# Do endowments hold a blueprint for donor-advised funds?

By **Derek Tharp**
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Donor-advised funds are flexible tools, but many are seriously underutilized. For donors who have the ability to be flexible in their distribution policy, allocations can be much more aggressive than those commonly adopted by endowments — meaning more income for charitable beneficiaries and the ability to sustain giving well into the future.

DAFs allows individuals to irrevocably donate assets to a charitable entity today, allowing that individual to receive a tax deduction now, while delaying the ultimate distribution of the assets to a final charitable entity in the future. In essence, the DAF functions as a conduit, providing greater flexibility in the timing of charitable gifts and allowing donors to effectively front-load charitable contributions in a high-income year, while retaining flexibility to decide when and how much will be given to the final charitable recipients in the future.

In addition to allowing donors to lump charitable giving into a single year — which is of potentially increased interest after the tax law changes of 2017 — donor-advised funds have the benefit of growing tax-free into the future.

Because a DAF is technically managed by a charitable entity itself — whether it be a community foundation or a non-profit entity with a close tie to a for-profit firm, such as Vanguard Charitable, Fidelity Charitable or Schwab Charitable — it receives the same favorable tax treatment as other investments held by a charitable entity.

— as well as to identify and advise on what qualified 501(c)(3) charitable institutions the DAF will send the money to at some point in the future.

Notably, this isn't a guarantee that the funds will be invested and donated exactly according to a donor's advisement and wishes, but in practice charities that don't keep their commitments to donors will struggle to attract other donors in the future. Consequently, most will faithfully follow what their donors advise.

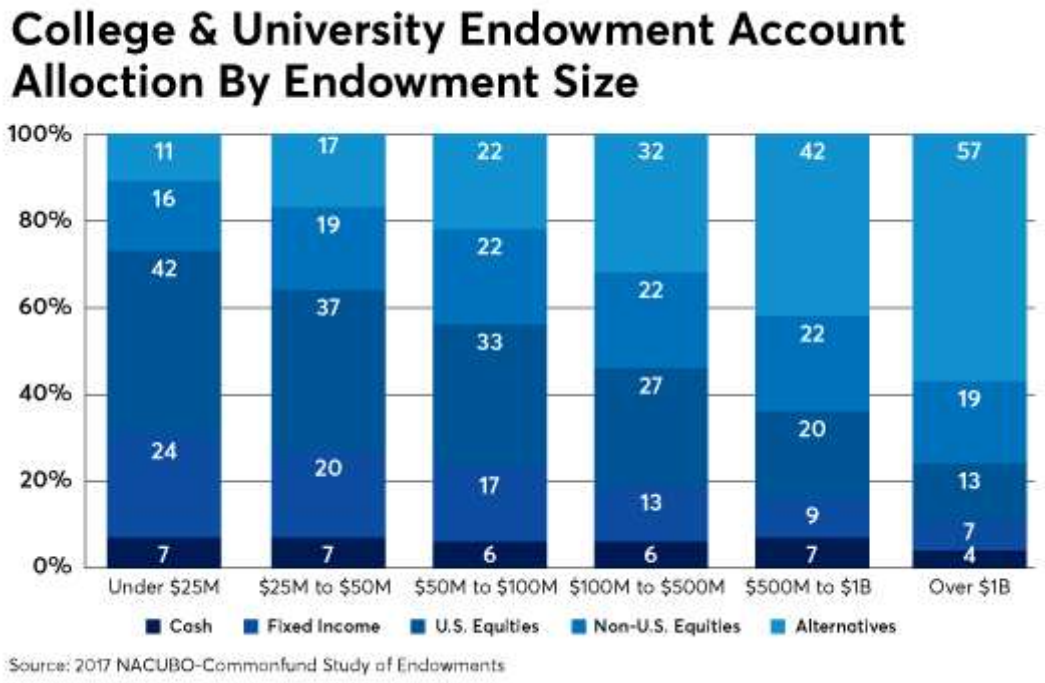
A unique aspect of DAFs is that they can be used for a variety of giving strategies. This flexibility allows for myriad distribution types, ranging from giving away the entire DAF balance within the year of a gift — e.g., for administrative purposes it may be much easier to donate highly appreciated and closely held stock to a single DAF, which can then sell the stock and distribute assets to many different non-profits — or using the DAF to hold and invest a long-term base of charitable assets from which gifts will be made perpetually into the future.

