

Different Definitions, Dueling Studies

Much of the confusion over the payout issue is rooted in a disagreement over the very definition of the term “payout.” Defenders of the current 5 percent standard tend to rely on the *legal* definitions of payout, which allow foundations to include administrative expenses related to their charitable purposes – program research and evaluation, trustee fees, publishing and annual report, etc. – in their payout total. NNG, NCRP and other proponents of increased payout tend to *exclude all administrative expenses* from their figures, believing that the only payout that matters is that measured in dollars available to grantees.

Both sides in the payout debate come armed with studies to back up their points of view. The studies sometimes defy direct comparison because of differing methodologies, definitions and assumptions. However, these studies and the rebuttals of them are central to the debate, so the most important of them are briefly described below:

- Perry Mehrling, PhD. for NNG. This September 1999 study concluded that foundation grantmaking – exclusive of administrative costs and expressed as a percentage of assets – “declined from 8%” in the study’s base year, 1981, “to below 5 percent in 1997.”
- DeMarche Associates for the Council on Foundations. This study, last updated in June of 1999, tested three different payout strategies (5 percent, 6 percent and 7 percent) for a hypothetical foundation that was started in 1950 with a \$1 million gift. It concluded that over the long term, more money is made available to charity (i.e. purchasing power grows) if a foundation maintains a consistent payout policy of 5 percent.
- Cambridge Associates for the Council of Michigan Foundations. Like the DeMarche study, this April 2000 report made projections based on a hypothetical foundation’s investment portfolio, but it also looked at the 1973-1997 tax returns of 33 Michigan-based foundations. It found that the average, inflation-adjusted return on investment from 1973-1997 for those foundations was 5.27 percent, so a payout rate of around 5 percent a year would have allowed them to maintain their endowments.

The Rationale for Increased Payout

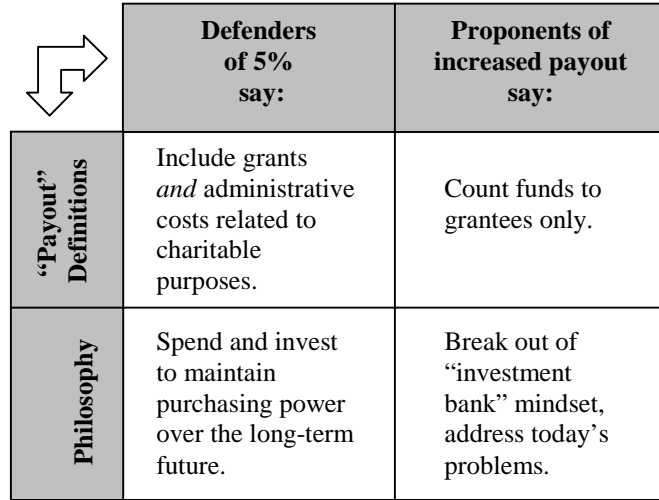
Proponents of a higher mandatory or voluntary payout rate claim that the legal floor of 5 percent has been regarded as a ceiling by too many foundations. In addition, they point to the widening gap separating the rich and poor and “other problems that flourish in the shadows of the soaring Dow,” as NNG’s Teresa Odendahl and Diane Feeney put it in the May/June 1999 issue of *Foundation News & Commentary*.

Proponents for a higher payout assert that the congressional rationale for simplifying and capping the distribution requirement was to help foundations recover from the erosion endowments suffered throughout the 1970’s, and that that objective has now been more than accomplished. In his 1999 report for NNG, Professor Perry Mehrling of Barnard

College wrote, “Total foundation assets have grown in real [*or inflation-adjusted*] terms by almost three times” since 1981.

The advocates of a higher payout rate criticize the DeMarche study, saying it favors a policy of *growing* foundation endowments rather than a policy of simply *maintaining* purchasing power; hence the study’s finding that more grant dollars would be available in later years at a 5 percent payout rate. They contend that the DeMarche numbers show that foundations could have paid out as much a 6.5 percent a year over the last twenty years without eroding their endowments.

They also assert that the DeMarche and Cambridge Associates studies missed the big picture by focusing on policies of individual foundations. One foundation’s conservative investment and spending policies is not the only guarantee that charitable dollars will be available to meet future needs. The flood of new wealth into the field of philanthropy will also renew the charitable well, they say.



	Defenders of 5% say:	Proponents of increased payout say:
“Payout” Definitions	Include grants <i>and</i> administrative costs related to charitable purposes.	Count funds to grantees only.
Philosophy	Spend and invest to maintain purchasing power over the long-term future.	Break out of “investment bank” mindset, address today’s problems.

The Case For 5 Percent

Most defenders of the 5 percent payout rule have no problem with foundations voluntarily choosing to serve their missions with a higher than required payout rate. However, they are concerned that Congress could become interested in making a rate increase mandatory. They say that such a move would, over time, erode foundation purchasing power and limit the freedom of foundations to choose whether or not to operate in perpetuity.

