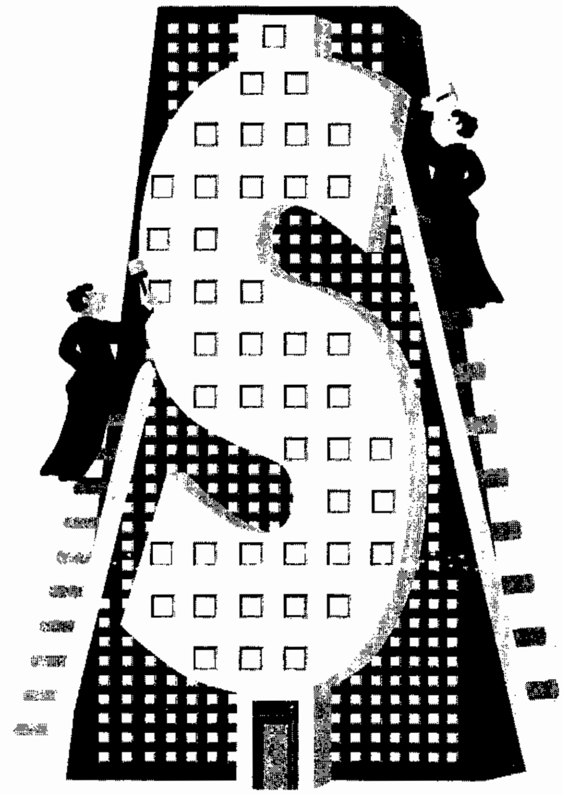
BUILDING ENDOWMENT

5 Steps to Success



By James E. Connell, FAHP, and Richard P. Green, J.D., FAHP

Health care organizations across North America are expressing great interest in building endowment. And no wonder. Endowment building is an age-old method that provides stable and consistent support to charitable missions. Not only does it offer your organization the opportunity to creatively honor your donors, but it matches their needs to those of your organization. It also gives your organization an opportunity to better market your institution's credibility, reputation, and record of good management.

Building endowment is a five-stage effort. First, the charity must establish endowment policies and protocols. Second, it must raise new money for its endowment priorities. Third, it must invest these funds with the long-term growth of capital as its objective. Fourth, it must determine a prudent spending formula, which will dictate how much of the portfolio's growth will be spent and retained. Fifth, it must build into each fund-raising and/or corporate budget a planned capital surplus, which can be allocated at the direction of trustees or set aside at the end of each fiscal year as an unrestricted endowment account.

This article will examine each of these stages. First, however, let's develop a better understanding of endowment and the fund-building process.

The what and why of endowment

The *New Webster's Dictionary of the English Language* defines endowment as "revenue or property permanently appropriated to any person or place." We'd like to offer a more functional definition: *Funds that are permanently set aside and invested to generate philanthropy resources; expenditures are made from the earnings while the principal remains intact.*

Endowments have their roots in the 13th century, when English landowners gave land to the Church to support the good works of the Franciscan fathers. In the 19th century, they evolved. Instead of land, moneys were set aside to generate interest funds that would be used for charitable purposes.

The main reason to have an endowment is to provide financial stability and security to your charitable mission. Endowment can provide a dependable source of annual revenue for your health care programs and help you develop a capital base to start new ones. Additionally, unrestricted endowment can be used to "match" other gifts. More importantly, endowment can provide a springboard for positive encounters with donors.

Endowment provides donors with a method of perpetuating their giving to your organization beyond their lifetimes. Donors can be honored or can honor others through named funds. A named fund allows donors and their families not only to become meaningfully involved with your organization, but to make contributions that truly "make a difference" to their communities.

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Step 1—Establishing endowment policies and protocols

The first step in the endowment-building process is to establish an ad hoc committee of your board to research endowment policies for your organization. The committee then proposes a resolution to the full board, setting forth policies for administering the fund. Among others, these policies should outline the fund's purpose, the individual or bodies who will oversee it, and the fund's investment policy, definition of principal, and spending formula. The resolution also should contain a policy stating that planned and estate gifts not otherwise designated be placed in the endowment fund.

Formulating a protocol calls for significant board education. The protocol itself serves as the institutional history for the account and is especially important because funds may not be needed or accessed for many years. All policies should be presented to the board for vote and recorded in the minutes of the board's actions.

Once developed, the policies can be reduced to an informational piece for general discussion with the donor. The final protocol is tailored to the wishes of the donor and the needs of the institution, and signed by both parties.

Communication plans

Every charity should develop a plan to communicate to its internal and external audiences the nature, impact, and community benefit of endowment funds. A charity may wish to develop a guide to achieving philanthropic objectives with endowments. This booklet would explain the benefits of creating an endowment; areas of priority needs; a legal review of the tax ramifications of gifting various assets to the endowment fund; administrative and investment opportunities; spending formula requirements; expenditure procedures; operating rules of the fund; the advisory role of donors in the granting process; and, possibly, a comparison of a public charity endowment fund and a private foundation. Booklets on the nature and impact of charitable life income arrangements and bequests should support the endowment brochure.

