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PERMANENT CAPITAL

Lasting Support for Endowed Institutions

(A Working Paper)

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Lasting Support for Endowed Institutions

Endowment funds have a singular role in the funding of higher education. Since the establishment of the first universities in Europe, endowments have provided a lasting source of income for institutions of higher education. "[U]niversities are among the most permanent of human institutions," wrote Charles W. Eliot, then President of Harvard, in 1886. "They outlast particular forms of government, and even the legal and industrial institutions in which they seem to be embedded." The very phrase *endowed institution* summons thoughts of that permanence. But over the hundreds of years since the first parcels of land provided rental income to support colleges and universities, the definition of endowment has been changing. From land, to other property, to cash gifts, to capital gains, to institutionally designated additions, what many institutions call endowment today is much more than funds gained from "the bestowment of money as a permanent fund, the income of which is to be used in the administration of a proposed work."[1]

If not simply a permanent fund, then what is endowment today? Endowment today is an aggregation of what has come to be known as "true," "term," and "quasi" endowment funds. It is permanent funds; it is capital appreciation; it is other gifts and additions that boards have designated to function like endowment; and it is yet other funds that have found their way in. But, in fact, neither legal restrictions, nor accounting standards, nor even shared understandings among endowed institutions consistently support the current conglomerations known as endowment. With the new financial reporting standards,[2] the three familiar categories (true, term, and quasi) and even the concept of endowment in aggregate have been overridden by accounting-based dicta that place institutional assets in categories defined by donor-imposed restrictions on their use, or on otherwise legally imposed restrictions. These new categories offer little insight into the size or nature of the endowment, and pay no heed to the endowment's economic function. Indeed some institutions have abandoned the term *endowment* in their official financial reporting.

To be sure, the accounting is not the only problem with the definition. Long before the introduction of the new accounting standards, endowment had come to be more than a "permanent fund," and there are a number of reasons why. For some institutions, pooling of funds with different purposes for investment

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[1] Endowment as defined in the landmark legal decision in this field, *St. Joseph's Hosp*. v. Bennett, 281 N.Y. 115, 118, 22 N. E. 2d 305, 306 (1939), as described in "The Law and the Lore of Endowment Funds," 1969, a report to the Ford Foundation by William L. Cary and Craig B. Bright.

[2] The Financial Accounting Standards Board (FASB) recently issued two statements of financial accounting standards, SFAS Nos. 116 and 117, that, among other changes, effectively make fund accounting obsolete for general-purpose financial statement reporting.

led to the blurring of the boundaries of the endowment.[3] For some, non-permanent additions were the result of policy or practice to add operating surpluses, unrestricted bequests, or other "windfalls" to the quasi endowment. And no doubt, *endowment per student* and other high-visibility comparative measures of endowment size and strength have motivated some institutions to place almost any available funds in the endowment. For many years, the changing nature of endowment composition and the accumulations of various funds within it did not *appear* to present real difficulty.

In reality, the combining of assets that are fundamentally different under the rubric of endowment does have its shortcomings. Investment policies and payout policies designed for endowment funds intended to be invested in perpetuity or for the very long term do not always work well when applied to funds that are not "endowment-like" by nature. Examples of activities in the endowment fund that are not true to the permanent nature of endowment include: payout that responds to short-term needs (e.g., linked to expense growth); payout or withdrawals linked to extraordinary expenses such as campaign financing and technology; the addition to and withdrawal from the endowment of large sums that also function as reserves (e.g., for enrollment shortfall or building repair); and the temporary addition and subsequent withdrawal of funds earmarked for construction or renovation projects. When payout rates and growth ratios are calculated, this type of activity has the effect of distorting the numerator, the denominator, or both. When there is no line separating permanent capital from other financial assets, there is confusion about the inviolability of endowment funds (e.g., when endowment is loosely defined), and risk of overstatement of the resources that can or should be consumed (e.g., when endowment is not identified).

