PAYOUT REDUX[1]

Charles H. Hamilton

In the next decade we need more thoughtful discussion—and a deeper understanding—of the issues and implications surrounding foundation payout decisions. For instance, two questions about foundation practice should be discussed by donors prior to establishing a foundation, and thereafter they should be regularly revisited by boards. Based on the mission and the intended strategy of a foundation: (1) is the intent that the foundation exist in perpetuity or spend out over *x* number of years? and (2) what is the best desired spending rate to meet the mission and the longevity desired?

Sadly, both questions get more attention from policy wonks and advocates than from donors and boards. Most data shows that about three-quarters of foundations are formed to exist in perpetuity and operate that way by default. Most foundations don't have a formal spending policy and simply give away the 5 percent minimum required by the federal government. Based on predilection, mission, and strategy, foundations may decide that spending out or perpetuity is the correction decision. They may decide a 5 percent payout is where they should be, or 7 percent, or 10 percent. In any of those cases, those decisions are fine, and should be made by the donors and boards. I have no specific preference or standing regarding them.

However, my experience has been that many foundations that do give more than the 5 percent don't understand the implications for (a) their assets, (b) their ability to exist in perpetuity, and (c) the foundation's combined philanthropic value over time. These implications are not well understood, to the potential detriment of particular foundations and to the philanthropic sector as a whole, for I believe that there are important values to enduring institutions in civil society which are not given sufficient voice.

We are still affected by the dramatic economic downturn in 2008 and the lingering volatility and malaise of financial markets. Foundation assets fell a record 17.2 percent in 2008 and have started to rebound since 2009. Interestingly, the Foundation Center originally estimated in April 2010 that foundation giving in 2009 had declined 8.4 percent from 2008. This was later revised when final figures

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for 2009 came in; actual giving for 2009 was down just 2.1 percent. The small decrease no doubt reflects the impact of lag and smoothing, as many foundations tend to base spending on three or five-year averages. Administrative cutbacks were also an influence. Most important, it appears that foundation percentage draws on their endowments dramatically increased. As the Foundation Center reported, "the 8.1% ratio of 2009 giving to 2008 assets—a rough proxy for foundation payout—was the highest level recorded by the Foundation Center since 1985" (Foundation Center 2011, 11).

Some have—perhaps overly dramatically—described recent strains on both the financial system and the foundation world as resulting in a "new normal." Perhaps it is more accurate to say that the last few years have been a reset button for how we should think about longevity, payout, and spending. Whatever our views on these matters, donors and boards as well as foundation watchers and policy analysts should be less complacent about these issues and think more carefully about what foundations are doing and why. Interestingly, on these topics "left" and "right" are not on clearly delineated opposite sides. One would hope that this will encourage a candid discussion. Perhaps it is now a good time to revisit questions of longevity and payout through the lens of payout: a sort of **payout redux**.

Payout and the "New Traditional" View

Before the recent economic crash, much was being made, once again, of raising payout rates for foundations. Some commentators advocated individual foundations adopt such an increase voluntarily; others wanted an increase mandated. There tends to be a bias among "philanthropoids" and in policy circles for spending policies that would accomplish spend-out over time. It has become the reigning viewpoint—it is actually the "traditional" view right now. For instance, philanthropic adviser and teacher Richard Marker noted, "I view myself as neutral either way on the question of spend-down or perpetuity. Yet readers of my book tell me that they perceive a leaning toward long-term/perpetuity. Some of that, I suspect, is because the current fashion is to downplay the value of perpetuity in favor of spend-down" (2010).

When the National Center for Responsive Philanthropy released *Criteria for Philanthropy at its Best*, in 2009, it was a strong voice in that "new traditional" direction: "warehousing of tax-exempt dollars does not serve the public interest; it shortchanges the social benefit of philanthropy" (Jagpal 2009, 99). Other publications favored increasing the 5 percent minimum annual payout required of foundations because it "reaffirms some of the basic principles of effective grantmaking, such as mission clarity, focus and impact" (Waleson 2007, 32). It does no such thing of course: payout does not determine mission, effectiveness, or social benefit. Calling for higher payout requirements seems more related to other agendas, the unquestioned conceit that giving now is always better than giving later, or a failure to understand the role of saving during good times.