In other words, DAFs can function in a manner similar to private, non-operating, grant-making foundations, except that DAFs are also cheaper to operate, more tax-efficient given their avoidance of potential excise tax on investment income, more flexible and also eligible for higher limits on tax deductibility of contributions.

DAFs are consequently an increasingly popular alternative to private foundations, with the latter only used now when there is a desire to engage in certain behaviors exclusive to private foundations — and not allowed of DAFs — such as making grants to individuals, retaining even greater control over investments and assets or compensating family members for involvement with a foundation.

Some states have even set up tax credits that reward donors for setting up DAFs designed to exist in perpetuity. As such, donors may be increasingly interested in setting up endowment-style DAFs, which are established with this very intent.

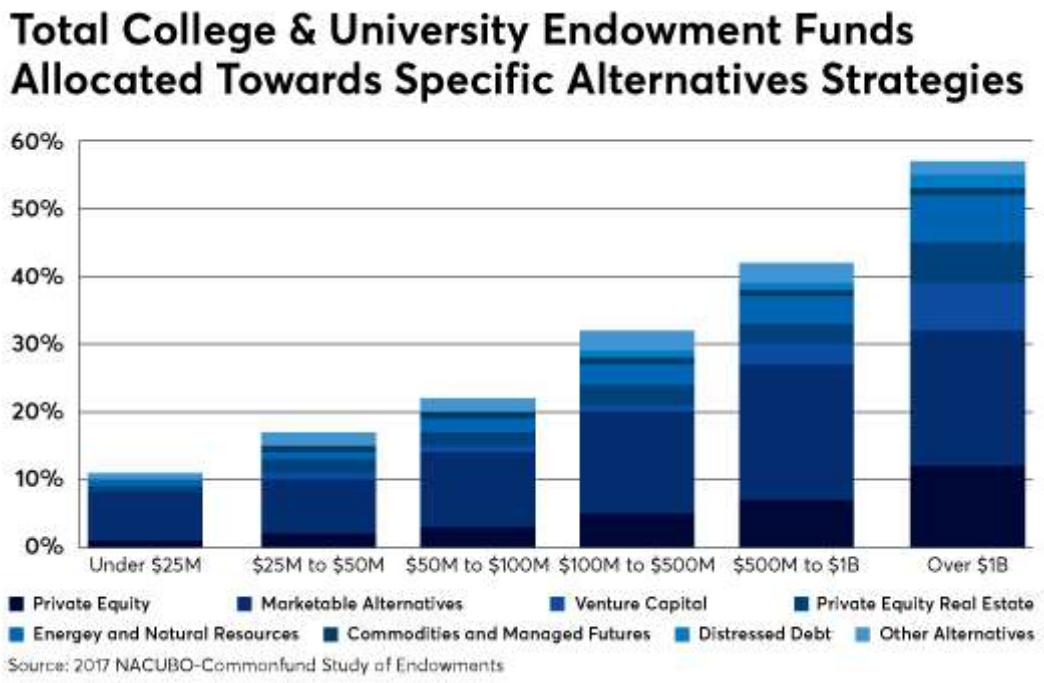
A natural response to that question is to look at the endowment accounts of existing non-profit institutions and mimic their allocations. The 2017 NACUBO-Commonfund Study of Endowments (NCSE) provides a nice summary based on data gathered from 809 U.S. colleges and universities.




Generally, the larger the endowment, the more assets held in alternative investments. This makes sense in theory, given that the long time horizons and large asset values of some endowments allow them to better manage investment costs, liquidity constraints and other limitations that can make alternative assets feasible for them — even if they remain impractical for many ordinary investors.

On the other hand, smaller endowments that lack the economies of scale to conduct the due diligence needed for efficiently allocating a sufficient quantity of assets toward alternatives end up roughly approximating a 60/30/10 (stocks/bonds/alternatives) allocation.

