NORTHERN TRUST
ASSET MANAGEMENT

HOW YOUR SPENDING POLICY CAN JEOPARDIZE YOUR GOALS

Lower expected equity returns could challenge spending potential for non-profits.

In the current market environment, we see falling equity return expectations and potential for higher levels of sticky inflation straining the ability of non-profits to maintain real spending power over the long term. This places us at an inflection point for non-profit organizations, particularly those with an inflexible spending rate. As such, it now seems an appropriate time to review, modify, or affirm spending policies. Yes, spending policy discussions can be rather dull, but they are critically important nonetheless, as spending policy directly impacts your organization's ability to shape its mission.

What it is
With expected lower equity returns over the next 10 years, we outline some of the difficult choices that non-profit organizations face over their spending rates.

Why it matters
Lower returns and elevated inflation could cause non-profits to cut into their funds' principal if they don't reduce their spending rates.

Where it's going
Now could be a good time for non-profits to model how a variety of market scenarios may impact spending and asset values over time, and to consider the circumstances in which they would be willing to adjust spending.

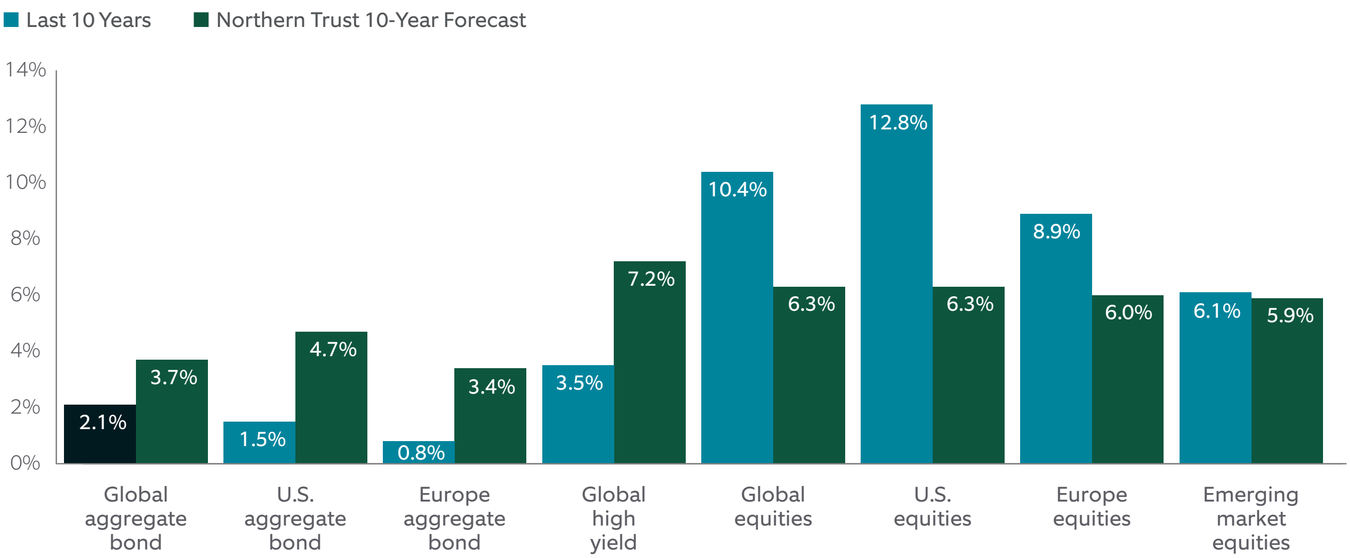
A LIKELY CHALLENGING MARKET IN THE COMING YEARS

We expect equity market returns will meaningfully decline more in the coming decade than in recent history. This sentiment is driven by a trifecta of lower expected growth, increased geopolitical risk, and higher anticipated inflation than what has been the norm. Exhibit 1 shows return expectations from our most recent Capital Markets Assumptions research, where equity returns in the next 10 years fall considerably below the previous 10 years.

