The Case for Endowment

A strong endowment provides a reliable stream of income for charitable programs and operations, as well as protection from fluctuations in other revenue. Endowment funds are invested to generate a combination of income and growth, normally with preservation of the principal (the amount originally contributed, sometimes called the "corpus") as one goal. The organization benefits by spending either the income or a reasonably modest fixed percentage of the value of the fund each year.

If a donor makes a gift designated for endowment and the charity accepts it, those funds are permanently restricted, unless there is an agreement between the donor and charity that would permit the charity to modify the restriction. This is a true perpetual endowment fund. A donor also may make a gift generally intended to be used as an endowment but permit the institution to use the principal in certain circumstances, or to spend the principal at its discretion. These arrangements often are called "quasi-endowments." Further, an organization may itself decide to restrict or designate some of its own assets to be used for an endowment. These sometimes are known as "board-designated" or "board-restricted" endowments. In most cases, the board of directors or trustees could vote to repeal the restriction or invade the principal for another purpose if needed or desired, unlike a donor-designated or donor-restricted endowment fund.

Typically, the payout rate from an endowment—the amount that can be spent by a charitable organization each year—is set with the expectation that the distribution can be made without spending principal. Thus, to preserve the principal (and have it grow), the payout rate must be set at a prudent level, and endowment funds must be invested in a way so that the value of the fund grows at a rate higher than the payout rate over time. As with any investment, there is downside risk: If the investment return of the fund is less than the payout rate, the fund balance (and the subsequent payment) will decrease. However, with prudent investment, most endowments perform very well over time.

<u>Example</u>

An organization has an endowment of $1 million at the beginning of the year and a payout rate of 5%. The charity would receive a distribution—sometimes called a "draw"—of $50,000 that year. Let's assume the income and principal growth of the fund that same year is $70,000—a 7% return. The next year, the charity's distribution would be $51,000, $1,000 higher than the current year. ($1,000,000 original amount plus $70,000 income and growth, minus $50,000 current year distribution equals $1,020,000. $1,020,000 multiplied by the 5% payout rate equals $51,000.)

Year	Starting Amount	Growth*	Distribution*	Year-end Amount
Year 1	$1,000,000	$70,000	$50,000	$1,020,000
Year 2	$1,020,000	$71,400	$51,000	$1,040,400
Year 3	$1,040,400	$72,828	$52,020	$1,061,208
Year 4	$1,061,208	$74,285	$53,060	$1,082,432
Year 5	$1,082,432	$75,770	$54,122	$1,104,081

* assumes annual growth of 7% and payout of 5%

There are several reasons why establishing and investing in growing an endowment are beneficial for an organization and the community. Among these reasons are:

- Perpetual support of programs and services important to donors.
- A reliable stream of annual income, improving an organization's financial stability.
- A sign to donors and the community that the organization is serious about long-term strength and viability.
- Increasing annual and total benefit to the organization and community.

When an organization's board of directors or trustees makes the decision to set aside and restrict funds to be used for endowment, or donors establish an endowed fund with an organization, they are making a commitment to the future of the charity and the communities it serves.