

From Foundations to Retirement Income: *A Different Take on Spending Policies*

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Trademark Capital

Three ideas that I would like to spread today

- Opportunities in serving nonprofits
- Basic concepts when serving nonprofits
- How some of this could be apply to individuals

Nonprofit Opportunities

Consider helping nonprofits evaluate the following actions in light of UPMIFA, consulting legal counsel as needed:

- Provide board and finance/investment committee training on the new standards of prudence.
- Help them review and update their policies and procedures to include UPMIFA's seven standards of prudence.
- Help them review and update their spending policy and calculation of spending, including the amount of spending from underwater endowments; determine whether these changes require changes to their asset allocation policy.
- Help them review and understand their portfolio performance, monitoring, and fiduciary duties.

Story/Case Study

- County Education Foundation (August 2000)
- Created an Investment Policy Statement for them containing a basic spending policy

Review: Spending Policy Basics

Equilibrium Spending Rate (ESR)

ESR = Modeled Return – Inflation – Investment Expenses

Example:

$$4\% = 8\% - 3\% - 1\%$$

Smoothing Rules

- Moving average (over three years)
- Preset amount over previous year (inflation adjusted)
- Judging the need

Story/Case Study

- Resulted in an inconsistent spending pattern
- Decided to create a separate spending policy
- Goal: To protect the spending power of the endowments for an infinite time horizon

How UMIFA Differs from UPMIFA

How UMIFA Differs from UPMIFA

UMIFA

- Investment Conduct
 - General obligation to invest prudently using ordinary business care

UPMIFA

- Investment Conduct
 - Express cost management obligation
 - Whole portfolio management standard of performance
 - Express diversification requirement
 - Portfolio balancing required
 - Special skills standard of performance

How UMIFA Differs from UPMIFA

UMIFA

- Expenditure of Funds
 - Net appreciation may be spent for purposes of endowment
 - Historic dollar value limitation

UPMIFA

- Expenditure of Funds
 - Express prudent total return standard seven (7) factors:
 - Fund Duration
 - Fund/institution purposes
 - General economic conditions
 - Effects, inflation/deflation
 - Expected total return
 - Other resources
 - Institutional investment policy
 - Optional, over 7% of total return presumed imprudent

UPMIFA Statute

“In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinary person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

- (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 possible effects 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.”

