Enterprise Approach to Endowment Management:

A Case Study of a Private University

Adopting an enterprise approach to endowment management can drive financial sustainability and help an institution achieve its long-term goals.

TIAA Endowment & Philanthropic Services

Managing and overseeing an endowment is a complex task. Too often, endowments are managed solely with the objective of maximizing long-term real return with all of the focus on asset allocation, manager selection, and spending policy.

While these tasks are critical, they do not take into consideration the institution's key strategic goals and financial metrics. Important factors such as the institution's reliance on endowment spending, the overall health of its balance sheet, expected capital spending, and future fundraising tend not to be integrated into the analysis, creating a potential disconnect between the management of the endowment and critical institutional objectives.

Helping to Ensure the Sustainability of Your Institution

In higher education today, it is essential for institutions to adopt an integrated, total enterprise approach to endowment management that closely aligns the investment strategy of the endowment with the institution's financial and operating profile.

A recently published report by the TIAA Institute and David Wheaton, vice president of administration and finance at Macalester College stated that "Higher education is under dramatic pressure as revenue growth has slowed while costs continue to rise steadily." The report also noted that "Primary revenue streams—net tuition, endowment returns and gifts, plus state support for public institutions—remain under pressure and likely will continue to be so for the foreseeable future."[1] For many institutions, endowment revenue has become an increasingly important source of annual funding as net tuition revenue and donor gifts have come under pressure.

Adopting an enterprise approach to endowment management can drive financial sustainability and help an institution achieve its long-term goals by ensuring optimal management of the endowment. This approach involves not only understanding the economic and financial operating profile of the institution, but also incorporating key strategic and financial metrics into the analytical process.

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[1] Wheaton, David. "Financial management as revenue growth slows," TIAA Institute, 2018.

The following questions are important to consider when framing an integrated analysis:

- What are your institution's long-term strategic goals and objectives?
- What is the make-up of your institution's operating profile and what are the primary sources of annual income and expenses?
- How flexible is the annual budget?
- What percentage of the institution's total annual income comes from endowment spending?
- What impact would a short-term or long-term decrease in endowment income have on the institution's ability to adequately fund ongoing operations?
- How did your institution and your endowment portfolio fare during the 2008 downturn?
- How reliant is the operating budget on net tuition revenue?
- How reliant is the operating budget on annual donations and is there a capital campaign in progress or planned?
- How consistent are your fundraising efforts? Can you rely on existing fundraising projections?
- Have portfolio volatility, drawdowns, or liquidity challenges impacted your investment processes, spending, asset allocation, or other endowment policies?

When engaging in an integrated analysis, you need to answer some important questions including: What impact would a short-term or long-term decrease in endowment income have on the institution's ability to adequately fund ongoing operations?

Your Institution's Revenue Profile and Endowment

When quantifying the risks associated with the endowment, it is important to consider the institution's overall operating results, including all sources and uses of funds. While the institution's endowment spending is often the primary focus of the investment committee and finance staff, other sources of revenue are potentially a more important factor in assessing risk. Net tuition, room and board, and associated fees typically represent the largest revenue source, and naturally attract a great deal of focus. There are other important sources of revenue over which the institution has less control including government grants, donations and gifts, and income from sales or services. The endowment, and the income it provides, can help mitigate potential shortfalls and volatility in these other revenue streams.

In an ideal situation, universities benefit from stable to rising enrollment and predictable increases in tuition that are both affordable to students and sufficient to cover rising operating costs. When this is not the case, short and long-term risk to the institution's financial health increases. In addition, reliance on gifts as an essential source of revenue is usually adversely affected during equity market corrections. Gifts also tend to lag during market recoveries, placing greater pressure on other revenue sources including the endowment. Institutions with properly structured and invested endowments should be in a better place to weather volatility in their other sources of revenue.

Most endowment spending policy analyses focus on the absolute level of income that the endowment will generate for a given level of return and risk; however, this represents only part of the equation. The first step is to determine how much of the institution's annual revenue comes from the endowment.

