right time to “go back to the well” to ask donors for additional support for physical or programmatic needs. The solution to having more funds available from an endowment to meet the mission is not as simple as increasing diversification, adjusting the asset allocation to include assets with a greater historical return, or even increasing spending policies. It is all of those activities considered in conjunction with the new possibilities that additional endowment related fundraising provides.

CASE STUDY

A large humane society in a metropolitan city developed a strategic plan that required substantial financial resources. While they had been successful at fundraising and operating with a surplus, the board initiated a discussion about the impact of starting new initiatives while continuing to meet the needs of the community.

Select Long-term Goals included:

- Significant expansion of agency network and community development activities;
- Significant investment in strengthening human resources;
- Changes in adoption marketing to improve service to an increasingly spread-out population; and
- Creation of targeted "capacity grants" to help a small, related shelter expand facilities and transportation.

Select Challenges included:

- Significant spending required by the strategic plan that increased cash operating budgets by 41% in one year
- New and unproven activities with shelter partners
- Scaling new projects gradually and the ability to fund pilots

For each initiative, the board established a detailed funding matrix that analyzed the following:

- Overall estimated cost to meet each strategic initiative
- Budgeted amount or percent that will cover estimated cost from existing operations
    - Operating surplus
    - Endowment – consideration to increase spending policy to 4%
- Budgeted amount or percent that will cover estimated cost from new sources of capital
    - Corporate Foundations
    - Private Foundations
    - Individual Donors
- Adjustments made to investment of endowed funds to support the strategic plan
- Investment Vehicle Utilization - Expand approved investments in IPS to include Alternative Investments designed to dampen volatility
- Asset Allocation – Apply results of asset allocation study to portfolio and increase allocation to equities based on current capital market assumptions with the goal of increasing the likelihood of higher expected returns over time
- Define and create policy benchmarks for Short-Term/ Intermediate/Long-term portfolios
- Establish manager evaluation guidelines and review manager performance quarterly

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Sources

McKeever, Brice S. and Sarah L. Pettijohn. 2014. The Nonprofit Sector in Brief 2014: Public Charities, Giving, and Volunteering. Washington, DC: The Urban Institute.

About SunTrust Foundations and Endowments Specialty Practice

SunTrust has nearly a century of experience working with not-for-profit organizations. Fiduciary stewardship is the heart of our culture. We are not merely a provider for our clients; we are an invested partner sharing responsibility for prudent management of not-for-profit assets. Our client commitment, not-for-profit experience and fiduciary culture are significant advantages for our clients and set us apart from our competition.

The Foundations and Endowments Specialty Practice works exclusively with not-for-profit organizations. Our institutional teams include professionals with extensive not-for-profit expertise. These professionals are actively engaged in the not-for-profit community and are able to share best practices that are meaningful to their clients. Team members offer guidance and advice tailored to the various subsets of the not-for-profit community, including trade associations and membership organizations. Our Practice delivers comprehensive investment advisory, administration, planned giving, custody, trust and fiduciary services to over 700 not-for-profit organizations. We administer $30.9 billion in assets for trade associations, educational institutions, foundations, endowments and other not-for-profit clients.[1]

[1] As of September 30, 2016

For more information about how fundraising impacts your endowment over time, contact your SunTrust relationship manager or investment advisor. You may also contact us by phone 866.223.1499.

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