In order to gain a complete understanding of the institution's endowment and other assets – its capital base – it is critical to clarify which assets are intended to function as permanent capital and which to function as consumable funds and reserves. Permanent capital refers to financial assets intended to provide lasting support. These might be the erstwhile "true" endowment funds including their accumulated gains, along with certain board-designated funds. *Permanent capital* is not to be confused with the accounting terminology, which defines *permanently restricted net assets*. Permanent capital is defined by the institution's intent (taking into account, of course, donor and legal restrictions); permanently restricted net assets are so labeled based exclusively on donor directive or legal interpretation.

[3] This needn't have been the case. Funds of different types can, of course, be pooled for investment purposes and still retain their identity or functional distinctions.

The Importance of Identifying Permanent Capital

Historically, as noted above, the definitions and treatment of various kinds of endowment, reserves, and fund balances have differed from institution to institution. While most institutions have been aware of these differences, there was thought to be sufficient common ground to accommodate the variety of practices. In recent years, however, several developments have combined to make it imperative for every endowed institution to clarify its capital structure in the interest of augmenting its future strength:

1. Growing importance of endowment. A look at the trends in the revenue structure of colleges, universities, and other endowed institutions suggests that endowments will become even more important to the long-term financial health of these institutions. At universities, for example, as tuition increases become constrained by the market, as research funding tightens, and as competition grows for charitable gifts, the size and performance of the universities' endowments will likely spell the difference between the strong universities and the ones that face serious budgetary crises.

2. New accounting and reporting guidelines. Whatever might be said in their favor, the accounting and reporting guidelines recently issued by the Financial Accounting Standards Board bear no relation to the economic function of invested assets. The new standards do not require the reporting of fund groups or dictate any structure for the reporting of endowment separately from other assets. In effect they have erased the distinction between operations and capital. Hence, the required financial statements making use of the new net asset categories provide even *less* information on the capital structure of the institution than the statements they replace. Officers, trustees, and others must look elsewhere for an understanding of the institution's permanent capital.

3. Increased need for long-term planning. Faced with rapidly changing markets, and expenses not easily curtailed, institutions cannot rely on budgets alone for fiscal discipline, but must increasingly align budgets with a long-term plan. The "financial equilibrium" approach – updated and with adjustments for market variables – remains one of the most effective ways to accomplish this. And, this approach *requires* a clear definition of the permanent capital base of the institution. Indeed, any worthwhile long-term planning model requires this.

4. Growing endowment allocations to alternative assets. As endowed institutions have diversified their investments away from domestic common stocks and bonds, allocations to private equity and other non-marketable assets require a firmer sense of what portions of the investable assets are considered permanent, inasmuch as illiquid investments typically involve a lock-up period of ten to twelve years. Hence an excessively restrictive definition of permanent capital carries with it an opportunity cost, because the institution may under-allocate to alternative assets and thereby forgo the benefits of such diversification.

5. Probable growth in unrestricted bequests. Much of the growth in college enrollments, museum memberships, and other nonprofit constituencies has occurred in the years since World War II. Demographics therefore suggest that these institutions stand to benefit from an increasing volume of unrestricted bequests. The handling of such bequests could prove critical to the future strategic position of these institutions. For example, a university that applies such funds toward operating shortfalls, or places them in "reserves" that are likely to be spent, may find itself at a strategic disadvantage when compared to the university that systematically designates these bequests as part of permanent capital. Absent a clear concept of– and emphasis upon – permanent capital, unrestricted bequests are often treated as windfalls that can be spent on unanticipated operating and capital needs.

The Economic Function of Invested Assets and the Income They Provide

The *economic function* served by permanent capital is to provide a growing and lasting stream of income (endowment spending or payout) to fund the institution's activities and budget growth. To the extent that permanent capital's growth rate exceeds the growth in the institution's operating budget, then it can provide increasing budgetary support and an expanding buffer against various market vicissitudes, such as college enrollment fluctuations, tuition constraints (financial aid demands), and lagging museum visitation or membership.

Permanent capital typically consists of donor-restricted endowment and board-designated endowment and the accumulated gains associated with both. In terms of the traditional terminology, permanent capital includes all of true endowment and some or all of quasi endowment. Endowment spending or payout associated with permanent capital should be consistent with the long-term goal of preserving the purchasing power of the invested assets, and thus should not exceed the real (i.e., inflation-adjusted) rate of return of the portfolio over time.

