American Council on Education
Leadership and Advocacy

Understanding College and University Endowments

Brief answers to questions frequently asked by students, faculty, alumni, journalists, public officials, and others interested in the financial circumstances of American colleges and universities.

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WHAT DOES AN ENDOWMENT DO?

An endowment links past, current, and future generations. It allows an institution to make commitments far into the future, knowing that resources to meet those commitments will continue to be available.

An endowment is an aggregation of assets invested by a college or university to support its educational mission in perpetuity. An institution's endowment actually comprises hundreds or thousands of individual endowments. An endowment allows donors to transfer their private dollars to public purposes with the assurance that their gifts will serve these purposes for as long as the institution continues to exist. An endowment represents a compact between a donor and an institution. It links past, current, and future generations. It also allows an institution to make commitments far into the future, knowing that resources to meet those commitments will continue to be available.

Endowments serve institutions and the public by:

- **Providing stability.** College and university revenues fluctuate over time with changes in enrollment (tuition), donor interest (gifts), and public (largely state and federal) support. Although endowment earnings also vary with changes in financial markets and investment strategies, most institutions follow prudent guidelines (spending rates) to buffer economic fluctuations that are intended to produce a relatively stable stream of income. Since endowment principal is not spent, the interest generated by endowment earnings supports institutional priorities year after year. This kind of stability is especially important for activities that cannot readily be started and stopped, or for which fluctuating levels of support could be costly or debilitating. Endowments frequently support student aid, faculty positions, innovative academic programs, medical research, and libraries.
- **Leveraging other sources of revenue.** In recent years, as the economy has been severely stressed, institutions have dramatically increased their own student aid expenditures, and endowments have enabled institutions to respond more fully to changing demographics and families' financial need. It is not surprising that the colleges and universities with the largest endowments are also the ones most likely to offer need-blind admission (admitting students without regard to financial circumstances and then providing enough financial aid to enable those admitted to attend). An endowment also allows a college or university to provide a higher level of quality or service at a lower price than would otherwise be possible. This has been especially important in recent years, particularly for publicly supported institutions that have experienced significant cuts in state support. Without endowments or other private gifts, institutions would have had to cut back even further on their programs, levy even greater increases in their prices to students, and/or obtain additional public funding to maintain current programs at current prices.

- **Encouraging innovation and flexibility.** An endowment enables faculty and students to conduct innovative research, explore new academic fields, apply new technologies, and develop new teaching methods even if funding is not readily available from other sources, including tuition, gifts, or grants. Such innovation and flexibility has led to entirely new programs and to important discoveries in science, medicine, education, and other fields.
- **Allowing a longer time horizon.** Unlike gifts expended upon receipt, an endowed gift keeps giving over time. Endowed institutions can plan strategically to use a more reliable stream of earnings to strengthen and enhance the quality of their programs, even if many years will be required to achieve some of their goals. By making endowed gifts, alumni and others take responsibility for ensuring the long-term well-being of colleges and universities; their gifts help enable future generations of students to benefit from a higher quality of education and allow these institutions to make even greater contributions to the public good.

Who has endowments and in what amounts?

Although the concept of endowment originated in England in the fifteenth and sixteenth centuries, the development of endowments for institutions of higher education is a decidedly American phenomenon. For more than 300 years, endowments have supported American colleges and universities. Many other kinds of institutions in this country also maintain endowments, including churches, hospitals, museums, private secondary schools, and cultural and performing arts groups. Endowments are frequently described as if they were a single fund, when in fact, they are an aggregation of discrete funds, each with its own stipulations about the purposes for which it can be used. Especially at institutions with graduate and professional schools, the aggregate size of the institution's endowment may be misleading because much of the endowment income may not be available to support undergraduate programs.

Much of endowment spending is restricted by the donor to specific programs, departments, or schools for which particular endowed funds have been designated.

While public attention focuses primarily on the relatively small number of colleges and universities with large endowments, most colleges and universities have only modest endowments or none at all. Although some public universities' endowments rank among the largest, most public institutions have only nominal endowments or none at all (although they may receive significant state subsidies, which typically are not available to private colleges and universities). As of fiscal year 2012, 53 percent of four- and two-year private nonprofit colleges and universities had endowments of less than $10 million. The median endowment at private colleges and universities is roughly $7.9 million, which at a typical spending rate of about 4 percent to 5 percent would support an annual expenditure of between $316,000 and $340,000. Of the nation's approximately 4,000 public and private nonprofit colleges and universities, only 657—or about 16 percent—had endowments over $50 million. Only 62 institutions (1.6 percent of all colleges and universities) had endowments exceeding $1 billion. Of these, 46 were private and 16 were public.