How UMIFA Differs from UPMIFA

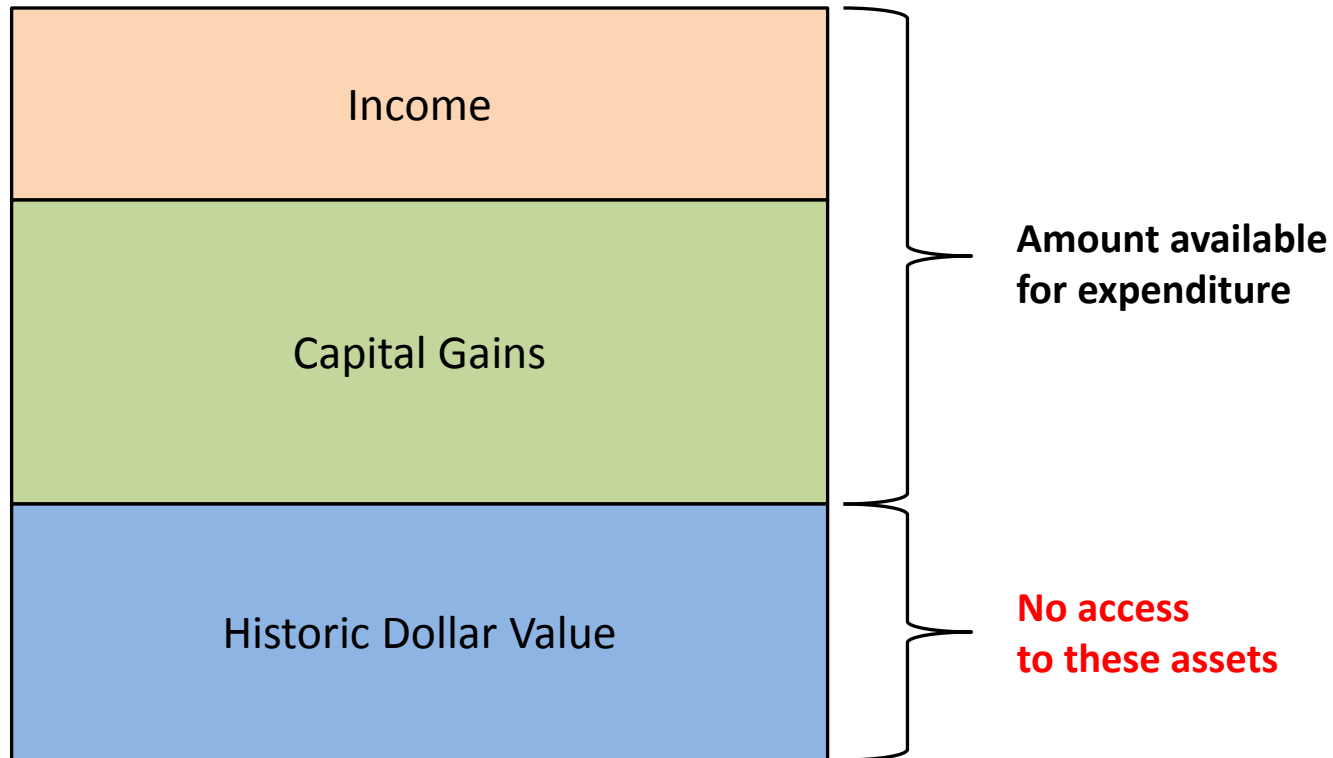
UMIFA

- Delegation of Management/Investment
 - Delegation allowed without express standards

