THE ABC's OF HIGHER EDUCATION ENDOWMENTS

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INTRODUCTION

Department administrators, with the assistance of their faculty, develop various programs to meet the goals of the university, college, and department. These programs are based on their various resources, which in turn are based on their level of financial funding. Higher education is one among many services funded by state governments. Regretfully, the demand for alternative services has caused many states to hold constant the dollars of higher education funding, which is actually a decrease on real basis when inflation is factored in. This shrinkage on a real basis is expected to intensify over time (Abdelnons, 1992, p. 20).

This funding gap has increased at an increasing rate, and most higher education institutions have been unable to raise tuition to an adequate level to maintain their existing levels of service, much less develop new programs. Faced with less governmental support and an inability to extract more support from students, many universities and colleges have been forced to increase their endowment fund raising efforts to help meet their needs (Williamson, 1993,p.I-1).

Many institutions that had meager endowments have successfully increased fund raising efforts and now have endowments making significant contributions to institutional and departmental budgets (Nicklin, 1995, p. 42). Departmental administrators can increase their department's funding through participating in the cultivation of their institution's endowment. In the scramble for resources, administrators who know the "basics" of endowments have an advantage over chairs who don't. This article covers these endowment "basics".

ORGANIZATION OF COLLEGE AND UNIVERSITY ENDOWMENT'S

Organization of an institution's endowment is affected by whether the institution is private or public, it's age, and size. Larger and older private institutions tend to have larger well established endowment programs, while smaller, and younger, public institutions generally have smaller and less developed programs. Fund raising activities (both annual and capital) and various forms of planned giving (gift annuities, life income trusts, and charitable remainder trusts) are at the heart of increasing endowment principle. These later types of activities are signs of a more mature stage of endowment development. They take time, but in the longrun, have a dramatic impact on an institution's endowment. Almost all institutions (private and public) today are actively involved in endowment activities or, at the least, contemplating entry into the field.

Private institutions have governing boards determining general policy (and even operations) but public institution's boards (or associated support foundations) have more modest duties but both must still oversee management of the institution's endowment. Board members are generally from the private sector with many (if not the majority) holding title of president or chairman of the corporation from which they come (Wood, 1983, p. 52).

Board's of trustees are responsible for the overall management of endowment funds but this function is usually delegated to an investment committee normally consisting of 8 to 12 board members. Investment committee members tend to be commercial bankers, stock brokers, investment bankers, or local business persons (Wiliamson, p. 2-29). Investment committees usually delegate day to day management and oversight of the endowment to external professional portfolio managers (Williamson, p. 2-27). Trust departments of commercial banks, mutual fund managers, and The Common Fund (a mutual fund that accepts investments only from higher education institutions) are the most likely external portfolio managers to be used.

One of the major responsibilities of the investment committee is the development of a comprehensive and workable "investment policy". Without an investment policy, the management of the endowment tends to lose focus resulting in excess spending, loss of return, or higher risk.

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INVESTMENT POLICY

An investment policy should cover: Basic objectives of the portfolio; categories of investments allowed; range of percentage of the overall portfolio allowed for each category; selection of investment managers; monitoring of manager's performance; spending from the endowment; and the investment committee reporting it's activities to the board of trustees. The investment policy should strive to balance the forces of expected level of gifts and fund raising, investment returns anticipated from the investment portfolio, and spending levels. The board will seek guidance from the investment committee on what sustainable level of spending is possible given the level of fund raising and the asset/risk composition of the portfolio.

COMPOSITION OF ENDOWMENT PORTFOLIOS

True endowment funds have purposes that are longterm and have restrictions on the spending of principal but quasi-endowment funds do not have such restrictions on principle but the purpose of quasi-endowments is still longterm. This means that institutions should treat quasi-endowment funds as though they are true endowment funds. Endowment and quasi-endowment funds have longterm objectives so investments of such funds should also be longterm. Funds with intermediate or shortterm goals should have an investment horizon that is intermediate or even short-term in nature.

