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# **BEYOND** BOUNDARIES

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## **PUBLIC UNIVERISTY ENDOWMENTS: WHAT STAKEHOLDERS NEED TO KNOW**

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## **Public University Endowments: What Stakeholders Need to Know**

Harvard has one; so does the University of Texas System, Yale, and the University of Michigan (NACUBO-Commonfund, 2015). In fact, more than 2,600 institutions of higher education in the United States, both public and private, maintain endowments (U.S. DoE, 2013). Some of the largest endowments according to their asset value include those institutions mentioned above: in 2014, Harvard came in first with over \$35.8 billion in assets; the UT System ranked second with more than \$25.4 billion; Yale was third with \$23.9 billion; Texas A&M held seventh place at \$11.1 billion; and Michigan ranked ninth at \$9.7 billion (NACUBO-Commonfund, 2015). The University of Virginia, ranked 18<sup>th</sup>, had an endowment of \$5.9 billion (NACUBO-Commonfund, 2015).

Along with an impressive accumulation of assets, institutions with large endowments received an impressive return on those invested assets. In 2014, the top ten percent of collegiate endowments returned an average of 19.8%, an increase from the average return of 16.4% in the previous year (NACUBO-Commonfund, 2014, 2015). Similarly, the top twenty-five percent of endowments returned an average of 18.6% in 2014, compared to 14.7% in 2013 (NACUBO-Commonfund, 2014, 2015). The overall average for return among those institutions studied was 15.5%, making the top-ranked institutions' results all that more impressive (NACUBO-Commonfund, 2015).

The accumulation of such immense wealth and generation of such impressive returns happens neither overnight nor without careful management of those resources. Furthermore, such generation and return occur within a context and for specific purposes, which are different from other large accumulations of institutional wealth, such as public or private pension funds, or short-term government investments. The purpose of this paper is to introduce the topic of endowment management to university stakeholders other interested readers. Scholars and professional endowment managers have outlined these topics in detail. This paper summarizes those topics, explaining what university endowments are, why they exist, and how university trustees and university administrators can best

manage them. The paper concludes by suggesting that effectively managed endowments provide a part of the solution to the major financial challenges currently facing higher education.

### **What are Endowments?**

Endowments are the accumulation of assets donated to an institution for its on-going support (Commonfund Institute, 2001; Ehrenberg, 2009). *Webster's Dictionary* defines an *endowment* as a "perpetual fund, the income from which is used to support a particular program or purpose" (cited in Spitz, 1999, p. 51). More than just donations received in a given year, endowments exist to preserve the original gift forever (Commonfund Institute, 2001; Ehrenberg, 2009). Universities invest their endowments in financial or real assets to preserve the principal and maintain its inflation-adjusted value (Spitz, 1999). When one refers to a university's endowment, the reference is to the entirety of the university's accumulated endowment funds, of which there could be hundreds or thousands of individual funds or accounts (Yoder, 2004).

Endowments may be restricted in three ways. A True Endowment refers to "a permanent fund with provisions that prohibit the spending the corpus, or principal, of that fund" (Yoder, 2004, p. 1). Only the proceeds, defined as the income and capital gains, from a True Endowment may be expended (Yoder, 2004). In addition to restricting the corpus, donors may also place other restrictions on the endowment fund, including how the proceeds are used, how the fund is invested, or how much of the proceeds are expended (Yoder, 2004). Donors may also establish unrestricted True Endowments that can be used for whatever purposes the university considers appropriate. In return for receiving the endowed funds, the university agrees to honor the donor's original intent and fulfill the purpose of the endowment (Yoder, 2004).

There are two other forms of endowment restrictions: Quasi-endowments and Term Endowments (Yoder, 2004). Quasi-endowments are excess financial resources generated through

current operations, unrestricted gifts, surplus operating funds, or unused reserves. The governing board treats them in the same manner as endowments. The difference is that the institution is not legally restricted to maintain the fund permanently and may, at any time, decide to expend either the fund's income or principal or both. The third restriction is Term Endowments or Wasting Endowments. For these endowments, the donor has stipulated that the principal may be expended at a specified rate, after a specific date or upon the occurrence of a specific event. Donors design this type of endowment to exist for a long-term, but not necessarily permanently (Yoder, 2004).

