Endowed nonprofits need to reconsider overly conservative approaches to their endowments. The traditionally wary payout rates miss the mark both in terms of the amount of funds released and in some cases their application. This paper addresses the reasons for change—such as enhancing intergenerational equity, avoiding a backlash against swollen asset pools, and tackling strategic challenges while time and resources are available—and suggests ways to improve payout policy.

Much has been made of the challenge we face in improving the results of our K through 12 schools. This need is real and urgent. But one could also argue that this strategy is about 20 years too late and by itself will have only a modest impact on national performance and on individual success. Why? More students currently leave the educational track during college than during high school. Society increasingly needs more and better-prepared graduates from four-year universities and colleges. A bachelor’s degree holder earns about $1 million more than a high school graduate during a working career, and this extra income can lift families out of poverty and increase the chances that future generations will attain degrees. The promise of equitable access to education lies at the core of the social compact that affords most higher education institutions their nonprofit status and ensures their social relevance. This compact is under increasing assault as rich institutions get richer without creating a commensurate societal benefit.

Payout rates are not an issue for most nonprofits, since they lack even the reserves to protect against revenue or expense volatility. Figure 1 shows that about two-thirds of nonprofits do not have reserves adequate to cover a year’s worth of expenses. Even if you believe that a six-month expense reserve would be enough, slightly more than half would not meet the test. For these organizations, the priority is building adequate financial reserves. For the fortunate few, the 35 percent of nonprofits who hold 75 percent of the net assets, payout rates are an issue.

This issue is particularly relevant in higher education since these institutions have more than held their own in the getting game. The investments held by the top 10 higher education endowments grew from $11 billion in 1984 to more than $100 billion in 2005. Fifty-six institutions now have endowments of more than $1 billion. And the future looks bright. Figure 2 shows that universities and colleges are gaining share in the competition for what is now almost $250 billion in annual U.S. philanthropy.

As the bounty mounts, we are already seeing signs of change in leading nonprofit boardrooms. Independent foundations such as Atlantic Philanthropies and the Goldman Foundation are committed to accelerated payout under a “giving-while-living” philosophy. In May 2005, a community foundation, the Boston Foundation, increased its payout rate from 5 percent to 6 percent, sending an additional $2 million annually to Boston charities. Despite a generally pessimistic near-term investment outlook, the board of directors felt comfortable with this action because even conservative expectations for future gifts suggested that higher payout rates were sustainable and the needs of Boston today merited the support. Board member Jack Meyer, formerly president of Harvard Management Company, said the changes bring the foundation a better balance between growing its endowment for the future and meeting the needs of the present. The Boston Foundation is not the only community foundation to increase its outflow, and
in fact the highest community foundation payout rate is now at 7 percent.

The case for rethinking payout policy is compelling. The core arguments in favor of doing so mirror broader themes now circulating in the nonprofit sector and revolve around a more holistic view of intergenerational equity, the need to manage a growing risk associated with ever-increasing asset accumulation, and the strategic need to change the game as many institutions now play it.

Intergenerational Equity: Future Gifts and Present Care

Exponents of cautious payout frequently cite intergenerational equity and the desire to preserve endowment value in perpetuity as the backbone of their case. But their analysis has explicitly favored the future at the cost of the present and ignores the role of future donations. Fear is also a factor, as trustees layer overly conservative assumptions on any forward-looking payout calculation in a determined effort to avoid being the board members “who let the endowment drop.” Both factors work against real intergenerational equity.

The contradiction is easy to see. The Commonfund Benchmark Study\(^2\) of 729 public and private higher education endowments found that institutions with more than $1 billion in assets earned an average three-year return of 11.6 percent and have an average return assumption of 8.8 percent for the next three years. However, the average payout for this same group was only 4.3 percent for fiscal year 2005, a drop from previous years and lower than spending rates among all other size categories except the smallest institutions, under $10 million.