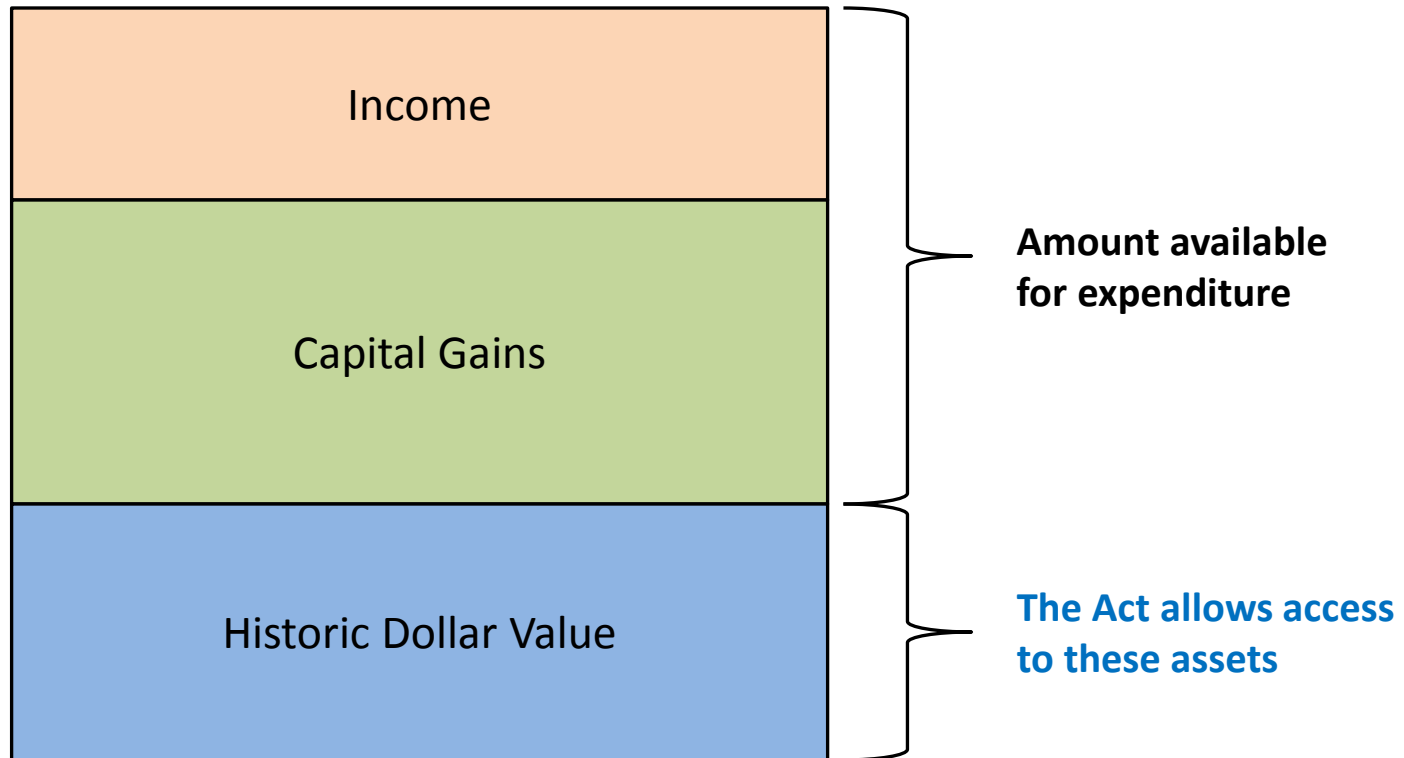
UPMIFA

- Delegation of Management/Investment
 - Prudent delegation in good faith, care standard of prudent person:
 - To select agent
 - Establish scope and terms of delegation
 - Requires periodic review and supervision of agent
- Agent has duty of reasonable care
- Agent subject to court jurisdiction
- Delegation to committees, officers or employees as authorized by law

Endowment Fund Spending Pre-UPMIFA



Endowment Fund Spending Post-UPMIFA



The Basics of Nonprofit Spending

(restricted vs. non-restricted funds)

Nonprofit Spending

Permanently Restricted Funds

- Funds with a designated purpose
- The usage of funds are restricted for a project
- Example: Scholarship fund

Temporarily Restricted Funds

- Usually pass-through money
- Example: Grant money for a specific program

Note: UPMIFA only applies to permanently restricted endowments, which are restricted by the donor or law

Unrestricted Funds

- Donated funds available for the nonprofit to use toward any purpose
- Usually operating expenses of the organization
- Free from external restrictions

Accounting Requirements for Restricted Funds

<u>Assets</u>	<u>Unrestricted</u>	<u>Restricted</u>	<u>Total</u>
Cash & Investments	\$200,000	\$500,000	\$700,000
Accounts Receivable	\$20,000		\$20,000
Leasehold Improvements	\$50,000		\$50,000
Equipment and Furniture	\$30,000		\$30,000
Interest Earnings	\$0		\$0
Total Assets	\$300,000	\$500,000	\$800,000

Liabilities and Net Assets

Accounts Payable	\$50,000		\$50,000
Accrued Expenses	\$30,000		\$30,000
Equipment Loan	<u>\$20,000</u>		<u>\$20,000</u>
Total Liabilities	\$100,000		\$100,000

Net Assets

Beginning of Year			
Change in Net Assets			
Total Net Assets	<u>\$200,000</u>	<u>\$500,000</u>	<u>\$700,000</u>
Total Liabilities and Net Assets	\$300,000	\$500,000	\$800,000

Balance Sheet Impact

Checking Account	Investment Account	Total
\$200,000	\$500,000	\$700,000
\$1,000	(\$100,000) -20%	(\$99,000)
<hr/> \$201,000	<hr/> \$400,000	<hr/> \$601,000

Accounting Requirements for Restricted Funds

<u>Assets</u>	<u>Unrestricted</u>	<u>Restricted</u>	<u>Total</u>
Cash & Investments	\$100,000	\$500,000	\$600,000
Accounts Receivable	\$20,000		\$20,000
Leasehold Improvements	\$50,000		\$50,000
Equipment and Furniture	\$30,000		\$30,000
Interest Earnings	\$1,000		\$1,000
Total Assets	\$201,000	\$500,000	\$701,000

Liabilities and Net Assets

Accounts Payable	\$50,000		\$50,000
Accrued Expenses	\$30,000		\$30,000
Equipment Loan	\$20,000		\$20,000
Total Liabilities	\$100,000		\$100,000

Net Assets

Beginning of Year	\$200,000		\$200,000
Change in Net Assets	(\$99,000)		(\$99,000)
Total Net Assets	\$101,000	\$500,000	\$601,000
Total Liabilities and Net Assets	\$201,000	\$500,000	\$701,000

Underwater Endowments

When an endowment declines below 70% of its HDV, then it is considered to be UNDERWATER.

Because of the 2008 Market Downturn...



