UNDERSTANDING COLLEGE AND UNIVERSITY ENDOWMENTS

September 2007

What is an endowment?

An endowment is created through gifts intended for the long-term support of nonprofit institutions – from churches, hospitals, and museums to colleges and universities. Although the concept of endowment originated in England in the 15th and 16th centuries, the development of endowments for institutions of higher education is a decidedly American phenomenon. For more than 300 years, endowments have supported American colleges and universities.

There is a widespread misconception that an endowment is a large pot of money that a college or university can spend however and whenever it chooses. In fact, a typical endowment is not a single fund, but actually numerous individual funds -- in some cases, literally thousands of funds. Donors frequently specify a particular purpose for their gifts and expect that the purchasing power will be preserved through careful management so that their donations can benefit future generations as well as today's students and society.

How is endowment money used?

Individual donors, foundations, and corporations contribute to endowments for a variety of reasons -- to fund student scholarships, enhance undergraduate and graduate education, create professorships, renovate or construct teaching and research facilities, and improve a wide range of campus activities, including the arts, public service, student housing, and athletics. Most charitable gifts to colleges and universities are made for specific purposes. Very few endowment gifts are entirely unrestricted.

Endowments help institutions provide students with educational programs and opportunities beyond what could be funded solely with student tuition and other forms of public and private support. Endowments and other private gifts are critical to maintaining high-quality programs and supporting the daily operational costs of running a university.

> An endowment links past, current, and future generations. It allows an institution to make commitments to future students as well as today's, knowing that resources to meet those commitments will continue to be available.

A number of institutions have been able to use endowment funds to help provide steep tuition breaks for low- and middle-income students, in some cases allowing them to graduate with little or no debt. These grant programs are made possible by donors who either specifically designated their gifts for financial aid or contributed unrestricted funds. Most gifts, however, are designated for other worthwhile purposes. At one university, for example, almost two-thirds of its endowment dollars are specifically designated for research and for campus departmental support.

Endowment funds that support research benefit America and the world. Over the years, donors have established endowment funds for such specific missions as conducting research in the cutting-edge area of nanoscience, finding treatments for dyslexia and reading disabilities, and exploring new ways to combat global poverty. One donor, whose relatives died in Poland during the Holocaust, bequeathed funds to a university to "eradicate illnesses causing pain and misery to millions here in our country and all over the world."

In addition to targeting their donations for specific purposes, donors expect their gifts to provide long-term benefits. Consequently, they typically specify that the college or university can spend only the investment income generated by their gift, not the principal, and they expect the value of their gift to keep pace with rising costs over time. Trustees of an endowment have both a legal and a moral obligation to honor the wishes of donors, many long since deceased, who intended that their gifts would support not just one generation, but succeeding generations indefinitely.

This long-term outlook is recognized by the 47 states that have adopted the Uniform Management of Institutional Funds Act, which specifically requires trustees to consider the "long and short term needs of the institution" and its "present and anticipated financial requirements."

Paying for the future

To protect the principal against inflation, institutions typically divide each year's earnings between dollars that are spent immediately and dollars that are re-invested to preserve the endowment's value for the future.

Colleges and universities have established various rules for spending their endowment earnings each year. In some cases, the trustees decide each year on the spending rate; in other cases, the spend-out is a percentage of the endowment's value over several years; in still others, an institution may increase its annual spending by a set percentage.

In unusually favorable financial times, institutions may be able to make upward adjustments in their spending of endowment earnings, while in unusually unfavorable times they may need to make downward adjustments. The goal is to achieve a sustainable balance between providing as much support as possible for the current generation while also building capacity to meet future needs.

> **To sustain the purchasing power of the endowment, institutions must divide each year's earnings between dollars that are immediately spent and dollars that are added to principal to preserve its value for the future.**

According to the National Association of College and University Business Officers (NACUBO), the most common policy is to spend 5% of the three-year average of an endowment's market value. Spending policies that are based on this or similar multi-year time frames enable universities to "smooth out" year-by-year fluctuations in earnings, reducing the likelihood of severe budget cuts when an endowment loses value over the short term.

In addition to establishing spending rules that buffer the effects of market volatility, trustees of an endowment have a fiduciary responsibility to set spending levels that permit sufficient reinvestment of revenues so that, over time, revenues from the endowment grow and the value of the endowment is maintained relative to rising costs.

In short, spending rules are the planning mechanism through which institutions seek to deliver quality educational services today and in the future.

According to NACUBO, college and university endowment spending rates have averaged between 4.5% and 5.1% of the endowments' market value over the last decade. For the 765 institutions who participated in NACUBO's 2006 survey, the average spending rate was 4.6%.

The difference between foundations and universities

One question that is occasionally raised regarding endowment spending is, "Should colleges and universities be required to spend a minimum amount from their endowments each year, much as foundations are required to meet minimum payout standards?" This question, though, mixes the proverbial apples and oranges. Foundations and universities are very different kinds of institutions.

In the case of a foundation, the public has an interest in ensuring that, in return for the tax advantages granted to the donor, the foundation is adequately serving its charitable purposes, and the most effective way to ensure this may be through a minimum payout requirement.

By contrast, funds donated to college and university endowments are given for the express purpose of supporting designated educational or scholarly activities over a long period of time. There are many constituencies that play a role in ensuring that these dollars are spent for their intended purposes, including students, faculty, alumni, local residents, and government agencies. If anything, the pressures on colleges and universities push in the direction of spending more of the endowment's earnings on current purposes, to the potential detriment of sustaining the purchasing power of the endowment for a future when the costs of high-quality education and research are likely to be even greater than they are now.

The many benefits endowments provide

- Endowments allow institutions to deliver greater value and attain higher levels of quality in their teaching and research than would otherwise be possible. Endowed professorships, for example, allow students access to first-rate educators whose salaries do not burden the tuition budget. Designated gifts to universities have established professorships in such worthwhile missions as special-education technology, helping children with disabilities to learn more efficiently; environmental studies, focusing on stewardship, conservation, and restoration of the environment; and rural health care policy, looking at ways to ensure there are enough physicians, nurses and other health care providers to provide services to the residents of rural areas.

- Reliable long-term support from an endowment enables institutions to increase student aid, initiate pioneering research, develop stronger teaching programs, invest in new technologies, make commitments to attract or retain senior faculty, and maintain their libraries, laboratories, and other physical assets.

- Even in difficult financial times, endowments can sustain institutions' teaching and research and allow them to provide essential support for faculty and students.

- Endowments allow institutions to engage in long-range planning with confidence that they will have the resources necessary to complete their most important projects.

- Endowments empower institutions to meet the long time horizons needed to make capital improvements, build strengths in emerging academic fields, and adapt to the changing needs and interests of their students and the broader society.

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