Whatever its size, an endowment can provide critical support for current programs and the promise of consistent support into the future. But even the largest endowments can only supplement—not replace—annual funding from tuition, non-endowment gifts, federal grants, and, especially in the case of public institutions, state appropriations. Most institutions can cover only very modest fractions of their annual budgets with earnings from their endowments.

How is an endowment created?

An endowment typically includes funds given to an institution by donors who have stipulated as a condition of the gift that its principal may not be spent, and who expect that its value will increase over time through a responsible balance between expenditure and reinvestment of its earnings. In many cases, the donor restricts the income to one or several purposes; if so, the institution must spend the income for those purposes. In other cases, the institution is given discretion by the donor to select the educational purposes to be served, but it is still restricted to spending only the income.

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Occasionally, colleges and universities receive gifts from donors who permit the spending of principal, but the institution's governing board decides for reasons of prudence and stability to treat the gift as an endowment. These may be referred to as "funds functioning as endowment." Institutions typically use these funds to meet long-term obligations that require increasing levels of support year after year (such as professorships or scholarships). For example, a donor may contribute $1 million to support a university's history department, but with no further stipulation as to how the money is to be spent. The university could decide to spend all $1 million the following year to augment faculty salaries, support graduate students, conduct research, add library books, or perhaps make physical repairs to offices, classrooms, or laboratories. Each of these expenditures would address important needs, but at the end of that year there would be no funds remaining to sustain these spending levels or to help meet the many continuing needs of the department.

Alternatively, the university could invest the $1 million so that its value would be preserved over time and its earnings year after year, in good times and bad, would be available to the department to meet its continuing commitments. At most colleges and universities, this investment would generate about $40,000 to $50,000 of spendable income each year (increasing annually at roughly the rate of inflation). If the university chooses to invest the gift, it will be "functioning as endowment." Among all higher education institutions, 88 percent of invested funds are reported as endowment and 12 percent are classified as quasi-endowed funds (funds functioning as endowments). While institutions retain some flexibility to re-designate funds that they have elected to use as endowment, they are legally obligated to adhere to the terms of gifts that have been contributed as endowment.

How do institutions with endowments balance the present and the future?

Endowments originated to establish a pact between generations: a promise from past and current donors to future students and faculty that the institution will sustain certain commitments over time. In the face of the international economic crisis following the financial collapse in 2008, most institutions made significant budget cuts, and in some cases, the difficult choice to temporarily increase their spending rate above normal levels in order to help moderate higher tuition increases, maintain or increase student aid, and support the quality of their programs. Similarly, the severe damage to facilities from recent tornados, earthquakes, and floods have cost institutions hundreds of millions of dollars, and given the inability of strapped governments to provide financial relief, some institutions temporarily increased their spending rate.

There is always a temptation to increase current spending to meet the very real needs of today's students and faculty. Institutional leaders understand that this generation could not be supported at today's level of quality if earlier generations had not had the discipline to sustain the purchasing power of their endowments. Similarly, future generations depend on the current one to balance the claims of the future against the claims of the present. In those instances where institutions temporarily increase their endowment spending rate, it is generally for a short period, and then the more conservative rate is reinstated.

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As fiduciaries, trustees have a legal and moral obligation to donors, many long since deceased, who intended that their gifts would support not just one generation, but succeeding generations indefinitely. Many states have statutes, such as the Management of Institutional Funds Acts, that specifically require trustees to consider both the "long and short term needs of the institution" and its "present and anticipated financial requirements." To keep pace with the rising costs of education, research, and campus life, trustees must reinvest some of each year's earnings and add new gifts as well. Forty years ago, a donor wishing to endow a professorship at a major university could have done so with a gift of about $700,000. That amount of principal in 1970 would have generated sufficient income to pay the salary of a distinguished professor. But if all of the income generated over the years by that principal had been spent, leaving only the original $700,000, its earnings now would not come close to supporting a professor's salary.