In a discussion of endowments during the Forum for the Future of Higher Education’s 2004 Aspen Symposium, a speaker defined intergenerational equity in a manner that seems to reflect the mindset in most organizations (see appendix); that is,

The state in which the nominal market value [of the endowment] is equal to or greater than the inflation-adjusted market value from one generation to the next.

“Equal to or greater than” is not equality; it is in fact an inequality. Defining intergenerational equity as a guaranteed minimum benefit for future recipients shifts all the risk of market volatility to the current generation. Equity needs to mean something closer to “equitable given the best available information at the time of the decision,” which is the only thing a trustee can influence.

Excess conservatism is also at work here. Given the uncertainty associated with returns from most investment assets, institutional leaders frequently resort to very conservative payout rates to cushion against potential declines. Goldman Sachs in its report “Sustainable Spending Policies for Endowments and Foundations”\(^3\) argued that while a 70/30 equity/debt portfolio is appropriate for many endowments, and while such a portfolio might be expected to yield a real return of slightly more than 6 percent (6.2 percent based on historical performance for the period examined), a corresponding 6 percent payout rate was inappropriate because the probability of a 10 percent decline in the real value of the portfolio was about 50 percent (see Figure 3). The report contended that payout rates on the order of 3 to 4 percent were more suitable to reduce, though not eliminate, the possibility of a decline. It also noted that a low payout rate would most likely result in significant real asset growth, on the order of 50 to 90 percent at a 3 to 4 percent payout for 20 years, but held that for trustees

---

**Figure 1.** Distribution of Nonprofit Reserves 2001

<table>
<thead>
<tr>
<th>Reserves/Annual Expenses</th>
<th>Percent</th>
<th>$ billions (2001)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserves greater than 5</td>
<td>15%</td>
<td>$995 billion</td>
</tr>
<tr>
<td>Between 1 and 5</td>
<td>20%</td>
<td>39</td>
</tr>
<tr>
<td>Between .5 and 1</td>
<td>13%</td>
<td>36</td>
</tr>
<tr>
<td>Between 0 and .5</td>
<td>45%</td>
<td>12</td>
</tr>
<tr>
<td>Negative net assets</td>
<td>7%</td>
<td>-1</td>
</tr>
</tbody>
</table>

*Reserves equals lesser of net assets or combined cash, securities, and other investments.

Source: IRS NCSAS Files for 2003; IRS Statistics of Income Files, 2001
committed to value protection at any cost, the payout must be conservative.

But even defining equity as an equal probability of greater or lesser value falls short of true equity because it ignores the impact of future gifts on endowment value over time. To test the concept, I employed the most finely tuned equity meter available—my younger son, Nick. I offered him this simple proposition: We love you and your brother equally. Suppose we divide the money we have now equally between you both. But if we make any more money in the future, it will all go to your brother. Nick, already frowning, asked whether we planned to keep on working. When he understood that we did, he pronounced the plan unfair. “He will get more than me” was his simple summary.

The truth is that most higher education institutions can and do expect a flow of future gifts. The Commonfund survey cited earlier reported that endowment growth from gifts averaged 5.4 percent in fiscal year 2005, compared with 5.5 percent in each of the two prior years. The wealthier schools begin alumni cultivation before the first day of class. Reunion appeals, major gift programs, capital campaigns, and planned giving are the vehicles that make the philanthropic revenue stream flow. Looking forward, the rich are likely to get richer. Higher education has been capturing an increasing share of the philanthropic dollar, which is now around 10 percent, or more than $24 billion annually. The Center on Wealth and Philanthropy projects that total charitable contributions, measured in 2002 dollars, will range from $5.5 trillion to $7.4 trillion over the 20-year period from 1998 to 2017. Assuming the 10 percent share is sustained (as opposed to continuing to grow), higher education’s annual take could average closer to $29 billion to $43 billion in inflation-adjusted dollars over the next 14 years. Even at the low end of this range, the potential for a robust stream of future gifts remains strong.

