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PRACTICAL WISDOM FOR GRANTMAKERS

- 2 Why an endowment?  
Rewards and risks**
- 5 Some definitions and  
basic ideas**
- 12 Where will the money  
come from?**
- 17 Who will govern and  
oversee the fund?**
- 19 How should it be  
invested and managed?**
- 21 How should the  
proceeds be used?**
- 24 Key lessons  
from grant  
makers**

# PROVIDING FOR THE LONG TERM SUPPORTING ENDOWMENTS AND INVESTABLE ASSETS

# providing for the long term

supporting endowments  
and investable assets

## **PAGE 2** **Why an Endowment? Rewards and Risks**

What are endowments for? What can they accomplish? And what issues can be expected to arise along the way? This chapter lists a few of the opportunities and challenges that come with making endowment grants.

## **PAGE 5** **First, Some Definitions and Basic Ideas**

Endowments and other related kinds of grants help to create an investable fund that generates recurring income for a grantee. There are many ways to approach such funds, and several issues to consider before setting off on this course. This section provides a few general concepts to start the discussion.

## **PAGE 7** **Does an Endowment Make Sense?**

Is a particular grantee ready for an endowment? And if so, how can the grant maker help to ensure that an endowment grant has the best possible effect? Here, grant makers offer some guidance on how to recognize the right moment for endowment grants, and how

to explore the challenges in advance with grantees.

## **PAGE 10** **How Big an Endowment?**

It's easy to underestimate the amount of money needed for an effective endowment. This section explores some of the elementary calculations, and shows how different assumptions can yield very different results.

## **PAGE 12** **Where Will the Money Come From?**

Sound planning is one part of creating an effective endowment, but the more obvious part is raising the money. Because of the large amount of capital needed for an endowment, it is wise to consider how an endowment campaign might affect the organization's other fundraising obligations. Here, grant makers offer some experiences and reflections.

## **PAGE 17** **Who Will Govern and Oversee the Fund?**

A grantee's leadership usually needs preparation, professional guidance, and some new structures and procedures in order to manage an endowment responsibly. This section offers some ideas and examples.

# contents

## **PAGE 19** **How Should the Money Be Invested and Managed?**

Professional advice and fund management are essential, but they're no substitute for a careful grantee and attentive grant maker. Here, grant makers share experiences on ways to set appropriate rules for managing the fund, how to select the right financial advisers and fund managers, and generally, how to help grantees get the most benefit from the endowment.

## **PAGE 21** **How Should the Proceeds Be Used?**

Depending on the size and nature of the fund, it can make sense to set limits on how the proceeds will be used, how much will be reinvested, and how (or whether) the rules might be changed down the road. This section suggests some approaches to working through these issues with grantees.

**IN THIS GUIDE** grant makers discuss the opportunities and pitfalls of supporting endowments and other long-term financial assets. When the goal is to help strong organizations make longer-term plans, adjust to fluctuations in revenue, or diversify their sources of funding, endowments can be helpful. But they're far from foolproof. This guide offers some thoughts on how to avoid the most common mistakes and get the most from endowment grant making.

## **SPECIAL FEATURES**

- 8 Ten Readiness Factors: A Preliminary Checklist**
- 16 Some Ways to Think Creatively About Endowment Fundraising**
- 24 Key Lessons From Grant Makers**
- 26 Worksheets: The 'Real' Value of an Endowment**
- 28 Other Ways to Use This Guide**

*This guide was written by Tony Proscio, under the guidance of Barry Gaberman, with assistance from Wendy Malina. It is part of the GrantCraft series.*

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*Publications and videos in this series are not meant to give instructions or prescribe solutions; rather, they are intended to spark ideas, stimulate discussion, and suggest possibilities. Comments about this guide or other GrantCraft materials may be sent to Jan Jaffe, project leader, at [jjaffe@grantcraft.org](mailto:jjaffe@grantcraft.org).*

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## Why an Endowment? Rewards and Risks

**“We knew, early on, that an endowment for one of our stronger grantees was likely to accomplish something really important and timely, both for us and for them. And we were right. But if we had understood how much work [creating the endowment] was going to entail, and how many technical and organizational issues we were going to have to face along the way, we would have prepared for it very differently. And in hindsight, I’d have to say, we would have gotten much more out of the endowment, much sooner, with that kind of information and preparation.”**

— A grant maker reflecting on her first experience with an endowment

**“Launching an endowment campaign when an organization isn’t ready can be really dangerous. That can’t be emphasized enough. You’ve got to weigh the impact of any capital campaign, whether for an endowment or a facility, on the whole organization — on its program, its finances, and its infrastructure. It’s all such a delicate balance.”**

— A grantee speaking from experience about starting an endowment

**Contributing to an endowment**, or to some similar kind of long-term investment fund, can accomplish things that other kinds of support can’t. That’s the good news. But such contributions also place extra demands on both grant maker and grantee, and not all of those demands are obvious or well understood.

The clearest difference between endowment contributions and other kinds of grant making is that endowments are meant to generate income that carries on long after the contributions are made. Thus endowments give a grant maker the opportunity to support years of activity by making one or two early contributions.

That’s their most noticeable benefit. Less noticeable, though, are the extra responsibilities and risks that go with endowment support. These can be managed and limited, and endowments can be a powerful way to pursue long-

### WHERE THE EXAMPLES COME FROM

This guide will discuss issues that many grant makers and grantees consider important to think through before deciding to pursue an endowment. The grant makers commenting on these issues had a variety of experiences — from making a large endowment grant all the way to rejecting the idea of an endowment altogether. And they worked in a variety of fields, with many kinds of grantees. A few examples:

- One grant maker endowed a single position on a grantee’s staff (almost like an endowed chair at a university), to help ensure that this position wouldn’t be jeopardized by fluctuations in fundraising.
- Another gave a research organization a grant that was similar to an endowment, but not permanent. The grant created a time-limited investment fund to pay for important-but-neglected work that wasn’t supported by the grantee’s regular funders.
- Another grant maker helped a community foundation start an endowment and build it over time.
- Yet another made grants that helped a human rights organization analyze and plan for an endowment. In the process, though, the grantee’s leaders learned that an endowment wasn’t really feasible for them, and decided to pursue other ideas.

*‘People tend to immerse themselves in technical stuff, and overlook the very basic questions at the front end: whether it makes sense at all, and if so when, and in what form.’*

term goals – but only if both grantees and grant makers understand and address the associated financial and management issues well before the endowment is created.

This guide offers grant makers’ suggestions and reflections on how to manage such risks and how to get the most from grants that support endowments and other kinds of long-term investment funds. It won’t answer all the detailed questions that will arise along the way. But it should provide a useful outline of the major opportunities and problems you’ll encounter if you decide to set off in this direction.

At that point, for more detailed guidance, you may want to consult ***A Primer for Endowment Grant Makers***, by Barry D. Gaberman with a team of Ford Foundation colleagues, which is available, like this guide, from [www.grantcraft.org](http://www.grantcraft.org). Several sections of this GrantCraft guide were distilled from material in the *Primer*, which provides more detail on virtually every topic discussed here.

### **WHEN IS AN ENDOWMENT CALLED FOR?**

An endowment usually represents a turning point – and frequently a great advance – in an organization’s life: Endowments bestow an **aura of permanence** on an organization, or at least on some aspect of its work. That, in turn, can give potential contributors and collaborators greater confidence in the organization’s long-term value. Leaders of an endowed organization may also feel more confident in **making longer-range plans** for their future. Endowment grants often

**After a brief set of definitions and basic concepts, the remaining sections of this guide will help you answer these questions:**

- Does an endowment make sense for this grantee at this moment?
- How big an endowment will be needed to generate a given level of income?
- Where will the money for the full endowment come from?
- Who will govern and oversee the endowment?
- How will the endowment be invested, and who will manage the investments?
- How should the earnings be used?

No approach to endowments can be risk-free, of course. But understanding and answering these basic questions can raise the odds of success considerably, particularly if the grant maker and the grantee come to a common understanding about the answers. In that case, the risks of a well-planned endowment program need not be prohibitive, and its goals can include things that other forms of support would address imperfectly, if at all.

recognize a major advance in an organization’s growth and development, **drawing attention** to the achievement and helping to ensure that it can be sustained.

Compared to all the financial calculations and management issues that an endowment raises, these may seem like the “easy” issues. Yet it’s worth devoting some critical thought, early in the process, to the rationale and goals of an endowment. As one longtime grant maker pointed out:

“There’s a peculiar thing about this, that people tend to spend most of their time on the least important issues. They tend to immerse themselves in technical stuff and overlook the very basic questions at the front end: whether it makes sense at all, and if so when, and what form makes the most sense.”