Some outsiders and policy people may emphasize the advantages of spending out because they fear the independence of foundations, don't trust staff and boards to do the perfect thing, or want to get the money out of foundation coffers now. For foundation staff and boards, spending out may be in their self-interest, because it increases their "giving power." Some board members, foundation staff, and donors favor spending out because they believe only they can make the best decisions; they hate the idea of passing control to others. Or they are flummoxed by how to negotiate the generational transfer of intent and governance. Spending more funds on particular issues now may indeed result in greater immediate impact. For many of the problems foundations address, however, spending more now may be a temporal illusion—the philanthropic version of the shortsighted, short-term thinking that plagues American corporations in search of short-term profit.

There are, of course, less attractive reasons for perpetuity as well. It is, for instance, the unthinking, default position for far too many foundations and donors. Sometimes a false belief in donor immortality and the urge for control from the grave are at play. In any case, all motivations, good and bad, should be discussed before deciding whether spending out or a longer lifespan will best serve a foundation's mission and effectiveness.

Is There a "Proper" Payout Rate?

Most of the past empirical research clusters around a 5 percent payout as the likely maximum that allows foundations the choice to be enduring institutions, taking into consideration market cycles, administrative expenses, excise taxes, and inflation. (A topic for further discussion is how the giving and asset allocation of an endowment should be congruent, how investment strategy must follow from a giving strategy, and then how it should be managed according to appropriate risk and reward parameters.) We need updated time series data on appropriate payout rates that take into account a much longer period. Given the recent recession and continuing volatility of financial markets, this new research would surely reaffirm the previous studies done, for instance, by Cambridge Associates for the Council of Michigan Foundations (2000) or the studies done by DeMarche Associates for the Council on Foundations (three studies were done: 1990, 1995, and 1999). For example, J.P. Morgan Asset Management recently published a report that used the firm's forward capital market assumptions to estimate a sustainable payout level. Their conclusion was that a fairly aggressive asset allocation of 80 percent equity and 20 percent bonds would only "support a spending rate of approximately 4% without damaging the long-term real value of the portfolio" (2011, 5).

It seems pretty clear that *if* there is to be a mandated payout rate, 5 percent is very close to a minimum rate allowing potential endowment (and grantmaking) growth for those crisis times, special needs, or opportunities that always occur and need a response. The Foundation Center's revision of the decline of giving in 2009 from 8.4 percent to 2.1 percent shows that the 5 percent rate works. It allowed asset growth in good times, so that an increased payout in bad times could smooth giving to the organizations and causes foundations care about when it is especially necessary. A rate above 5 percent will likely erode the endowment over time and result in the foundation spending out.

Thus, as a matter of public policy any mandated payout rate should allow wide choice of the goals, strategies, and lifespan decisions donors and boards can make to meet mission. Then the "private policy" decisions that individual donors and boards make for their foundation can be based on their values, missions, and strategies, whether that is a payout rate of 5 percent or greater. Several intrepid researchers have even suggested that "nothing other than the elimination [of] any and all mandated payout rates" will "clearly encourage foundations to adopt a payout rate that strategically links mission and payout decisions within foundations" (Deep and Frumkin 2001). The mere suggestion of no mandated payout rate caused arrhythmia among policy wonks and foundation watchers. It was such a radical policy thought that the idea was quickly put back into the bottle. Although politically unpalatable, it may well be that this is the most sensible prescription.

Understanding the Implications of Payout Decisions on Grantmaking Dollars

In any case, foundations should understand the implications of their payout decisions. A chosen or mandated payout rate in excess of 5 percent greatly increases the probability that a foundation will eventually run out of money and close. That is because annual returns have to cover not only payout but also noncharitable expenses, inflation, and excise taxes. Even a 10 percent annual return (which is not the long-term average of the market or of most portfolios) would likely result in a flat endowment at best.