A more realistic definition of intergenerational equity might be the following:

The payout rate for which there is an equal chance of greater or lesser inflation-adjusted value, with an acceptable level of uncertainty, taking into account expectations for future gifts.

Failure to take into account likely gifts rigs the game in favor of future generations. Conservative payout rates that don’t take gifts into account speak to a lack of confidence in the future or in an organization’s ability to use the extra funds wisely. This may or may not be the right strategy depending on the institution, but let’s stop claiming that intergenerational equity has anything to do with currently low payout rates.

A final compelling reason to consider higher payouts is the logic imposed by the time value of money. Without repeating those arguments or calculations here, the existence of attractive social investment options today necessitates discounting future expenditures and benefits to reflect
the real opportunity cost of funds. If we spend tomorrow rather than today, children remain uneducated, subsequent generations have a reduced chance of completing a college degree, endangered habitats shrink, and diseases such as HIV infect and kill more.

The multiplicative effect of some nonprofit investments is rarely considered in payout rate discussions. Yet a time-value-of-money mindset argues that we should lean toward the present, not the future. While not everyone agrees that this thinking applies to questions of social benefit (Klausner6), it is strangely ironic that, in a nonprofit board’s finance committee, considerations of long-term investment returns and the requirement to deliver an attractive return on capital are paramount, while across the hall the program committee gives little consideration to the societal benefit of educating another child or funding a key project because the costs of not doing so are borne by others. The imperative to deliver value to society lies at the heart of the rationale for nonprofit status, and some seem to have forgotten it.

For any of these reasons, the simple truth is that a higher payout rate is sustainable unless the goal is accumulation of assets. Embedded in the Goldman Sachs analysis is the view that, in the long haul, a payout rate on the order of 6 percent is more likely to result in real value maintenance. To achieve perpetuity, an organization simply needs to pay out its expected real return, on the order of 6 percent. It simply can’t be that astute investors are expecting to underperform the market so significantly as to limit themselves to a sub 5 percent payout. If so, they should fire their investment advisers. To achieve intergenerational equity for an organization still actively fund raising, which most are, the equity-achieving payout rate also needs to reflect expected future gifts.

The Potential for Backlash

The least inspiring, but perhaps ultimately most compelling, reason to reconsider holding practices is the risk of legislative intervention or donor backlash. Nonprofits (including foundations) hold about $1 trillion in investment assets. These holdings have grown rapidly and will continue to grow as accumulated wealth works its way through the intergenerational system. The buildup of funds held by higher education institutions and more broadly in the nonprofit sector increases the risk of negative reactions that could damage nonprofits everywhere. If the highly concentrated distribution of these funds and the tax benefits that accompany them becomes an issue of social equity, many nonprofits will be hurt.

Endowments are most concentrated among education and health nonprofits. In 1982, nonprofits (excluding foundations) held about $130 billion (in 2002 dollars) in investment assets. By 2002, that total had risen to $574 billion. As noted earlier, higher education institutions have more than held their own throughout this period, with well more than $250 billion in investment assets.

Harvard’s success may well be the case that prods legislators to act. From 1997 through 2002 (the date of the last available IRS Form 990 from Harvard), this nonprofit produced a cumulative profit of more than $10 billion. Its current $27 billion endowment, driven by Harvard’s astute investing, spins off more than $2 billion per year, tax free. While the Bill and Melinda Gates Foundation also has an endowment greater than $20 billion, it operates under legislative restrictions and gives more than $1.3 billion each year to causes such as immunizing poor children, searching for an HIV vaccine, reforming urban schools, and helping the poorest students attend college. Harvard’s “cause,” too easily characterized as educating the elite in increasingly luxurious facilities, might not fare so well in the hands of politicians looking to make a mark and win an election.

