Spending Policy Challenges For Not-For-Profit Organizations

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The challenging economic conditions and market fluctuations have led many not-for-profit organizations to revisit their spending policy assumptions. Traditionally, a 5% calculation based on some type of rolling market value average is a common approach. The 5% basis is derived from the Internal Revenue Service Guidelines for Minimum Distribution Requirements for private foundations.

It is surprising to learn how many organizations do not coordinate their spending policy with their investment policy. Most organizations are reviewing their Investment Policy Statement annually however the same "due diligence" should be given to their spending strategies. Many academic white paper reports make the case that a traditional 5% spending policy can be a long term self liquidation strategy when taking into consideration inflation and a net growth target.[1] This is even more important today given capital market projections and the persistence of very low interest rates.

The availability of multiple types of investment options from hedging strategies, international investment, indexing and the traditional stocks and bonds add to the complexity of coordinating a consistent payout with the current allocation target. Some of the more complex investment alternatives have limited availability to investors due to minimum size and liquidity constraints making investment policy modifications even more difficult. Most organizations are looking for consistency over time versus maximum payouts during shorter periods of time or special needs.

Another challenge facing not-for-profits relates to their level of reliance on government funding, annual fund raising success and direct donor support.

Has the economy led to staff reductions, specifically in the development department? Are there special project needs (building or program expansion) that require attention now? Is there a capital campaign taking place? These factors can exasperate an already widening gap between the organization's investment resources and spending needs.

So what can be done? First, make sure you closely work with your investment advisor to integrate your Investment Policy with your Spending Policy. Keep a long term focus even though short term conditions may cause unexpected shortfalls. Ask the question "Can our current asset allocation target along with any restrictions imposed achieve the overall results we need?" Remember to consider inflation and its impact on purchasing power and your net real required rate of return. There are tools that exist that can assist in completing this analysis. Tools can include historical results and realistic capital market projections. This would be a good time to consider whether alternative investment strategies should have a role in the overall investment scheme.

External funding sources should also be considered when looking at the "big picture". Examples would include fund raising efforts, planned giving development and new potential sources of income. Some organizations have determined their core competencies and strengths in order to turn them into new revenue generating activities.

It's a great time to reevaluate where your organization is, what your mission truly is and align a financial strategy that not only matches expectations but actually puts you on a pathway to success.

[1] SPENDING POLICIES AND INVESTMENT PLANNING FOR FOUNDATIONS: A Structure for Determining a Foundation's Asset Mix, THIRD EDITION, Council on Foundations by DeMarche Associates, Inc., prepared by Donald W. Trotter, CFA, April 3, 1990; updated by Carter R. Harrison, Jr., CFA, February 28, 1995; updated by Carter R. Harrison, Jr. CFA, June 1, 1999.