There is an even more important—indeed stunning—implication of such decisions. One can calculate, over a set period of time, the combination of (1) the annual total of a foundation's cumulative grantmaking adjusted for inflation and (2) the foundation's remaining assets in the endowment. The sum of that spending and those assets is the dollar value that a foundation represents over time. Not surprisingly, a lower spending rate can very often result in a *higher* total foundation dollar value of those two elements over a period of time: a larger combined philanthropic value, as it were. This is because a higher payout reduces the size of the endowment by eliminating market growth and the power of compound interest. The actual total dollars paid out over a period of years can actually be reduced by a higher payout because the endowment size erodes—for example, 5 percent of a $100 million endowment is more than 7 percent of a $70 million endowment.

The potential costs of higher payouts became clear to me years ago through two examples. I was told the story of a foundation in the 1970s that heeded President Nixon's call for private charity to do more. It increased its grantmaking payout rate significantly over ten years or so. That is a fine decision to make. However, there was a cost involved. It took the foundation decades to recover its endowment and rebuild its grantmaking budget. Another foundation, one for which I worked, was regularly paying out over 7 percent in the early 1990s. That, too, is a perfectly fine choice for a board to make, but I thought they should understand what their decision meant. I ran a simple analysis of spending over time at both the current 7 percent payout rate and the 5 percent minimum. The report clearly showed that the higher payout resulted in an erosion of the endowment, and over about a fifteen-year period, less total money was given to grantees because the lower asset base in the endowment resulted in a lower annual-dollar grantmaking budget even at the higher percentage. If the foundation had actually kept payout at 5 percent, the growing endowment would have allowed the foundation to distribute more in total.

Admittedly, there are times when a grant made now is more important and valuable than amounts given later. That assessment must be made within the larger context of philanthropic goals and mission. In this last example, however, as a result of that analysis, the foundation's board brought its annual spending down to the 5 percent range as a better way to meet its goals and mission.

Unintended Consequences of Higher Payout

Whatever the payout rate, attention to unintended consequences is also crucial. Two examples will suffice.

It has been suggested that any endowment loss and any foundation closures as a result of higher payout will be offset by the creation of new foundations. Perhaps. The increases in foundation formation even in recent years suggest that foundation formation will likely remain robust (as a result of the intergenerational transfer of wealth to heirs and philanthropy that baby boomers are now implementing, as well as the success of efforts such as the Giving Pledge). However, a higher payout rate that effectively forces foundations to spend-out over time will very likely significantly decrease the attractiveness of foundation formation to donors for whom perpetuity and family legacy are important. Other alternatives will become proportionately more attractive—such as current consumption, private investment, larger legacies for children and favorite charities, or other philanthropic vehicles. That could further decimate the growth and role of foundations as independent, creative, and enduring institutions of civil society.

Others have urged an indirect approach to increase payout: eliminating foundation administrative expenses from the 5 percent minimum (currently, administrative expenses related to charitable activity can be included in the 5 percent calculation). This is an ironic and self-defeating idea. Foundations are finally beginning to understand that the administrative expenses of grantees are often quite integral to their grantees' organizational health and program effectiveness. That is also the case for foundations. Eliminating administrative expenses from qualifying distributions will decrease the amount spent on due diligence, public policy, advocacy, assessment, communication, and technical assistance by, in effect, increasing their cost in comparison to grants.

Does Increasing Payout Improve Results?

One can understand and appreciate the call for greater payout, because it derives in part from a desire to get more funds into the hands of nonprofit organizations for their programs, clients, and causes. (A topic for further investigation is the many ways philanthropic giving should be greater, can be greater, and can be much more effective.) There may be self-interest in these calls, since nonprofits want access to more funds too. In all of these calls for increased payout, however, there is an unspoken assumption that simply giving out more money will increase results and impact. This assumption provides the calls for greater payout a moral patina that is rather misleading.