The nonprofit sector’s trillion-dollar investment account can yield almost $100 billion in annual returns. Even at a 20 percent capital gains tax rate, that’s $20 billion to fund the many items on politicians’ wish lists. Throw in the budget strains from Katrina or Iraq—along with a few more scandals involving administrator compensation or expense levels—and 2003’s unsuccessful Congressional bill HR 7, which sought to raise foundation distributions by disallowing expenses from payout calculations, could well gain more support and expand in scope beyond foundation expense limits. Extending legislation to other nonprofits becomes more likely if highly endowed but unregulated nonprofits are sitting on treasures and paying out at a rate below the 5 percent minimum legally mandated for endowed foundations.

A second source of risk lies with donors, who are becoming more demanding about the use of their gifts. Charity rating agencies are on the rise and increasingly ask questions such as “How much working capital does the charity hold?” A prudent level is a plus, but too much can be a negative. Large endowments beg the question “If you can’t spend what you have now, why do you need my gift?”

A simple calculation is instructive. Assuming a 4.5
percent initial payout rate and a 9 percent annual return on investment, it would take about 45 years for an institution to spend the money it currently has even if it were to grow annual disbursements by 5 percent each year—regardless of how big that might make the payout rate in the latter years. If you invest as well as Harvard, the time extends to more than 100 years. How many development offices would want to lead with the pitch “Give us your money and in a couple of decades or maybe a century we’ll start to think about how we might spend it.” The rising share of philanthropy captured by higher education suggests that donors haven’t hit this point yet, but will we be able to see the signs of a potential backlash amid the rising tide before it is too late?

The Strategic Imperative: Productivity and Repositioning

Most organizations face a strategic need to approach payouts differently. More than a few university leaders complain that if they do not build their endowment, they will never be able to keep up with Harvard, Stanford, or (insert your overendowed competitor here). Given that Harvard has at least a $10 billion lead, decades of happy alumni, 7,000 annual graduates, a world class development function, top performing investment managers, and a 4.5 percent payout rate, the truth is that nobody is going to catch them by trying to play the same game. They’ve won! A “me too” strategy driven by fear of losing this race almost guarantees failure. New tactics are necessary. Likewise, simply routing endowment distributions straight into the operating budget without a more thoughtful consideration of other options misses an opportunity to fund innovative strategies designed to create sustainable differentiation from peers.

In industry, companies without attractive uses for their excess cash buy back stock or issue dividends. Nonprofits simply hoard their cash for the future. Can it be that the higher education arena is bereft of appealing investment opportunities? From a strategic perspective, if you believe in your product, expand; if you don’t, fix it. Will second-tier universities still be able to compete for top students on a global scale if they do not have a source of distinctiveness, particularly for top international students for whom strong alternatives are developing closer to home? Will luxurious student facilities and merit scholarships that favor the already wealthy form the basis for a sustainable advantage? Will they be able to withstand the scrutiny of those looking for funds for other societal priorities? A more strategically defensible approach is essential.

Productivity has proved to be a crucial competitive lever in numerous industries and could be a powerful one in higher education as well. Department of Education data suggest that the inflation-adjusted cost per student rose by almost 40 percent in the period 1975 to 1995. Higher Education Price Index (HEPI) growth in the period since then has exceeded inflation by well more than 1 percent per year. If we define productivity as output—say, degrees granted—divided by inflation-adjusted cost, then productivity in higher education is on a long-term slide. While this measure is admittedly flawed, it is sobering. We are paying much more for less.

Few industries or institutions can survive productivity

<table>
<thead>
<tr>
<th>Losses from 8th Grade to College Completion</th>
<th>Thousands of Students</th>
</tr>
</thead>
<tbody>
<tr>
<td>8th graders(^1)</td>
<td>Graduated with a high school diploma(^2)</td>
</tr>
<tr>
<td>-------------------------------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>4,100</td>
<td>3,100</td>
</tr>
</tbody>
</table>

1. Based on a sample of 11,384 1988 8th graders who were respondents both in 1988 and 2000 drawn from 1,052 8th grade schools.
2. NELS rate of 83% (excluding G.E.D. and certificate of attendance recipients) adjusted to 75% because NELS sample excludes students in institutions and likely underreports “hard to sample” students, skewed toward not completing high school.
3. Includes students who had no postsecondary experience and 100% of the students who complete a certificate/license program.
4. NOT longitudinal—estimated based on the number of degrees conferred in subsequent years for an average cohort graduating with a B.A. in 1993–94. First professional degrees include M.D., D.D.S., and law degrees.