## ENDOWMENTS CONVEY A 'SEAL OF APPROVAL'

Launching or supporting an endowment effort represents a highly public endorsement of that organization, over a long term, by any major contributor. It's a decision of enormous importance not only for the grantee, but for the grant maker as well. One grant maker recalls the widespread reaction that the prospect of an endowment grant provoked, both with the grantee and among others in the field where this grant maker was working:

"Big bucks to one grantee sends a message to the whole field. In funding an endowment for one group, we need to think about what the effect will be on other grantees. It is important to think about the entire field before one makes an endowment grant to one organization. Are we indirectly saying that other institutions aren't as important? Or are we going to do the same with other similar grantees in the same field? What principles will we apply for making choices and for determining the size and purpose of grants?"

In general, there are three broad reasons for making an endowment grant or for helping a grantee to create or build an endowment fund.

■ **Financially**, an endowment can give a grantee a **secure funding base** that:

- partially alleviates the need for raising project or core support year by year,
- reduces dependence on specific donors,
- facilitates long-term financial planning, and
- acts as a fundraising mechanism to leverage additional support.

■ **Organizationally**, an endowment can contribute to **long-term stability** that:

- strengthens an institution and its relationship to other players,

- enables greater attention to long-range program objectives, with less worry about year-to-year survival,

- allows for more flexibility in adjusting the program as opportunities change.

■ **For program purposes**, an endowment can be a **message to a whole field** – essentially designating one grantee's methods, or one of its activities, as worthy of permanence (and perhaps by implication, worthy of imitation).

If the endowment is targeted at one aspect of the grantee's program, it can also be a way of **safeguarding the endowed activity** and attracting more support to it from within the grantee's organization.<sup>1</sup> Targeting an endowment to one area of activity can impose extra administrative costs and responsibilities, but it may benefit the program enough to make that worthwhile.

<sup>1</sup>For a detailed example of how this worked in one case, see "Building Financial Strength and Program Quality," a case study developed for Ford Foundation training programs. The case is available at GrantCraft's Web site: [www.grantcraft.org](http://www.grantcraft.org).

## First, Some Definitions and Basic Ideas

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**Endowments and endowment-like actions** typically create or support a **long-term financial asset** of an organization — a fund that is intended not primarily to be spent, but to be invested. The year-to-year benefits from the endowment come primarily, and often exclusively, from the earnings on that investment. If some of the proceeds are invested back into the endowment fund every year, instead of being spent, then the fund will be more likely to keep up with inflation and to weather downturns in the market.

**In this discussion**, we refer to three different kinds of actions by which grant makers usually create or support endowments and other investment funds:

- **Endowment grants** — which provide some (or in rarer cases, all) of the capital for an organization’s permanent investment portfolio. Endowment grants can be made available to a whole organization (a “**general institutional endowment**”), or only to one specific division, activity, or project (a “**special purpose endowment**”).
- **Endowment-like grants** — which provide capital for a long-term asset that isn’t *quite* an endowment, but is very similar. Like endowment grants, these variations provide investable assets, but they aren’t meant to be permanent. Two examples, which we’ll discuss in more detail, are:
  - **Capital-depletion grants**, which provide income over many years, but aren’t permanent. The funds are expected to be spent down gradually over a given period — usually between five and ten years

— until the grant is fully used and there is nothing left from which to earn further returns. (See a five-year-long example on page 28.)

- **Working capital reserves**, a kind of gap-filling or “rainy-day” fund, meant to give a grantee a way of dealing with unexpected dips in revenue or with unanticipated expenses. A reserve fund could be permanent, but only if withdrawals are kept below the amount earned, or if the withdrawn amounts are eventually replaced with new fundraising. Given that the exact use of proceeds from reserve funds usually isn’t known in advance, the life expectancy of the fund often can’t be predicted with precision. (There’s an example of this also on page 28.)
- **Endowment-related grants**, which don’t create a permanent asset at all, but instead help grantees **prepare for, raise, or manage an endowment** — say, by helping them plan the structure and use of an endowment, design a fundraising campaign for it, develop appropriate financial controls and management systems, train the board or staff to oversee the fund, or otherwise build their capacity to handle an endowment effectively and responsibly.

When we refer to **earnings** from an endowment, we are including not only dividend and interest income, but also realized and unrealized capital gains and losses — that is, the total return on the investment, minus the costs of investing and managing the money.

*‘This isn’t the kind of decision you want to make primarily from the gut.’*

HOW THEY DID IT/WHAT THEY DID  
**A MULTI-YEAR GRANT,  
PAID UP-FRONT, CAN  
PROVIDE A ‘PRACTICE  
RUN’**

One grant maker found it helpful to disburse a multi-year grant in a single lump sum, then worked with the grantee on ways to invest the money. Not only did that produce greater earnings, it helped the grantee acquire skills that might later be useful in administering a full-scale endowment.

“When we provide a substantial grant up front, and they’re allowed to invest and earn interest on the grant, it can be a real boost to them in terms of long-term sustainability — for example, developing an employee benefit plan for their staff. Most non-governmental organizations [in a developing country] don’t have any kind of benefit plan. Or in other ways, [the grantee] can do something long-term that builds the institution. The point is that the ability to earn income from the grant while they spend it down is an additional advantage, both financially and organizationally.”

**WHAT DOES IT TAKE TO PURSUE AN  
ENDOWMENT STRATEGY?**

Because endowment grants often hinge on the hope of very long-term results from (usually) a large, up-front investment, they often call for more preparation, analysis, and weighing of alternatives than other kinds of grant making. Many foundations have little experience with endowment support, or in some cases, they have a mixed experience that has left them uneasy with the idea, even when it seems appropriate for some of their grantees. To quote from *A Primer for Endowment Grantmakers*:

“Both grantors and grantees tend to pay insufficient attention to the risks and complexities of pursuing an endowment strategy. An organization may not have matured to the point, organizationally or financially, where an endowment makes sense. And it may not have the capacity to raise endowment funds while concurrently soliciting core and project support. Most importantly, building an endowment carries risks, because, in the end, it may not produce the anticipated revenue.”

The trouble is that the idea of establishing an endowment can seem deceptively simple. Not only do endowment grants require more careful plan-

ning and analysis than some might imagine, but they also offer more options, variations, and alternatives than might be apparent at first. Grant makers looking for ways to create or support a long-term asset for their grantees have many more choices than simply to endow or not to endow. As one veteran put it:

“When I think back on endowments I’ve been involved in, some of the experiences I’ve been most grateful for have been the times when we decided *not* to pursue an endowment. It’s such a big investment, so visible, affecting so many years of work and planning, that if you take it unwisely and run into trouble, you can do much more harm than if you simply hold back and wait a few more years. This isn’t the kind of decision you want to make primarily from the gut.”

Endowment and endowment-like grants may seem ideally suited to foundations seeking to tie off a long period of year-by-year funding to a single grantee, or may appear to be a good way to recognize a major advance in a grantee’s growth and development. And maybe they are — provided that they’re considered with care and thorough preparation. The following sections explain what that sort of preparation will entail.

## Does an Endowment Make Sense?

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### NEED AND READINESS

Too often, it seems, endowments are seen as a panacea, offering a swift, permanent solution to an organization's financial instability or problems. In other cases, endowments are mistaken for an easy way of providing long-term support without continually renewing grants year after year. Yet it is often far from obvious whether an endowment is right for a given grantee at a given moment.

One grant maker framed the question this way: "Does a *permanent need* exist for this organization, and are we now sure enough of that need to provide for it financially?"

**Another grant maker** approaches the question not only by considering need, but also by asking whether the organization is *ready for the obligations* of an endowment:

"Too often, organizations — both grantees and funders — presume the answer to that question is self-evident. Yet consider just the fundraising required for an endowment: A major capital campaign is costly and time-consuming. It requires detailed negotiations between recipients and donors over the [fund's] terms and conditions. It usually demands different skills and expertise, compared to other kinds of fundraising: Among other things, organizations typically have to reach out to a wider circle of donors and prepare to accept new kinds of contributions — donations of securities, for example, or planned bequests. An endowment campaign may also interfere with an organization's regular year-to-year solicitations for project or core operating funds."

