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Build a Better Endowment

Solid university endowments can survive economic storms

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Like the little piggie who built his house out of brick while his brothers used twigs and straw, some charities prepare for the worst by building endowments that help them weather financial storms�while others don�t and are blown away. Be sure that your endowment is built of brick.

Charities with adequate endowments are less common than you might think. At least that�s the surprise I got when reading a recent survey of 842 colleges and universities by the National Association of College and University Business Officers and Commonfund, an investment firm for endowments.

Sure, we�ve all heard about the huge endowments at places like Harvard and Yale. But they are the exception among the more than one million charities in the United States. Most charities have little to no endowments.

The survey of 842 higher education institutions found about a dozen endowments were down more than 30 percent. Indeed, endowments are down for a second year in a row�with the average long-term debt load carried by the participants increased more than 50 percent in the fiscal year ending June 30, 2009. That means they�re borrowing more because they don�t have adequate endowment funds. In addition, many universities are cutting staff, reducing student aid and dramatically reducing capital improvement spending.

Brandeis University, for example, lost 42 percent of its endowment during the last two years and is down to $619 million. The university is being forced to restructure its entire budget and cut not only staff, but also entire majors. It�s planning to sell $180 million in revenue bonds, even after Moody�s cut it rating to A1 (which is bad). The university is even still considering an extremely controversial sale of the entire contents of its Rose Art Museum, with an estimated value of $350 million to $450 million.

Even the great university endowments with incredible investment track records got smashed in the market during these last few years. The survey found that the largest endowments, after two decades of average annual returns of 15 percent on their investments, lost 18.7 percent of their total value for the fiscal year ending June 30, 2009. Indeed, because they were so heavily invested in alternative assets that were particularly hard hit in 2008, Harvard�s endowment dropped nearly 30 percent to $25.7 billion and Yale�s endowment dropped 28.6 percent to $16.3 billion. Worse yet, these losses came at a time when, according to the Council for Aid to Education, contributions to colleges and universities in the United States in 2009 declined 11.9 percent � the greatest decline ever recorded.

But remember that endowments invest for the long-term and their performance must be looked at in 10-year intervals. So, during the past decade, even including recent losses, Harvard�s endowment earned 8.9 percent annually while Yale earned 11.8 percent annually. Brick houses. Lucky thing too, considering the financial storm they�ve just weathered.

Still, all the rest of the nation�s existing and potential endowments should take heart. While it�s unlikely that charitable contributions will increase significantly in 2010, they will come back eventually, particularly with the specter of higher income tax rates on the horizon. Already, there are indications that university endowments have made back a good bit of the money lost through June 30, 2009. Princeton recently changed its endorsement growth forecast for the year to 10 percent from zero.

Of course, some charitable organizations may never be able to build an endowment because they are too small, too new or don�t have an appropriate donor base. But most can. And while they may not be able to replicate the Harvard/Yale returns, they can still do well. It just takes time, effort and money, along with a good bit of legal, consulting, accounting and investment advice.

One of the first hurdles many charities must overcome is demystifying the concept of endowment. What exactly is an endowment? How is it established? What are the rules for spending an endowment fund?

If you don�t understand the underlying concepts, you are never gong to be able to build your endowment correctly. And if you build it wrong, it�s either not going to be successful or you�re going to run into a lot of trouble with donors and/or the state attorney general. Many of the stories that end up on the front pages of local papers are about donor-restricted endowment funds that have been mismanaged or mishandled.

So, let�s get the basics right.

WHAT IT IS

The concept of endowment is based on the premise that charities need to be able to plan for the long-term and not be completely dependent on current revenues. Charitable endowments are the vehicles that allow for this long-term stability because, by definition, only a portion of the assets in an endowment fund may be spent by the charity in a particular year.

Although we tend to speak of the endowment as a single fund, it usually consists of many, sometimes thousands, of different funds.

Endowments tend to be subject to two different sets of restrictions. By definition, all are subject to the restriction that only a portion of the endowment fund may be expended annually. In addition,

many donor-restricted endowments require that a fund may be used only for a specified purpose, such as scholarships, endowed professorships, cancer research, etc. There can be thousands of these different donor restrictions.

Although most endowment funds are established by individuals, corporations or private foundations as charitable donations or grants, certain endowment funds can actually be set aside by the charity�s board. Donor-restricted endowments (sometimes known as �true endowments�) are subject to a large body of common and statutory laws protecting the wishes of the donors from unauthorized use by the recipient charity.