Endowments breaks out how the analyzed colleges and universities are investing their alternative allocations.




As you can see in the chart above, at all endowment levels the bulk of alternative assets are invested in marketable alternatives — i.e., hedge funds, absolute return funds, market neutral funds, long/short strategies and others — so it's difficult to say precisely how much risk endowments are taking through their alternatives allocation. But looking at the smallest endowment accounts — which would likely be closest in composition to the asset levels donors would put in an endowment-style DAF — we might discern that small college and university endowments invest in portfolios with roughly the risk profile of a 60/40 to 70/30 traditional stock and bond allocation.

Does that mean the typical endowment-style DAF should be similarly allocated? Unfortunately, it's not that simple.

Consider a typical university endowment. Universities are often dependent on their endowment to fund scholarships to students, pay faculty salaries, support research and provide services to their local communities. Because endowments can be very large — Harvard, Yale, Stanford and Princeton all have over $20 billion in assets, while over 100 other universities have endowments larger than $1 billion — many universities have become reliant on funds provided by their endowments for ongoing operations.

However, a donor with an endowment-style DAF is likely not in a similar position. Even if that donor's ultimate goal is to give a fairly consistent amount from year to year, the institutions that the individual gives to are unlikely to be as dependent on that individual for their funding.

In other words, while a certain state university may be dependent on their endowment to fund ongoing operations, that school is likely not dependent on John Smith's donation from his donor-advised fund in any given year. As a result, individuals establishing endowment-style DAFs may want to consider the long-term outcome of adopting various types of spending policies.

**DISTRIBUTION POLICY**

Historically, institutional endowments were assumed to have an obligation to protect the principal of their endowment, taking an income-only approach to distributions. Income was generally understood to include funds from sources such as interest and dividends, but did not include capital appreciation. As a result, endowments were incentivized to invest in income-generating assets such as bonds and mortgages.

However, as it became clear that this preference for income-generating assets over assets with more potential for capital growth did not necessarily serve the interests of donors, reforms were proposed to allow endowments to adopt more of a modern total-returns investment approach.

fund value did not exceed the original value of gifts to the fund — i.e., the fund's historic dollar value — leading to spending constraints if a market correction led to an endowment being underwater. This unintentionally pushed institutions toward the use of income-generating assets.

As a result, in 2006 the NCCUSL drafted the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which further increased spending flexibility for endowments by eliminating the need to distinguish between income and principal. The act officially permitted the spending of principal as long as the endowment was managed in a manner that prudently protected the purchasing power of the endowment.


Without those older restrictions in place, endowments now would have much greater flexibility in crafting a distribution policy that would best align with that endowment's purpose. As a result, today's well-managed endowment has not only an Investment Policy Statement but also a Spending or Distribution Policy Statement.

Similar to withdrawal policies in retirement, endowment-style annual distribution policies can be thought of at two extremes: fixed-dollar spending strategies and fixed-percentage spending strategies.

commonly assumed of retirees — i.e., the safe withdrawal rate approach — at least in terms of non-discretionary expenses that a retiree needs to have in order to ensure they will not run out of money. Of course, with such an approach it's important to set an initial spending rate that is low enough to survive the risk of an unfavorable early sequence of returns.

At the other end of the spectrum is a fixed-percentage strategy. Under such a strategy, an endowment may target annual distribution of some fixed percentage, e.g., 4%-5%, of endowment assets. Unlike fixed-dollar distributions, which can jeopardize principal if real returns are not sufficient to continually preserve or recover losses, fixed-percentage strategies will never entirely spend down their assets. If the portfolio declines, the withdrawals are reduced accordingly, although with catastrophic losses the remaining distributions may potentially be minuscule.

In practice, endowments tend to take more of a fixed-percentage approach. That said, some greater spending stability is often built in by distributing some fixed percentage — often 4%-5% — of a moving average endowment value, e.g., 5% of three-year average portfolio balance. By smoothing out the portfolio value, endowments can maintain greater stability due to experiencing less distribution volatility driven by market gyrations, although this increased stability can also mean a greater risk of actually running out of assets.