Even when an organization succeeds at raising the total amount needed for an effective endowment, it must then assemble a governance structure, financial management systems and procedures, and appropriate management controls to ensure that the endowment is protected and used effectively. Putting all of these elements in place takes time, forethought, and skill.

So another way to pose the first question might be: *Does this organization have a strong enough board, management, staff, and administrative system to handle an endowment?* And if not, *can those requirements be assembled, with appropriate support, before raising funds for an endowment?*

### TWO USEFUL PRELIMINARY STUDIES

To help answer these questions — and generally determine whether an endowment makes sense — one grant maker suggests conducting an **overall management review**:

"This type of review, usually conducted by an outside consultant or firm, develops a clear picture of [an organization's] strengths and weaknesses. For example, you'll probably want to analyze how effectively an organization pursues its programmatic mission, and appraise the depth of its fundraising, investment, and management expertise at the staff and board levels. Getting a professional to do this review, or someone with real experience in this kind of management, can be helpful even if you *don't* end up pursuing an endowment. It can tell you what this organization needs to move to the next level — whether or not that level involves an endowment."

*An analysis by 'someone with real experience in this kind of management can be helpful even if you don't end up pursuing an endowment.'*

## TEN READINESS FACTORS: A PRELIMINARY CHECKLIST

Grant makers have suggested ten key organizational and financial indicators that help in considering whether a given organization might be a good candidate for an endowment — that is, whether the organization can handle the planning, fundraising, and long-term program and financial management that a successful endowment requires. The ten factors are:

- Outstanding performance, including a track record of adapting to changing needs in its field over time
- Strong leadership and experienced management
- A history of at least one successful leadership transition and board succession
- An active and diverse board that truly governs the organization
- Financial stability during several previous years, with income at least equaling expenses
- Fiscal accountability, with annual outside audits
- A diversified base of support
- Evidence of board and staff commitment to pursuing an endowment strategy
- Sufficient staff and other capacities to conduct an endowment campaign, to manage an investment program, and to continue raising core and project support
- The potential to raise matching support from other donors

One grant maker who has worked on many endowment grants summed up this checklist this way:

“These are really the markings of a mature organization that’s ready for a step upward. I read this not just as a checklist for an endowment, but for an *organization*, especially the first seven points. You don’t have to have all of those, but for those that you don’t have, you ought to have a convincing explanation that satisfies the potential funder as to why this or that one can be ignored in considering an endowment in your case.

“It’s the first test, and if the organization meets that challenge, then you can move to the second test, which is really the last three points: OK, you’re a strong, well-run organization, but do you have the wherewithal specifically to manage an endowment? And second, do you have some real assurance that the necessary contributions [to the endowment fund] are going to be there?”

This commentator hastens to point out that for some organizations, even if they can’t meet all of these tests imme-

diately, endowment-related grants can help them build their readiness. And if they aren’t able to meet the final test — if potential contributions aren’t likely to provide enough for an endowment — there are still other alternatives to explore: “It’s not just back to business-as-usual, just annual funding rounds and project grants. There are still some steps you can consider: special-purpose endowments, or endowment-like grants.”

During a seminar on endowment grant making, a specialist in this field remembers hearing from a frustrated participant, who said, “Come on — the only organization that could get an endowment from you is one that doesn’t need it!”

“I said, ‘Well, that’s not true, but it’s a fair point. And there’s a truth lurking behind it: Endowments aren’t a salvage job. If you *need* an endowment in the sense that you’re about to go under without one, then it’s true: You’re the wrong target for this kind of support. If you’re in bad shape, the one way we can really sink you is to throw you into an endowment campaign!’”

*'We saw the research that was done for them, and we raised questions, and each of us had some control, some ownership.'*

A second helpful tool — a companion to the management review, in a sense — is a **feasibility study**. While the management review examines an organization's internal readiness for an endowment, the feasibility study looks both internally and externally. On the outside, it tries to gauge the responsiveness of potential donors to an endowment campaign. (In the process, it can help grantees start to understand the fundraising challenges they will face if they go through with the idea.) Internally, it assesses whether a given financial target will yield enough to warrant the time and resources needed for raising and managing the endowment effectively.

"When we first started negotiating this grant, [the grantee] worked with an external consultant. That wasn't covered by our grant, it was their own independent relationship, part of their process of negotiating. The consultant told them how many years a fund of this size could last and [how much return it would generate]. Then, as part of the activity covered by our preliminary grant, they hired two consultants to help them come up with a financial plan for the eventual endowment: where to put the funds, and how to negotiate the financial

plan with the banks, the best [investment] options in the market, and in which banks and under which conditions the funds should be managed. We saw the research that was done for them, and we raised questions along the way. And the result was that we and they were working off the same level of information, and each of us had some control, some ownership in a sense, over the advice we were getting."

#### **FOR ORGANIZATIONS BASED OUTSIDE THE UNITED STATES**

Grant makers who work internationally also suggest a close look at whether, in a given country, there is likely to be a clear, consistent understanding of the purpose, fundraising process, governance, investment options, and spending policies for an endowment fund. Given variations in market conditions, legal systems, and cultural differences from country to country, even subtle differences of understanding between the grant maker and grantee could become significant over time. Local authorities and advisers should be consulted about any legal, financial, regulatory, and administrative restrictions specific to particular countries that might affect the attractiveness of building an endowment.

#### **AN ENDOWMENT CAN HELP SUSTAIN A GRANTEE, BUT IT'S RARELY THE LAST WORD**

Although an endowment is sometimes meant as a "tie-off" grant, to conclude a funding relationship with a grantee, some grant makers find that it's hard to create a big enough endowment right away to replace the previous funding stream. Also, grantees often need time to learn to manage and use the endowment wisely. As a way of "tying off" a grant relationship, an endowment may be one step in a longer process.

"Nine years ago, when we started with this grantee, we were making very small grants. But by now, every renewal is in the neighborhood of \$300,000. Meanwhile, we've helped them start an endowment, but that isn't big enough to meet all their needs, and we still kind of want to watch their developments and support some of that [work]. So it's hard just giving endowments, and then just saying, 'OK, you can do whatever you want.' They still need lots of money going forward."

## How Big an Endowment?

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**There are no ‘industry standards’ on the minimum size of an endowment.** Yet some grant makers suggest that a fund producing less than 10 percent of an organization’s (or a project’s) operating budget probably wouldn’t be worth the effort involved in raising and managing the money. Still, there are obviously exceptions to any such rule, particularly when the endowment is intended to grow significantly over time – for example, through future capital campaigns or expected bequests.

### **IT CAN TAKE MORE MONEY THAN YOU’D THINK**

It isn’t uncommon to underestimate the size of an endowment needed to generate a specific amount of income. Among other things, some organizations and grant makers pay insufficient attention to the corrosive effects of inflation over the long term. Others may overlook ongoing management expenses. And some forget that investments will sometimes go down in value, as well as up. To provide a given amount of money reliably over time, and to preserve the real value of the endowment, it’s important to create a big enough fund so that some of the yearly income can be reinvested, rather than spent.

It can be surprising to learn how big an endowment must be to generate a substantial amount of spendable earnings. Setting too small a target is an easy mistake to make, but it can be the surest route to failure. Here’s an example:

Assume that an organization decides to build an endowment fund that generates \$1 million in general support. If this organization projects earnings of 7

percent on the fund, it might seem to need an endowment of \$14.3 million ( $.07 \times \$14.3 \text{ million} \approx \$1 \text{ million}$ ).

However, if this organization also wants to ensure that its endowment fund keeps pace with inflation, a portion of the fund’s earnings had to be reinvested in the endowment fund, not spent. If we assume an average inflation rate of 3.5 percent, that means that this organization would really need to raise an endowment valued at \$28.5 million. (In this simple case, only half of the 7 percent earnings would be spent annually, so  $.035 \times \$28.5 \text{ million} \approx \$1 \text{ million}$ ). It becomes a much more daunting task.

To look more closely at how these assumptions would work over time, you might find it helpful to turn to the simplified worksheets on pages 26 and 27 of this guide. (To try out some assumptions of your own, you will also find an online endowment calculator at our Web site: [www.grantcraft.org](http://www.grantcraft.org). There you can see firsthand what happens when you change dollar amounts, spending rules, or assumptions about market conditions.)

*It can be surprising to learn how big an endowment must be to generate a substantial amount of spendable earnings.*

*The principal amount needs to be large enough to weather inflation and market fluctuations.*

## ENDOWMENT-LIKE GRANTS

Many organizations have found that they needed some of the stabilizing elements of an endowment, but they didn't need it to be permanent, or to generate a fixed level of support every year. Like the grant maker we quoted earlier ("the grantee came to us for an endowment, ... but it wasn't clear they could raise enough money just yet"), some may find it useful to create more limited investable assets, like **capital-depletion grants**, or **working-capital reserve funds**.