March 2009

- Virginia Tech Foundation with 2,300 endowments, valued at \$417.2 million, had lost 25.8% and was underwater
- University of Virginia endowment fell to \$3.86 billion losing 25.9%
- University of North Carolina reported that 70% of the endowments at one campus were underwater
- University of Wisconsin suspended payments from 38 underwater endowments amounting to \$700,000 in scholarships
- North Carolina Symphony had \$6.9 million but was underwater (\$7.25 million HDV)
- The American Conservatory Theatre in San Francisco endowment was underwater at \$18 million (\$22 million HDV)

Underwater Endowments

Options Include:

- Tap into unrestricted reserves
- Ask donors to modify their gift agreements
- Ask donors to make additional gifts
- Suspend distributions until the funds recover in value

Florida Gets In Line

- All states have enacted the law except Mississippi, Pennsylvania, and Puerto Rico
- Florida is the 50th state or territory to enact UPMIFA (July 2012)
- Mississippi (SB2351) July 2012
- UPMIFA was drafted and approved by the Uniform Law Commission in 2006

UPMIFA HAS INCREASED THE NEED FOR COMPREHENSIVE SPENDING POLICIES

Governing Boards are subject to a general standard of prudence in applying a total return spending policy to the entire endowment fund, allowing invasion of the historic dollar value.

Nonprofit Opportunities

Consider helping nonprofits evaluate the following actions in light of UPMIFA, consulting legal counsel as needed:

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Back to Our Case Study

- Definitions:
 - Endowment Book Value
 - Endowment Initial Spending Base
 - Endowment Spending Base
 - Underwater Endowments
 - Endowment Market Value
 - Endowment Annual Spending Rate

Case Study

- Endowment Book Value = Dollars Donated
- Endowment Initial Spending Base
 - For each new gift, the initial spending base is set to 90% of the gift value at the date the gift is invested in the endowment pool.

Underwater Endowments

- If the market value of the endowment falls below a pre-determined percentage of the Endowment Book Value, no spending transfers will be made.
- The Foundation set 75% of book value as the target for determining if the endowment is underwater.

Current Ratio (CR)

- At the end of each quarter, the Endowment Spending Base (ESB) is measured against the Endowment Market Value (EMV) to arrive at the Current Ratio (CR).

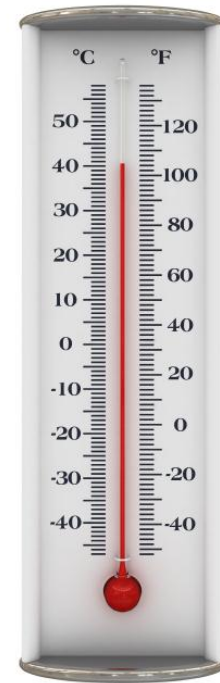
$$CR = EMV/ESB$$

Current Ratio (CR)

- If the CR falls between 85% and 95% no adjustment is made
- If the CR falls below 85%, the Endowment Spending Base will be increased so the CR equals 85%
- If the CR is greater than 95%, the Endowment Spending Base will be decreased so the CR equals 95%

Spending Adjustment Bands

$$\frac{\text{Spending Base}}{\text{Current Market Value}} = \begin{matrix} 95\% \\ \updownarrow \\ 85\% \end{matrix}$$