EXHIBIT 1: RETURN FORECASTS POSE A SPENDING CHALLENGE

Lower equity return forecasts may put a strain on non-profit organizations' ability to spend.

Actual vs. Expected 10-Year Returns by Asset Class



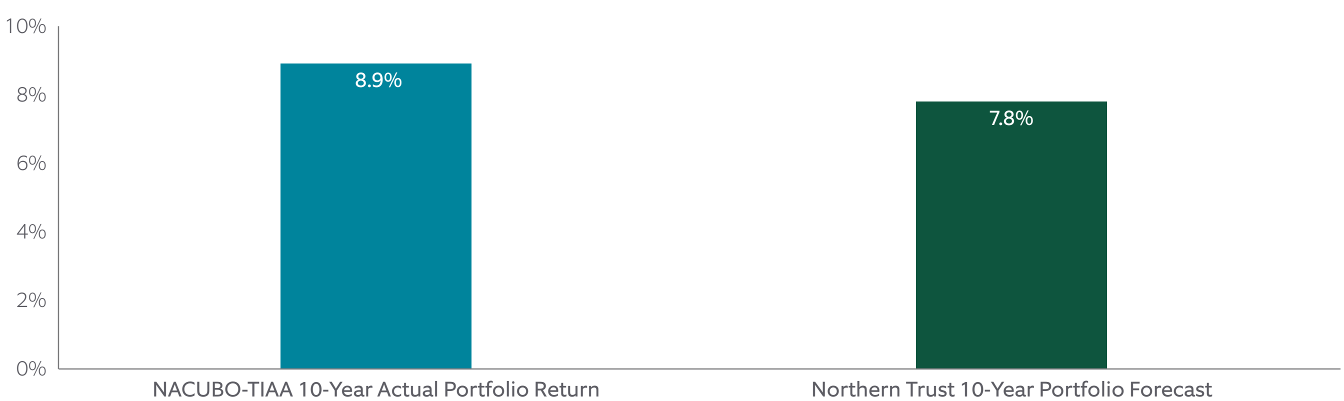
Sources: Northern Trust, Bloomberg. Annualized return data in local currency from June 30, 2013 to June 30, 2023. Forecasts are from Northern Trust's 2024 Capital Market Assumptions research, representing the forward-looking period from June 30, 2023 to June 30, 2033. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Past performance is not indicative of future results.

To show how these lower returns may impact a diversified portfolio, Exhibit 2 shows portfolio performance over the last 10 years from the 2022 NACUBO-TIAA Study of Endowments Report for portfolios with more than $1 billion in assets versus our expectations for a similarly positioned portfolio in the next 10 years.

EXHIBIT 2: LOWER EXPECTED PORTFOLIO PERFORMANCE

Our return forecasts indicate that returns may decline in the next 10 years.

2022 NACUBO-TIAA Actual 10-Year Portfolio Return vs. Northern Trust 10-Year Forecast



Sources: Northern Trust, 2022 NACUBO-TIAA Study of Endowments Report. The average dollar-weighted asset allocation for the 2022 NACUBO-TIAA Study of Endowments Report's Over $1 Billion group reflects 75.3% in equities, 9.5% in fixed income, 12.2% in real assets, and 3.0% in other holdings. More detailed asset allocation information can be found within the report. The 10-year forecast represents the expected return for a similar portfolio, based on Northern Trust's 2024 Capital Market Assumptions research.