"I like capital depletion funds. The management of the money is much clearer. You start with a given amount of principal and estimated earnings, and you draw down from that. The grantee manages the fund; they are then less reliant on the [grant maker] for disbursements. But you [the grant maker] still know just how much they draw down, and when. At the end, they have had an experience managing interest as well, which can be drawn down year-by-year or used as reserves to tide them beyond the end of the grant. This results in a good learning process, where the grantee manages the funds, and the [grant maker] helps to set the parameters. It may be a good exercise prior to a full endowment."

Among the worksheets at the end of this guide, you'll find two (see page 28) that walk you through examples of endowment-like funds.

In general, what distinguishes "endowment-like" grants from ordinary endowments is:

■ **They're usually time-limited, rather than permanent** — though they still last longer than a typical project grant of one-to-three years' duration.

■ **They provide for expenditure of principal** under certain conditions.

Still, just as with regular endowments, the amount of the fund must be large enough to allow for some reinvestment of the proceeds. Or, if the asset is meant to be spent down and proceeds aren't to be reinvested, then the principal amount needs to be large enough to weather inflation and market fluctuations. The goal, as with endowments, is to make sure the fund doesn't lose its value before the intended purposes are accomplished.

The advantages of the capital-depletion approach can be considerable — beginning with the fact that it generates a great deal of income for much less money than would be required for a perpetual endowment. Consider the hypothetical calculation on page 10, where it took \$28.5 million in endowment capital to generate \$1 million per year in perpetuity. It's possible to get the same benefit every year with less than one-third the amount of capital — a little over \$8 million — by spending a bit of the principal, as well as all the earnings. The disadvantage, of course, is that the fund and all its revenue will expire in roughly ten years. Still, for some grant purposes, that might be a sufficiently long period to ensure that important goals are achieved.

## HOW THEY DID IT/WHAT THEY DID AN ENDOWMENT-LIKE GRANT VS. A REGULAR ENDOWMENT

One grant maker considered several endowment options before choosing to make a working-capital reserve grant. The grantee needed a source of stable income and wanted an endowment, but a close look at reality led to another choice. The grant maker describes the decision-making process this way:

"Here was an organization [the grantee] that could really be doing more and taking more of a leadership role. And yet they were being held back — or at least they *felt* held back — by uncertainties over future grants. They needed to attract really top-quality professionals for the next phase [of their work], but they felt they couldn't make a long-term commitment to people like that, given how variable their budget was.

"They came to us for an endowment, and eventually they probably need one. But when we gave them a small grant to study the fundraising potential [for an endowment], it wasn't clear they could raise enough money just yet. Gradually, as we looked at the options with some really good advisers, we designed this "reserve fund." And along the way, they learned volumes about what might be possible down the road — and so did I."

## Where Will the Money Come From?

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*It's important to have a clear idea, up-front, about the grantee's fundraising plans.*

Besides the amount of money needed for an endowment, the other factor that grantees and grant makers sometimes underestimate is the challenge of **raising capital** for a sizable fund. Fundraising for an endowment is, of course, the grantee's responsibility. But grant makers also have a stake in the success of the fundraising campaign, since an endowment grant is only as effective as the endowment it ultimately supports. So it's important for grant makers to have a clear idea, up-front, about the quality of a grantee's fundraising plans for an endowment, the odds of success, and the kinds of special help the grantee may need, if any, to bring the campaign to completion.

**Among other things**, building an endowment can easily get in the way of other fundraising — say, for projects or for core support — that is just as important, or maybe more important, to the organization's continued health and success at that moment. It can be essential, both for the success of the endowment and for the grantee's overall well-being, that the endowment campaign not drain off sources of other contributions.

In one instance, a grant maker recalls, a grantee received a generous contribution to a capital campaign from a donor who always gave regularly to the organization's annual fund drive.

"But the following year, that same donor declined to continue their annual contribution — on the grounds that they had supported the endowment. Suddenly, the grantee found

itself minus one major donor — and the earnings from the new endowment would barely be enough to replace the lost contributions! So [the grantee organization] was actually *worse off* than if it had left this donor out of its endowment campaign."

Of course, in the very rare case where one grant maker is willing to create an endowment single-handedly, these issues would not arise. But in the great majority of cases, the initial grant maker provides at most a starter (commonly known as a "lead gift") or a challenge grant, which must then be supplemented from other sources before the endowment can be "activated" — that is, before the grantee can begin using the proceeds. In most cases, that gift will be effective only if the endowment lives up to expectations. The grant maker thus has a keen interest in knowing whether the grantee is prepared for the fundraising challenges ahead.

### **INITIAL PLANNING FOR AN ENDOWMENT CAMPAIGN**

It is not unusual for grant makers to precede the initial endowment grant with endowment-related support — for example, to conduct the preliminary studies described on page 7.

Another use for endowment-related grants might be to hire a **fundraising consultant** to plan out the scope of an endowment's fundraising effort and the kinds of resources, staff, and leadership it will need. The initial fundraising inquiries should normally cast as wide a net as possible for potential donors, including:

*An organization may have to reach out beyond the circle of funders who are already familiar to them.*

■ **Likely ‘inside’ contributors.** Before soliciting outside funds, an organization should begin by examining its internal sources. Donors often ask if an organization’s board members or volunteers have contributed to the endowment drive. These “lead gifts” from insiders are far more meaningful than the actual amount of funds they provide, because they demonstrate a strong and personal commitment to the work of the organization by the people who know it best.

■ **The universe of other major contributors.** While more donors are expanding their endowment grant making, many others still have not made such grants, and will consider providing only core or project support. As a result, organizations that want to build an endowment may have to reach out beyond the circle of funders who are already familiar to them. It is usually worthwhile to explore all three general categories of donors: **public**, such as government, bilateral, and multilateral agencies, **private**, including individuals and foundations; and **corporate** donors.

■ **Donors with special needs or interests.** In reaching out across the wide spectrum of potential donors, organizations need to anticipate donors’ special requests. One example: If a donor wants its contribution to be permanently identifiable – for instance, a separately “named” fund, like an endowed chair or scholarship – then it is probably wise to have a policy in advance that sets a minimum level for such special conditions. Separate funds and other

special conditions imposed by donors can increase the cost of managing an endowment and can limit an organization’s flexibility in using the proceeds.

■ **The effect of a challenge grant.**

A grant maker who wants to help an organization create or enlarge an endowment may set up the initial contribution as a challenge to the grantee to match the contribution at a specified ratio – which may be dollar-for-dollar, or more, or less. An organization building an endowment may welcome this kind of challenge – which can be useful in mobilizing other contributors to meet the matching requirement. But this device compels an organization to set specific goals and deadlines, and it carries explicit monitoring and reporting requirements. Questions that need to be answered include:

- What matching ratio (e.g., one-to-one, two-to-one) will be selected?
- What contributions will count toward the matching requirement?
- How will the funds be released (in a lump sum up front, or periodic payments as matching funds are received, or only when all conditions are met)?
- What will be the time frame for meeting the matching requirements?
- What will happen if the grant funds are not fully matched?
- How long will reports be required?

## **SOMETIMES, BETTER FUNDRAISING IS THE REAL SOLUTION**

Providing an endowment is one way to help a grantee raise its annual income – but it’s a costly and complicated way of reaching that goal. For some organizations, the most direct way to increase income is to find more contributors for regular fundraising, and tap sources of donations that may have been neglected. Before shouldering the heavy burden of an endowment, many grant makers encourage a close look at expanding the current contributor base.

Keep in mind that, unless an endowment is very large, the annual earnings might well be in an amount that could realistically come from more deliberate annual fundraising.

“One organization actually *turned down* an endowment, and chose instead to use our funds to grow its base of individual contributions. In some cases, where an organization hasn’t yet made the most of its natural constituency, launching a direct-mail effort to augment the individual donor base may be the way to go instead of endowment fundraising.”