In “In Favor of Five Percent,” his article in the May/June 1999 issue of *Foundation News & Commentary*, John E. Craig, Jr. of the Commonwealth Fund supported the DeMarche and Cambridge Associates findings. He maintained that a typical foundation maximizes its “risk-adjusted returns with an asset mix in the neighborhood of 70 percent equities and 30 percent fixed income.” Looking at average annual returns on U.S. equities and bonds since 1900, the average inflation rate for the same period, and typical investment management expenses, Craig concluded that a foundation with such an asset mix could only have maintained its corpus over the last century by spending “around 5 percent annually.”

Defenders of the 5 percent standard have criticized the methodology used by Professor Mehrling in his study for NNG. They point to his failure to include program-related administrative expenses in his numbers. They also contend that he skewed his results by

studying the years 1981 through 1997, a period that includes the longest bull market in history, and note that he lumped all foundations together, including community and operating foundations, which are not subject to the federal payout requirement. Furthermore, Mehrling compared payout and asset numbers from the *same* year. Many foundations plan a year's payout rate as a percentage of the assets held in the *previous* year, a practice permitted by the IRS.

Supporters of the 5 percent rule also say that we are experiencing a unique period of stock market growth and new wealth creation. There is no guarantee that recent trends will hold, or that money spent today will automatically be renewed in the future by new sources or phenomenal returns on investments. Again, in defending 5 percent as the correct legal payout floor, they point to perpetuity -- that foundations may choose to stick around to solve future problems or to serve as a stable source of "social capital" throughout the dips and peaks certain to come in the economic future.

The Council on Foundations' Position

As Council members, you may be interested in the resolution adopted by the Board of Directors on December 3, 1999:

The Council on Foundations supports the Federal legal requirement that private foundations must incur a minimum level of charitable expenditure each year.

The Council encourages private foundations to review periodically their spending policies in light of economic conditions, long-term priorities and current needs. We support those private foundations that choose to spend more than the minimum required, that choose to spend all their endowment assets over time, or that choose to preserve their endowments in perpetuity.

The current five percent rule strikes an appropriate balance between requiring a reasonable, annual level of charitable expenditure and preserving the option to maintain the real value of a permanent endowment.

In Sum, Ask Yourself

- Do we want the foundation to exist in perpetuity?
- Regarding perpetuity, what were/are the intentions of the donor whose funds established the foundation?
- What do we value more – meeting societal needs on a consistent basis over time or focusing additional funds on current needs?
- How should these values be expressed in our investment and spending policies? How often should we revisit these policies?

Bibliography

Web locations are included. For the *Foundation News and Commentary* articles cited, please go to:
www.cof.org/foundationnews/backissues.htm

Cambridge Associates, Inc. "Sustainable Payout for Foundations." Council of Michigan Foundations, April 2000. www.cmif.org/payout.htm.

Craig, John E., Jr. "In Favor of Five Percent." *Foundation News and Commentary* 40 No. 3 (May/June 1999): 23, 25

Curtis, Jody. "Context: What do These Numbers Mean?" *Foundation News and Commentary* 40 No. 6 (November/December 1999): 37.

Curtis, Jody. "Payout Research Round-Up: Two Out, Two More on the Way." *Foundation News and Commentary* 40 No. 6 (November/December 1999): 34

DeMarche Associates. "Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix." Prepared by Donald W. Trotter (1990) and updated by Carter R. Harrison (1999). Washington, DC: Council on Foundations, 1999.

The DeMarche Associates study updated by Carter Harrison can be purchased from the publications area of the Council's Website, also a brief description of the study can be found in the password-protected, "members only" section of the same site in the "Educational Collaborations" area. Go to: www.cof.org.

Dundjerski, Marina "Playing the Percentages," *Chronicle of Philanthropy*, October 21, 1999.

Harrison, Carter R., Jr. "It's How You Slice It." *Foundation News and Commentary* 40 No. 6 (November/December 1999): 32-33, 35-36

Mehrling, Perry. "Spending Policies for Foundations: The Case for Increased Grants Payout." National Network of Grantmakers, 1999
www.nng.org click on "payout campaign."

National Committee for Responsive Philanthropy fact sheet available at www.ncrp.org/advocacy.htm.

Odendahl, Teresa and Diane Feeney. "Who's Afraid of Increasing Payout?" *Foundation News and Commentary* 40 No. 3 (May/June 1999): 22, 24.

Troyer, Tom. "The Cataclysm of '69." *Foundation News and Commentary* 40 No. 3 (March/April 1999): 40-47.

For more information or additional copies, contact Family Foundation Services at the Council on Foundations, 202-467-0433, or email family@cof.org.