HOW PORTFOLIO PERFORMANCE IMPACTS SPENDING

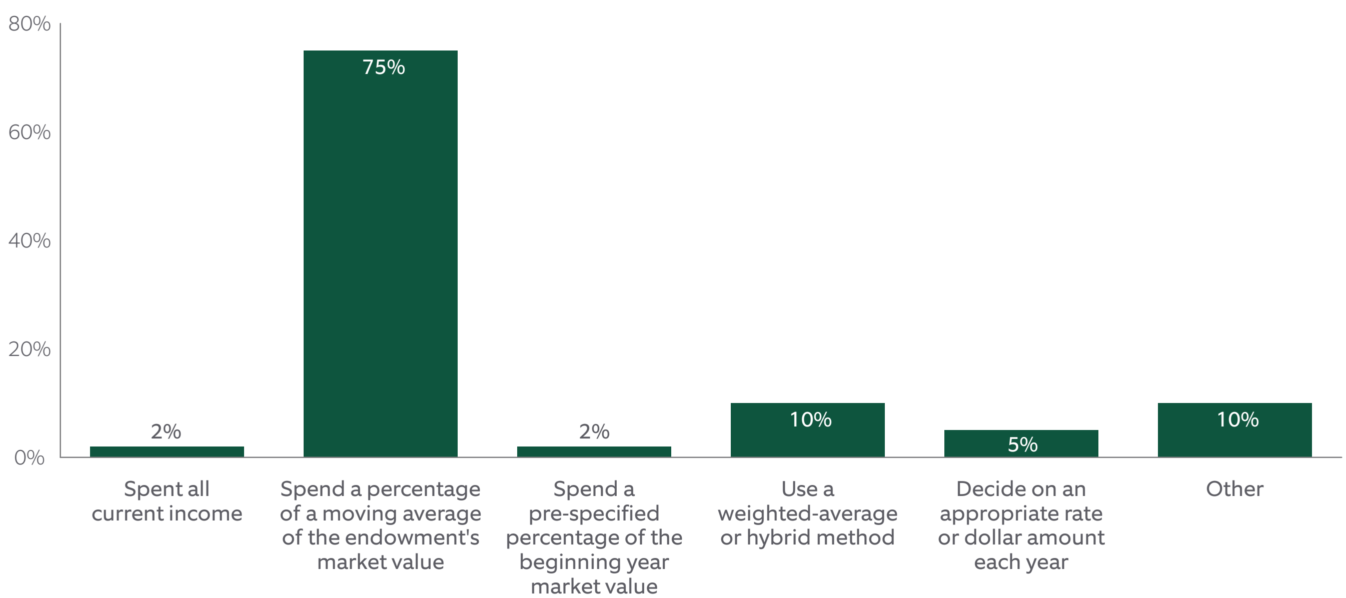
Views vary from investment organization to organization, but directionally the tone is universal — don't expect the returns generated for the past 10 years, or even much of the past 20 years, to be replicated over the coming decade.

How does this impact spending? Some organizations — primarily foundations — have a firm floor on spending 5% annually to maintain their tax-exempt status. Other organizations — mostly endowments — have flexibility in setting policy and they also have the greatest diversity of practices in spending policies. In Exhibit 3, we show the current practices from the 2022 NACUBO-TIAA Study of Endowments, with the vast majority reporting a spending policy based on a percentage of the rolling average of the endowment's market value. Both of these dominant types of policies rely on the portfolio to generally earn an investment return greater than inflation plus their spending, in order to maintain (or, ideally extend) inflation-adjusted spending over time. That proposition is more challenging with lower expectations for market returns.

EXHIBIT 3: SPENDING POLICY PRACTICES: MOST ARE A STATIC PERCENTAGE OF ASSETS

Most institutions determine their spending through a percentage of a simple moving average of market value, putting a strain on spending when portfolio performance lags for extended periods.