Endowment procedures should stipulate the minimum required amount to endow selected programs or projects.

Minimum gift amounts

The establishment of permanent endowment funds requires that the charity's leadership establish minimum gift amounts. The minimum suggested gift level for a permanent named endowment should be $10,000. In addition, a maximum pledge period should be determined. A five-year pledge period to fully fund an endowment fund is common. If the fund is not fully funded within that time, it should be converted to a term endowment, and the principal and earnings should be spent within three years. Endowment fund policies should determine whether the charity may use funds raised for a minimally funded endowment (e.g., one of $10,000) for restricted or unrestricted purposes.

In addition to a minimum entry level, endowment procedures should stipulate the minimum required amount to endow selected programs or projects. Endowments of $25,000 or more can be used to support both unrestricted and restricted purposes. Endowments of $100,000 or more can support a named position and involve donors in grant decisions. Endowments of $250,000 or more could support a named program (e.g., a cancer or heart program) to which the donor's name is permanently associated. Because endowments will exist forever, endowment minimums should be established carefully, reviewed periodically, and changed when the financial requirements dictate higher minimums.

Endowment agreements

Typically, endowment agreements between the donor and health care organization include the following:

- a statement from the donor as to what he or she wishes to create and how he or she wishes it funded;
- a listing of the formal name of the endowment account;
- a statement about how the endowment will not support a program or project until the historic dollar amount of principal of the fund reaches a stated level;
- a definition of the endowment's spending formula, which defines the annual maximum spending limits for your charitable mission. This definition should include a statement indicating that the spending formula may change from time to time at the direction of the board of directors. (Spending formulas are discussed in greater detail in Step 4);
- a statement about how the spending amount will be used if it is not expended within the fiscal year;
- a statement about who may make additional contributions to the endowment account;
- a listing of the anticipated funding strategy for the endowment;
- a stipulation that if the purpose designated for the spending amount from the fund no longer exists, then the amount can be applied elsewhere at the direction of the board of directors.

The donor and the charity's chief executive officer should sign the agreement. The donor, the finance department, and the development department of the charity should each retain an official copy. A charity should discourage a donor-prepared endowment agreement because it may ultimately cause administrative and/or other problems. The charity also should guard against

Endowment Fund Prospects and Donors

To ensure endowment campaign success, donor segments must be identified and a prospect list established. The endowment program should target internal and external prospects and all donors who have identified themselves as future bequest or trust donors. Donors with a modest gift history but a long-term commitment also should be identified.

Priority program lists are especially important because they stimulate leadership to think about those individuals who have an intense interest in a particular program area. Physicians involved in those areas, for example, can identify individuals who have been provided superior service or who closely identify with the specialty area.

Although individuals are the primary market for endowment building, groups of individuals, such as service clubs, can be involved in creating their own endowment accounts. Special events also can be developed, the sole purpose of which is to deposit net proceeds into a specific endowment account.

Note: Corporations and foundations do not normally support endowment fund efforts. They are not in the business of transferring their capital to become the capital for a charity. Rather, they direct their funds to a specific program or project that has immediate impact.

the donor exercising undue control over the endowment account.

Step 2—Securing money for endowment priorities

Raising endowment funds requires additional planning and program activity beyond the scope of normal fund-raising activities. These include the following:

Unrestricted bequests

One of the first steps toward raising or increasing endowment funds is to have trustees agree that the majority of unrestricted bequests be designated for endowment. Depending on a charity's financial situation, it may be difficult to convince trustees to permanently restrict the funds. When trustees are reluctant to do so, they should consider conditionally restricting them. This conditional restriction, sometimes termed a "quasi-endowment," gives the leadership the opportunity to access more than the spending formula, if there is sufficient need.

The sufficient-need criteria and the method of accessing the funds should be spelled out clearly in the endowment protocol. Additional unrestricted bequests may be deposited to the existing "quasi-endowment" account; if the amount is significant, a new account also may be established.

When an institution receives a restricted bequest, its wording should be examined to determine if it is possible to create an endowment account or if the funds must be spent.

Planned gifts programs

Establishing a charitable estate and gift planning program allows a charity to work toward fulfilling its present and future needs. Many significant gifts of a donor's assets require the transfer techniques of charitable estate planning. From basic bequest development to complex life income trust transfers, estate planning requires that both the charity and its donors think about the long-term impact of their gifts. Developed but unfunded endowment protocols may encourage donors to "prefund" their commitment with current gifts, with the final funding coming from the estate or planned gift.

Allocation of current annual gifts

Most institutions use annual unrestricted contributions for a current program or project. Few of them combine their annual appeals with endowment building. Management can do so in several ways, however.

First, the annual program goal could include an endowment goal as a subset of the appeal. Second, when the annual fund goal is reached, all additional funds could be applied to the endowment. Third, a set percentage of all annual fund gifts, e.g., 10–20 percent, could be allocated to the endowment. Fourth, all annual gifts could be put toward a major endowment with wide donor appeal. In academic medical centers, for example, it is commonplace to deposit all current contributions into an endowed teaching and research fund. The spending formula then provides annual support to sustain the quality efforts of a department or program.

