Understanding Endowments: Types and Policies That Govern Them

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What Is an Endowment?

An endowment is a donation of money or property to a nonprofit organization, which uses the resulting investment income for a specific purpose. An endowment can also refer to the total of a nonprofit institution's investable assets, also known as its "principal" or "corpus," which is meant to be used for operations or programs that are consistent with the wishes of the donor(s). Most endowments are designed to keep the principal amount intact while using the investment income for charitable efforts. [1]

- Most endowments are designed to keep the principal amount intact while using the investment income for charitable efforts.
- Endowments tend to be organized as a trust, private foundation, or public charity.
- Educational institutions, cultural institutions, and service-oriented organizations typically administer endowments.

Understanding Endowments

Endowments are typically organized as a trust, private foundation, or public charity. [2] [3] Many endowments are administered by educational institutions, such as colleges and universities. Others are overseen by cultural institutions, such as art museums, libraries, religious organizations, private secondary schools, and service-oriented organizations, such as retirement homes or hospitals. [4]

In some cases, a certain percent of an endowment's assets are allowed to be used each year so the amount withdrawn from the endowment could be a combination of interest income and principal. [5] The ratio of principal to income would change year to year based on prevailing market rates.

Policies of Endowments

Most endowment funds have the following three components, which govern investments, withdrawals, and use of the funds.

Investment Policy

The investment policy lays out which types of investments a manager is permitted to make and dictates how aggressive the manager can be when seeking to meet return targets. Many endowment funds have specific investment policies built into their legal structure so that the pool of money must be managed for the long term. [6]

Endowment funds of larger universities can have hundreds, if not thousands, of smaller funds that invest the pools of money in various securities or asset classes. The funds typically have long-term investment goals, such as a specific rate of return or yield. As a result of the investment goals, the asset allocation (or types of investments within the fund) is designed to meet the long-term returns set forth in the fund's objectives. [6]

Withdrawal Policy

The withdrawal policy establishes the amount the organization or institution is permitted to take out from the fund at each period or installment. The withdrawal policy can be based on the needs of the organization and the amount of money in the fund. However, most endowments have an annual withdrawal limit. For example, an endowment might limit the withdrawals to 5% of the total amount in the fund. The reason the percentage of withdrawal is typically so low is that most university endowments are established to last forever and, therefore, have annual spending limits. [7]

Usage Policy

The usage policy explains the purposes for which the fund can be used and also serves to ensure that all funding is adhering to these purposes and being used appropriately and effectively. Endowments, whether set up by an institution or given as a gift by donors, can have multiple uses. These include ensuring the financial health of specific departments, awarding scholarships or fellowships

Chair positions or endowed professorships can be paid with the revenue from an endowment and free up capital that institutions can use to hire more faculty, reducing professor-to-student ratios. These chair positions are considered prestigious and are reserved for senior faculty. [10]

Endowments can also be established for specific disciplines, departments, or programs within universities. Smith College, for example, has an endowment for its botanical gardens, and Harvard University has more than 14,000 separate endowment funds. [11] [12]

Endowment Types

There are four different types of endowments: [13]

- **Unrestricted Endowment** – This consists of assets that can be spent, saved, invested, and distributed at the discretion of the institution receiving the gift.
- **Term Endowment** – This setup usually stipulates that, only after a period of time or a certain event, can the principal be expended.
- **Quasi Endowment** – This is a donation made by an individual or institution and given with the intent of having that fund serve a specific purpose. The principal is typically retained, while the earnings are expended or distributed per specifications of the donor. These endowments are usually started by the institutions that benefit from them via internal transfers or by using unrestricted endowments already given to the institution. [14]
- **Restricted Endowment** – This has its principal held in perpetuity, while the earnings from the invested assets are expended per the donor's specifications.

Except in a few circumstances, the terms of endowments cannot be violated. If an institution is near bankruptcy or has declared it but still has assets in endowments, a court can issue a cy pres doctrine, allowing the institution to

Important: Drawing down the corpus of the endowment to pay debts or operating expenses is known as "invading" or "endowment fund invasion," and sometimes requires court approval. [16]

Requirements for Endowments

Managers of endowments have to deal with the push and pull of interests to make use of assets to forward their causes or sustainably grow their respective foundation, institution, or university. The goal of any group given the task of managing a university's endowments, for example, is to sustainably grow the funds by reinvestment of the endowment's earnings while also contributing to the operating cost of the institution and its goals.

