



## Some Thoughts on Endowment Spending Policies

There are two basic ways of distributing money from your endowment fund: an “income-only” policy, or a “total return” policy.

In the “income only” policy the board spends only the money earned from interest and dividend income. In the “total return” policy the board considers both the income earned *and* capital appreciation of the investments, thus “total.”

Using the “total return” policy the board will also need to establish a “spending rule” which is usually stated as a fixed percentage of an average net asset value of the funds held. The current average percentage selected by most churches is between 4% and 5%. It is usually applied to a rolling three-year average value of the endowment fund taken at the end of the previous 12 quarters. If you are just starting the fund, you could apply the percentage to 90% of the value of the fund in the first year or use some other formula.

By restricting the spending to a fixed percentage, and applying it to a rolling average value of the fund, the “total return” policy should capture the ups and downs of the market (in terms of appreciation/depreciation) and over time tend not to invade principal.

If you use an “income only” policy, you may be inclined to invest in more fixed-income investments so as to generate more “income” and miss out on capital appreciation. Or, if you enjoy significant capital appreciation but relatively little income generation, you will begin to see the value of the fund grow, but will not see much growth in the money available for expenditure.

One advantage of using the “total return” policy is that you are able to spend both the income received and some of the capital appreciation. The discipline of setting an annual spending rule, in light of current market conditions, helps to preserve the principal.

Another important consideration in setting the percentage of the draw, or in using the income earned, is the effect of inflation. For example, if you set an annual draw of 5%, experience 3% inflation, you will need to achieve a total return of 8% in order to stay even in spending power of the endowment. On the other hand, if you use fixed-income investments only, such as a Certificate of Deposit, and spend the income earned, you will deplete the spending power of your endowment by the rate of inflation. Most churches that we work with use the “total return” policy and set an annual percentage of draw.