Board-restricted endowment funds (sometimes known as �quasi-endowments�), on the other hand, may be unrestricted by board vote at any time and are not subject to the large body of state law protecting donor-restricted endowments from improper use.

STATE LAW

State law regulation of charitable endowments is governed in virtually all states by the Uniform Management of Institutional Funds Act (UMIFA) or its replacement, the Uniform Prudent Management of Institutional Funds Act (UPMIFA).

UPMIFA has been adopted in 43 states and is expected to be enacted in virtually all states in the next few years.

UMIFA revolutionized charitable investing by adopting more of a corporate law standard for investing and allowing the management of charitable endowments based on two general principals:

(1) the assets should be invested prudently in diversified investments that seek growth as well as income (the first statutory approval of modern portfolio theory); and

(2) that appreciation on assets (that is to say, capital gains) can be prudently spent for the purposes of any endowment fund held by a charitable institution.

UMIFA frees investment managers of endowments to invest for growth using a �total return� approach to investing. No investment is on its own inappropriate. Its appropriateness has to be looked at in the context of the entire endowment portfolio. Released from prior investment restraints, large endowments added not only equities to endowment portfolios, but also alternative investments, such as hedge funds, private equity, derivatives and real estate. Large university endowments now invest more than 50 percent of their assets in alternative investments.

UPMIFA maintains the two guiding principles of UMIFA but updates the statute to reflect more modern concepts of trust law investment.

UPMIFA emphasizes that endowment investment decisions must be made in relation to the overall resources of the institution and its charitable purposes. No investment decision may be made in isolation. Rather, it must be made in light of the endowment fund�s entire portfolio, and as part of an investment strategy �having risk and return objectives reasonable suited to the fund� and to the institution. Under UPMIFA, a charitable institution must diversify assets in its endowment unless �special circumstances� dictate otherwise. Also, investment experts are held to a standard of care consistent with that expertise and charities are encouraged to delegate investment management to a professional investment advisor.

UPMIFA permits a charity�s decision makers to delegate management and investment functions to external agents if these decision makers exercise reasonable skill, care and caution in selecting the agent, defining the scope of the delegation and reviewing the agent�s performance. Unlike UMIFA, UPMIFA explicitly protects decision makers who comply with the requirements for proper delegation from liability for actions or decisions of the agents. The ability of a charity�s board or investment committee to relieve itself from liability for the investment management of an endowment may make it easier for a charity trying to grow its endowment to attract talented board or investment committee members.

SPENDING

UMIFA initiated the concept of total return expenditure for endowment purposes, expressly permitting prudent expenditure of both income and appreciation and replacing the old trust law concept that only income could be spent. Thus, under UMIFA, income and appreciation could be appropriated for program purposes, subject to the rule that a fund could not be spent below the �historic dollar value� defined under UMIFA as the amount contributed by the donor.

UPMIFA builds upon that rule permitting the expenditure of appreciation, but eliminates the concept of �historic dollar value.� Instead, UPMIFA provides better guidance on what constitutes a prudent expenditure, making a rigid rule providing a floor on spending unnecessary. UPMIFA states that the charity may appropriate for expenditure or accumulation so much of an endowment fund as the charity determines to be prudent for the uses, benefits, purposes and duration for which the endowment is established.� Seven criteria guide institutions in their yearly expenditure decisions:

(1) the duration and preservation of the endowment fund;

(2) the purposes of the institution and the endowment fund;

(3) general economic conditions;

(4) the effect of inflation or deflation;

(5) the expected total return from income and the appreciation of investments;

(6) other resources of the institution; and

(7) the investment policy of the institution.

These criteria allow a charity to set an annual spending policy for the endowment�which for most charities is between 4 percent and 5 percent.

RELEASING DONOR RESTRICTIONS

Sometimes a restriction on an endowment fund imposed by a donor becomes impractical or wasteful or may impair the fund�s management. UPMIFA provides that the donor may consent to release the restriction without court approval, if the donor is alive and able to do so.

If the donor is not available or the charity does not want to seek the donor�s approval, UPMIFA makes clear that the trust doctrines of cy pres and deviation apply to charitable funds held by a nonprofit corporation. A charitable corporation may petition a state court to release or modify a donor restriction in a manner that the court determines to be in accordance with the donor�s

probable intent. If the charity asks for court approval of a modification, the charity must notify that state�s chief charitable regulator (usually that�s the attorney general) and the regulator has the right, but not the obligation, to participate in the proceeding.