There is simply no relationship between greater payout, more grantmaking dollars flowing out, and greater philanthropic and nonprofit impact. Two anecdotes may illustrate this. First, about seven years ago I had the strange experience of hearing, unbidden, the same story from either executive directors or senior program officers of five significant New York City foundations. Each person complained that there were simply "not enough good organizations and programs" to fund. I would add that I occasionally faced the same quandary. There are times when meeting the budgeted 5 percent payout meant that less effective organizations were funded. Second, when the recessions of 1990, 2001, and 2008 started to show up in reduced budgets for many foundations, many executive directors and program officers saw in this an opportunity to cull their grantee list of those organizations they considered less effective.

There is no question that not finding enough good organizations is partially the fault of the foundations too. Foundations sometimes have extremely narrow missions; they may have theories of change or agendas that narrow the list of potential grantees. And foundations are certainly partially to blame for not helping nonprofits become effective organizations, because of ways they restrict their funding or the ways they can ignore or interfere with nonprofit management. (These points also deserve their own article.) The point remains: the call for greater payout and thus greater amounts of money out the door and to nonprofits does nothing to increase social benefit in and of itself. It may even lead to support of a layer of less effective organizations and programs which can be socially detrimental and certainly not the best use of funds.

What is a Foundation to Do?

None of this, though, means that 5 percent is the proper ceiling for all foundations! What is a sensible foundation to do? It depends, and that is the beauty of a diverse and independent philanthropic sector. As a general rule, I would suggest that foundations simply make sure they meet the 5 percent minimum but otherwise ignore it. Thoughtful consideration of mission and strategy should determine whether more than 5 percent is a proper payout. Very sophisticated considerations of asset allocation, risk and diversification, etc. become important in ensuring that a foundation's assets are appropriately invested. Certainly foundations should have an Investment Policy Statement (only about 69 percent do) and a formal Spending Policy (only about 42 percent do) which they revisit regularly. (These percentages come from the 2011 *Foundation Operations and Management Report*, published by the Association for Small Foundations. Since the report focuses on smaller foundations, the percentages are probably a bit higher for the entire population of private foundations.)

Most foundations report that they intend to be enduring institutions, so maintaining fiduciary care and being concerned about future impact are important. In good times, endowments may grow, leading some to raise the "warehousing of wealth" alarm. But we might reframe the issue with the following questions. Aren't foundations simply being fiscally prudent by saving for a rainy day? Aren't foundations providing social benefit and protecting their missions by growing endowments that will allow greater funding during economic downturns? Don't growing endowments provide more chances to make innovative and big bets when opportunities arise?

Assuming that asset growth is a permanent state (as many who advocate increasing the payout rate seem to do) means ignoring the risks and reality of market cycles. Over time, markets go up, but they also go down, wreaking havoc on endowments and the nonprofit sector in general (see the 1970s, 1987, 2002, and 2008). The 1973 recession, for example, resulted in the Ford Foundation losing a third of its value, $1 billion, resulting in nearly 50 percent cuts in staff and grants. If foundations are careful about their assets (and asset growth), they can respond to those inevitable rainy days, crises, or unique opportunities without jeopardizing the foundation's future, its mission, or their grantees' programs.

This appears to have been the case with 2009 giving as reported above (Foundation Center 2011). Foundations could dip into their endowments for short periods without bringing their own existence into question or decimating their ability to respond to grantees in the future, *if* their earlier payout rates allowed them to "save" and build their endowments. There can thus be important social benefits to foundation thrift, and conversely, there can be real social costs to higher payouts (mandated or chosen) beyond the impact on a particular foundation's longevity, mission, and grantees, as a result of lower grantmaking in subsequent years or spending out.