Management of an endowment is a discipline unto itself. An outline of considerations compiled by a leading management team includes setting objectives, developing a payout policy, building an asset allocation policy, selecting managers, managing risks systematically, cutting costs, and defining responsibilities. [17]

Philanthropies, or, more specifically, private nonoperating foundations, a category that includes the majority of grant-making foundations, are required by federal law to pay out 5% of their investment assets on their endowments every year for charitable purposes in order to keep their tax-exempt status. [18] Private operating foundations must pay substantially all—85% or more—of their investment income. [19] Community foundations have no requirement. [20]

Under the Tax Cuts and Jobs Act of 2017, substantially large university endowments must pay a tax of 1.4% on net investment income. This tax is levied on endowments held by private colleges and universities with at least 500 students and net assets of $500,000 per student. [21]

Endowments and Higher Education

provide colleges and universities with the ability to fund their operating costs with sources other than tuition and ensure a level of stability by using them as a potential rainy-day fund. [13] Older educational institutions, such as the Ivy League schools in the United States, have been particularly successful in building extremely robust endowment funds, having the advantages of continued donations from wealthy graduates and good fund management. [22]

FAST FACT

Marcus Aurelius established the first recorded endowment, circa 176 AD, for the major schools of philosophy in Athens, Greece. [23]

Criticism of Endowments

Harvard and other elite higher educational institutions have come under criticism for the size of their endowments. Critics have questioned the utility of large, multibillion-dollar endowments, likening it to hoarding. [24] Large endowments had been thought of as rainy-day funds for educational institutions, but during the Great Recession, many endowments cut their payouts. A 2014 study published in the American Economic Review looked closely at the incentives behind this behavior and found a trend toward an overemphasis on the health of an endowment rather than the institution as a whole. [25]

It's not unusual for student activists to look with a critical eye at where their colleges and universities invest their endowments. In 1977, Hampshire College divested from South African investments in protest of apartheid, a move that a large number of educational institutions in the United States followed. [26] Advocating for divestment from industries and countries that students find morally compromised is still prevalent among student activists, though the practice is evolving to improve efficacy, according to reporting by The New Yorker. [27]

More recently, three prominent universities with multibillion-dollar education included in the CARES Act, according to reporting by The New York Times. [28] Indeed, Harvard University has now declined emergency COVID-19 relief money from the federal government three times, most recently $25.5 million from President Biden's American Rescue Plan. [29]

Real World Examples of Endowments

The oldest endowments still active today were established by King Henry VIII and his relatives. His grandmother, Countess of Richmond, [30] established endowed chairs in divinity at both Oxford and Cambridge, while Henry VIII established professorships in a variety of disciplines at Oxford and Cambridge. [31] [32]

According to the National Center for Education Statistics article from 2020, the top 10 U.S. universities by endowment size at the end of the fiscal year 2020 were: [22]

1. Harvard University – $41,894,380,000
2. Yale University – $31,201,686,000
3. University of Texas System Office - $30,522,120,000
4. Stanford University – $28,948,111,000
5. Princeton University – $25,944,283,000
6. Massachusetts Institute of Technology (MIT) – $18,381,518,000
7. University of Pennsylvania – $14,877,363,000
8. Texas A&M University – $12,720,530,000
9. University of Notre Dame (IN) – $12,319,422,000
10. University of Michigan—Ann Arbor – $12,308,473,000

Harvard University Endowment

Harvard officials had expected the endowment to shrink in 2020 due to the impact of the pandemic on the economy and financial markets. [33] They were wrong, though, as it returned 7.3% on its investments and actually increased a investments and grew by $11.3 billion to $53.2 billion. [35] This made it the largest amount in the endowment's history. [36] And that is saying something, as, according to The New York Times, Harvard in 2020 was already “the most well-heeled university in the world.” [37] [38]

There are thousands of specific funds within the overall endowment fund for Harvard. The funds' asset allocation was spread out through various types of investments, including: [35]

- Equities: 14%
- Hedge funds: 33%
- Private equity investments: 34%
- Real estate: 5%
- Bonds: 4%

The endowment's annual payout rate is typically capped. Harvard's payout rate was 5.2% in 2021, which totaled $2.0 billion. [39] Distributions provided 35% of total revenue for 2021, and another 10% of revenue came from current gifts of philanthropy. Cash gifts to the endowment totaled $541 million. [38] Approximately 70% of the annual distribution is restricted to specific departments, programs, or other purposes. In other words, the funds need to be spent according to the terms established by the donors. Only 30% of the fund can be used by Harvard for flexible spending. [40]

In 2021, Harvard paid nearly $161 million from the endowment to undergraduates for scholarships. [41] Approximately 55% of the students receive need-based scholarships and pay, on average, $12,700 per year to attend Harvard. Of the students who receive scholarships, 20% pay nothing to attend Harvard College. [42]

From an investment perspective, Harvard's endowment fund has consistently produced strong returns over the long term, although ongoing infusions of

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