



Regions Wealth Podcast

Episode 26: The Benefits of an Endowment: Ensuring the Longevity of Your Nonprofit

Episode Description:

In the wake of COVID-19, the widespread cancellation of funding events paired with the economic downturn left many nonprofits in a difficult position. A survey conducted by Ernst & Young found that over 70% of nonprofits surveyed have had to cut back on services as a result. In times like these, endowments are more important than ever. In this episode, Chief Investment Officer Alan McKnight joins us to discuss endowments and how they can help support the long term success of your nonprofit.

Episode Transcript

Sarah Fister-Gale:

Welcome to Regions Wealth Podcast, the podcast that tackles life's challenges with financial experience. I'm your host, Sarah Fister-Gale.

In the wake of COVID-19, the widespread cancellation of funding events paired with the economic downturn left many nonprofits in a difficult position. A survey conducted by Ernst & Young found that over 70% of nonprofits surveyed have had to cut back on services as a result. In times like these, endowments are more important than ever. Joining me remotely is Alan McKnight. He's the Chief Investment Officer for Regions Bank. Alan, thanks for joining us today.

Alan McKnight:

Sarah, it's my pleasure.

Sarah:

In this episode of Regions Wealth Podcast, we're discussing endowments and how they can be structured in order to support the long term success of your nonprofit. We've taken some frequently asked questions and have developed a character who needs your help. Let's listen.

Shanice:

"Hello, I'm Shanice, and I'm the executive director at a large nonprofit. I launched the organization out of my church's basement, if you can believe it! We have been blessed with a



wonderful group of advocates and grew quickly... our cause is one that many people have been able to get behind.

We've had a large amount of success with fundraising over the last ten years. I'm quite pleased with the size of our cash reserves — which, for a nonprofit of our scale, are quite impressive. Of course, giving has slowed down a bit since coronavirus. Once it spread to our region, we had to cancel our largest annual event—a charity ball and auction—which was difficult. Our advocates found other ways to support us, which has been lovely, but the experience has forced me to start thinking a bit more about setting up an endowment fund. I'm not certain where to begin. I'll admit—financial management isn't my forte, and our board is lacking someone with that particular skill set, too.”

Sarah:

Let's start with the basics. What is an endowment fund, and how common are they in the nonprofit world?

Alan:

They're actually very common. And they're an incredibly effective long-term tool to pool funds, and as noted before, for the success of an organization with assets dedicated to the benefit of the nonprofit. There are restrictions about how they can be used, and the amounts that can be utilized, which truly run the gamut. It depends on how the money was donated and any stipulations that came along with those funds. With unrestricted gifts, the board and investment committee can utilize them in the way that they think is most important and valuable to the organization. Whereas, others are very restrictive. As an example, an endowment for a university may have a donor that provides a million dollars, but with that million dollars stipulates that you can only spend that money on Freshman Sociology majors living in dorm number two every year.

Sarah:

At what point do many nonprofits choose to create an endowment fund?

Alan:

If you're fortunate as a nonprofit, you would have one from the outset. And someone would have provided funds for you at the outset of the organization, when you first conceptualized the idea of the nonprofit. But the reality is, it typically takes years to build a donor base at a grassroots level to fund an endowment. You're building out a long term plan about what you want to do and how you want to achieve those goals, and the endowment fund sits alongside of that.

Sarah:



That's interesting. I always picture an endowment fund coming from one charitable giver, right? Here's my million dollars to support you. But it sounds like you're saying that a lot of donors can build an endowment fund to support a nonprofit.

Alan:

That's exactly right. And many times you have a foundational gift from a donor that provides the basis for the endowment longer term. But then you build on that with a donor base that is really along a continuum of both small givers and large givers. But it just depends on the nonprofit. So organizations like universities have been around for hundreds of years, will have built upon their endowment and have much larger corpuses than, say, a newly initiated nonprofit that may only have a few people involved, and may not have the benefit of a large donor.