*When a full endowment campaign isn't realistic, there are other options worth considering.*

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#### **OTHER SERVICES OF A FUNDRAISING CONSULTANT**

Beyond identifying potential donors, an organization will often want a consultant's help with these other basic elements of an endowment campaign:

- **A case statement** – an overall description of the campaign, a compelling statement about the permanent need for this organization or project, and an explanation of how the organization plans to meet its campaign goal and govern and invest the resulting endowment.
- **Campaign strategies for different types of donors**, including ways of approaching and cultivating different donor categories, and the special obligations that may be attached to particular sources of support.
- **Target contribution levels** from these different categories of donors.
- **Written proposals** tailored to each of these donor types and levels of contribution.
- **Opportunities for donor recognition** – for example, displays of major contributors' names on a wall, or opportunities to name some aspect of the program after a significant donor.
- **Who-does-what** – staffing and management responsibilities for various elements of the campaign.
- **Timetables and milestones** of achievement, with interim fundraising targets.

#### **OTHER POSSIBLE APPROACHES TO ENDOWMENT FUNDRAISING**

Much of the discussion thus far has been based on the assumption that the organization will pursue an

*organized capital campaign*, with a defined beginning and end, and with a plan for raising the full endowment amount within that time span.

Sometimes, the demands of a capital campaign are more than an organization can undertake at the moment, and yet the goal of an endowment is still judged to be realistic and worthwhile. In that case three other approaches are worth considering:

- **Gradual accumulation.** It is possible to build an endowment over time by gradually raising money from individual supporters and a close circle of contacts. An initial challenge by a lead grant maker may get the endowment fund started, or may serve as a challenge to other contributors, but the endowment would not be fully funded and "activated" until a given amount of total contributions has been reached. This approach can be slow, but it is inexpensive, does not require the preparation of extensive campaign materials, and consumes only limited energies from staff and volunteers. One risk of this approach is the possibility of "drift" – meaning that participants might gradually lose focus and energy, and never reach the funding target. Another risk is that, until the target is reached and the endowment activated, the grant maker's initial grant and other contributions are sitting idle, producing no benefit for anyone.

"When the foundation works with a grantee to help raise endowment funds, we need to think about where that organization is in terms of its fundraising maturity. You need to think through where it plans to raise the money. Are they seeking to

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raise money from their regular donor groups? Are those regular donors ready to dig deeper into their pockets? Are they ready to make asset-related donations as well as giving operating support? Or is it going to be a trade-off – where they give money for the endowment, but then *stop* giving their regular contributions? If these expected contributions don't turn out as planned, or come in very slowly, the endowment grant will be locked away and can't be used."

■ **Working with a community**

**foundation.** Community foundations can pool funds from many donors into an endowment account, which the foundation then manages on behalf of the organization the donors wish to support. Organizations that are the ultimate beneficiaries of this arrangement receive distributions from the community foundation, and thus don't have to develop all the financial and investment capacities normally associated with long-term management of an endowment. They may even realize better returns at lower costs. This arrangement minimizes the risk that the beneficiary organization might someday invade the principal balance of the endowment, thus jeopardizing its long-term stability. It also ensures that whatever happens in the future – even the demise of the organization for which the endowment fund was created – the capital and earnings can be redirected to match the donors' original intentions.

This arrangement may not appeal to some organizations interested in endowments or long-term investment funds, since it means that they would have much less control over the management of the funds. Legally, funds held by a community foundation are the property of that foundation, not of the organization(s) designated to benefit from the earnings.

■ **Building an endowment in stages.**

For organizations that plan to assemble a large endowment, it may be feasible to build and activate a smaller fund first, then increase it in phases thereafter. The difference between this and the gradual-accumulation approach is that each stage can be treated as a separate campaign –with a declaration of success and a pause for regrouping after each stage. Meanwhile, by meeting a modest goal at an early stage, an organization can demonstrate its effectiveness in soliciting endowment support and its prudence in establishing the necessary mechanisms and guidelines for managing the fund wisely. An organization with a successful track record in the first stage or two is then better positioned to solicit funds later from other donors. This option is less practical, however, if the overall endowment goal is too modest to break into smaller stages.

## SOME WAYS TO THINK CREATIVELY ABOUT ENDOWMENT FUNDRAISING

Grant makers who have had success with endowments suggest these four additional points for making the most of the fundraising effort:

- **Think locally.** Many organizations too easily conclude that their local communities or constituencies have insufficient resources. That's unfortunate, because these donations, even if modest, are far more important than the amount of funds received. They establish an organization's credibility and legitimacy – its value to the people it serves – and can have a powerful effect on potential contributors.
- **Reach globally.** People may move across local and national boundaries and yet maintain a keen interest in the communities and countries they have left. Even people who have never lived in a given community may have emotional, cultural, or family ties to those who do live there. In these situations, "diaspora" fundraising may be surprisingly productive.
- **Get personal.** Follow-up is essential, because soliciting larger contributions always requires several meetings and conversations. It's worth getting to know potential donors, their interests, and the particular things they might value about a given organization. Donors considering a large grant for an endowment often want to get to know the organization, its leaders, and its personality in a more intimate way than other kinds of donors might – to become part of the family, in a sense. Some donors are more receptive to an approach by one of their peers – particularly if that person knows the grantee exceptionally well.
- **The best fundraisers may not be professionals.** Volunteers, beneficiaries, and board members can be very effective in the fundraising process, even if they have no special connection to potential donors. Sometimes, *what* you know really is more important than *who* you know. Some volunteers, for example, are people who have a compelling personal story to tell about the value of the organization and the potential importance of the endowment. The most effective appeal may come from an institution's fellowship recipients, graduates, or mentoring participants. Some of its regular donors may be willing to tell others why they believe this organization is a worthwhile grantee.

## Who Will Govern and Oversee the Fund?

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**The most straightforward answer** to the question “who should govern the endowment?” is unquestionably *the organization’s board*. This answer may seem obvious, even simplistic, but in fact governance is one of the most critical issues in considering endowment support for any institution.

### **THERE IS NO SUBSTITUTE FOR BOARD LEADERSHIP**

Sometimes, organizations and their boards tend to think of endowments as a matter of arcane high finance, best left to the Wall Street experts. Board members, if they are not financial professionals, may even be tempted to think that their role is limited to spending the proceeds. This is not a mistake made only by small charities and community-based groups — a few large institutions and municipalities have landed in financial crises precisely because they exercised too little stewardship over their own investable resources.

So it’s worth restating: *Responsibility for an endowment rests with an institution’s governing body*, normally the board of directors or trustees. A board decides the investment program’s goals and the means for achieving its objectives within the terms and conditions set by donors. It also assesses the organization’s internal capacity for implementing and monitoring investments, evaluates its risk tolerance, and decides the appropriate mix of fund assets. Experts can (and should) advise on all these matters, but only the board has the authority, the duty, and the means to carry them out according to the grantee’s best interests.

### **PREPARING THE BOARD**

If the governing body does not have members who feel confident about overseeing investable assets, then it may well need to recruit some members with skills in that area, and also consider training for current members. Several grant makers argue that one effective use of an endowment-related grant is to support board development — training, facilitated discussion, expert presentations, and perhaps new-member recruitment — for organizations considering an endowment campaign. Said one:

“There are aspects of an endowment campaign that specifically highlight the support and leadership coming from the board. In that process, some individual board members’ engagement with [the organization] — in their personal contributions and in their outreach to other potential contributors, and in their understanding of their own leadership responsibilities — all of that really comes to the fore. That’s when you start to see where the board-development work needs to be done. But once the [endowment campaign] is under way, you don’t have a lot of time to prepare people [for their responsibilities]. So that’s something to think about, and maybe to invest in, ahead of time as much as possible.”

### **WRITTEN RULES**

Grant makers and endowed institutions both agree that any board preparing to oversee an endowment should start by drawing up written investment policies and guidelines. These tools outline the organization’s plans for achieving its goals. They also make certain that the board remains informed and accountable, and help avoid misunderstandings

*Responsibility for an endowment rests with an institution’s governing body.*

*‘Our discussion became very careful on the nitty-gritty of what the endowment was for, and how it would be handled.’*

with staff, constituents, donors, and outside service providers.

“As soon as we started talking about an endowment, our discussion became very careful on the nitty-gritty of what the endowment was for, and how it would be handled. We then pushed [the grantee] to develop an endowment investment strategy plan. How are you going to invest your principal? Who will monitor your investment? What sort of a committee are you going to set up? What sorts of expertise will there be on the committee that manages the investment? Have you looked at all the rules and regulations under which investment is possible? And so on.”

The contents and use of written guidelines are discussed more thoroughly in ***A Primer for Endowment Grant Makers***, which would make useful reading for anyone involved in preparing a board for an endowment program. The *Primer* also describes how boards can prepare themselves for expanded responsibilities, organize investment and management committees, recruit members with needed expertise, and seek the right kind of outside professional advice when needed.