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A Case Study of a Private University

Below we use as a case study a sample private university and apply an enterprise approach. As noted in **Exhibit 1**, our sample university's endowment provides 7% of the institution's annual revenue. The next step is to understand the potential sensitivity of this revenue to changes in the endowment's market value.

Exhibit 1: Revenue Sources

Percent distribution of revenues: Fiscal year 2017

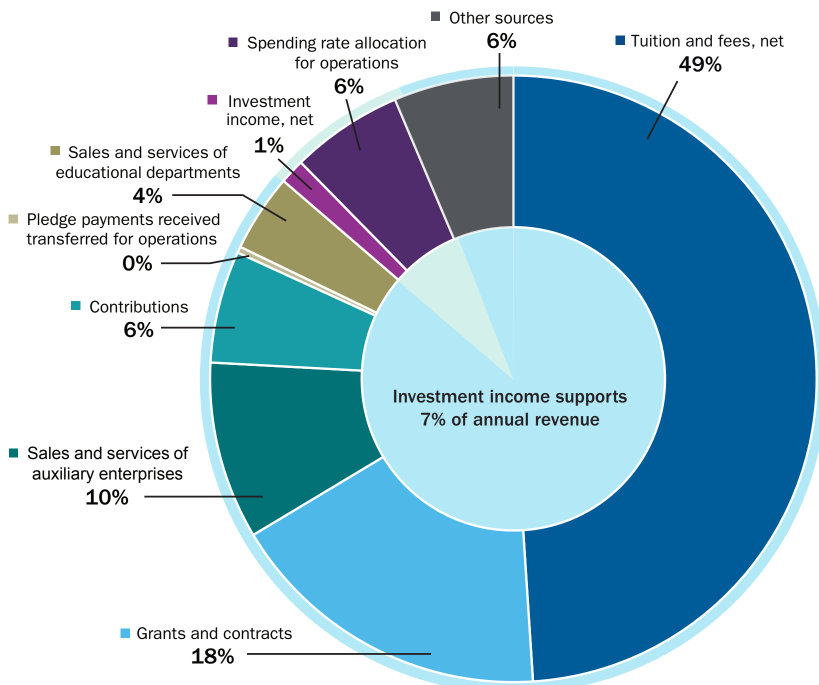
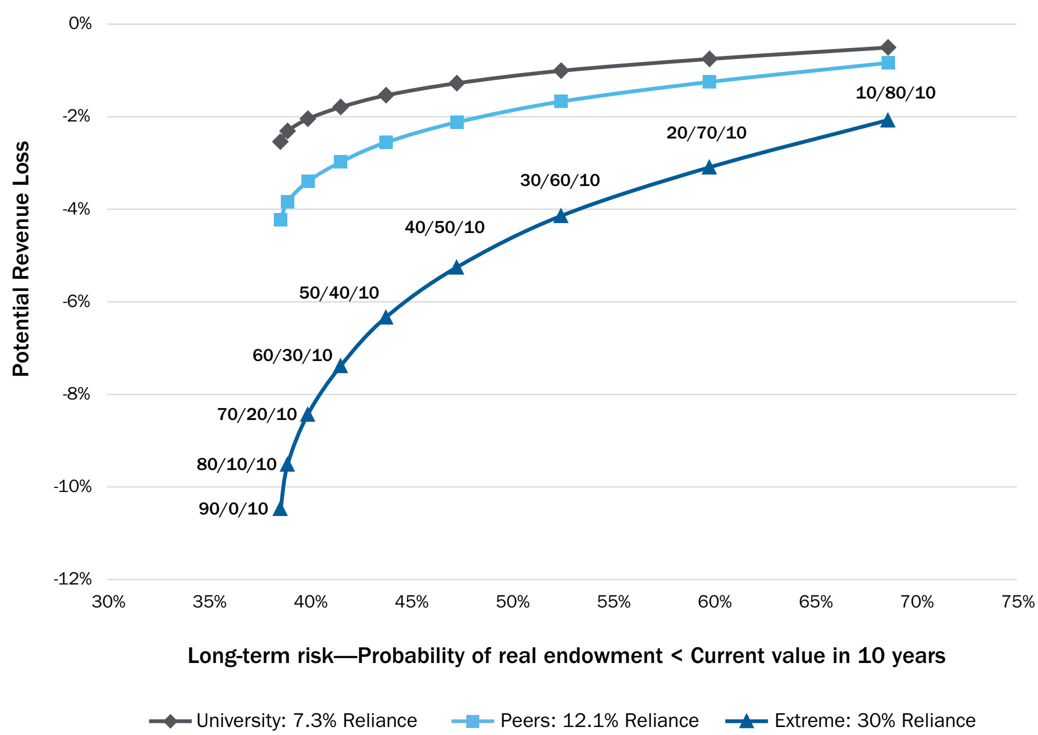