Additionally, a Vanguard report notes that other distribution strategies common among endowments are percentage-based distributions with a ceiling and floor tied to the initial distribution amount — e.g., 5% of three-year average portfolio balance, not to be less than 80% of the real initial distribution or exceed 120% of the real initial distribution — and hybrid approaches that contain elements of both fixed-percentage and fixed-dollar distributions.

An example of this may look like an annual distribution comprised of two parts: 2% of three-year average portfolio balance, plus a fixed-dollar distribution based on 2% of the initial endowment value adjusted annually for inflation.

investment allocations.

All else being equal, the more flexible and endowment's spending policy is, the more aggressively an endowment can afford to invest, given its ability to defer distributions and wait out a stock market decline. In fact, considering endowments have a perpetual time horizon and more potential to adopt flexible spending policies than any retiree, the upper limit for how much risk endowments can prudently take is arguably far higher than any comparable limit for a retiree or prospective retiree.

An endowment donor who wishes to maximize total giving and is not concerned about distribution consistency from year to year may seriously consider 100% equity allocations or even leveraged strategies to fulfill their charitable goals. By contrast, a donor who wishes to maintain year-to-year giving may need to take a more balanced approach.

**THINKING LONG TERM**

In order to assess the long-term implications that spending and investment policies have on an endowment's ability to grow and give, we can simulate the potential trade-offs with Monte Carlo projections.

We specifically evaluate below both fixed-dollar and fixed-percentage distribution strategies with three portfolio allocations: 1. Conservative (100% bonds); 2. Balanced (50% stocks and 50% bonds, rebalanced annually); and 3. Aggressive (100% stocks).

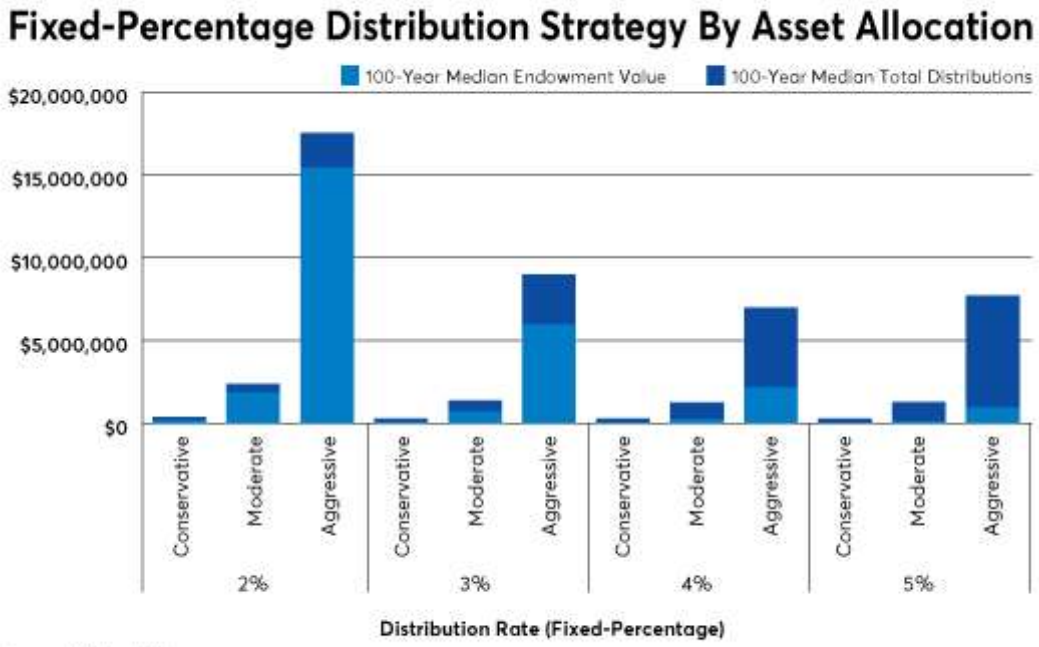
Note: The real return assumptions below are based on Robert Shiller's annual return data set going back to 1871 on stocks (S&P 500), bonds (One-Year U.S. Treasury Bills) and inflation (U.S. Consumer Price Index). Notably, because Monte Carlo naturally incorporates volatility drag into projections, real returns are based on arithmetic rather than geometric real returns.