Initial Spending Base at 90%

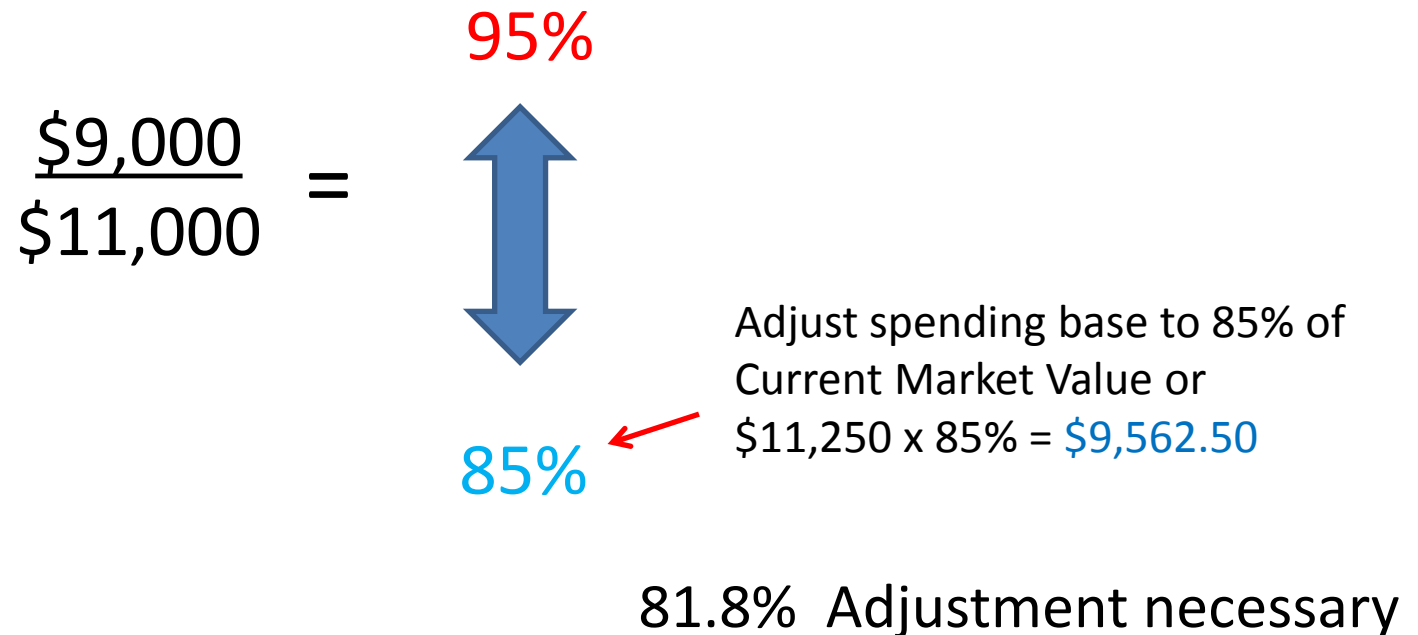
$$\frac{\$9,000}{\$10,000} = \begin{matrix} 95\% \\ \updownarrow \\ 85\% \end{matrix} \quad \begin{matrix} 90\% & \$9,000 \\ \text{No adjustment necessary} \end{matrix}$$

Spending Adjustment Bands

$$\frac{\$9,000}{\$11,000} = \begin{array}{c} 95\% \\ \updownarrow \\ 85\% \end{array}$$

81.8% Adjustment necessary

Spending Adjustment Bands



Spending Adjustment Bands

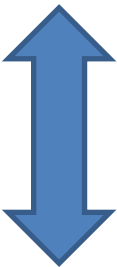
97.30% Adjustment necessary

$$\frac{\$9,000}{\$9,250} = \begin{matrix} 95\% \\ \updownarrow \\ 85\% \end{matrix}$$

Spending Adjustment Bands

97.30% Adjustment necessary

$$\frac{\$9,000}{\$9,250} =$$

95%  85%

Adjust spending base to 95% of Current Market Value or
\$9,250 x 95% = \$8,787.50

Applying a Spending Policy to Retirement Income Planning with Individual Clients

Is the 4% Rule Still Viable?

- A lot of great minds are working on this important retirement planning matter.
- These include Bengen, Gardner, Williams & Finke, Evensky & Katz, Reichenstein and others.

Luck Plays A Major Factor

- Sequence of returns poses a major risk
- Requires serious planning
- In-depth counseling with client
 - Cash flow analysis
 - Fixed vs. variable income sources
 - Family matters

Luck Plays A Major Factor

- 1901 to 1921
- 1929 to 1949
- 1966 to 1982
- 2000 to today

Dow Jones from 1897 through 2011



For investment professional use only.

Index Returns Over Time

75 Gain Years
65% of the Time

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Highlighted Index Returns from 1966 to 1982 – Bear