Many endowments have restrictions on what funds can be spent for from the endowment and therefore, these endowments are referred to as "restricted" funds. Usually these restrictions do not affect what the funds can be invested in unless some form of "social responsibility" or "ethical" restriction might apply. An example would be: Investment in tobacco companies of funds restricted to cancer research would pose such a conflict.

Investment of funds exhibit significant "economies of scale" making "pooled" investments preferable when dealing with small individual endowments. Smaller endowment amounts are generally invested in "pooled" portfolios and then returns are proportioned to the individual endowments based upon the relative size of the individual endowments. Investment committees seldom become involved in the detail of investment income distribution; instead they decide on the investments and investment manager for the "pool" leaving the details of income allocation to the institution's development staff.

The general guidelines for the composition of the endowment portfolio is specified by the "investment policy". Most endowments have longterm preservation of principle (from default and inflation risks) with maximization of yield as the overall objective. Common stock investments are almost mandatory with this investment objective and is reflected in that approximately 60% of higher education investments are in equity type investments with the balance in fixed income or cash equivalents (Winegerd, 1993, p. 2-7). The endowment common stock investments tend to be conservative but there is some activity in foreign stocks and bonds, high yield bonds, and derivatives (Nicklin, 1993, p. 43).

Higher education endowments in the past with the above referenced compositions have had a nominal return of approximately 8.5% which would support a spending level (on a real basis net of inflation) of approximately 5% per year (Nicklin, 1993, p. 4-1). The latter is the most common spending objective stated for higher education endowments and illustrates a realistic balance between return and spending in today's investment environment.

SPENDING POLICY

Endowments to perpetually support a particular activity date back to at least the twelfth century. Early endowments were established by the dedication of substantial quantities of land. Over time endowment investments shifted towards financial assets. By the early part of the 20th century, most educational endowment funds were held in bonds and mortgages with the spending levels set at the interest income derived from the assets. This basic mode of operation remained unchanged until the 1960's and 1970's.

During the 1960's returns on common stock were considerably higher than fixed income investments, inflation was increasing, and institutions desired expanded program offerings. Increasing stock investments seemed to be a solution since stock returns were higher and during inflationary times common stocks, as compared to fixed income assets, would probably have capital appreciation to offset inflation.

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The drawback was that common stock dividend yields are typically less than the interest on bonds therefore causing a shortage of spendable income (at least in the shortrun until dividend growth caught up with fixed interest income) unless an institution sold part of their investments to convert to cash a portion of the capital gains. This posed the question: Was selling shares to cash out capital gains the same as selling principle and therefore a violation of most endowments? Until the 1960's most legal opinions indicated that "sell-offs" would be an invasion of the principle and contrary to the general rules of endowment management. Opinions reversed during the 1960's and selling a portion of the portfolio to convert capital appreciation to cash income using a "prudent" person standard is allowed as long as sufficient appreciation is left to offset inflation. This concept was enacted into legislation in the majority of the states with the passage of the Uniform Management of Institutional Funds Act.

As a result of the above, over the last quarter century endowment investments have shifted significantly towards common stock as a means to offset inflation and maintain endowments on a real basis. The implication for a general spending policy is that spending should be set at a level of "real" return net of inflation that can be reasonably expected to be sustained in the long run from the endowment portfolio. Based on long term market return studies, this level of spending would be approximately 5% of the endowment principle per year if the endowment portfolio has significant stock investments with the balance in fixed income assets. Hence, the origin of the commonly used spending policy of 5% of the average of the last three years endowment balance. Each institution needs to examine its expected level of fund raising, investment returns expected, and current demand for spending to determine what variation from this general rule is prudent for its needs.

SUMMARY

All of the areas of endowment management (fund raising, management of investments, and setting spending levels) have important effects on the resources available to the various academic departments within an institution. Administrators who understand the rudiments of endowment management will be able to enhance the benefits available to their department derived from endowment funds.

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