Temporary capital might typically consist of board-designated assets used for purposes such as debt service, the financing of capital campaigns, and the renewal and replacement of physical plant. In terms of the traditional terminology, temporary capital consists of varying percentages of quasi endowment as well as fund balances and reserves, including unexpended plant funds. These assets might be "used" by withdrawal (decapitalization), by means of a payout policy, or by a combination of the two. Because the overarching consideration for temporary capital is not preservation of purchasing power, the applicable payout policy might provide for greater spending, or be less rigid in other respects, than the payout for permanent capital. Temporary capital should be invested in a manner that accommodates the anticipated withdrawals and with a time horizon that is less than perpetuity but which may include long-term investments. Some institutions also, in effect, use temporary capital to meet unbudgeted operating and capital needs; however, clearly it is advisable to minimize unbudgeted expenditures. *Operating funds* are self-explanatory.

The accompanying exhibit provides an illustration of these three functional categories of invested assets – permanent capital, temporary capital, and operating funds. It also illustrates the differences between these *economic* definitions and both the traditional terminology and the new accounting and reporting categories. The exhibit makes clear that for institutions with large endowments, the accounting and reporting category called "unrestricted net assets" is virtually meaningless for the purposes of understanding their economics and operations. It also highlights why the use of traditional terms such as *quasi endowment* and *plant funds* can obscure the roles of permanent capital versus temporary capital. As the traditional terminology becomes less and less consistent in its application (with the adoption of the new financial standards), it becomes increasingly important to develop a clear and consistent definition of the institution's permanent capital base.[4]

In Conclusion

An *economic* – as distinct from accounting – definition of the endowment is of considerable strategic importance to all endowed institutions. Identification of their permanent capital is critical to these institutions' future strength because it guides investment decisions, payout and accumulation policies, and capital management overall. Moreover, clarification of the intended uses of and purposes for their accumulated invested assets not only will help the institutions plan and understand their financial challenges and opportunities, but will provide a basis for understanding and comparison by trustees and officers, faculty and staff, parents and students, alumni and donors, and credit-rating agencies and other evaluators of financial position. And, in time, perhaps permanence will once again be synonymous with endowment.

[4] Cambridge Associates has initiated two databases that provide to officers and trustees the financial data necessary to distinguish operations from capital, and to evaluate the performance of each. Currently, approximately 50 colleges and universities participate in the databases and have access to the comparative data and receive our analyses and reports.

CATEGORIES OF INVESTED ASSETS

Long-Term ⟷ **Short-Term**

<table>
<tr><th></th><th>A</th><th>B</th><th>C</th><th>D</th><th>E</th><th>F</th></tr>
<tr><td>Type</td><td>Donor-Restricted Endowment (Original Gift Value)</td><td>Accumulated Gains Associated with Original Gift</td><td>Board-Designated Endowment and Associated Accumulated Gains</td><td>Board-Designated for Long- or Medium-Term Investment; and/or for Budgeted Capital-Related Needs</td><td>Funds Available to Meet Unbudgeted Operating and Capital Needs</td><td>Operating Cash (Budgeted Operating Needs)</td></tr>
<tr><td>Economic Function (Proposed Terminology)</td><td colspan="3">Permanent Capital</td><td colspan="2">Temporary Capital</td><td>Operating Funds</td></tr>
<tr><td>Investment Horizon</td><td colspan="3">Invest in Perpetuity</td><td colspan="2">Invest for Targeted Horizon*</td><td>Invest for Short Term*</td></tr>
<tr><td>Traditional Terminology</td><td colspan="2">True Endowment</td><td colspan="2">Quasi Endowment</td><td>Fund Balances and Reserves (including Unexpended Plant Funds)</td><td>Operating Funds</td></tr>
<tr><td>Net Asset Classification**</td><td>Permanently Restricted Net Assets</td><td>Permanently Restricted, Temporarily Restricted, or Unrestricted Net Assets</td><td colspan="4">Unrestricted (or Temporarily Restricted) Net Assets</td></tr>
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* At some institutions a portion is invested, in effect, for the long term.

** Per SFAS Nos. 116 and 117; net asset classification based on donor restriction and interpretation of applicable law.