Spending Policies Employed by Respondents



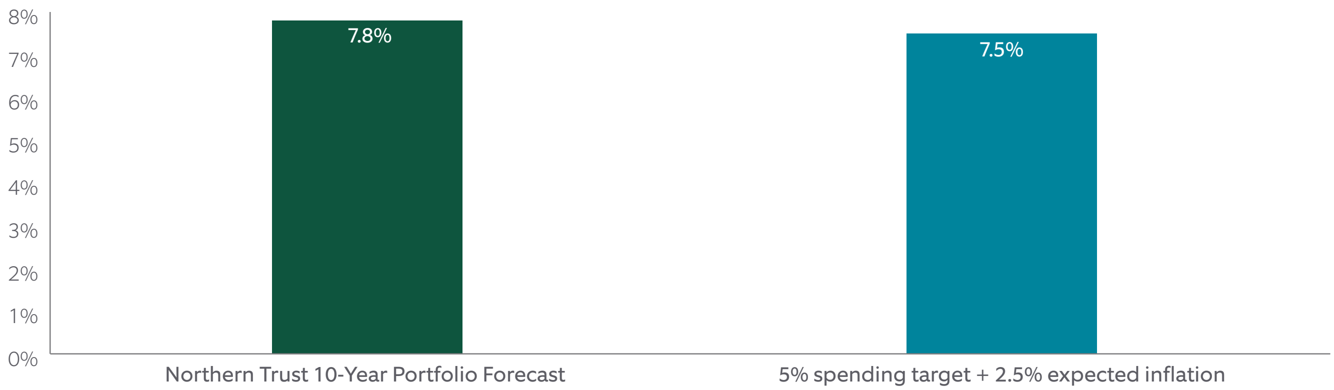
Source: 2022 NACUBO-TIAA Study of Endowments Report. Note: Respondents include 654 institutions. Respondents were able to choose more than one response; therefore, the percentages do not sum to 100%.

Inflation compounds this challenge further as higher levels of inflation raise the performance target that an organization needs to achieve on a real basis to avoid depleting the corpus of the pool. If an organization seeks to spend 5% annually not including an adjustment for inflation, we anticipate that means about 7.5% assuming the long-term historical average of 2.5%.[1] Exhibit 4 again shows the 10-year expected portfolio return of 7.8% (from Exhibit 2) narrowly squeaks by the fixed threshold of 7.5%. The expected outcome is even more grim when we modeled out the asset allocation for other cohorts who have allocated less to return-seeking assets like private equity.

EXHIBIT 4: INFLATION COMPLICATES THE SPENDING CHALLENGE

Portfolio returns may barely clear the real return threshold of a 5% spending rate plus inflation given lower expected market returns and higher levels of inflation.

Northern Trust Expected 10-Year Portfolio Return vs. Inflation + Spending Target



Sources: Northern Trust, 2022 NACUBO-TIAA Study of Endowments Report. The average dollar-weighted asset allocation for the 2022 NACUBO-TIAA Study of Endowments Report's Over $1 Billion group reflects 75.3% in equities, 9.5% in fixed income, 12.2% in real assets, and 3.0% in other holdings. More detailed asset allocation information can be found within the report. The 10-year forecast represents the expected return for a similar portfolio, based on Northern Trust's 2024 Capital Market Assumptions research.

WHAT NON-PROFITS CAN DO AMID EXPECTATIONS OF LOW RETURNS

This dilemma leaves non-profit fiduciaries in a difficult position with a few potential options:

Increase risk-taking with the aim of achieving a higher return

This type of approach generally exposes portfolios to additional risks, such as volatility and illiquidity, that likely won't fit your needs.

[1] Despite today's elevated inflation environment, for modeling purposes over long-term periods (i.e., 10 years or greater), we believe it is prudent to use 2.5% which reflects the approximate 20-year historical average.

Accept the cyclicality of the markets and the occasional erosion of the corpus

It is important to look at the very long term — 10 to 20 years — when considering spending and the impact it has on the corpus of your asset pool. In some markets, the corpus will grow, net of all spending and inflation, and in others the corpus will shrink. We think the correct asset mix, staying the course, and not over-spending in markets where the corpus is growing is important. If you are still concerned about erosion of corpus due to spending, consider whether to factor in your capital inflows and fundraising into your planning. We've found that organizations tend to look at contributions as a way to bolster short-term spending needs.