40 Loss Years
35% of the Time

75 Gain Years
65% of the Time

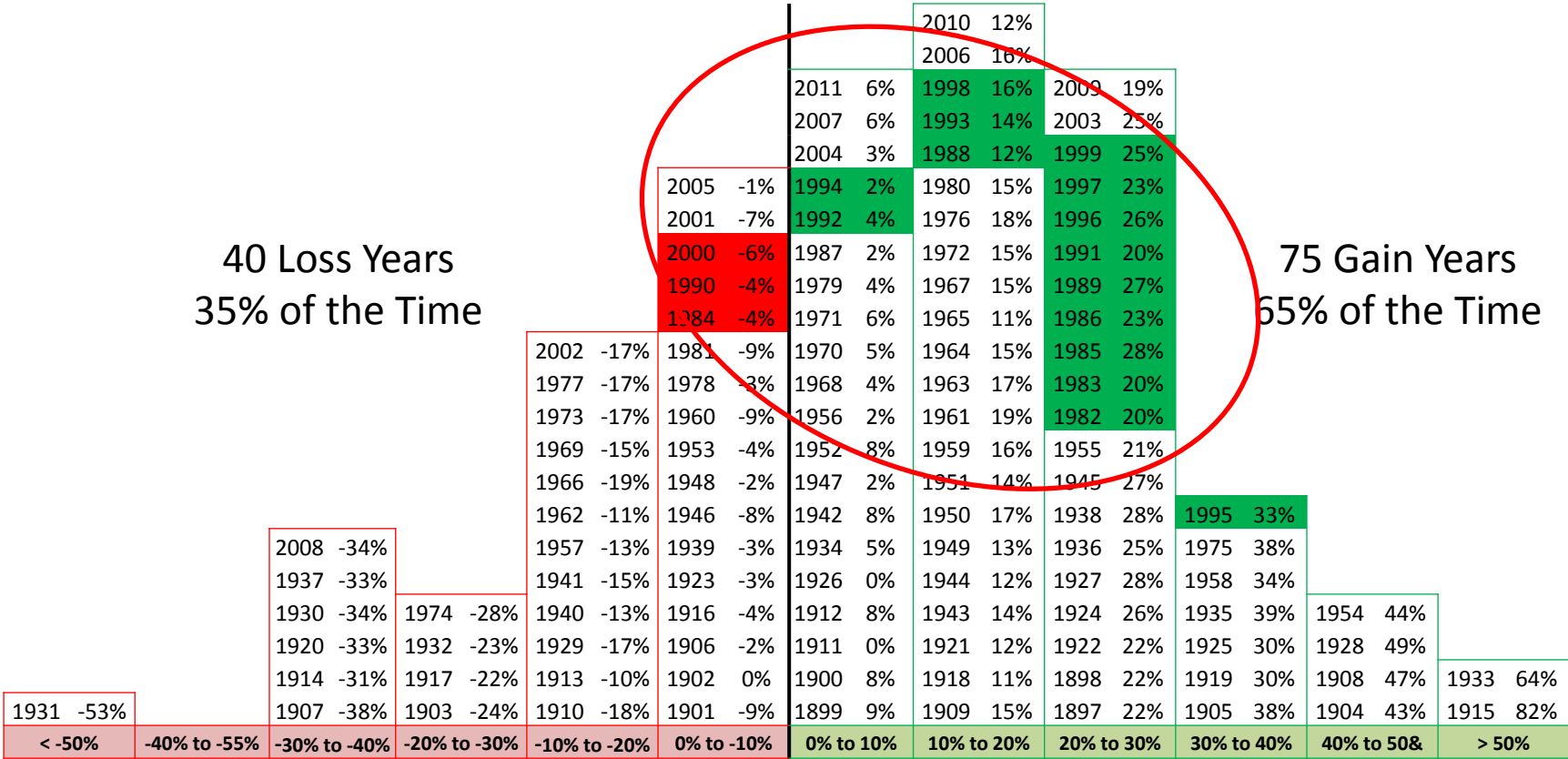
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Historical Summary of Gain vs. Loss

