California-Nevada United Methodist FOUNDATION

Total Return Spending Policy with Sample

History

Historically, non-profit organizations used income from the investment portfolio to make distributions to their cause. As interest rates fell over the past decades, many non-profits found they were reducing distributions to reflect the lower interest and dividend income. In addition, their portfolio asset allocation became over-weighted in income producing assets (i.e., bonds), thereby reducing the allocation to equities, which typically provide long-term growth.

In 2008, California passed adopted the Uniform Prudent Management of Institutional Funds Act (California Amended Probate Code, Section 18500-18509) allowing non-profits to spend principal and income by developing a total return strategy. Thus, it may be possible to revise current foundation and/or endowment fund documents to transition from an income-only spending policy to a total return spending policy.

What is a Spending Policy?

A spending policy utilizes the increase in principal appreciation made possible by a total return investment policy. By selecting a percentage rate (usually between 3% and 5%) to calculate the annual charitable payout, an appropriate sum is available for distribution to the various charitable causes served by the foundation and/or endowment fund.

What is Total Return?

Total return is the combination of income, dividends and principal change due to market fluctuations. The portfolio selection and spending policy should complement the Investment Policy.

Calculation Methods

Another advantage of a spending policy is that distributions can be calculated and budgeted on an annual basis without immediate concern regarding market changes in principal and income.

There are various methods for calculating the appropriate spending policy. Generally, expenses (such as fees, accounting charges, etc.) will be deducted from the investment portfolio market value before calculating the amount available for distribution.

Many non-profits will use a rolling average in order to smooth out the spending process due to market volatility. For example, using a three-year average market value calculated annually or quarterly will smooth out market fluctuations. This calculation can be done at fiscal year end, calendar year end, or at some point prior to the year-end for budgeting purposes as long as the process is consistent. The spending policy percentage can drive the investment policy or vice versa and should be determined after studying historical returns of the various asset classes.

Add name & address of the church or Agency here.

SAMPLE OF A TOTAL RETURN SPENDING POLICY

You may find the sample below helpful in understanding and creating your own **Total Spending Policy.**

The Spending Policy Assumptions

- This Spending Policy recognizes the definition of income as the **Total Return** concept. Income will include not only interest and dividends, but also include increases and/or decreases in the market value of the endowed assets. Market value fluctuations are included as an integral part of investment returns.
- This Spending Policy also separates or de-links the investment decisions regarding asset allocation of the portfolio from the identified cash flow needs.
- Distribution from any newly created endowment fund will not commence prior to obtaining a minimum of $100,000 in assets in the Fund. *(Note: this limit is to be set by the church, agency or endowment fund. You may wish to set a lower or higher asset figure.)*
- Spending rates may be adjusted or distributions ceased in poor investment years.

Fund Development Process

The Spending Policy is developed to implement existing *(Name of fund or organization)* Policy.

- The level of cash needed, the need for cash flow stability, and the need for the cash flow to grow to offset inflation is examined.
- Various asset classes are examined to determine what asset classes are needed to achieve the Total Return objective.
- Historic and projected outcomes are examined on a portfolio basis, to determine how the asset classes work together.
- The *(Name of fund or organization)* then must decide how to balance the different possible combinations of current cash flow, stability, growth, investment risk and total return.

Example

Let's assume, using the asset classes of stocks and bonds that the *(Name of fund or organization)* has decided the following:

- The cash flow should be relatively stable, but some modest year-to-year variation can be tolerated.
- The initial projection is that inflation will be 3.0% but the real measure going forward will be the Consumer Price Index (CPI).
- The **Income** (interest and dividends) generated by this portfolio is not sufficient to meet the criteria expressed above. The source of the investment returns (income or capital gains) is irrelevant to the spending policy concept. Spending policy focuses on total return, not the income component.

- Since the market value of a portfolio with 60% in stocks will vary from year-to-year in value, and one of the objectives is stability of cash flow, a straight 5% of each year's market value will result in a variable cash flow.
- The *(Name of fund or organization)* therefore, needs to adopt a smoothing technique by basing distribution on a 3-year average *(Generally organizations choose anywhere from 3 to 5 years averages)* of the market value of the fund. This evens out the cash flow and also focuses on long-term results, not single year performance results. If more stable cash flow is desired, a longer-period average can be used.
- Once the objectives and expected outcomes have been balanced the Spending Policy can then be stated as:

Spending Policy

Goal

The Trust Administrator will annually distribute 5% of a three-year moving average of the market value of the fund. Based on expectations for long-term returns and inflation, the general investment guideline for the funds will be in, or the equivalent of, an asset allocation portfolio equal to approximately 60% in equities and 40% in fixed income. *(Determine where and how the funds will be invested. You may not choose an asset allocation portfolio.)*

Objectives

Provide equal fund benefits to present and to future generations by providing for inflation and wise investing.

Analysis

Because **Total Return** focuses on both income and appreciation, the spending policy recognizes that income and appreciation are equally valuable, particularly to the *(Name of fund or organization)* since it is exempt from income and capital gains taxes.

A typical spending goal under a **Total Return** model is to have a spending rate that will produce constant real spending; i.e., spending that will grow at a rate equal to the cost of living increases.

Measuring Total Return:

The *(Name of fund or organization)* will calculate **Total Return** using a three-year rolling average You may wish to choose a longer period.)by:

- Total return = income received [interest and dividends]

  Plus
- Realized and unrealized gains and losses (Market Value)

  Divided by
- Beginning market value

Foundation Spending Policy

In order to provide a sustainable level of income to support the *(Name of fund or organization)* special needs of the organization while preserving the real (inflation adjusted) purchasing power of the (*endowed, trusts and reserved funds – list the fund or funds covered by the TRP)*, the *(Name of fund or organization)* establishes the following spending policy with regard to the use of available *(Endowed, Trusts, and Reserved Funds*) as follows:

1. Up to 5% of the total market value of the available funds may be distributed annually based upon a three-year rolling average. Distributions shall be calculated annually.

2. The percentage distributed shall be reviewed annually by the *(Name the Committee with oversight responsibility, such as, Endowment Committee Trust Administrator, etc.)* and adjusted as appropriate according to the needs of the Foundation and the current market climate.
3. Should the *, (Endowment Committee Trust Administrator, etc.)* deem it necessary to exceed the 5% limit, the change must be approved by three-fourths (3/4) of the members at a *(Charge Conference if a local church or other appropriate unit for other entities) (*or votes solicited via any appropriate electronic notification, such as email or telephone *– This statement may not be appropriate for the organization in question.*).
4. Should the suggested distribution result in a reduction of the real value of the endowment and reserve funds to a level below the adjusted real value, the *(Charge Conference if a local church or other appropriate unit for other entities)* shall determine the percent or amount to be withdrawn."
5. The policy shall be effective ______________________..
   Date

Adopted by the *(Charge Conference if a local church or other appropriate unit for other entities)* on

____
Date

Chairperson, Endowment Committee	Chairperson, Administrative Council
Chairperson, Board of Trustees	Presiding Officer, Charge Conference

(Use the appropriate signatories for the organization if not the local church. It could be just the secretary's signature for an agency board.)