Sarah:

So, you briefly mentioned restricted endowments. Let's talk a bit more about those. Do restricted endowments need to be managed differently?

Alan:

They can be managed in the same way, but with restricted endowments, it needs to be tracked separately. And in those situations, the utilization of something that's called sub-accounting, so that each restricted element can be accounted for, is critical. And you have to document exactly how those funds are utilized, where they are going, and the restrictions so that they can be sequestered accordingly. What you don't want is to then mix those monies together with other endowed funds and run the risk of jeopardizing a relationship with those donors going forward. If you've given your \$10,000, and you put restrictions on it, you want to know that they're following those restrictions and that they're not being used for other things because 10 years from now, you may come back and ask about it. And if they can't prove that that's been done, it's a pretty big risk to the organization. So it's been created to try to ensure that donor intent is preserved. It's something that you really need a specialist for, and you need an organization that can understand the intricacies of this. And typically, nonprofits don't have this experience in-house, so to find an external specialist that can help advise and counsel is critical to ensure that you're meeting not just the legal definition of what is required, but really the intent that is provided by those donors.

Sarah:

That's great information. So, going back to the purpose of an endowment fund, I'm curious: How are endowment funds typically used?

Alan:

So the concept of an endowment is one that has been going on for many years. And professor James Tobin, who was a Nobel Laureate in economics, brought about the idea of inter-



generational equity. And the concept of that is the trustees of endowed institutions are the guardians of the future against the claims of the present. And their task in managing the endowment is to preserve equity among generations. So endowment funds are used to source funding for operating activities, and typically a spending policy is adopted around that. But at the same point in time, that spending policy has to be mindful of the future of the organization, and managing the endowment to preserve that equity across generations, because the goal is to go on in perpetuity. So let's say a private foundation has a million dollars in assets, and they decide to spend 5%, which would equate to \$50,000 per year of that million dollars. Well, with that \$50,000, they could use it, to fund daily operating activities. But at the same point in time, they don't want to overspend and run the risk or jeopardize the overall corpus of one million dollars.

Sarah:

So, is the idea to only spend the amount of money that the endowment earns so that it's there for perpetuity?

Alan:

Conceptually you're spot-on. And so the idea would be to think of it as the spending policy which can run the gamut. Obviously the lower the spending policy, the more conservative to ensure that the money would go on as long as possible, and hopefully in perpetuity. Then you have inflation, which can run between one and 3.5% per year depending on the year. And then finally, the costs associated. So if you roll those up in a very basic example, a 5% spending policy, plus a 2% inflation, plus a 1% cost, would mean that you would have 8% per year that needs to be covered to ensure that you don't actually eat into the corpus of your assets. And for an organization that may have limited support and external support, it's critical that they can keep that corpus alive, if you will, as long as possible to ensure the longevity of the organization. And it's not an easy task, and it's a difficult one when there's so much need out there. But at the same point in time, being mindful of it is important.

Sarah:

So how might an endowment fund be beneficial during these times when charitable giving is down due to the pandemic?

Alan:

It's really that foundational support, which is exactly why it's inter-generational in its nature and it's going on in perpetuity, because you don't know when these situations such as the pandemic will occur. And better to be prepared for it and provide for it than to hit one of these situations and realize that you're not going to have the funding to keep the lights on. It's critical that when the markets are down, that you don't eat into that corpus too much, and if the donor base is down and people aren't comfortable providing additional funds to your nonprofit, that endowment can be relied upon to ensure that you're able to pay for your



ongoing operating activities. And you don't have to worry as much about sourcing funds day-to-day to ensure the longevity of the organization.

Sarah:

Wow. So it's like a financial safety net for these nonprofits?

Alan:

That's exactly right. It's that safety net that allows them to navigate the most difficult of times, and to be prepared for those times in the event that they aren't able to receive the support that they've come to enjoy over the years from a broader donor base.