Source: NELS 1988/2000; Census Bureau; Digest of Educational Statistics
declines in perpetuity. None plan for them. Can strategic use of the endowment payout reverse the productivity decline? We suspect so.

Here is a good place to start: Increase graduation rates. More students drop off the path to a four-year degree in college than in high school. As Figure 4 shows, about 50 percent of those who enroll in a degree program fail to finish, and the losses are greatest among the poorest students. While quality of preparation, life circumstances, maturity, and other factors are no doubt involved, almost 30 percent of every class of 8th graders will drop out at the college level. Society benefits if more qualified students graduate—and the university does as well, since most graduates donate more generously than dropouts. Recent moves at some schools to convert loans to grants mean hundreds of graduates may gain access, but the effect will be incremental and will not significantly alter the productivity decline. Students need new support systems, time and attention, and a culture that makes their success a shared objective. That takes money, but net productivity improvement is clearly achievable.

Technology could also help reduce administrative costs and expand student bodies without increasing faculty size, thus improving productivity. However, real barriers to productivity improvement remain, such as a history of sterile technology investments and organizational resistance to change. Yet new models and mindsets are essential, and the competitive advantage of cracking the productivity challenge 5 to 10 years ahead of peers could be significant.

Productivity alone is not enough. Higher education institutions need aspirations as big as their endowments. Endowments permit investments that can reposition an institution in a way that fancier student centers or new dorms simply cannot. The right time frame for achieving such a strategic repositioning, funded by increased endowment payout, is 10 to 20 years. For example, if you increased payout from 4.5 percent to 6.5 percent it would take about 20 years for the amount distributed under the 4.5 percent policy to catch up to the 6.5 percent policy (ignoring the effect of new gifts). Over that period, a $1 billion endowment could have provided an additional $220 million for strategic investment. Could this amount of money competitively reposition an institution? What if an exciting initiative inspired donors and differentially positioned a school in the eyes of the most attractive students or faculty? Why isn’t there a Harvard in India or a university-funded, multidisciplinary initiative to reform the teaching of science or math in U.S. schools? In a globalizing economy with new sources of competition, universities need to look for ways to break the paradigm of squeezing a bit more out of the same organization or supporting largely disconnected research initiatives that do not add up to meaningful impact or reputation building.

Rethinking Payout

In rethinking payout rates, universities must develop not only a new formula for releasing funds but also a more strategic mindset that focuses on spending funds for the greatest benefit in an increasingly competitive environment. The issue is admittedly complicated since it involves questions of now versus later, the management of volatility, risk and return, the impact of future gifts, and the use of funds. A number of recommendations may help policy makers as they consider alternatives:

Seek equitable decisions, not guaranteed outcomes. Any payout strategy meant to guarantee real endowment growth has an inherent bias toward the future, with an offsetting strategic and societal cost in the present. For institutions with few current opportunities or with urgent future needs, accumulation may make sense. But for others, a bias toward strategic use today may be more compelling. Assuming no intergenerational bias, trustees should create payout decision rules that reflect equity under uncertainty. For example, are growth and decline in the endowment equally probable? Over what time frame will we evaluate probability and equity? Is the range of uncertainty acceptable? If results are better (or worse) than expectations, how will we modify our payout approach? Good answers to these questions are the cornerstones of a sound payout strate-
gy. Trustee guidance on time frame will shape the risk tolerances and expected returns that underpin a strategically sound payout approach. Given that most institutions have a perpetuity orientation, payout rates should at a minimum approximate the expected long-run investment returns.