#### **SAFEGUARDING PRINCIPAL**

Among the chief purposes of the written plan is to set rules and procedures for preventing inappropriate “invasions” of the endowment. Invasions typically occur when an organization withdraws some of the endowment’s principal or borrows against the fund. Another kind of invasion can be the result of no ill intent, but simply inadequate forethought: An endowment’s principal value can be “invaded,” in

effect, by failing to provide for the likelihood of market losses or the corrosive effects of inflation. If nothing is done to replace the value of the endowment that is lost to inflation, the real value will decline year by year, just as surely as if someone were making withdrawals. A board’s written investment policies and guidelines therefore should make provisions for future risks like inflation and market downturns, as well as ensuring the proper handling of current assets.

#### **ORGANIZING COMMITTEES AND GETTING OUTSIDE HELP**

Before considering an endowment grant, many grant makers look for a committee of board members — with the right mix of technical expertise and overall leadership — who can oversee the fund at close range. If such a committee doesn’t yet exist, the grant maker usually encourages the grantee to create one well before it receives any investable funds. Some organizations establish a separate corporation with its own board to receive and manage endowment grants.

Even on a board with several expert members, it will be hard to attend to all aspects of managing an endowment without some professional advice. An asset management consulting firm can develop an asset allocation plan consistent with the organization’s goals, assess and recommend potential fund managers, measure and evaluate a fund’s performance, and offer advice about terminating a poorly performing manager. The *Primer* offers specific guidance on how boards can find, select, and work with consultants and investment managers for best effect.

# How Should the Money be Invested and Managed?

For an endowment to serve its long-term purpose, it needs to yield a **predictable level of earnings**. But as with any investment, there is always some risk that the investment won't earn as much as is needed, or may actually lose money. In weak economic times, nearly all investments can expect disappointing results. Even in periods of general economic strength, a given mix of investments may still perform poorly. Therefore, how funds are invested can have a profound effect on the effectiveness of an endowment or endowment-like grant.

For that reason, when considering such grants, grant makers typically consult closely with grantees on the **ground rules for investing and managing the funds**. The grantee's board will have independent responsibility for most investment decisions that are not spelled out as part of the grant agreement. So if grant makers wish to set restrictions on these decisions, or if they want to be consulted along the way, they might do well to make those intentions known early in the process, and to discuss the implications thoroughly with the grantee.

An excellent source of detailed guidance on these issues is *Investment Management for Endowed Institutions*, by Laurence B. Siegel. It's available, like the *Primer*, on our Web site: [www.grantcraft.org](http://www.grantcraft.org).

## BASIC, OVERALL PRINCIPLES

Investment risks can be managed to some degree, especially when a fund is to remain invested for many years. But preserving an endowment and earning reliable returns takes thorough planning, a prudent mix of investments,

and expert management of the fund. For these services, **professional managers are essential**.

This brief guide obviously can't offer a complete course in investing. Those who have reached this stage of deliberation in their thinking about endowments would benefit from a careful reading of the *Primer* and *Investment Management*. Here, we raise some basic issues commonly mentioned by grant makers who have used endowments successfully. Most of all, a grantee expecting to receive an endowment or an endowment-like grant should be prepared, with expert guidance, to invest the funds according to four main principles:

- **Balance the need for safety and growth.**
- **Monitor the performance** of investments carefully and consistently.
- **Adjust the investment plan** in response to performance results, changing market conditions, and changing institutional needs.

## INITIAL DECISIONS

Among the first things the endowment grantee will need to decide – in consultation with the grant maker and, most importantly, with help from an expert adviser – are these:

- **Spending policy.** The size of the endowment or endowment-like grant will have been based on a calculation of how much a given amount of capital is likely to earn in a typical year. (See the simplified calculation on page 26.) The grant maker and grantee will also need to agree on when the endowment is "activated" – that is,

*Even in periods of general economic strength, a given mix of investments may still perform poorly.*

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the point at which the grantee will have access to the earnings. Before that time, based on the assumed level of earnings, the organization and the grant maker will together need to reach clear understandings on what percentage of those earnings can be spent for the purposes of the grant, what percentage should be reinvested in the endowment fund, and what changes can be made in those percentages if circumstances change — for instance, if the organization receives substantially more contributions to its endowment, or if a given year brings an unusually high or low return on investment. Such questions should be addressed explicitly, in advance, and the process for arriving at answers should be part of a written policy.

The next section will have more to say about how proceeds from an endowment can be used. But the main point is that these understandings should be the result of painstakingly clear and detailed negotiations up front — a process that, as one grant maker illustrates, can be slow and sometimes daunting:

“At every stage it was very complicated. There were two contrasting forces within the [grantee’s] board, with different ideas about how they wanted to proceed. One wanted to be more aggressive about spending [the earnings from the endowment] to build the program, the other was

more conservative and wanted to keep a tight rein to be sure they didn’t lose value. So every step was discussed, and kind of negotiated — and at every step, nothing went simply, nothing was automatic. Everything was negotiations and debates.”

■ **Asset allocation and time horizon.**

In establishing its investment plan and policies, the endowed organization should consult its advisers and decide on the percentages of the endowment funds (within reasonable ranges) that will be invested in the main classes of assets — most commonly stocks, bonds, and cash. These percentages may vary according to the purpose for which the funds are invested, the level of risk that the organization can prudently tolerate, and, if the fund isn’t meant to be permanent (as in an “endowment-like grant”) the amount of time that the asset is intended to last.

The mix of assets in an investment portfolio will depend partly on when the proceeds are to be spent. In very general terms, an organization that will need to spend its earnings very soon will need a safer, more conservative portfolio than one whose investments can sit undisturbed through a few years, thus bridging prosperous and lean years. All these decisions should, of course, be analyzed by expert financial planners.

## How Should the Proceeds Be Used?

### A SOUND SPENDING POLICY IS CRUCIAL

A spending policy spells out the amount or percentage of investment earnings (including not only dividends and interest, but also realized and unrealized capital gains and losses) that an organization may spend each year, and any adjustments it may make in those percentages. To set an appropriate spending policy, an endowed institution must balance two competing goals:

- **preservation of capital** – the need to preserve the real value of the endowment’s assets, adjusted for inflation; and
- **adequacy of income** – the ability to produce enough annual proceeds to meet a given amount of the grantee’s project or core operating costs.

Meeting both objectives is essential if the endowment is to be an enduring mechanism for long-term financial planning, organizational stability, and programmatic independence. If an endowed institution sets its spending at a level that exceeds the return on its portfolio, it will effectively erode its asset base over time by spending down its endowment. An endowed institution can also jeopardize the real value of its fund by failing to account for inflation or to anticipate the impact of fluctuating market conditions.

“We wanted the grantee to understand and plan that this endowment is meant to be *in perpetuity*, so it was incumbent on them to think about preserving the value of the endowment. Unfortunately, we learned this the hard way – from the way we had approached a previous

endowment grant. [On the earlier endowment], we didn’t establish a spending policy up-front, and when we saw the value of the fund starting to erode, we had to come back and hammer out a policy later.”

Even if the fund isn’t meant as a permanent endowment, it will nonetheless be based on some set of reasonable assumptions about how much spending the asset can support each year until it is fully used. Exceeding those levels of annual expenditure, or sustaining too great a loss due to inflation or market shifts could well mean that the purposes of the grant won’t be fully achieved.

### HOW SPENDING, PRESERVATION, AND GROWTH INTERACT

When the aim of an endowment is to generate a permanent (or very long-term) flow of usable, expendable income, an endowed institution must set a spending policy that accommodates both asset preservation and portfolio growth. An endowment fund can generate a consistent amount of real income and provide for inflation, but only by making a prudent plan for weathering variations in earnings year-by-year. (For a concrete illustration, see the first three worksheets at the end of this guide.)

### ‘PAY-OUT’ OBLIGATIONS AND OTHER LEGAL CONSIDERATIONS

The spending policies of certain endowed institutions in the United States may be affected by government regulations and mandates. For example, the U.S. Internal Revenue Code requires “private foundations” – a technical designation for certain kinds of tax-exempt organizations – to disburse 5 percent of the market value of their investment

### ENDOWMENTS CAN BE FOR GENERAL PURPOSES, OR AIMED AT VERY SPECIFIC TARGETS

An endowment or endowment-like grant can be a way of helping an organization start a new, experimental area of activity, or to help it persevere in an important area of work despite lapses in funding for such activities. Targeting an endowment to one area of activity **can impose** extra administrative costs and responsibilities on the grantee, but it may benefit the program enough to make that worthwhile.

