Intergenerational Equity and the Endowment Model

What is Intergenerational Equity and is it still relevant?
Does Intergenerational Equity apply to my non-profit institution?
What can other non-profits learn from Educational Endowments?

At investment committee meetings, investment managers are frequently asked to “look into their crystal ball” and forecast future investment returns. We all know the caveat about historical performance – that it is not indicative of future results and should not be used as such. However, as we are fond of quoting Mark Twain about his observation that “history does not repeat itself, but it does rhyme….,” we find that the investment markets move in cycles and oftentimes, those cycles can be repetitive. So with one eye monitoring the rearview mirror, we look into the crystal ball and search for the most successful way to preserve current benefits for future generations.

A History of Intergenerational Equity
James Tobin, a Nobel Prize winning Economist at Yale University, is generally believed to be the father of the concept of Intergenerational Equity (IE), in an economical context:

“The Trustees of endowed institutions are the guardians of the future against the claims of the present. Their task is to preserve equity among generations.”

Tobin is credited with this quote in 1974, which is an interesting point in time as the world economy was in the throes of a severe bear market that began in January 1973 and lasted through December 1974. All of the global stock indices of the future G7 countries sank to a bottom over the fall of 1974, with nominal returns that year losing 34% and real returns bottoming out at 43%. With double digit inflation in 1974 as well, the threat to the mere existence of future financial support from endowments was very real. The investment environment over the last fifteen years has been no less interesting. With two major recessions (2001 and 2007-08) and an historic liquidity crisis in late 2008 into 2009, the challenges confronting nonprofit investors are greater than ever.

Endowments of educational institutions typically provide operational and budgetary support, with support levels ranging from a few percentage points to over half of an institution’s budget. Consistency in that level of support is dependent on the reliability of investment results and is fundamental to future operational viability. Administrations and trustees generally achieve that consistency by developing and applying spending policies to endowment funds. However, endowments of other nonprofits do not usually have this type of budgetary need, but they may rely on consistency of results to maintain their level of support for grant making or other charitable purposes. Most of these institutions also employ a spending policy, and for some, their spending level is mandated by tax law. Because most endowments are established in perpetuity, the concept of intergeneration equity is as relevant today as ever.

Investment Policy and Spending Policy
For many colleges and universities, determining a spending policy can be as important a decision as establishing an investment policy. Inflation is a significant risk to endowments, because costs will increase over time and thus drive up the level of distributions required to keep services the same over time. This naturally leads us to define the primary investment objective for most endowments:

Investment Return Objective = Spending + Fees + Inflation

If actual investment results exceed the sum of these three factors, then the endowment is a net saver, and if results are less than the sum, then the endowment is a net spender. Most will agree that success results from achieving the investment return objective. But how do we successfully define what that return percentage is, when each factor is variable?
The two most recent major declines in the markets uncovered the inherent weakness in spending policies – most failed to protect the endowed institution from severe volatility in the level of financial support on which they depend. Many blamed those failures on another concept known as the Endowment Model; this concept allocates a significant portion of assets to non-traditional asset classes, such as hedge funds, absolute return, private equity and real estate: investment strategies with limited or no liquidity. Many endowments believe these strategies provide the “illiquidity premium,” i.e. they are a good source of excess returns over the traditional markets, and because of their unlimited time horizon, endowments can bear the liquidity risk of these investments. The credit crisis of 2008 proved otherwise. Many endowments struggled to meet the liquidity needs of the institutions they support when the marketable portion of their investments declined severely and they could not access their non-traditional investments. A balance is needed between the return expectations of an endowment’s investment policy and the funding expectations from the institution’s spending policy.

Return expectations are driven by investment policy and asset allocation. We know that over full market cycles and longer periods of time, equities outperform bonds (see chart at the end of this article for historical returns), and in moderation, non-traditional investment strategies can provide an illiquidity premium to returns. Funding expectations are driven by spending policy and methodology. The majority of educational endowments use a “moving average” based policy, where the spending formula is calculated by taking an established percentage of the average of several annual market values. Two widely used examples of this methodology are to spend 5% of a three year (12 quarters) or five year (20 quarters) average of market values. This methodology is what leads to the most common investment return objective we see:

\[
\text{Net investment return} = \text{Rate of Inflation}^2 + 5\%
\]

This annualized objective is usually measured over a market cycle or specific time period linked to the methodology used in the spending formula.

Another calculation is the “effective spend rate” and it varies the most from year to year, as it is calculated by taking the actual spend amount and dividing it by the current year’s market value. The effective spend rate is what makes some in the public domain believe that an endowment is not spending enough today; some even posit that spending/investing more today will preserve the value of the institution in the future.

Can an endowment achieve returns that exceed Inflation + 5%? It depends. There are many factors that impact performance and the point in time of measurement. See the charts below for past performance of traditional portfolios in varying allocations compared to the performance of Consumer Price Index (CPI) + 5%.