Important implications for endowment management follow from the definition of endowments. First, universities come to rely upon the support provided by endowments (Spitz, 1999). Therefore, the larger the share of income provided by the endowment, the more reliance on the endowment for continuing programs and operations, and the more sensitive to changes in endowment funding the university becomes (Ehrenberg, 2009). In other words, universities prefer income predictability, and investment policies should be designed to promote reasonable growth and reliable income (Spitz, 1999). Second, permanent funds provide challenges and opportunities. The opportunities include investing in complex, higher-returning, illiquid, or long-term investments (Spitz, 1999). The challenge entails maintaining a long-term investment horizon when most trustees maintain a relatively short-term focus on their 3- to 5-year term of service (Spitz, 1999). Successful endowment managers and administrators maintain a careful balance between immediate needs and the permanent nature of the endowment fund (Spitz, 1999).

### **Why Endowments Exist**

No single answer exists to answer the question why do university endowments exist. There are several, which are discussed below. Understanding the various purposes for endowments helps the informed university stakeholder make informed decisions concerning the reason why their own

university endowment exists. One reason endowments exist is because it is a custom and tradition of universities to have them; long-established universities have them, so other universities do too (Hansmann, 1990). While this may not be a very logical reason, it is one nonetheless. The remaining rationales can be divided into two groups: one related to the interests of society vested in students and another to the interest of others vested in the university.

### **The Interests of Society Vested in Students**

Many of the reasons for a university endowment to exist are an appeal to the long-term, best interests of society, particularly of students (Hansmann, 1990). One of the reasons offered most is that university endowments exist to promote intergenerational equity between students (Hansmann, 1990). The maxim given in support of this notion is that “The trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations” (Tobin, 1974, p. 427). Thus, endowments exist to provide future students with the same or similar programs that current students enjoy (Tobin, 1974).

Another reason for endowments reflects a solution to the phenomena of annual donations being “lumpy,” that is, they are received intermittently and often in large amounts (Hansmann, 1990, p. 19). While there are donors who give to universities small amounts annually, universities frequently but discontinuously mount more aggressive campaigns to secure larger amounts of funding. Thus, income streams are variable and somewhat unpredictable (Hansmann, 1990). A third reason relates to mitigating financial downturns (Hansmann, 1990). Revenues may be affected by several factors, including loss of enrollment (especially of those who pay full tuition), private donations, or state appropriations or federal government grants. Similarly, expenses outside the university’s control might surge for a number of different reasons; universities experience increases in health insurance or energy costs, for example. Endowments assist institutions by providing funds during periods of net revenue

shortfalls so that institutions may minimize operational disruption (Hansmann, 1990). Endowments also act as a form of insurance, a fourth reason, against the complete demise of the entire institution (Hansmann, 1990). There are good reasons for universities to exist regardless of their ability to completely fund current operations, and endowments permit them to survive long periods of fiscal difficulty (Hansmann, 1990).

A fifth reason for endowments is the tax incentives endowments provide since public universities are nonprofit, tax-exempt organizations (Hansmann, 1990). This benefit makes giving of greater advantage to both donors and the institution, since the return on capital invested in an endowment is higher than the return on corporate or personal investments which are taxed (Hansmann, 1990).

The sixth and seventh reasons relate to the freedom of the institution. A university endowment insulates an institution from the need to cater to whoever ultimately provides the institution's funding no matter who it is—the state, private donors, or students (Hansmann, 1990). In the near-term, endowment funding prevents the university from being held hostage to any singular source of current funding (Hansmann, 1990). Seventh and lastly, an endowment also allows universities to promote values associated with the institution (Hansmann, 1990). Through an endowment, current donors insure that their values, perhaps the ones shaped by their university experience, will be transmitted to future generations. Examples of such values include the freedom of inquiry, liberal arts education, the discovery of new knowledge, the perpetuation of a particular religious creed (in the case of private institutions), or the inculcation of the social norms or mores of a particular elite. In this sense, the present generation subsidizes the values formation of future generations (Hansmann, 1990).