“You can endow a position or a forum, for example. This is especially effective when you want to help an organization bring focus to a piece of its work and/or start something new. For example, we endowed a forum where leaders from several countries could come together regularly. In endowing just the forum, there was less risk inherent in the fund, and it was directed to a clear purpose. In another case, we directed an endowment for use in programs related to certain disadvantaged populations. This helped keep a group focused on an important issue without tying their hands.”

*Most institutions limit their spending to around 5 percent of the amount of the endowment.*

assets every year, in what are termed “qualified distributions.” These are usually disbursements for grants, the direct conduct of charitable activities, program-related investments, and certain administrative expenses. This payout requirement does not apply to publicly-supported charities. (An organization’s official notice of tax exemption will specify whether it’s considered a private foundation or a

publicly supported charity.) Organizations based outside the United States have to comply with other rules and regulations imposed by the countries where they are headquartered. These can vary considerably — anywhere from a complete absence of any regulations all the way to stringent requirements governing the details of a fund’s governance and investment.

### **SETTING SPENDING LIMITS: A CAUTIONARY TALE**

One grant maker recalls working on a special-purpose endowment grant, where the grantee was one part of a much larger institution. The parent institution, the grant maker pointed out, “is extremely well established and experienced. In fact, their overall endowment is bigger and older than ours is.” Still, the funder had good reasons to help create and contribute to a separate, smaller endowment fund for one of the institution’s programs.

“Keep in mind, the spending policy on this institution’s main endowment allows it to draw out 4 percent [of the principal] a year. Now, I might argue that that’s somewhat conservative. But the part of the organization that was applying to us for an endowment wanted us to assume [spendable earnings of] 8 percent! I said, ‘No way, the economics of the thing simply can’t support it.’ We went back & forth, and they fought me down to 6 percent.

“Of course, within a few months of the grant, they were back knocking at our door, saying that they could no longer do what they thought could be done with the endowment. And we’d have to amend the purpose of the grant. Because of a dismal earnings picture that year, they wouldn’t be able to sustain 6 percent for a very long time, if ever. It is human nature, even among the most sophisticated and mature of organizations, to be too optimistic about what their earnings potential is, because they are so committed to supporting so many activities.”

Of course, excessive optimism about the performance of an investment fund isn’t limited to grantees or grant makers.

“That’s why basing your projections on long-term historical information is so useful, because it introduces some cold reality into people’s optimism. In 1998 and ‘99, there were all these people in the market saying that the underlying assumptions [about stock performance] were all wrong, that in the new market and the new reality of the Information Age, you’re talking about sustained growth rates way in excess of anything typical in the past. Well, then 2000 came along, and guess what? They were all wrong.”

### **HOW MUCH SPENDING IS TYPICAL?**

The spending policies of endowed institutions in the United States, including universities and other nonprofit organizations that are not subject to the 5 percent spending rule, generally fall within the range of 4.5 to 5.5 percent of the principal amount of their endowment. Considerable financial analysis and historical research show that these modest rates of spending help endowed institutions to:

- avoid excessive risk or volatility with their investments,
- weather declines in the value of their invested assets,
- develop portfolios with an asset mix balanced for safety and growth,
- realize sufficient returns for their core and project costs, and
- reinvest a sensible amount of their earnings as a hedge against inflation.

### **RULES GRANT MAKERS MIGHT SET**

If an endowment is intended to be permanent or very long-lasting, many grant makers try to guide their grantees by prohibiting them from using or borrowing against principal. These restrictions may be imposed in perpetuity or applied during the first

*An endowment-related grant to hire expert advisers can help grantees think through the questions that lie ahead.*

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years after an endowment grant is made or “activated” – say, when required matching funds are raised. Some donors also prohibit grantees from spending any proceeds during a specific period, thereby compelling them to build their endowments by reinvesting all earnings in the fund in the short-term.

**GET ADVICE – EARLY**

Spending levels are an issue that many grant makers believe should be addressed at the outset, during the earliest discussions about the amount of the grant and the size of the eventual endowment.

To help applicants engage in such discussions, many grant makers encourage them to seek advice from accounting professionals early in the

negotiations. For that reason, some grant makers suggest starting applicants off with an endowment-related grant to hire expert advisers, so they are fully aware of the responsibilities and choices that await them if they pursue an endowment.

Meanwhile, grant makers and applicants alike can benefit from meeting with staff of other endowed institutions that have successfully maintained and built endowments. This can be an opportunity not only to learn more about the administrative and financial issues an endowment inevitably raises, but the effect the endowment has had on the institution’s program, its relationship to funders, and its internal management.

## Key Lessons from Grant Makers

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- **An endowment makes sense for a select range of grantees:** organizations whose work has risen to a stage where it deserves some permanence and stability, and institutions with histories of outstanding performance and skilled management, strong leadership, a diversified base of financial support, an active and diverse board, and the commitment and ability to manage and invest an endowment fund. The benefits of a well-managed endowment – or other long-term “endowment-like” funds – are considerable. But the demands they place on an organization’s leadership and management are also great. Another factor to consider carefully in advance: An endowment or endowment-like grant conveys an especially public “seal of approval” from the grant maker, and thus may call for particular confidence in the enduring quality of the grantee’s program.
- **The right size for an endowment is easy to underestimate.** The principal amount needs to be great enough not just to generate the amount of earnings that the grantee wishes to spend on year-to-year operations, but also to yield enough reinvestable money to preserve the value of the fund. Otherwise, the endowment’s value is likely to be lost to inflation, market fluctuations, or other erosions over time.
- **A single grant maker rarely provides the full amount of an endowment or endowment-like fund.** Grant makers more often begin with *endowment-related* grants to help grantees plan, organize, and solicit endowment contributions. They may then make an endowment grant, sometimes with a matching requirement or other provisions to help grantees raise the amount needed. The fundraising challenge can be formidable, and often requires the grantee to reach out to completely new categories of potential contributors. Besides all the financial and management advice that a grantee is likely to need when getting started with an endowment, professional fundraising counsel can be essential as well – especially if the endowment is to be amassed in a single large capital campaign.
- **Governance and oversight of an endowment is the responsibility of a grantee’s board,** in consultation with expert advisers. Before going very far with endowment discussions, grant makers often want to be sure that the board understands and embraces this responsibility, and that it has some knowledgeable members or can readily recruit some. Since many grant makers wish to place some restrictions on how endowment grants may be managed and used, they may want to make sure that the board understands and accepts these conditions early in the process.
- **Endowment funds should be managed and invested within strict written guidelines, and probably conservatively,** since they are usually intended to generate stable returns over many years. Choosing the right mix of investments, selecting the best managers, and determining how investment policy should be adjusted over time – all of

*Deciding on investments, managers, and investment policies calls for independent expert advice.*

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these are complex, technical exercises on which both the grantee and the grant maker will want to get independent expert advice.

■ **Rules for how the earnings can be spent should be negotiated carefully between the grant maker and the grantee**, according to the intended purpose of the fund, the length of time it is meant to last, and any foreseeable changes in the grantee's circumstances or needs during that time. On average, endowed organizations spend

between 4.5 percent and 5.5 percent of the fund's asset value each year, but the spending target for any given endowment grant should be based on clear assumptions that are grounded in the fund's specific purposes and circumstances, with particular attention to preserving its real value. As in all other areas, grant makers strongly recommend getting professional advice early in the process, to ensure that expectations are realistic and that the grant agreement adequately addresses all foreseeable issues.

# Worksheets

## A VERY BASIC ENDOWMENT FUND The First Five Years

YEAR	1	2	3	4	5
Principal Balance of the Endowment	\$1,000,000	1,030,000	1,060,900	1,092,727	1,125,509
Real Value After Inflation @ 3.0%	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
<b>EARNINGS</b>					
Average Earning, assumed @ 7.0%	70,000	72,100	74,263	76,491	78,786
<b>USES OF FUNDS</b>					
Earnings to be Reinvested @ 3.0%	30,000	30,900	31,827	32,782	33,765
Earnings Available to be Spent	40,000	41,200	42,436	43,709	45,020
Real Value of Spendable Earnings	40,000	40,000	40,000	40,000	40,000

We're assuming 3% inflation. Some years have seen much higher rates but this is consistent with longer historical trends.

Let's start with a very simple assumption: The fund earns a steady return of 7% every year. Reality usually isn't that predictable.