Sarah:

OK, let's pause here and listen to the next portion of Shanice's story.

Shanice:

"My biggest question is, how can we structure our endowment in a way that sets us up for long-term success? I've thought about contacting an investment advisor, especially as our endowment has grown a lot over the last few years. Like I said, I'm proud of the funds we have in place, but I'm not sure we're large enough yet to justify hiring someone to manage the investment. Plus, I'd want to make sure we choose the right advisor."

Sarah:

Let's start off by talking a bit about the benefits of working with an investment advisor as a nonprofit. How might Shanice's organization benefit from this?

Alan:

Shanice and her organization would benefit from having outside counsel and insights that are being brought to bear to understand the intricacies of the organization, and how to structure a portfolio that will appropriately deliver on the needs of the organization going forward. The investment advisor is really set up to sit at the same side of the table as the nonprofit to understand the needs of the stakeholders, the goal of the organization, and then to be able to craft an investment portfolio that reflects that and all the nuances that are associated with that. And the critical element to that is going to be around the custom nature of it to ensure that it accurately represents the comfort level around risk, the need for return, and producing a diversified portfolio that can help that organization navigate both the ups and the downs of the market. And as we talked about earlier, the goal of these funds is to ensure the longevity of the organization. You would hate to think that there wasn't time spent in preparation and in planning and a policy to jeopardize that.

Sarah:



So would an investment advisor help the nonprofit build the value of the endowment as well as figuring out how best to spend it?

Alan:

They can. And it runs the gamut in terms of the nature of the relationship with the advisor. But at its core, it's someone who can sit on the same side of the table as the nonprofit to understand what are your spending policies today? Should you be spending less or more? Is that possible? What's feasible? Looking at an investment policy that articulates, what are the risks that you're willing to have? How much can you draw down those assets? Can you take on more risk, or are you not behaviorally comfortable with that? And that's really understanding the organization and understanding what is most important to not just the board, but the staff and the overall intent of that organization.

Sarah:

Okay. So what qualifications and capabilities should Shanice look for when choosing an investment advisor?

Alan:

We think it's critical to find an advisor who specializes in nonprofits, who understands the nuances of an organization and how other nonprofits are set up and really to be able to apply that best thinking and knowledge across other organizations. Understanding the key components around spending policies, around sub accounting for donated assets, around what the financial landscape could look like going forward, and even getting down to where grants are available and the understanding of what that may mean for the organization, aligned with and parallel to an investment program, that articulates how much investment return is needed to be able to support their goals.

Sarah:

So should Shanice or her board reach out to other nonprofits for recommendations?

Alan:

That's exactly right. Look in the mirror and say, who sounds like me, who has similar goals or aspirations as a nonprofit, and then reach out to them, ask them who do they use? Have they been impressed with them? Have they liked them? Then bring together all of those various names that you find. And that's when a request for proposal or an RFP could be utilized. So that you can consolidate all that information for the board and the staff to understand what makes each of these unique, what makes them similar and then undergo that process around who we should select.

Sarah:



So Shanice is concerned about having a large enough endowment to justify working with an investment advisor. Is there a minimum endowment size that an organization should have before they begin working with an advisor?

Alan:

Really, it's about finding a good fit and finding an advisor who understands your unique needs as a nonprofit, and has other experience with other organizations like yours. It may look a little different depending on the size of your Corpus, the size of your asset base, if you will, but it doesn't exclude you from using any particular advisor. It really comes down to that engagement with the advisor and to ensure that they are a good fit, that they work with others like you. And a request for proposal or an RFP can help you get that information and get to the heart of, do they work with other organizations like yourselves? Do they have dedicated experience in your realm? And can they provide the sort of insights and counsel that will be reflective in the success of your organization for years to come?

Sarah:

That's all really helpful advice. Let's pause here and listen to the final portion of Shanice's story.