### **The Interest of Others Vested in the University**

The remaining reasons endowments exist entail the interests of others and the benefits that accrue to them because a university endowment exists. For a donor, a gift to a permanent endowment purchases “a bit of personal immortality” (Hansmann, 1990, p. 33). Some donors find it attractive to give knowing that a fund bearing their name will be maintained in perpetuity. Furthermore, as much as endowments signify the success and permanence of the institution, this also acts as an incentive for donors, because success attracts additional resources (Hansmann, 1990). Indeed, some characteristics of world-class universities include “high levels of government and nongovernment sources of funding” that include “government budget funding for operational expenditures and research, contract research from public organizations and private firms, the financial returns generated by endowments and gifts, and tuition fees” (Salmi, 2009, p. 6, 23).

Endowments also serve the interests of faculty and administrators, since they maintain control over the university and determine how to distribute the university’s resources (e.g. teaching load, working environment, travel funds, or highly capable students) (Hansmann, 1990). Faculty and administrators maintain a vested interest in the university’s long-term success. The stability and continuity that endowments afford to universities cannot be under estimated in the eyes of university employees. Finally, trustees maintain an interest in a university endowment. Trustees, especially those with a business background or career, better understand financial affairs and what it means to succeed in this area as opposed to the other objectives of universities that are less well defined and much less immediately observed (Hansmann, 1990).

In sum, while most trustees or administrators tout endowments as means to intergenerational equity, other reasons exist. Many of those reasons result in benefits for society or to the students who matriculate and graduate with a university education. Other reasons result in benefits to those directly related to the university—faculty, administrators, and trustees. Regardless of the reasons why endowments exist, there are some best practices for managing endowments.

## **How University Trustees and Administrators Best Manage Endowments**

Seven key issues confront university trustees and administrators. They must address these issues to bring about the best management for university endowments. The key issues include endowment objectives, payout policy, asset allocation, manager selection, risk management, costs and responsibilities (Commonfund Institute, 2001).

### **Endowment Objectives**

Setting the objectives for the university's endowment is the fundamental issue decided by trustees. Many trustees are accustomed to working in the private sector, but a university operates in a nonprofit realm that measures success by achieving its mission (Commonfund Institute, 2001).

Therefore, trustees should have a thorough understanding of the university's mission. The process of producing a written statement of endowment objectives helps to clarify trustees' understanding of institutional mission and sets the trajectory for additional endowment policies. The governing board should address some key questions in this policy statement: the function of endowment in supporting the institution's mission, the role of endowment in maintaining a healthy balance sheet; whether the investment return should be reinvested and spent; the amount of expendable gifts that should be permanently reserved versus immediately spent; how much of endowment spending should be allocated to current operations or to other projects; the overall asset allocation and investment strategy; who has responsibility for investment decisions; and which investment decisions, if any, should be delegated to outside consultants, advisors, or managers (Commonfund Institute, 2001).

### **Payout Policy**

Additionally, the issue of how much payout from endowment proceeds ought to be expended each year raises important concerns. A primary concern is how much can be contributed to the



university while maintaining the endowment permanently (Commonfund Institute, 2001). Subsidiary concerns include how much the university needs for operations or how much the endowed investments returned. Furthermore, excessive withdraws limit the possibilities for greater future returns. In contrast, a payout policy that is extremely conservative limits the possibilities for current operations. Trustees address these issues in a different ways: spending all annual income; spending an amount equal to a percentage of a rolling average amount of current assets over a 3- or 5-year period; spending based on an inflation increase from the prior year's expenditure; or some other method combining multiple variables (Spitz, 1999). No matter how trustees decide what the final payout policy is, they are the ones to decide how to balance current payout against savings for future growth (Commonfund Institute, 2001).

### **Asset Allocation**

Another issue concerns how to allocate invested endowment assets (Commonfund Institute, 2001). Traditional investments include stocks, bonds, and cash, but increasingly university endowments invest in alternative investments: options and futures, foreign securities, real estate, private equity, hedge funds, venture capital, and natural resources (Lapovsky, 2007). To mitigate risk and increase returns, endowments use asset diversification within and between asset classes (Commonfund Institute, 2001). The importance of asset allocation cannot be understated: more than 90 percent of variability of return to endowment can be attributed to asset allocation; the remaining 10 percent or less attributed to manager selection (Brinson, Hood, & Beebower, 1986). The asset allocation is entirely dependent on trustees' understanding of endowment objectives, anticipated market behavior, and appetite for risk (usually measured by volatility) (Matloff & Chailou, 2013), which is the subject of the next section.