Exhibit 2 illustrates various endowment asset allocations and assesses the impact of adverse market conditions on the university's annual revenue. Institutions with a lower percentage of annual revenue from the endowment, as illustrated by our sample university with a 7.3% reliance, have significantly less risk than an institution that receives 30% of its income from its endowment. This suggests that the sample university endowment can adopt a riskier asset allocation than the university with the 30% reliance on its endowment because of the smaller reduction in income from adverse endowment performance.

Exhibit 2: Operating Budget Sensitivity to the Endowment's Asset Allocation

Revenue constraint vs. asset allocation (equities/bonds/real assets)



Your Institution's Balance Sheet Profile and Endowment

Assessing risk also requires understanding an institution's assets and liabilities. As with the revenue analysis, the value of the endowment as a percentage of the university's balance sheet can be an important risk factor. It is also important to consider the overall debt level, the weighted-average interest rate, and the potential trend in the institution's debt and interest rate burden. More leverage coupled with higher interest rates could result in a negative impact to the university's credit rating and debt covenants should there be a downturn in revenues supporting the debt.

It is important to analyze the impact that the endowment has on the institution's balance sheet. As shown in **Exhibit 3**, our sample university's endowment represents 53% of the institution's total assets. After determining this percentage, the next step is to understand the potential sensitivity of the balance sheet to changes in the endowment's market value.