By spending less today, you can help preserve the corpus to lead to the ability to spend more tomorrow in absolute dollar terms.

Spend less

Spending less can be difficult, and the practices of peers underscore this. Even with the flexibility to spend less, 86% of NACUBO-TIAA 2022 respondents stated they have no intention to lower spending in the next two to three years. According to the 2022 Council on Foundations-Commonfund Study, 65% of private and 73% of community foundations did not change their spending levels. Nearly one-fifth of private foundations and 10% of community foundations reported increased spending. Only 5% and 6% of private and community foundations, respectively, decreased spending. However, by spending less today, you can help preserve the corpus to lead to the ability to spend more tomorrow in absolute dollar terms.

ONE STRATEGY TO ADAPT TO LOWER RETURNS

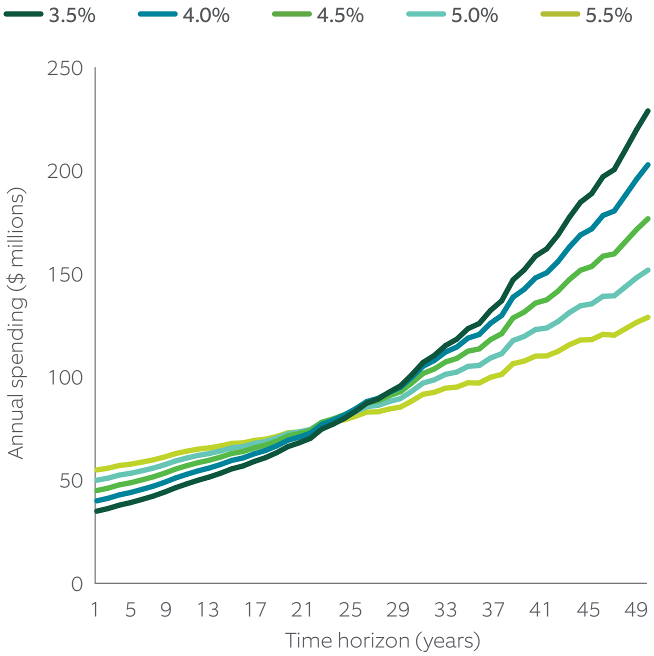
Given the high probability of a lower expected return environment, the math behind reducing your spending rate in the short-term may actually lead to greater dollars spent in the longer-term. While it may be counterintuitive that a lower spending rate leads to increased spending in dollars over time, it may make more sense when one considers the prospective return environment. We think this approach works best for organizations that have some flexibility in their spending needs and place more emphasis on long-term impact than meeting short-term needs.

To underscore this point, in Exhibit 5 we again utilized the 2022 NACUBO-TIAA Study of Endowments Report's Over $1 Billion cohort's average dollar-weight asset allocation as of June 30, 2022 and applied our 20-year capital market assumptions to a starting market value of $1 billion. From there, we ran spending simulations of 3.5%, 4%, 4.5%, 5% and 5.5% based on the most recent market value per year. Time horizon and patience are critical but what is depicted in Exhibit 5 below is that there is a convergence in year 27 whereby the portfolio with a 3.5% spending rate distributes more annually and, ultimately, cumulatively than the portfolios with higher spending rates in perpetuity. This ability to spend more in later years is driven by the higher asset values for portfolios with lower spending rates, as shown in the chart on the next page.