**Is CPI + 5% Attainable?**

**Rolling 5 Yr Returns of Portfolios vs. CPI + 5%**

> ![Chart 1](source: Morningstar Encorr)

> ![Chart 2](source: Morningstar Encorr)

> ![Chart 3](source: Morningstar Encorr)

> ![Chart 4](source: Morningstar Encorr)
We compared performance of four portfolios of varying asset allocations to the track record of CPI +5%, and evaluated the rolling five and ten year annualized returns. We used the S&P 500 Index, EAFE Index and Barclay’s Aggregate in multiple combinations of equity and fixed (60% Equity and 40% Fixed, 70% Equity and 30% Fixed, 80% Equity and 20% Fixed and 100% Equity). The rolling five year returns comparison show greater success at exceeding inflation and spending; the rolling ten year returns exhibit less volatility, but at the endpoint, arrive much closer to the real return target.

The Future of Intergenerational Equity: Endowment Feng Shui

What will it take to achieve Intergenerational Equity in the future? Endowments are long term investors and this “in perpetuity” time horizon is difficult for most investors to appreciate. We want to make our mark now: increase payouts to add endowment values and reserves that could make a difference in the mission of the institution.

1. Asset allocation – Diversification is the most important decision an investor can make. As Harry Markowitz’s pioneering work in modern portfolio theory proved, asset allocation is responsible for 90% of investment results. Take care to ensure portfolios are diversified among asset classes and strategies. Stress test the portfolio with liquidity constraints to determine the minimum level of liquidity your institution needs to maintain support.

2. Spending Rate – Consider a review of how your institution calculates its spending policy (if allowable). Perhaps there may be another methodology that can be employed, one that combines a percentage of an average market value with the last spending amount grown by a measure of inflation. If consistency of spending amounts is more important to your institution, it is likely this inflation-based or hybrid spend rule may be more effective. And of course, controlling spending today enables higher future spending levels tomorrow.

3. Costs – Investment costs and administrative costs all factor into performance calculations and can erode investment returns. This doesn’t mean that cheapest is best; but monitoring results versus how much they cost is important. A relative performance measure is helpful for determining success here.

4. Gifts – GIFTS! Often overlooked as a factor of growth for endowments, fundraising and consistency of annual gift flow can significantly increase the probability of success in achieving current cash flow requirements and maintaining that level in the future. Consider instituting an annual fund for giving that provides unrestricted assets for current operating support. Capital campaigns are big projects and come with costs of their own; however, the potential payoff from increased endowment values and reserves that could make a difference in the mission of the institution.
All of these strategies and activities are indicative of best practices in the nonprofit world. While some private foundations may not be fund-raising charities (capital campaigns would not apply), they can actively manage asset allocation, along with certain aspects of their spending policy and monitor costs in order to support the perpetuity of their mission.

The SunTrust Foundations and Endowments Specialty Practice Group provides nonprofits with investment advice, best practices and governance issues that may impact their future. Please let us know how we can help your institution.

1 As of September 30, 2016

2 Measures of inflation vary and report price changes with differing components; there is the Consumer Price Index (CPI), Higher Education Price Index (HEPI) and the Higher Education Cost Adjustment (HECA). CPI is an economy wide price index using a basket of consumer goods and services. Both HEPI and HECA report on baskets of goods purchased by colleges and universities, and are heavily weighted to salary costs. It is important for the institution to select the inflation index most relevant to their mission.
The information and material presented in this commentary are for general information only and do not specifically address individual investment objectives, financial situations or the particular needs of any specific person who may receive this commentary. Investing in any security or investment strategies discussed herein may not be suitable for you, and you may want to consult a financial advisor. Nothing in this material constitutes individual investment, legal or tax advice. Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance.

SunTrust Bank and its affiliates and the directors, officers, employees and agents of SunTrust Bank and its affiliates (collectively, “SunTrust”) are not permitted to give legal or tax advice. Clients of SunTrust should consult with their legal and tax advisors prior to entering into any financial transaction.

Securities and Insurance Products and Services: • Are not FDIC or any other Government Agency Insured • Are not Bank Guaranteed • May Lose Value

SunTrust Private Wealth Management is a marketing name used by SunTrust Bank, SunTrust Banks Trust Company (Cayman) Limited, SunTrust Delaware Trust Company, SunTrust Investment Services, Inc., SunTrust Advisory Services, Inc. and GenSpring Family Offices, LLC which are each affiliates of SunTrust Banks, Inc. Banking and trust products and services, including investment management products and services, are provided by SunTrust Bank and SunTrust Delaware Trust Company.

SunTrust Bank and its affiliates do not accept fiduciary responsibility for all banking and investment account types offered. Please consult with your SunTrust representative to determine whether SunTrust and its affiliates have agreed to accept fiduciary responsibility for your account(s) and you have completed the documentation necessary to establish a fiduciary relationship with SunTrust Bank or an affiliate. Additional information regarding account types and important disclosures may be found at www.suntrust.com/investmentinfo.