UPMIFA adds a new provision that allows a charity to modify a restriction on small (less than $25,000) and old (over 20-years-old) fund without going to court. If a restriction has become impractical or wasteful, the charity may notify that state regulator, wait 60 days, then, unless the regulator objects, modify the restriction on the small fund in a manner consistent with the charitable purposes in any documents that were part of the original gift.

FEDERAL REGULATION

There are no federal tax laws specifically dealing with charitable endowments�although that will change if Senator Grassley (Republican of Iowa) has his way.

Grassley has expressed the belief that certain large college and university endowments should be subject to a mandatory 5 percent payout requirement similar to that of private foundations. Such a requirement would mean that endowments would have to pay out at least 5 percent of their assets each year�regardless of whether the assets in the endowment increase or decline in value.

The Senator has said that he hopes that the extra funds would be used to defray the cost of a college education by increasing student aid or reducing tuition.

For now, the only time endowments need to be concerned about federal tax law is in the context of the unrelated business income tax (UBIT). The general principal is that charities are exempt from federal income tax. A charity�s income is subject to tax (at corporate tax rates) only if it�s considered to be unrelated business income, which comes from:

(1) an activity that constitutes a trade or business;

(2) the trade or business is regularly carried on; and

(3) the activity is not substantially related to the organization�s exempt purposes.

Most passive income (such as rents, royalties, dividends, interest and capital gains) is not subject to UBIT; but passive income is�to the extent the passive income is derived from �debt-financed property.� Debt-financed property is basically any property held to produce income (including gain from the sale of such property) for which there is acquisition indebtedness at any time during the year. The UBIT amount is proportionate to the debt on the property.

Large charitable endowments invest heavily in alternative investments. These investments regularly generate large amounts of UBIT for which the charity must file a Form 990-T (a public document) and pay tax. Endowments many times get around having to pay UBIT, by having their alternative investments owned by an offshore blocker corporation that purifies the UBIT by turning it into passive dividend income.

Senator Grassley is investigating this technique for charities to avoid UBIT.

In recent years, large charities have been able to increase the size of their endowments by creating a tracking stock (approved in numerous private letter rulings) that allows charitable remainder trusts (CRTs) to invest in the endowment without generating UBIT. Although charitable endowments pay a tax on their UBIT at corporate tax rates, CRTs are taxed at 100 percent on their UBIT.

ACCOUNTING STANDARDS

On top of legal requirements for managing and investing, endowment funds are subject to certain financial accounting standards. These standards are set forth in the �Statement of Financial Accounting Standards No. 117: Financial Statements of Not-for Profit Organizations,� loved by the Financial Standards Accounting Board.

SFAS No. 117 requires an organization to classify its assets into three categories, based upon the existence or absence of donor restrictions:

(1) permanently restricted net assets;>

(2) temporarily restricted net assets; and >

(3) unrestricted net assets.>

FAS No. 117-1, issued on Aug. 6, 2008, clarifies SFAS No. 117 to take into consideration changes made by UPMIFA, generally, and in particular, the removal of the concept of historic dollar value as a floor on expenditure from a particular endowment fund. Also, FAS No. 117-1 improves disclosures about a charity�s endowment funds (both donor-restricted and board-restricted endowment funds), regardless of whether the organization is subject to UPMIFA, to enable users of financial statements to better understand the net asset classifications, net asset composition, changes in net asset composition, spending policies and investment policies of the charity�s endowment funds.

BAD NEWS / GOOD NEWS

Charitable endowments are subject to a host of legal, investment, tax and accounting rules that can discourage small or mid-sized charities from focusing attention on building endowments.

That�s the bad news.

The good news is that there is plenty of help to guide an interested charity through the maze of rules.

Given the recent financial meltdown and its impact on charitable assets and contributions, charities can no longer ignore the role of endowments in ensuring the long-term viability of their organizations

So, put together a mission statement for the endowment, gather the best investment committee you can find, do your due diligence when hiring advisors, and most importantly, identify potential donors to the endowment.

In a decade or two, you�ll be on your way to endowment success.

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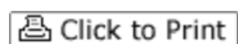

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