

THE EQUILIBRIUM SPENDING RATE FORMULA AND WHY IT IS IMPORTANT

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“Upon this rock I will build my church.” God was talking about Peter in the book of Matthew. He needed a foundation to build something great. As is with much of the Bible, the analogy can be used in so many circumstances.

**EVERYONE WHO
IS TRYING TO
BUILD SOMETHING
SPECIAL NEEDS A
FOUNDATIONAL
PIECE FROM WHICH
TO BUILD.**

**THE EQUILIBRIUM
SPENDING RATE IS
THE FOUNDATIONAL
PIECE OF A WELL-
CONSTRUCTED
PORTFOLIO IN THE
INSTITUTIONAL
WORLD.**

Companies use Mission Statements as their foundation. It doesn't matter what the business is, a good mission statement will keep it on track. Likewise, foundations and endowments have a Statement of Purpose, which is a formal statement of why they exist and what they hope to accomplish. Organizations that fail have often times forgotten their purpose.

The common denominator of Mission Statements and Statements of Purpose is that they don't sweat the details. They simply declare what the big picture is going to look like. The details are left up to the staff, internal and external, to figure out.



It allows investment committees to have significant input into the construction of the portfolio without straying too far from their expertise.

Investment committees are charged with managing a fiduciarily sound investment portfolio that will meet the needs of the foundation. It's a big responsibility for a committee that is usually made up of people that have a passion for the purpose but lack the skills of determining the appropriate correlation of asset classes, capital market projections, downside standard deviation, manager alpha, or successful implementation of a socially responsible investment strategy.

What investment committees can do well is weigh in on the big picture components that advisors use to create the appropriate portfolio. That is where the Equilibrium Spending Rate Formula does its work.

The Formula is as follows:

$$\text{ESR} = \text{TR} - \text{I} - \text{E}$$

Equilibrium Spending Rate

=

Targeted Return - Inflation - Expenses

As in all good four variable equations, if you have three of the variables, you can get the fourth. The exercise of filling in the numbers is significant for an investment committee. Successful investment committees need to agree on the big picture. There are no right or wrong answers when determining the future rate of inflation, expenses, or spending needs, but agreeing on the target numbers the committee will use in the equation is paramount to a successful long-term strategy that will withstand the onslaught of market turbulence over time.

Let's look at each component of the equation going from the easiest to the hardest for an investment committee to determine:



EXPENSES:

Expenses are any costs that come out of the portfolio before putting the money to work for the purpose of the organization. In many portfolios expenses for money management, custody, trading, etc. are included before reporting the return on investment. These "internal" costs are not considered part of this equation under expenses because they will be picked up under the targeted return which is determined net of those fees.

Typical expenses that are to be considered are operating expenses of the organization, outsourced provider expenses and project fees. Often an organization takes a certain percentage, such as 1% of portfolio market value to determine their operating budget, making it much easier to determine this component. If that is not the case, a committee must look at previous years to determine an average of expenses and then convert that number into a percentage of the portfolio to use. In other cases, operating expenses are raised separately from the portfolio so it is possible that the expense component could be zero.

EXPENSES ARE SOMETHING THAT A FOUNDATION CAN ABSOLUTELY CONTROL, HOWEVER IT IS NOT EASY OR FAST TO DO SO. CUTTING SERVICES, FIRING EMPLOYEES OR SELLING ASSETS TAKES TIME.



INFLATION:

There are so many factors that affect the rate of inflation over a period of time (in this case ten years or more) that it is virtually impossible to forecast an average inflation rate with any confidence. Nevertheless,

A CORE GOAL OF MOST FOUNDATIONS IS TO MAINTAIN PURCHASING POWER BY EARNING A RATE OF RETURN THAT KEEPS PACE WITH INFLATION AFTER EXPENSES AND DISBURSEMENTS ARE SUBTRACTED.