Shanice:

"One thing that's really important to me is making sure our endowment can withstand a market drop. I know that it's crucial that the endowment be structured properly. I think I might sleep better at night knowing that everything was structured so that we're able to depend on our endowment in the future."

Sarah:

If Shanice wants to make sure her endowment is structured properly, where should she get started?

Alan:

She should start with working with an investment advisor to review what a diversified investment portfolio would look like, what the draw down risk is, and what that may mean for the organization over the long term. And in many cases, it's not just the math, it's also the behavioral element to the organization to understand how much risk can you take on. What is your risk tolerance? What are the potential outcomes? And you may actually realize that you're more conservative than you would have realized going into it. So, as an example, you have a scenario whereby you have a \$10 million portfolio, and you think that you're comfortable with taking on more risk. And you'd say, "I can go down 10% in a year," but then when you look at the math and you say, "Okay, are you comfortable going from 10 million to \$9 million?" Can you sleep at night? Are you comfortable with that? And those are the types of dialogues that you need to have with an advisor.



Sarah:

Risk tolerance seems like a difficult measure to figure out on your own.

Alan:

You're exactly right. It's incredibly difficult. What you want is an advisor who can bring you information that allows you to make the best decision for that organization. The best thing the advisor can do is provide a host of different outcomes and that everyone around the table is comfortable with what those could be. What you don't want is a situation where you don't know what the various outcomes could be. And specifically the downside outcomes. So going from 10 million to nine million or going from 10 million to seven million and there's surprise around the table because they weren't expecting that from the portfolio. If you have a 5% spending policy and initially you had \$10 million in your endowed funds, and now you've got seven million. What you can spend in absolute dollars has gone from 500,000 to 350,000. So imagine the \$150,000 that you can no longer spend for your beneficiaries, that you may not be able to use to keep the lights on. And so that's why the math is so critical because it makes a big difference in the ultimate benefit to who you're trying to serve.

Sarah:

So are there ways that Shanice's organization should structure the endowment so that it can handle a bit of market uncertainty?

Alan:

Without a doubt, the critical element there is having a diversified portfolio and being able to weather the downturns. There's a wonderful line I heard early in my career that if you take care of the downside risk, the upside risk will take care of itself. It doesn't mean that your portfolio won't go down. If you have any exposure to the stock market or risk assets, more broadly, you will go down. But at the same point in time, you can't just sit on cash that's not generating any return. If you're spending 5% and you're using cash, you're going to burn through the endowment. And that's exactly what you don't want to do. So the key takeaway is that constant trade off: how much risk are you willing to take to ensure the longterm viability of the organization versus the comfort level of taking no risk at all, while limiting longterm viability.

Sarah:

So Alan, as you know, on every episode we like to ask for some key takeaways that we can share with our listeners. What are some key takeaways you'd like to share with someone in Shanice's position?

Alan:

First and foremost, understand the mission of your organization and how you hope to accomplish it moving forward. Alongside of that is understanding the financial necessity of



those goals and the benefits of having a long term endowed pool of funds. Those endowment funds are incredibly beneficial to an organization to ensuring the long term success and viability, or the intergenerational equity as professor Tobin liked to talk about. And finally understand how you can utilize those funds to ensure the long term viability of your organization. And from there, understanding the benefits of working with an investment advisor is critical.

Sarah:

That is such great advice. Thank you so much, Alan McKnight, Chief Investment Officer for Regions Bank. It's always a pleasure.

Alan:

It was a pleasure to speak with you today.

Sarah:

And thank *you* for joining us today. In our next episode, we're discussing a great topic: early retirement. Now, we've *all* stumbled upon blog posts written by everyday people who've been able to retire decades before their peers, but how achievable *is* early retirement? And what sort of financial planning *really* needs to occur for someone to retire before the age of 60? Check back in two weeks to find out. In the meantime, be sure to visit regions.com/wealthpodcast to explore past episodes.

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