Exhibit 3: Balance Sheet Profile

Assets and Liabilities

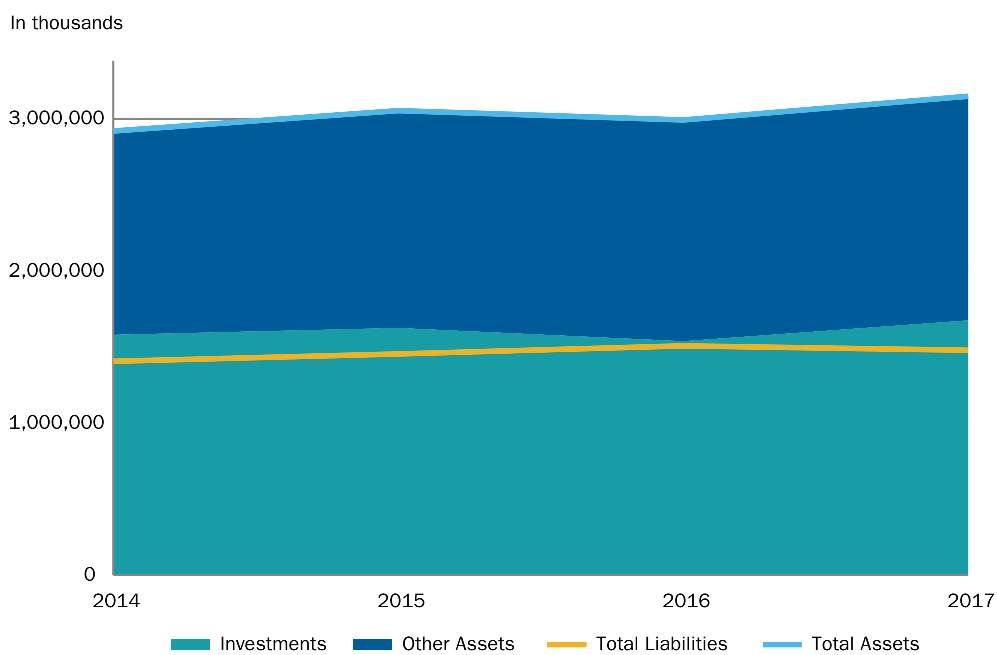
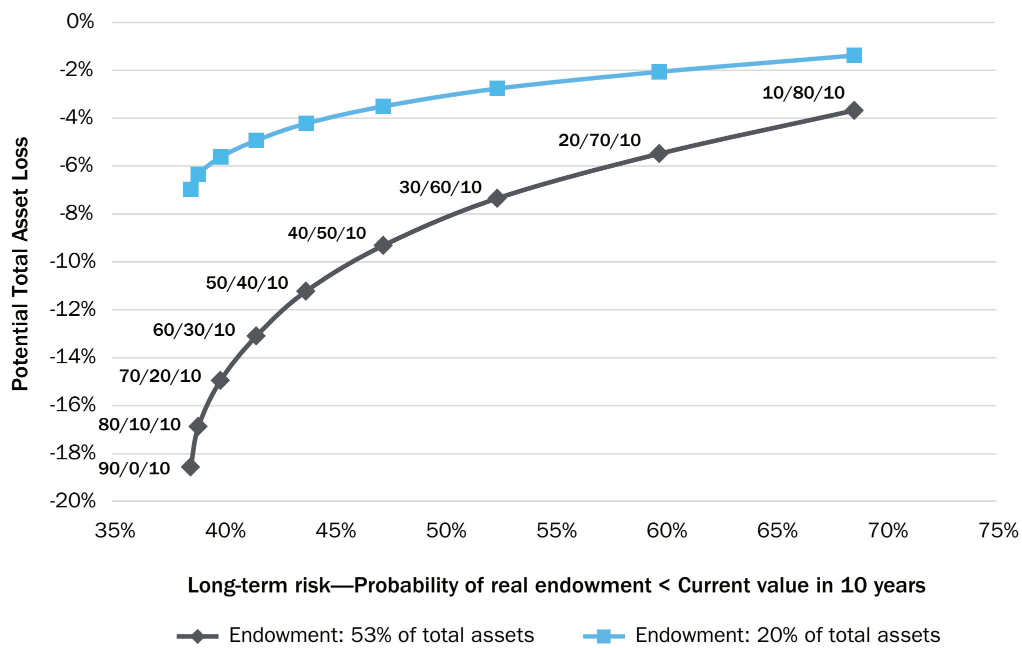


Exhibit 4 illustrates various endowment asset allocations under adverse market conditions and assesses the impact of a market downturn on the institution's balance sheet. When the endowment represents a higher percentage of the total institutional assets as illustrated by this sample university, there is significantly more risk than for an institution with a lower percentage. These differences point to taking on more or less risk in the endowment depending on the institution's reliance on endowment spending. In other words, institutions with more leverage might experience greater challenges to the health of their balance sheet during a market correction—which might argue for a more conservative asset allocation for the endowment.

Exhibit 4: Balance Sheet Sensitivity to the Endowment's Asset Allocation



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Enterprise Approach to Endowment Management: The Benefits

The above examples represent just two integrated analyses. In order to fully understand the institution's total risk, planned capital spending, fundraising efforts and capital campaigns, refinancing opportunities, and revenue and expenses should all be factored into the integrated analysis. The potential benefits of this approach to the endowment and the institution it supports include:

- Ensuring that the endowment is being used in the most productive way for the benefit of the institution;
- Quantifying the risks to the institution's financial profile that result from the endowment's investment strategy; and
- Providing a framework for managing the endowment that optimizes the long-term sustainability of the institution.

Today, it is important for trustees, investment committee members, and finance staff to have a clear picture of whether the endowment is taking on too much risk or not enough—and to fully understand the implications to the institution of their choices. As fiduciaries, they have an opportunity and an obligation to engage with stakeholders to ensure the long-term sustainability of the institution.

TIAA Endowment & Philanthropic Services offers an enterprise approach to endowment management that delivers critical insights using balance sheet, income statement, and capital market analyses to model scenarios. For more information, please email TEPS@tiaa.org.

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