Here, we'll assume that the grantee always reinvests part of the earnings back into the fund to cover inflation. Note that as a result, the "real" inflation-adjusted value of the endowment remains constant at \$1 million.

Thanks to these simple assumptions — steady inflation, steady earnings — the grantee gets a consistent "real" amount of money to spend every year. Because the annual reinvestments gradually increase the size of the endowment to cover inflation, the grantee's spendable earnings maintain a consistent real value. Even so, that amount is just 4 percent of the endowment's original face value!

Next, let's see what happens when our assumptions aren't quite so simple ...

## SAME ENDOWMENT, DIFFERENT ASSUMPTIONS

YEAR		1	2	3	4	5
Principal Balance of the Endowment		\$1,000,000	1,030,000	1,055,750	1,087,423	1,120,045
Real Value after Inflation @ 3.0%		1,000,000	1,000,000	995,146	995,146	995,146
<b>EARNINGS</b>		(7.0%)	(2.5%)	(8.0%)	(10.0%)	(6.0%)
		70,000	25,750	84,460	108,742	67,203
<b>USES OF FUNDS</b>						
Earnings to be Reinvested @ 3.0%		30,000	25,750	31,673	32,623	33,601
Earnings Available to be Spent		40,000	0	52,788	76,120	33,601
Real Value of Spendable Earnings		40,000	0	49,757	69,660	29,854

In the real world, earnings jump up and down. Note that, in these assumptions, Year 2 is a pretty bad year.

Because the fund didn't earn enough in Year 2 to cover inflation, the "real" value of the fund has dropped—even though the grantee prudently reinvested 100% of earnings in the bad year, and spent nothing.

Thanks to the loss of real value in Year 2, and subsequent earnings that were good but not spectacular, the grantee's "real" benefit from this fund in Year 5 is 25% below the amount they started with. In hindsight, it looks like they shouldn't have spent all that money in Years 3 and 4, but should have reinvested more of it.

### Now, assume the grantee SPENDS part of the low earnings from Year 2, instead of reinvesting the entire amount...

YEAR		1	2	3	4	5
Principal Balance of the Endowment		\$1,000,000	1,030,000	1,040,000	1,071,200	1,103,336
Real Value after Inflation @ 3.0%		1,000,000	1,000,000	980,300	980,300	980,300
<b>EARNINGS</b>		(7.0%)	(2.5%)	(8.0%)	(10.0%)	(6.0%)
Assume the Earnings Vary Considerably		70,000	25,750	83,200	107,120	66,200
<b>USES OF FUNDS</b>						
Earnings to be Reinvested @ 3.0%		30,000	10,000	31,200	32,136	33,100
Earnings Available to be Spent		40,000	15,750	52,000	74,984	33,100
Real Value of Spendable Earnings		40,000	15,291	49,015	68,621	29,409

Here, we're assuming the grantee REALLY needs the annual earnings from this fund — and simply isn't in a position to reinvest the entire return in Year 2. The long-term consequences of that are harmful. Note that, by Year 5, the real value of the grantee's available money is even lower than in the previous example.

Once again, here is where the grantee might have prevented future problems. Instead of spending significantly more in Year 4, when earnings were above average, it would have been a smart time to reinvest and make up for the eroded value of the fund. That's where prudent management and good board oversight come in!

# ENDOWMENT-LIKE GRANTS

## A 5-Year Capital-Depletion Fund

YEAR		1	2	3	4	5
Principal Balance of the Endowment		\$1,000,000	842,340	666,814	471,966	256,234
Real Value after Inflation @	3.0%	1,000,000	817,806	628,536	431,916	227,661
<b>EARNINGS</b>						
Average Earning, assumed @	7.0%	70,000	58,964	46,677	33,038	17,936
<b>USES OF FUNDS</b>						
Earnings to be Reinvested	0.0%	0	0	0	0	0
Earnings to be Spent Every Year		227,660	234,490	241,524	248,770	256,233
Real Value of Spendable Earnings		227,660	227,660	227,660	227,660	227,660
Balance at End of Year		772,340	607,850	425,290	223,196	1

Let's assume that the grant maker wants to provide a steady amount of income for a grantee over a short period – in this case, five years. Because the fund isn't meant to last beyond that period, the grantee can spend MUCH more each year: all of the earnings, plus part of the principal. There's no need to reinvest, because the fund is meant to disappear.

As before, inflation still takes its toll: Spending must increase each year in order for the grantee to get a steady amount after adjusting for inflation. Also, keep in mind that we're once again using VERY simple assumptions here: Both inflation and earnings on this fund are perfectly steady from year to year.

The consequences of this approach are obvious at the end of Year 5: It has been a very nice income stream, but now the grantee must either learn to live without it, or must replace it from some other source. At the end of this year, the fund is now down to its last dollar.

## A 5-Year Working Capital Reserve Fund

Here, we assume that both earnings and spending needs vary considerably from year to year...

YEAR		1	2	3	4	5
Principal Balance of the Endowment		\$1,000,000	1,055,000	956,375	282,885	261,174
Real Value after Inflation @	3.0%	1,000,000	1,024,272	901,475	258,880	232,049
<b>EARNINGS</b>						
Variable Annual Earnings		(7.0%) 70,000	(2.5%) 26,375	(8.0%) 76,510	(10.0%) 28,289	(6.0%) 15,670
<b>USES OF FUNDS</b>						
Earnings to be Reinvested	0.0%	55,000	0	0	0	0
Earnings to be Spent		15,000	125,000	750,000	50,000	16,883
Real Value of Spent Earnings		15,000	121,359	706,947	45,757	15,000

Many grant makers prefer to make short-term, endowment-like grants as "reserve" funds – to cover unexpected needs or shortfalls in other revenue. This example shows one reason why: The earnings from these funds are likely to be just as uneven as from a long-term endowment. But since the time period is much shorter, there is less time to reinvest earnings and build up a safety cushion.

Luckily, in this example, the grantee didn't need very much of the money in Year 1, so most of the earnings could be reinvested. It's a good thing, too – because in Year 2 the earnings are well below average, and in Year 3 something serious arose, requiring the grantee to spend more than 3/4 of the value of the fund in a single year. Fortunately, this Reserve Fund did exactly what it was meant to do: It gave them a means of getting through this very demanding period.

Although the basic value of the fund is now much depleted, there remains enough to cover some future need, or to cover smaller expenses for a few more years. At this rate, though, the fund won't last much longer, and one emergency will certainly wipe it out.

## OTHER WAYS TO USE THIS GUIDE

This guide was written primarily for grant makers and donors who may be considering a contribution to endowment funds. It is intended as a first step in helping them decide how to proceed and what further guidance to seek. But it may be just as useful for grantees who are considering an endowment campaign or are planning to approach funders with the idea. Grant makers may also find it helpful to share this guide with the people on whom they rely for ideas and advice, like supervisors, colleagues, and outside experts.

As you work through the issues raised in this guide, it may be worthwhile to distribute copies to others who can be important to your success. For example:

**With Your Board** – If you consider requests for endowment grants or other contributions toward long-term investable assets, board members might want some guidance in thinking through the special considerations that such grants raise. You could offer this guide with questions such as these in mind:

- Do we have – or do we want to develop – the skills and technical resources to make endowment grants?
- Are there opportunities for endowment or endowment-like grants that we should be considering – or should consider in a different way – in the future?

**With Grantees** – If you feel ready to have a candid conversation with a grantee or grant applicant about whether an endowment grant is advisable, this guide could help in organizing that conversation. You and the grantee could use the conversation to explore:

- Whether you now have, or could readily obtain, enough information about the challenges, opportunities, and uncertainties that an endowment campaign would entail?
- What preliminary studies or technical advice you should pursue to help you formulate decisions?
- What options other than an endowment might also serve the same, or similar, purposes?
- What organizational, management, and fundraising strains an endowment might place on the grantee, and whether the likely benefits are worth the cost and effort?

**With Colleagues and Advisers** – You might find it helpful to discuss this guide with other grant makers, or with experts who advise you on grant making, either informally or in organized discussion sessions. The guide could prompt a discussion about:

- What resources have others found useful in considering or making endowment grants?
- How have others approached endowment grant making, and how does their experience compare with your own or with the suggestions in this guide?

**As a Training Tool for Grant Makers** – Because this guide explicitly offers guidance to grant makers from their colleagues and other experts, it is readily suited for use in training sessions – either in the initial orientation of new grant makers, or in personal-development training later on.

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