



Key Definition

Intergenerational equity: A concept originally set out in 1974 by economist James Tobin, who wrote, "The trustees of endowed institutions are the guardians of the future against the claims of the present." The Spending Policy governs the flow of funds in support of present and future commitments, preserving intergenerational equity.

About the Firm

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Spending Policy Rules: Which One is Right for you?

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This article is an abstract of a piece on the benefits and drawbacks of various spending policy rules and rule hybrids. For the complete version, or for a complimentary proforma analysis of how your portfolio would have performed under any of these spending rules, contact Lancaster Pollard Investment Advisory Group President William M. Courson at (866) 611-6555 or wcourson@lancasterpollard.com.

The traditional goals of an endowment are preservation (or growth), budgetary stability and intergenerational equity. Unfortunately, no spending policy can simultaneously maximize all three; each organization must implement a spending policy that best reflects these goals' relative importance. The two major tradeoffs of any spending policy are stability vs. utility maximization and spending vs. portfolio growth. Utility, in this article, is the real value of spending plus the current portfolio value, which accounts for the differences in a dollar amount's value over time.

Research of various spending rules has been somewhat sporadic, but a selection of conceptual rules can be applied to fulfill an endowment's specific spending objectives. Adopting one of these rules, or a hybrid thereof, can help endowments oversee their performance more efficiently and further the endowment's purpose according to steward-defined goals.

Generally, spending rules are classified into two groups: (1) those that emphasize budgetary stability ("stable"); and (2) those that emphasize total utility at the expense of volatility, with a secondary objective of balancing spending vs. portfolio growth ("adaptive"). Adaptive rule

utilization is driven by the desire to spend more during years of plenty, while stable rules reallocate those higher returns to offset years with lower returns.

Stable Rules

UPMIFA: The most commonly utilized spending rule is defined in the Uniform Prudent Management of Institutional Funds Act. It averages (at a minimum) the 12 most recent quarter-end portfolio values and spends a percentage of that average. This rule is simple to apply and provides a relatively stable spending amount. But any anomalous returns will continue to impact spending for at least three years.

Inflation-Linked Rule: Similar to UPMIFA, this rule begins with a spending amount of \$X (e.g. 5% of the existing portfolio value) that is adjusted annually by an inflationary index.

Adaptive Rules

Yearly Spending Rule: A percentage of the portfolio value is spent at the end of the fiscal year. Essentially, this is the UPMIFA rule, but applied to a single point in time rather than an average. Its singular cross-section point of view and failure to account for other factors make this spending policy less than ideal.

Milevsky-Browne Rule: This and the Alpha/Beta rule have yet to be widely adopted due to their relatively volatile spending patterns. In simulations, however, they are incredibly effective at preserving corpus in real terms as well as maximizing utility. Milevsky-Browne's probabilistic approach follows a complex formula that intends to achieve a certain endowment value within a certain time frame. A simple example is an endowment that aims for a 99%, 95%

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or 90% probability of achieving returns of 6% per year over 30 years with a spending rate that ensures the target portfolio value is reached. Applying a higher probability makes this a conservative approach, but a lower probability can lead to higher returns with increased volatility.

Alpha/Beta Rule: This is a two-tiered approach. A small percentage of the real initial value of the fund (typically 2-3%, defined as Alpha α) is spent. A higher spending rate (typically 7-8%, defined as Beta β) is then applied to assets in excess of the real initial value. A portfolio with an initial value of \$10 million might have a real value after five years of \$13 million, while the portfolio's market value might be \$16 million, leading to an excess of \$3 million. The α spending rate would apply to the \$13 million and the β spending rate would apply to the \$3 million.

Hybrid Rules

Yale Rule: Part of the annual spending amount is determined by the previous year's spending, adjusted for inflation, while the other part is a fixed target percentage of the portfolio's market value.

Yale & Alpha/Beta Hybrid: The previous year's spending component used in the Yale rule is combined with the standard Alpha/Beta rule, such that 70% of spending is dictated by last year's spending adjusted for inflation and 30% is dictated by Alpha/Beta. This combination protects corpus, but also allows for significant spending when markets are strong.

The need to develop and follow an effective spending policy is often overshadowed by the drive to re-examine investment strategies, especially in a down economy. A well-defined and tailored spending policy, however, allows for minimal annual oversight and the fulfillment of an endowment's specific goals. Applying rules can help balance the three objectives of endowment preservation, budgetary stability and intergenerational equity.