To sustain the purchasing power of the endowment—so that a fund supporting a faculty position today will still be able to support a faculty position 20, 30, or even 50 years from now—institutions must divide each year's earnings between dollars that are spent immediately and dollars that are added to principal to preserve its value for the future. The trustees of many colleges and universities have established spending rates under which their institutions spend endowment earnings each year equal to about 4 to 5 percent of the value of their endowment. If the institution achieves a total return of 7 to 8 percent, and can expect inflation of 2 to 3 percent, it can reinvest the 1 to 2 percent it does not spend to cover inflationary increases in costs. Because of the labor-intensive nature of the educational process, the increasing costs of laboratories, libraries, and new technologies, and the growing demand for institutional sources of student aid, college and university costs can be expected to rise faster than the Consumer Price Index (CPI) by at least a percentage point or two. At current CPI levels, a 1 to 2 percent real (inflation-adjusted)

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increase in the value of the endowment each year through reinvestment should keep pace with increases in the institution's costs, although this level of reinvestment may not be sufficient for the endowment to support new initiatives or substantial improvements in quality without the addition of new gifts. And as we have seen in the past two decades, including the financial collapse of 2008, sustaining average returns of at least 1 to 2 percent has not always been possible.

In the exceptionally strong financial markets of the 1990s, many endowments achieved returns higher than 9 to 10 percent. While this led some institutions to adopt spending rates higher than 4 percent, others chose an alternative strategy of making periodic upward adjustments in the amounts spent without changing their basic policies. This strategy allowed institutions to apply some of the unusually high earnings of those years to current needs while recognizing the period's rates of return were not likely to continue indefinitely. In other words, students and faculty benefited from higher spending levels than otherwise would have been the case, but some of the strong earnings of those years were held in reserve. The wisdom of this strategy was illustrated in the latter years of this century's first decade, when the financial markets were far weaker and average returns were far lower than the traditional 9 percent to 10 percent target.

To appreciate the importance of preserving the long-term strength of endowments, it is useful to compare the period of 1990 to 1999 with 2002 to 2012:

In the year ending June 30, 1999, the average return for all college and university endowments was 11 percent. The 10-year average, from 1990 through 1999, was 12.9 percent, and while some years were significantly higher, the average returns were only 7.4 percent in 1991 and 3.0 percent in 1994.

Since 2002, there have been significant fluctuations in average endowment returns, including four years of negative annual average returns in 2002 (-6.2 percent), 2008 (-3.0 percent), 2009 (-18.7 percent), 2012 (-0.3 percent).

In the fiscal year ending June 30, 2013, the average return of all college and university endowments was 11.7 percent. The 10-year average, from 2003 through 2013, was 7.1 percent.

Every year, some endowments significantly outperform the averages, while others lag behind or may even lose value, depending on their particular investments. Just like families, institutions need reserves to protect against unexpected expenses. Reserves protect against future economic downturns or declines in enrollment, donations, or government support, and to pay for unanticipated costs, such as repairs or renovations to comply with new safety standards or to recover from natural disasters, such as floods or earthquakes. Funds functioning as endowment and other capital funds permit an institution to cover its deficits and pay its bills without having to take hasty actions that might seriously damage its quality or its financial capacity. When institutions do have to spend principal, they reduce the size of their reserve and the future income that their investments will be able to generate. This, in turn, reduces the stream of steady, reliable income that will be available to make future commitments and enhance the quality of their programs. The challenge is to find an appropriate balance: not being so cautious that important current needs are unmet, but being cautious enough so that the institution is prepared to weather serious reversals in the national economy.

How are endowments invested?

Before the twentieth century, real estate was a primary endowment asset for educational institutions. Today's endowments are invested most heavily in commodities, natural resources, private equity, and other illiquid assets. One of the most important responsibilities of trustees is to oversee the management and allocation of the institution's assets. Trustees are legally obligated to be prudent in their investment management, but they also should make every effort to achieve as substantial a return as prudence will allow. As the investment world has become more sophisticated in recent years, such nontraditional investments as commercial real estate, venture capital, foreign securities, and other kinds of funds have received increased attention. A 2013 study by the National Association of College and University Business Officers (NACUBO) and Commonfund Institute found that whereas the average institution had invested 95.3 percent of its endowment in traditional stocks, bonds, and cash in 1990, by 2013 this percentage had declined to 47 percent, with 20 percent in marketable alternatives (hedge funds), 12 percent in private equity, 7 percent in non-campus real estate, 5 percent in natural resources (oil, gas, etc.), and 9 percent in other investments. For educational and many other charitable institutions, most endowment investments yield earnings that are exempt from taxation. This exemption dates back to the earliest days of the income tax in this country, and recognizes the public purposes that are served by these institutions. Because of this exemption, donors know that institutions will be able to use all of the earnings on their gifts to support the purposes the donors wish to serve. The tax exemption on endowment earnings is an important way in which society contributes to the support of American higher education.