| | | | |
|---|---|---|---|
| Annual Real Return | 2.8% | 5.4% | 8.0% |
| Standard Deviation | 6.6% | 9.8% | 17.8% |

Source: Michael Kitces

**FIXED-DOLLAR STRATEGIES**

In order to examine the impact of long-term investment allocation decisions when utilizing a fixed-dollar strategy, an initial endowment value of $100,000 was assumed. In each case, a distribution based on this fixed-dollar value was determined and then adjusted annually for inflation.




Source: Michael Kitces

Regarding the impact of asset allocation on total endowment depletion, the results largely indicate what we might intuitively expect. For instance, with a conservative allocation — average real return being 2.8% — fixed-dollar distribution rates initially beginning at 3% and above are problematic. And 64%, 94% and 99% of the time the endowment was depleted based on initial distribution rates of 3%, 4% and 5%, respectively. However, at a 2% distribution rate, the endowment only ran out of money 12% of the time, therefore being able

year to year, distributions still never exceed the maximum amount of distributions possible, regardless of how large the endowment grows.

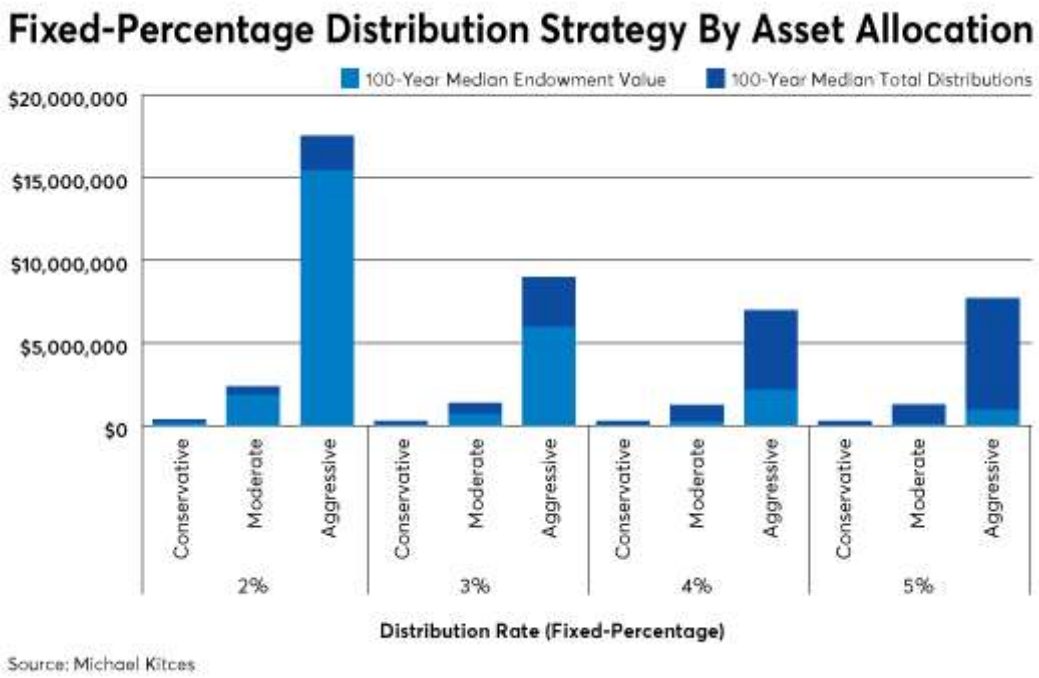
Therefore, while a 2% initial distribution rate generates $200,000 in real distributions regardless of the allocation, the only difference is that the median endowment values increase to $7.4 million with a balanced allocation and $34.3 million with an aggressive allocation. In other words, with a fixed-dollar withdrawal strategy, more aggressive portfolios result in much higher remaining balances.