A minimum rate of 5 percent seems to make sense and allows for the kind of diversity and choices of lifespan, mission, and strategy that make philanthropy a vibrant part of civil society. I would feel a tad better about that sentence if I really believed most foundations were deliberate in their decision-making about payout, spending, and perpetuity. We need more careful discussion, openness, and questioning about these issues, without a lot of politically imbued or self-interested baggage. We need donors and foundation staff and boards to question both the default decisions about paying out at 5 percent and the simplistic calls for greater payout in and of itself. At the end of the day, though, I trust the imperfect results of open discussion, publicity, and the press—as well as the often maddening diversity among thousands of foundations—more than tinkering with a one-size-fits-all mandated rate and basing that tinkering on all sorts of agendas from both the left and right while ignoring the unfortunate unintended consequences embedded in them.

The Importance of Enduring Institutions

In an "exit interview" published in *The Chronicle of Philanthropy* before she left the Ford Foundation, Susan Berresford talked passionately about the importance of long-term institutions: "Our society values enduring institutions. . . . We treasure them because they express and reinforce our values" (Wilhelm 2007). Strong, diverse, and long-lasting institutions are a vital part of a sustained civil society. New foundations and other philanthropic formations constantly help to renew civil society, and that is a good thing. At the same time, foundations that have long histories, existing cultures, experience, working capital, and human capital are immensely valuable as well. As enduring institutions, foundations can be significant, independent organizations within civil society. They are "countervailing" institutions, to use a phrase now out of fashion. They can reveal and respond to failures of both government and market. They can stand separate from governmental, corporate/commercial, and other special interests. Both centuries of history and events in recent decades—in the United States and internationally—should remind us just how important enduring and independent institutions can be to society. If one is going to talk about the "public good," surely having long-lived foundations should be one such public good.

I wrote "should be" because one of the challenges for us is how to ensure that long-lived foundations don't become calcified dinosaur bones. How can they remain an independent voice? How can they remain vital, be renewed, and use their history, knowledge, and cultures to enrich civil society and the causes for which they care? These broad questions and the very history of philanthropy deserve a great deal more discussion than they generally receive in the field and in the boardroom.

We need foundations with long-lasting commitments to issues that require long-term attention. All too often the short-term belief that we can, for instance, eliminate poverty or cure cancer in ten years is supremely presumptuous and wasteful. Indeed, there are some "technical" issues or projects that can be addressed by foundations fairly easily and directly. But very few troubling social issues can be so easily solved in a lifetime. Although that is certainly due in part to foundation ineffectiveness, many problems philanthropy seeks to address are immensely complex, some must be addressed over many generations, and some tragically, may be part of the human condition. Foundations represent not only a workshop for immediate passion and innovation, as many have remarked; they also represent the financial, temporal, and human capital needed to address issues with a longer-term perspective.

Discussing the social value of having enduring, sustainable and independent philanthropic institutions should be an explicit part of what individual donors and foundation boards think about, though I am sure they rarely do think that way. Perhaps, when one looks at mission, impact, payout, and longevity, one value to include is a foundation's role as an enduring, vital, and independent institution; as a long-term, committed philanthropic citizen; and as a countervailing power within the complex workings of modern civil society. Having regular discussions about mission and effectiveness in that larger social context would, no doubt, be fruitful.

Assuming perpetuity and a simple 5 percent payout rate as the default, or presuming that larger payouts and spending out is the better choice, are both mistakes. Either spending out or enduring can be a legitimate strategy if it helps meet a particular foundation's mission and is the choice of the donor and/or board. Setting a payout rate, then, is properly, I believe, a complex "private policy" decision. It is not best to subject it to a single "public policy" prescription as many advocates have promoted in the past. Doing so not only restricts the diversity, and wide choice of the goals, strategies, and lifespan decisions donors and boards should have, but it also ignores many important implications and unintended consequences of a higher rate.

It is hoped that this article will help serve as a reset button to start thinking more broadly and deeply about payout, longevity, spending, and the value of enduring, independent institutions in civil society.

NOTES

[1] This article is a greatly revised version of a blog contribution to Smart Assets (April 9, 2010), while the author was a senior fellow at Philanthropy New York. It was subsequently presented at the Conversations on Philanthropy Colloquium on July 8-11, 2010.

The views expressed in this article reflect those only of the author.

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