**Payout rates should take into account expected gifts.** The second definition of intergenerational equity suggested above, which accepts a certain level of uncertainty and takes future gifts into account, is more appropriate than the definition that most institutions use today. Expectations for future gifts need to appear explicitly in the formula because their omission will result in considerable real asset growth and therefore generational inequity. In the case of the Boston Foundation, the revised formula rests on a simple construct:

\[ S_t = \alpha E + \beta F_t, \]

where \( E \) is the projected real value of the initial endowment and \( F \) represents the deviation of the total endowment from \( E \). \( \alpha \) and \( \beta \) are payout rates selected to produce the target-seeking behavior of initial endowment value preservation. By linking the values—setting \( \alpha \) somewhat below the expected real return and \( \beta \) about twice \( \alpha \)—institutions can establish a reasonable balance between spending and real fund growth uncertainty.

While some have questioned aspects of the formula (see appendix) it has the useful result of producing two-income streams with different attributes. The \( \alpha \) stream is relatively stable, rising with inflation. Basing this stream on the average endowment value over the previous three to five years would increase the stability even further. The \( \alpha \) stream is a natural for funding normal operating costs that are likely to grow steadily over time. The stability simplifies budgeting, an attractive feature for most CFOs. The \( \beta \) stream is inherently more volatile and is a natural for more time-limited commitments, such as capital improvements, forward-funding special programs, and transformational investments. Trustees looking to increase payout without locking the organization into a potentially unsustainable cost base will no doubt find the self-correcting \( \beta \) stream attractive. Moreover, discussion of the strategic rationale for these targeted investments is a powerful way to focus on issues that fall outside business as usual. Figure 5 shows

![Segmenting Endowment Payout Streams](image)

*50/50 debt/equity mix, \( \alpha = 6\% \), \( \beta = 12\% \), initial endowment value = 1,000
how each of these streams would have emerged over the last 25 years for a 50/50 equity/debt portfolio with the $\alpha$ and $\beta$ values of 6 percent and 12 percent, respectively. The specific numbers matter less than the different characteristics of the streams, since future performance will not necessarily reflect historical results.

*Spend with a strategic investor mindset.* Whether you separate endowment streams or not, an institution’s payout debate should focus as much on strategy as on the level of annual disbursements. Challenging the assumption that the operating budget automatically swallows up endowment proceeds has the benefit of forcing a more strategic discussion. Universities and colleges need to reexamine the overly decentralized budgeting processes that encourage incrementalism and protecting fiefdoms. The current student amenities or scholarship arms race does little to enhance reputation and typically increases costs while graduating no more students. In contrast, effective IT investments reduce administrative costs or increase academic capacity. Investing in repositioning the institution through new programs and better faculty can yield access to new student groups and new donors. Enhancing an institution’s reputation benefits not just future students but also alumni, a refreshingly different form of intergenerational transfer. While each institution will have its own set of strategic opportunities, it is our sense that most trustees need to adopt a more aggressive stance in questioning the business-as-usual approach. Not all schools can be good at all things. Strategy implies making choices, and real distinctiveness is the standard that will be used by future students, faculty, and donors.

**Conclusion**

Universities are likely to face ever-greater societal and strategic pressure to challenge overly conservative approaches to endowment payout. Payout discussions need to focus as much on the strategy for using funds as on the amount of annual disbursements. The challenge organizationally is to create a compelling voice for the lost opportunity. Higher payout rates are sustainable and more equitable, but changes to how the funds are used may be as important as changing the payout rate. The need to differentiate institutions will continue to grow. Society will increasingly ask for greater relevance and contributions from those most able to make them. Well-endowed institutions need to have aspirations commensurate with their resources. Higher education institutions simply must make a more compelling case that they are delivering value in return for their tax-protected status or the decision may be taken out of their hands.


Paul Jansen is the director of McKinsey & Company’s global nonprofit practice. Jansen can be reached at paul_jansen@mckinsey.com.