Also aligned with intuition is the fact that at the highest initial distribution rates, e.g., 5%, an all equity portfolio reduces the probability of depletion relative to a balanced portfolio because the higher returns are necessary to sustain. But at initial distribution rates of 3% or lower, the stability provided by a balanced allocation reduces the probability of depletion relative to an aggressive allocation, as the higher risk/return profile isn't needed to sustain the distributions, and just increases the risk of a bad sequence. With increased certainty still comes considerably lower median ending endowment values, as indicated above.

These differences are in real dollars, so if we assume an average annual inflation rate of 2.5%, a $1 million difference indicated in the chart above would actually correspond to a roughly $12 million inflation-adjusted difference 100 years from now. And this consideration is probably the least intuitive for advisors. The magnitude of the impact of a long-term asset allocation decision is huge, and it is hard for us to intuitively grasp how large this impact would be compounded out over 100-year time horizons or longer, since endowments exist in perpetuity. Indeed, we are far more used to thinking about time horizons of 30 to 60 years.

We can also use the results above to see why the 4% rule would not be helpful in an endowment context. Recall that Bengen's 4% rule applies to a 30-year time horizon. As Bengen also found in his study, the safe withdrawal rate declined to 3.5% over a 45-year time horizon. Effectively, the results are suggesting that for balanced and aggressive portfolios, a reasonably safe withdrawal rate over 100-plus-year time frames may be somewhere in the 2%-3% range.

that smoothing is a common practice — in an effort to compare the most flexible annual distribution extreme. Smoothing would result in somewhat less response to market volatility, and therefore could result in portfolio depletion rates greater than 0%.




Source: Michael Kitces

The relative strength of fixed-percentage distribution strategies becomes evident when looking at the results. Any allocation is now protected against depletion of the entire endowment, although it is possible that purchasing power can be reduced in real terms.

This may mean that some combinations of fixed-percentage distribution rates and asset allocations can be seen as imprudent. For instance, despite a conservative allocation having a 0% depletion rate under all scenarios, the median endowment value is actually declining within the 3%-5% distribution scenarios. In other words, although the portfolio is not running out of money, the purchasing power of the endowment is being eroded over time.

A fixed-percentage approach also helps guard against excessive accumulation within an endowment, as distributions are automatically increased under good sequence-of-return