How are endowments managed?

Each institution adopts its own strategies and rules to maximize its endowment's capacity to support both current spending and future needs. Some institutions manage their endowments with their own staff; others rely on their trustees; others contract with professional managers; and others use a combination of approaches. Some institutions seek to maximize income, while others focus on total return (defined as income plus capital appreciation). Many adopt formal spending rules that seek: (1) to ensure a growing stream of revenues from the endowment to support each year's expenditures; (2) to ensure sufficient reinvestment so that the value of the endowment is maintained relative to rising costs over time; and (3) to permit greater predictability in budgeting by smoothing out year-by-year fluctuations in earnings. To meet this third objective, an institution might call for spending a somewhat smaller fraction of earnings during favorable periods so that somewhat larger fractions can be spent during leaner times. For many institutions, this strategy has proven to be preferable to expanding the institution's budget in response to higher returns, only to have to make substantial spending cuts in a later year to accommodate a more typical—or an unusually low—level of income.

Spending rules are the planning mechanism through which institutions seek to deliver a maximum quantity and quality of educational services today without eroding their capacity to support equivalent educational services in the future.

How are endowments used?

For private—and increasingly for public—colleges and universities, endowments provide stability, flexibility, and a degree of confidence for the future. They enable institutions to aim higher and to achieve their educational and charitable purposes more effectively. These benefits—to the institutions and to those they serve—justify the effort necessary to build and maintain endowments. For students, their families, and society generally, endowments allow institutions to deliver greater value, and attain a higher level of quality, than would otherwise be possible in their teaching and research. The reliable long-term support from an endowment enables institutions to increase student aid, make commitments to senior faculty, initiate pioneering research, develop stronger teaching programs, invest in new technologies, and maintain their libraries, laboratories, and other physical assets. Even in difficult financial times, an endowment can sustain an institution's teaching and research and allow it to provide essential support to its faculty and students.

> For private—and increasingly for public—colleges and universities, endowments are used to support student financial aid, teaching, research and innovation, public service, and other campus activities.

Endowments also allow institutions to engage in long-range planning with confidence that they will have the resources necessary to complete their most important projects. Institutions need long time horizons to make capital improvements, build strengths in emerging academic fields, and adapt to the changing needs and interests of their students and the broader society. Finally, endowments stimulate contributions from donors who want to be sure that their gifts will benefit an institution's educational purposes in perpetuity. This charitable impulse to commit private dollars to the unceasing support of valued public purposes continues to create and strengthen endowments for the benefit of this and future generations.

Why do institutions with large endowments keep increasing tuition?

Institutions with endowments use them, along with other resources, to offer programs of greater quality than either the endowed funds or the institution's other resources could support by themselves. In many cases, donors explicitly direct their gifts toward expenditures that expand or enhance the institution's programs, and may even make the institution more expensive to operate. It is not uncommon for a donor to pay for the construction of a building but not for its maintenance or operation, or to seek assurance that the institution will not substitute endowment dollars for other funds. Even at the best-endowed institutions, endowment income represents only a small fraction of the overall operating budget. Tuition plays an important role in meeting other costs. At the same time, endowments help institutions provide financial aid to students who cannot afford full tuition. If institutions spent additional endowment earnings or principal rather than increasing tuition (thereby depleting the purchasing power of the endowment over time), tuition would have to rise more sharply in the future as endowment earnings declined, and there would be less funding available for financial aid.

Why do institutions conduct campaigns to increase an endowment rather than raise funds for immediate needs, such as student aid or building renovations?

Most institutions do both. They raise annual funds to help meet immediate needs, but they also raise endowment to help meet these kinds of needs—and other needs—in the future. Endowed institutions meet the needs of today with earnings from endowed funds they were given in the past, and the endowed funds they raise now will help ensure that they can continue to educate students and support faculty research even when government budgets are tight or economic downturns reduce annual voluntary contributions.

Questions & Answers

Why should a donor give to a college or university with a large endowment, as opposed to a charity in greater need of funds?

Most colleges and universities hope that donors will do both. These institutions typically encourage students—and in some cases alumni and others—to participate in community service. But with the costs of high-quality education and research growing rapidly as colleges and universities expand financial aid programs to support students, pursue the very best faculty, adopt new technologies, and try to keep pace with the expansion of knowledge, these institutions also need additional resources if they are to serve their public purposes effectively and remain world leaders in their fields. As centers of learning, these institutions preserve the experience and wisdom of the past while also shaping the future by expanding human understanding and preparing the leaders of each generation.