Highlighted Index Returns from 1982 to 2000 - Bull

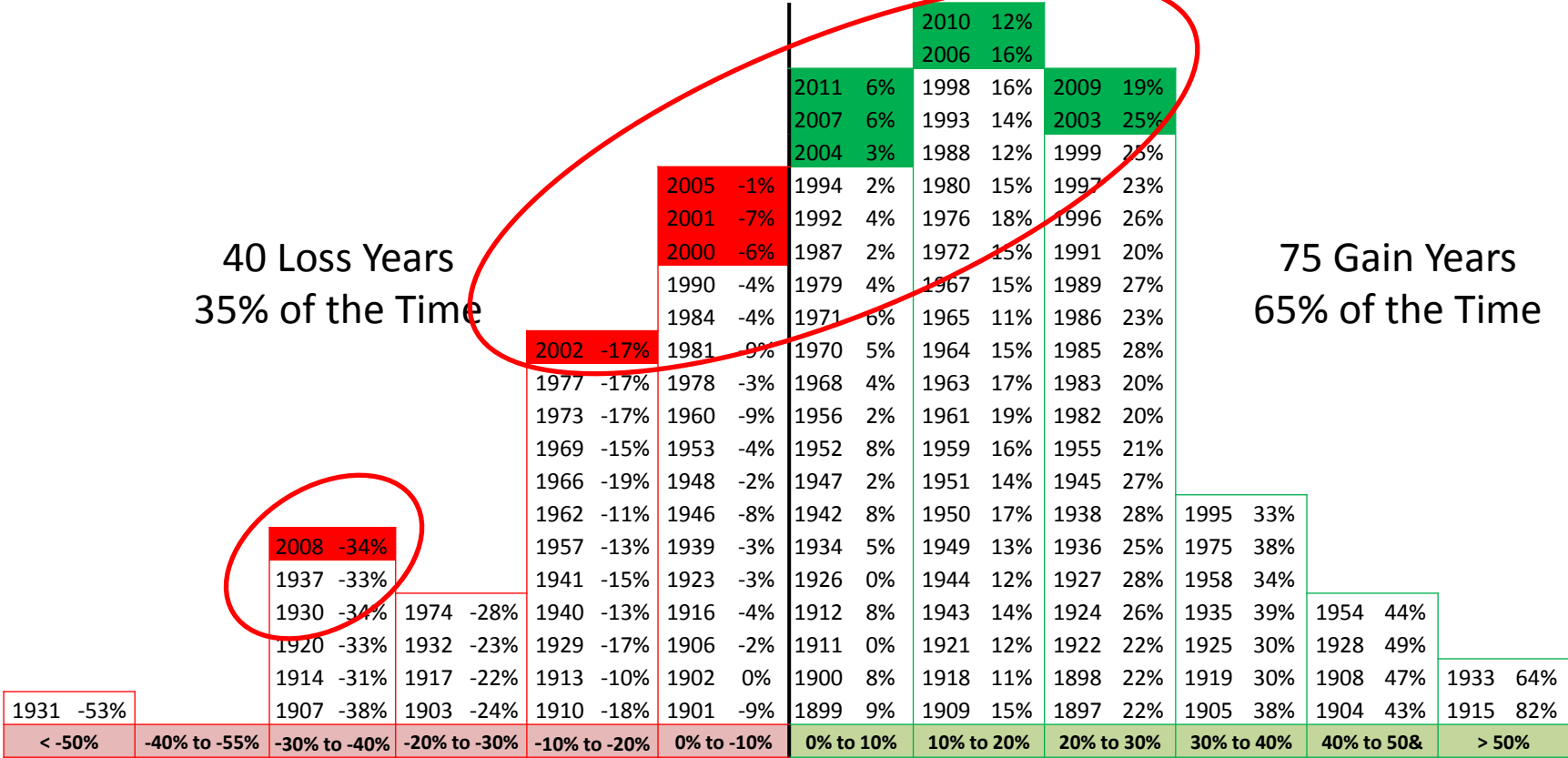
Dow Jones Industrial Average
1897-2011



Historical Summary of Gain vs. Loss

Highlighted Index Returns from 2000 to 2011 – Bear

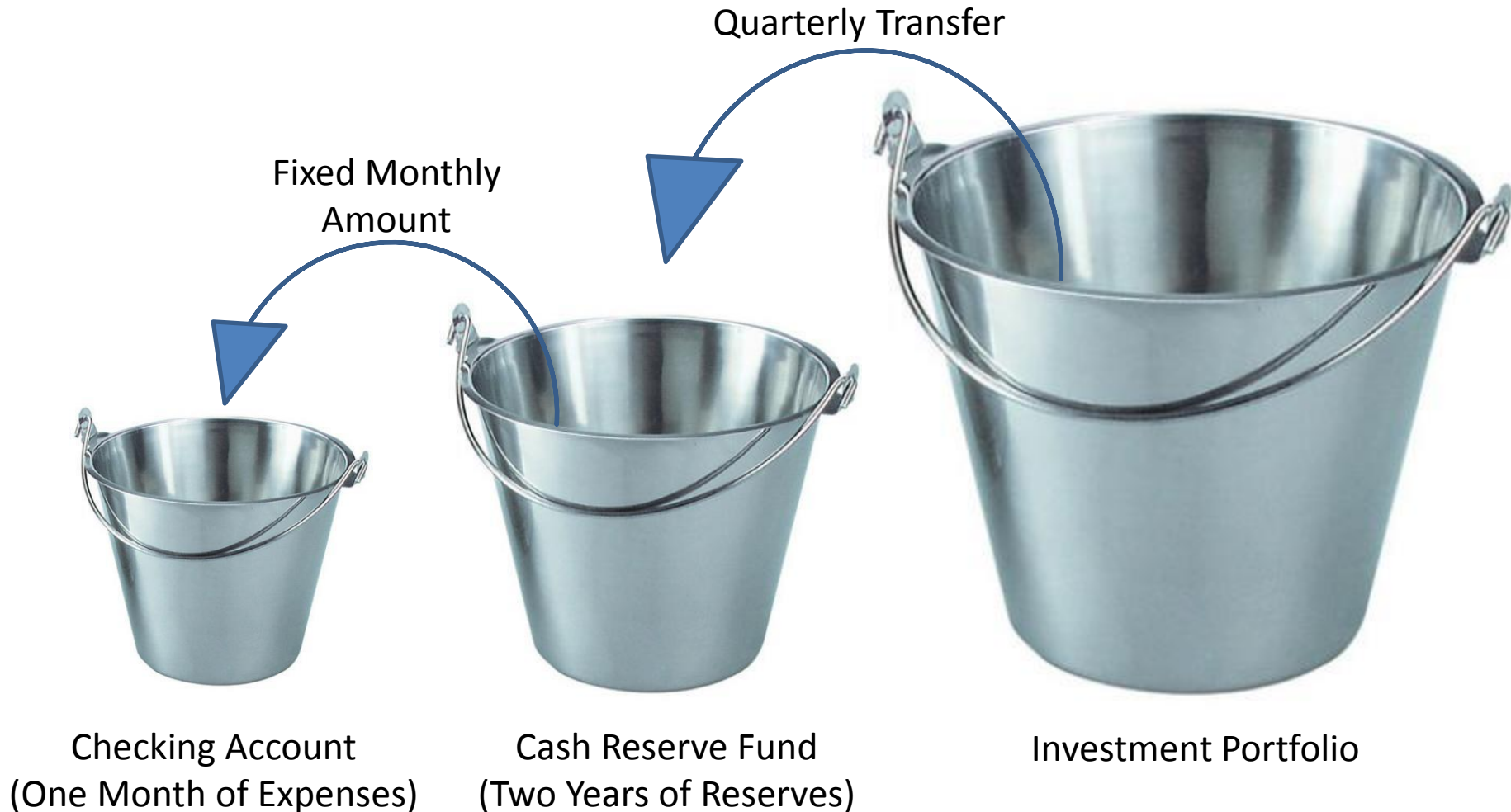
Dow Jones Industrial Average
1897-2011



The Human Element

- Getting people to accept variable income is not easy.
- Creating a steady, lifetime income stream is what most people seek.
- Two main approaches:
 - Creating buckets of money with reserves
 - Creating multiple income streams: fixed & variable

Money Buckets



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Split-Funding: Fixed & Variable



Conclusion/Resources

- The Case for a High and Growing Dividend Stock Strategy in Retirement Portfolios - Investment & Wealth Monitor - Jack Gardner, CIMA, AIFA
- Conserving Client Portfolios in Retirement by William P. Bengen, CFP®
- Retirement Income Redesigned - Master Plans for Distribution – Edited by Harold Evensky & Deanna Katz
- In the Presence of Taxes: Applications of After-tax Asset Valuations – William Reichenstein, PhD, CFA®



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Steve Athanassie is the Founder and Managing Principal of Trademark Capital. He has been guiding individuals, families and institutional clients since 1985.

Steve serves as Chief Market Analyst and is responsible for communicating the firm's investment policies and strategies. Steve prepares and delivers oral and written reports that are used to keep Trademark's clients abreast of meaningful events in the international and domestic markets. Widely respected for his financial acumen, Steve has been a frequent guest on TV, and is often quoted in some of the industry's most influential print publications.

Steve received his Bachelor's degree in Finance with a minor in Psychology from the University of South Florida in 1984. Steve is a current member of the National Association of Estate Planners & Councils, the Florida West Coast Employee Benefits Council, the Financial Planning Association and the American Society of Pension Professionals and Actuaries.



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