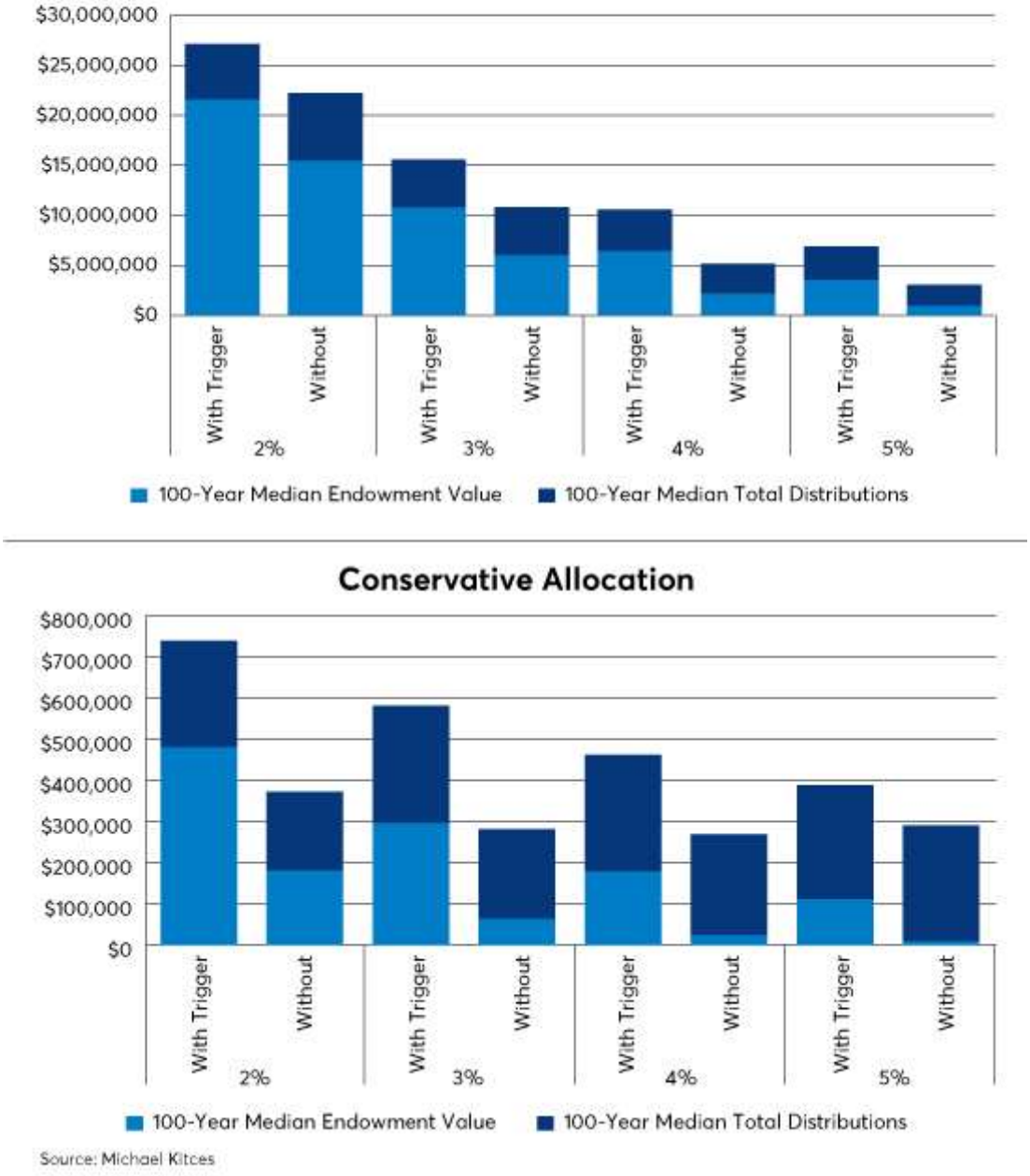
million was accumulated at the 75th percentile simulation.

Of course, this balance may still not reflect what any particular donor would prefer. A 4% fixed-percentage distribution would more evenly balance distributions and endowment value over a 100-year time horizon: $7.5 million and $7 million at the 75th percentile, respectively. But the key point is that fixed-percentage strategies are inherently responsive to market fluctuations, whereas fixed-dollar strategies are not.

**TRIGGERS**

How a distribution is calculated represents only one consideration for an endowment weighing the implementation of a flexible distribution policy. Another would be adjusting or even eliminating annual distributions based on market performance itself.

To examine how such a strategy could influence both endowment values and total distributions, a simple rule — i.e., distributing only if real returns exceed 2.5% — was considered. In other words, a normal, percentage-based distribution would be made only in the event that real returns were higher than 2.5% in a given year.




Source: Michael Kitces

As the results above indicate, implementing a simple decision rule can have a positive impact on both preserving endowment value and increasing total giving. Of course, this works because an endowment cannot distribute anything if it runs out money. Therefore, preserving the endowment value also preserves the future cash flow that can be generated from the endowment.

For instance, when utilizing a conservative investment allocation, taking a fixed-percentage distribution regardless of actual returns in a given year eroded the endowment value when the distribution rate was 3% or greater (median 100-year values of $8,000 [5% distribution] to $64,000 [3% distribution]) while generating median distributions ranging from $193,000 (5% distribution) to $245,000 (3% distribution).

By contrast, implementing a distribution trigger based on a 2.5% minimum real return preserved median 100-year endowment values ($111,000 at 5% distribution; $296,000 at 3% distribution) while also generating median distributions ranging from $277,000 (5% distribution) to $285,000 (3% distribution).