Why shouldn't colleges and universities be required to spend a minimum amount from their endowments each year, much as foundations are required to meet minimum payout standards?

Foundations and universities are very different kinds of institutions. In the case of a foundation, the public has an interest in ensuring that, in return for the tax advantages granted to the donor, the foundation is adequately serving its charitable purposes, and the most effective way to ensure this may be through a minimum payout requirement. By contrast, funds donated to college and university endowments are given for the express purpose of supporting designated educational or scholarly activities over a long period of time. There are many constituencies that play a role in ensuring that these dollars are spent for their intended purposes, including students, faculty, alumni, local residents, and government agencies. If anything, the pressures on colleges and universities push in the direction of spending more of the endowment's earnings on current purposes, to the potential detriment of sustaining the purchasing power of the endowment for a future in which the costs of high-quality education and research are likely to be even greater than they are now.

Size

- Most public colleges and universities have no substantial endowments.
- 54 percent of private institutions have endowments of less than $10 million.
- The median endowment at private colleges and universities is roughly $7.9 million, which at a typical spending rate would support an annual expenditure of annual expenditure of between $316,000 and $340,000.
- Of the nation's 4,000 public and private nonprofit two- and four-year colleges and universities, only 657—about 16 percent—have endowments over $50 million.
- Of the 62 institutions with endowments exceeding $1 billion, 46 are private and 16 are public (as of fiscal year 2012). Of the 100 largest endowments, roughly 31 were at public universities.
- In addition to colleges and universities, other institutions with endowments include churches, hospitals, museums, private secondary schools, and performing arts groups.

Composition

- An endowment typically includes many different funds.
- Some funds are given with the stipulation that principal shall never be spent. In many of these cases, the donor restricts the income to one or several purposes, programs, or departments. Especially at research universities, a significant fraction of the endowment may not be available to support undergraduate programs.
- In other cases, the institution can select the educational purposes the gift will serve, but it can still only spend income.
- Sometimes donors permit the spending of principal, but the institution decides to treat the gift as endowment so it can continue to yield income in support of long-term obligations. These are called "funds functioning as endowment."
- Among all higher education institutions, 88 percent of invested funds are reported as endowment and 12 percent as quasi-endowment.

Endowment Fact Sheet

Spending Rules

- Most college and university governing boards adopt endowment spending policies that are designed to maintain a smooth spending course while achieving intergenerational equity. The principle of intergenerational equity ensures that future generations of students and faculty receive at least the same level of support from an institution's endowment as the current generation enjoys. Typical spending policies aim to prevent weak investment returns from forcing commensurate decreases in spending. When investment returns are robust, spending rules help to ensure that any increased spending can be sustained into the future. Thus, a "smoothing" rule determines spending based on the multi-year value of an endowment that promotes consistent funding over time to ensure sustained academic quality and support for students.
- Institutions, on average, seek endowment growth of at least 8 percent a year (dividends plus appreciation) to keep up with inflation, cover investment management costs, and approach a 5 percent spending rate.
- Different assumptions about the long-term rates of increase in costs or in the value of the endowment might yield a different rule. In periods with consistently strong financial markets, institutions may go beyond their rules and make additional upward adjustments in their spending of endowment income, while also creating additional reserves for those years when markets fall short of their long-term targets.
- Over the past decade, the average return for college and university endowments was 7.1 percent; in 2009, the average return was -18.7 percent. In 2013, the average one-year return was 11.7 percent.
- Over the past decade, the average spending rate for college and university endowments was 4.5 percent; In 2010 and 2011, the institutions with the largest endowments (above $500 million) spent over 5 percent each year; in 2013 the average spending rate was 4.4 percent.

Benefits to Society

- Endowments allow institutions to deliver greater value and attain higher levels of quality than would otherwise be possible.
- Reliable long-term support from an endowment enables institutions to increase student aid, make commitments to senior faculty, initiate pioneering research, develop stronger teaching programs, invest in new technologies, and maintain their libraries, laboratories, and other physical assets.
- Even in difficult financial times, endowments can sustain institutions' teaching and research and allow them to provide essential support for faculty and students.
- Endowments also allow institutions to engage in long-range planning with confidence that they will have the resources necessary to complete their most important projects.
- Institutions need long time horizons to make capital improvements, build strengths in emerging academic fields, and adapt to the changing needs and interests of their students and the broader society.

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