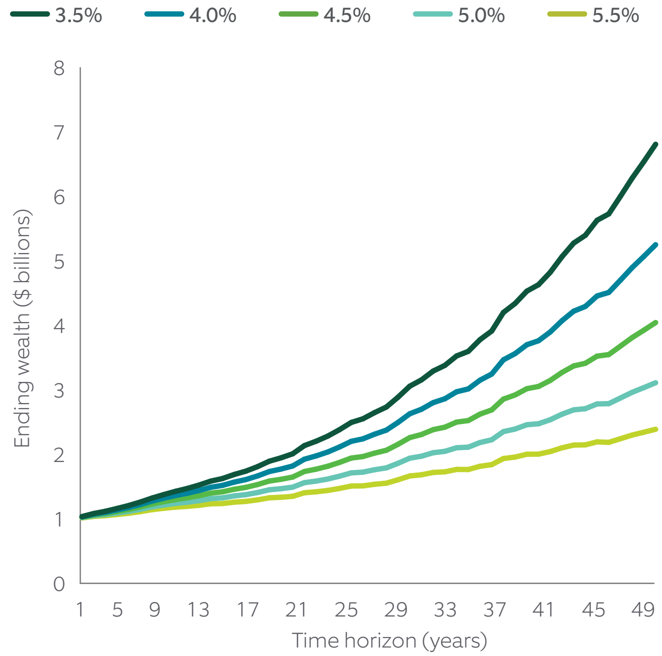
EXHIBIT 5: LESS SPENDING NOW CAN BOOST SPENDING CAPACITY LONG-TERM

The left chart shows how spending at a lower rate in earlier years with a $1 billion portfolio can allow for more spending long-term. As the right chart shows, this is because lower spending in the early years allows the portfolio to accumulate notably more wealth long-term.

Annual Spending Based on Spending Rate ($ millions)



Ending Wealth (50th Percentile) Based on Spending Rate ($ billions)



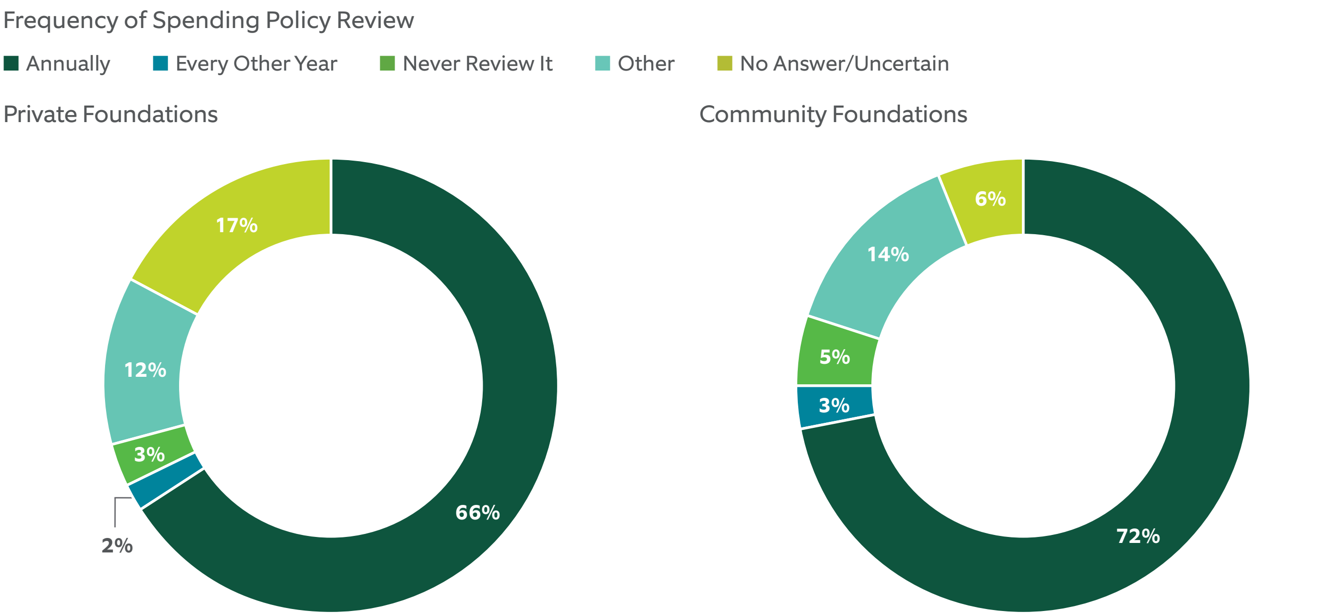
Sources: Northern Trust, 2022 NACUBO-TIAA Study of Endowments Report. The average dollar-weighted asset allocation for the 2022 NACUBO-TIAA Study of Endowments Report's Over $1 Billion group reflects 75.3% in equities, 9.5% in fixed income, 12.2% in real assets, and 3.0% in other holdings. More detailed asset allocation information can be found within the report. The 50-years of returns for the assets in the portfolios are based on our 20-year average annualized returns in our most recent Capital Market Assumptions research.