The most common paths to determining an inflation rate are:

- » A consensus of the investment committee after open discussion
- » The use of an historical average
- » A projected rate determined by a considered expert in the field

The inflation rate is going to be what it is going to be. There isn't anything that an investment committee can do to change the inflation rate. They can only react to it. That is why it is imperative that they continue to monitor movements in the rate of inflation in the event that there is a need to change the rate in the formula.

The last two components are critical as they have a direct effect on each other and they are the two components that are the most easily changed.



SPENDING RATE:

Changing the spending rate or the targeted return are both very easy and fast to accomplish. At least from a mechanical point of view. However, the effect on the foundation can be substantial.

CHANGING THE SPENDING RATE CAN HAVE MAJOR CONSEQUENCES TO THOSE CAUSES THAT A FOUNDATION SUPPORTS.

If a million dollar foundation changes its spending rate from 5% to 4%, that means that the money they spend on the causes they care about has gone from \$50,000.00 to \$40,000.00 annually, a 20% reduction. It is easy to change the rate yet can be very hard to implement the change.

TARGETED RETURN:

Changing the targeted return is also easy to do yet hard to implement. If a foundation decides to increase their spending rate from 4%-5% then the portfolio is required to earn an extra percent return per year. That means a change to a more aggressive portfolio, which means an increase in the risk taken to get the return. An investment committee that is comfortable with their current risk level may not want to take on more risk.

MANY INVESTMENT COMMITTEES SET THE DIFFERENT COMPONENTS IN THE EQUATIONS WITHOUT CONSIDERING THE EFFECT EACH ONE HAS ON THE OTHER.

However, they each have an effect on the final result.

Inflation is a guess and because of that it is easy to see why an investment committee would be tempted to change their forecast so you don't have to make other, more difficult choices. No one knows what the right number is, so there is a chance that, even after changing it, you may be right. However, that can be a big mistake in regards to the long-term



performance of the foundation. Changing the number simply so you don't have to make a hard choice in another part of the equation is not a good idea. Pick a number and stick with it.

Expenses are what they are. A committee can certainly do things to increase or decrease their expenses, however, in most foundations this is a fairly fixed number.

Once you agree on inflation and expenses, then all you have left is to plug in one more number. The investment committee is charged with determining which of these last two components is the most important.

If it is imperative to have a certain spending rate, then you can simply add together $ESR + I + E = TR$. You have found your targeted return and you can put together a portfolio that is anticipated to get that return over time. If the investment committee is uncomfortable with taking more than a certain amount of risk and that risk level won't, in turn, get the return needed to maintain the agreed upon spending rate, then the spending rate has to change.

The one thing that is never appropriate is to put numbers in the equation that don't add up. It is not unusual to see a foundation with, for example, a 5% spending rate, inflation forecasted for 2.5%, expenses of 1% and a portfolio targeted return of 7.5%. This is what that formula looks like:

$$5 = 7.5 - 2.5 - 1$$

OR

$$5 = 4$$



As someone once said to me, math don't lie. I don't think he was an English major but he was good at math. What do you have to do in this case? You have to either change the spending rate to 4% or you have to change the targeted return to 8.5%. Either one will give you $5=5$.

Once again, easy to do, hard to implement. The investment committee has to either spend less on good causes or take more risk in their investments. The coward's way out is to change the inflation rate and pretend that you made an informed decision. Expenses can be changed but in general, as stated above, expenses are expenses. Changing the expense number may take smoke and mirrors and that will get you in trouble down the road.

At some point in this scenario it should become apparent that the two factors that have to be looked at when the numbers don't add up are:

- » How much you spend (ESR)
- » How much you make (TR)

Changing either of these factors requires tough choices but, if it were easy, anyone could do it.

THE THING I LIKE ABOUT MATH IS THAT IT WON'T LIE TO YOU JUST TO MAKE YOU FEEL GOOD.

It doesn't tell you what to change but it will tell you if your numbers don't match up. The process of going through the Equilibrium Spending Rate Formula is a critical step in making sure that your numbers add up and your foundation is on the right track to get you where you want to go.