Note that not all scenarios saw an increase in total distributions based on this particular trigger. When analyzing an aggressive portfolio allocation, 100-year median distributions were reduced from $6.8 million without the trigger to $5.5 million with the trigger, although median endowment value was also increased from $15.5 million to $21.6 million, resulting in an increase in real asset values that still exceeds the decrease in distributions. Consequently, the distribution gap could be closed with a one-time distribution and still have a larger endowment balance going forward.

Additionally, the trigger was still successful in increasing both median 100-year endowment values and distribution rates when utilizing higher distribution rates — e.g., 5% — with an aggressive allocation. This resulted in a median endowment value of $3.5 million and median total distributions of $3.4 million when using the trigger, versus $900,000 and $2.1 million, respectively, without the trigger.

**OPPORTUNITY COST**

As these results indicate, there's a considerable cost to selecting a conservative endowment allocation. Such an allocation can certainly make sense when cash flow consistency is a primary motivation, as is common for traditional endowments — though even then, a more balanced approach will likely provide adequate stability with more long-term distributions and more long-term accumulation.

more aggressively, in a manner that is feasible once such spending flexibility is introduced.

Of course, institutional endowments could adopt the same course of action — particularly if they're able to be more flexible with their spending. But in practice, it may still be difficult to do so, both because prospective donors may feel that funds are being poorly managed due to merely seeing the paper losses that inevitably occur with any aggressively allocated portfolio, and also because endowments managed by committees of volunteers at small non-profits often have a high level of turnover and may be more liable to implement strategies based on rash or uninformed decisions.



Nonetheless, in the context of individuals setting up their own endowment-style DAFs, many of these obstacles can be avoided. The key point is to acknowledge that an endowment-style DAF's ideal allocation depends on how flexible a donor can and wants to be in distributing assets.

Through the use of a quality spending and investment policy statement — one that appropriately reflect the reciprocal influence each has on the other, while also managing behavioral risks by not allowing personal risk tolerances to influence an endowment's investment allocation — donors can have a tremendous impact both now and in the future through the use of an endowment-style DAF.

***So what do you think? How would you allocate an endowment-style DAF? What should donors consider when coordinating an investment and distribution policies? Is it necessarily imprudent for an endowment-style DAF to have an equity allocation of 100% or more? Please share your thoughts in the comments below.***

Derek Tharp ...

Comment

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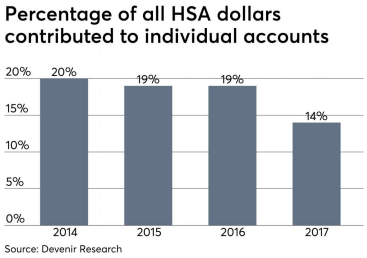


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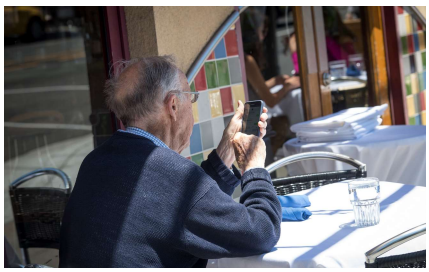

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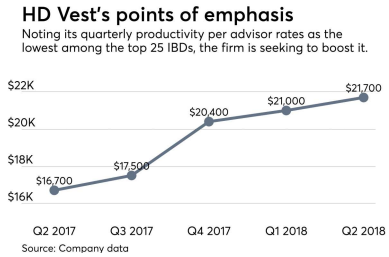


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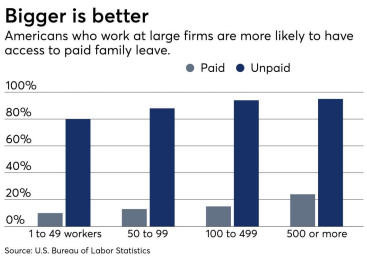


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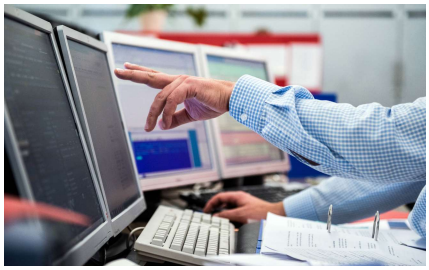

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