TIME TO REVISIT YOUR SPENDING POLICY? SOME KEY QUESTIONS TO ASK

Exhibit 6 shows that most foundations review their spending policies annually and a small minority never review it at all. We have found practices amongst endowments to be similar. Of course, sound governance practices call for a periodic review of spending policy when possible, preferably annually.

EXHIBIT 6: A REGULAR SPENDING POLICY REVIEW MAY HELP

Roughly 30% of foundations don't review their policies at least annually or aren't sure how often they review it. Those who don't have a regularly scheduled review may want to start soon given market expectations.



Source: 2022 Council on Foundations–Commonfund Study of Foundations report, which included responses from 171 private foundations and 106 community foundations.

Regardless of how you decide to forge on, you may find the potential questions below helpful for a finance committee, investment committee or board discussion on your spending policy. We believe that this type of dialogue reflects good housekeeping measures for all organizations, especially before taking the plunge and modifying your spending policy.

Consider short-term spending vs. long-term portfolio growth

• Is short-term spending more important than long-term asset growth?

Model your spending policy's impact on asset growth

• Have you modeled spending policy relative to long-term asset growth in a variety of return environments?

Prepare for spending volatility

- Have you modeled the potential impact of volatility and lower spending on your institution's needs?
- Can your institution adapt to lower spending if necessary? If so, what would be a tolerable spending floor?
- Have you set reasonable parameters to move outside of your spending policy under certain circumstances?
- Can fundraising/contributions augment spending in certain environments?

Educate stakeholders

- Have you provided education and modeling to key stakeholders in advance so that you can react in a challenging environment?

CRITICAL CHOICES ABOUT SPENDING

Over the next 10 years, we expect declining equity returns and potentially higher levels of inflation compared to long-term averages, which could strain the ability of non-profit organizations — particularly those with inflexible spending rates — to maintain real spending power over the long-term. To address this problem, investors can increase risk-taking to potentially enhance return (which we don't recommend), accept the cyclicality of returns and allow spending to cut into principal, or reduce their spending rates. While we understand that organizations may struggle to cut spending or can't do so because of policy restraints, those who can take a longer view may find that a lower spending rate now could set up more spending capacity later. Now could be a good time to model how a variety of market scenarios may impact spending and investable assets, consider under what circumstances the organization would adjust spending, and educate stakeholders on those scenarios.

As a leader in the outsourced chief investment officer (OCIO) industry since 1979, we manage $124 billion in outsourced assets, including $36 billion on behalf of not-for-profit organizations, as of September 30, 2023.

Learn more about Outsourced Chief Investment Officer (OCIO) Services at Northern Trust Asset Management.

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Northern Trust Asset Management is a global investment manager that helps investors navigate changing market environments in efforts to realize their long-term objectives. Entrusted with $1.18 trillion in assets under management as of December 31, 2023, we understand that investing ultimately serves a greater purpose and believe investors should be compensated for the risks they take — in all market environments and any investment strategy. That's why we combine robust capital markets research, expert portfolio construction and comprehensive risk management in an effort to craft innovative and efficient solutions that seek to deliver targeted investment outcomes. As engaged contributors to our communities, we consider it a great privilege to serve our investors and our communities with integrity, respect and transparency.

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