## **Risk Management**

Investment is fraught with risk—defined as the possibility of loss either of income or principal; the failure to achieve objectives outlined by the trustees’ investment policy; not meeting an investment target; or not earning sufficient income. But still other types of risk exist: failures can occur in operations, in safe-guarding and accounting of assets, in legal or regulatory issues, and in fraud and abuse. Furthermore, trustees or administrators may suffer from the risk of unrealistic expectations, especially in times when the stock market performs well, and expectations are high. Though challenging, one way trustees can mitigate risk is by asking difficult questions. Awareness is the first step in addressing risk, and although trustees may not be able to address all risks themselves, others may be able to if so informed (Commonfund Institute, 2001).

## **Manager Selection**

Many trustees spend a great deal of time and energy deciding which investment professionals will manage the day-to-day operations of the investment portfolio (Spitz, 1999). Common practice today entails dividing investment management among several professionals, either internal or external to the institution, with expertise in managing specific asset types (Commonfund Institute, 2001). Important considerations for selecting an investment manager include the asset class (e.g. stocks, bonds, cash), specific investment style (e.g. growth, value, large cap, small cap, etc.), and the manager’s qualifications and track record. When selecting an investment manager, trustees should recall that past performance does not necessarily guarantee future returns (Spitz, 1999). However, when selecting an investment manager, trustees should consider the manager’s long-term performance in generating returns better than the market benchmarks. Another consideration includes whether to manage the investments actively, with the managers making trades regularly, or passively, by investing in an index funds (Spitz, 1999). Trustees should also be mindful that investment management involves costs, which

reduce the total return (Commonfund Institute, 2001). Managers should report portfolio performance regularly and trustees should monitor that performance. All of these are important considerations for choosing investment managers and expectations for monitoring their effectiveness.

### **Costs**

The old adage states that to make money one must spend it: there are costs involved with generating a return on investments. The trick is to minimize those costs while maximizing returns. This requires the deliberate commitment to managing costs and keeping them as low as possible (Commonfund Institute, 2001). Diligent consideration of alternatives helps keep costs low. Negotiation with investment managers over management fees also reduces costs. Careful management of the managers is a third way to reduce costs. Avoiding unnecessary transactions or “middle men” reduces investment costs, too. Good advice to trustees is to keep asking, “Can we get the same results at lower cost?” (Commonfund Institute, 2001, p. 20).

### **Responsibilities**

Since a major function of trustees is to establish policy, together as a group they can define the responsibilities of all the important players in the investment process (Commonfund, 2001). Creating an Investment Committee does not release the entire board from its responsibility for managing the endowment to preserve its value and generate income for future beneficiaries. The effective board assigns roles and responsibilities to trustees, administration, and consultants—and has all the particulars written down in a memorandum reviewed periodically and distributed to all the key participants so as to avoid misunderstandings and provide continuity. Such a written memorandum also enhances accountability (Commonfund Institute, 2001).

In sum, the best practices of university endowments include several elements. Effective boards of trustees consider the objectives of the endowment. They determine the policy for annual payout and

asset allocation. The board or Investment Committee establishes parameters for selecting investment managers and employ or discharge them accordingly. Boards manage risk by asking difficult questions and considering alternatives. They also keep costs under control to maximize return on investment. Finally, they define roles and responsibilities—in writing—and hold participants accountable.

### **Conclusion**

This paper began with examples of well-endowed private and public universities. The reality is that these universities became well-endowed through careful and effective management over a long period of time. In a 2010-2011 survey of 823 public and private universities, effective management allowed endowed universities to fund an average of 9.2 percent of their operating budgets (NACUBO-Commonfund, 2012, p. 36). Indeed, larger endowments provided a greater share of support for operating expenses than smaller endowments: universities with endowed assets between \$501 million and \$1 billion provided 16.9 percent of operational revenue while institutions with endowed assets under \$25 million funded only 3.5 percent of the operational revenue (NACUBO-Commonfund, 2012, p. 36). Thus, effectively managed endowments provide greater resources for universities to accomplish their mission. In a time when costs are increasing and some resources are decreasing, endowments provide an additional source of income for universities. Through effective management university endowments provide one part of the solution to the challenge of financing university education.

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