Capital effort

Endowments offer health care organizations great opportunities to sustain excellence in today's competitive market, especially when coupled with capital campaigns. For example, whenever an institution is constructing a new facility, it can conduct both capital and endowment campaigns.

Even if the organization does not need philanthropic funds to complete a project, its leadership should consider raising endowment funds. Endowment campaigns allow the leadership to focus on the organization's future and to view endowment building as a primary effort rather than a secondary or periodic effort. In addition, it allows the leadership to plant the seeds of long-term support in younger donors. They, in turn, can develop their own endowment funds and work toward a long-term significant financial goal. This goal may have several funding elements, including a gift of cash or life insurance, as well as charitable life income programs.

Developing an endowment/capital effort may require that a campaign feasibility study be conducted. During this phase, the charity must determine if the campaign is worth the effort, if donors will support its priorities, and if the organization will meet its goal. It is during the interview phase of the feasibility study that many future endowment opportunities are uncovered.

To develop parallel endowment and capital campaigns, consider the following. First, adequate funds must be budgeted for the endowment effort; additional staffing and consulting arrangements also must be considered. Second, the case for support should clearly and convincingly describe the purpose, scope, and impact of the endowment. Third, the endowment campaign should focus on donors' needs and wishes, and allow for the development of a comprehensive endowment/capital campaign. In such a campaign, different types of gifts would count toward the goal and may include cash gifts, bargain sales, charitable life income trusts, annuity agreements, life estates, and life insurance.

Counting procedures

As the fund-raising adage goes, "What gets measured gets done." Therefore, it is important to develop specific counting procedures for an endowment campaign.

An endowment campaign's public results differ from the financial department accounting procedures. Fund-raising programs, for example, count overall total campaign production, current cash pledges, and future commitments, while accounting departments count current cash, the discounted present value of

Donor Motivations

In identifying donor motivations for endowment building, it is important to consider the "decision tree" developed by Robert Sharpe Jr.

According to Sharpe, the first decision donors must make is to determine if they will be providing the charity with small current gifts or a major gift. Although every individual and charity defines a major gift differently, it generally is a commitment of between $5,000–$10,000. If the donor is not convinced or motivated to make a major gift, then charitable estate planning techniques or endowment-building techniques are not possible. Donors must be motivated to make a large gift; once motivated, various planning strategies can be used to finalize the gift commitment.

—See Sharpe, Robert E. Jr. "Donor-driven Pyramid," *Give and Take* (Memphis, TN: Robert E. Sharpe Jr. & Company, 1988).

pledges, and future commitments. The latter also may record many gifts as conditionally restricted and not as unrestricted gifts. It is important to review your reporting and accounting procedures with your organization's financial department prior to your campaign, so that results are represented properly to the campaign leadership.

Gift counting procedures should closely follow those developed by the Council for the Advancement and Support of Education and the National Association of Foundation and University Business Officers[1]. They should include procedures for counting gifts beginning at the campaign's start and extending through its defined pledge period. These procedures should stipulate if gifts to the annual fund program qualify for campaign counting, and they should define how bequests received during the campaign will be counted.

Planned gift counting procedures also should be defined in sufficient detail for bequest intentions, annuities, trusts, gifts of real estate and personal property, lead trusts, assets administered by others for the benefit of the campaign, life insurance, retained life estates, and other forms of charitable estate planning arrangements.

In addition, the charity will want to establish counting procedures for government or foundation grants, and corporate matching gifts. If a gift does not fall within the counting guidelines, then a campaign gift acceptance committee should decide on the credit that the gift will receive toward the campaign total.

Other Nuts and Bolts

An endowment campaign tends to be more staff driven than leadership driven. The volunteer leadership helps identify and cultivate prospects and donors, and encourages them to consider establishing a named endowment with a significant gift. Experienced and adequately trained staff work closely with prospects and donors to explain how multiple giving techniques can be used to fulfill their gift commitment.

Much of the early planning for an endowment campaign can be done initially with word-processed supporting documents. As the campaign expands and becomes more "public," it should be supported with appropriate and appealing brochures. Videos, campaign logos and graphics, and a listing of giving opportunities also should be made available.

The campaign's theme should emphasize the permanent nature of the endowment program vs. the program nature of annual support gifts.

A gift opportunity is a tool to encourage donors to stretch their support to ever-increasing levels. For this reason it is imperative that leadership determine early in the campaign when and how gifts, non-cash gifts, and future expectancies will be recognized.

Step 3— Investing for growth

Clearly written investment policies are critical to the long-term success of endowments. Investment policies are set by the charity's board of directors and translate organizational objectives into specific action steps for the investment advisor.

The long-term investment objective of most charities is to grow an endowment fund's principal, thus its spending amount. The investment objective regarding institutional surplus funds usually is more short-term.

According to Robert P. Fry Jr.[2], charitable organizations adopt investment policies to discharge their fiduciary responsibilities in a way that protects both the organization and its board members from investment liabilities. It is key, therefore, for each board member to understand risk-to-return relationships; the use of portfolio techniques to control risk; and the importance of asset allocation, compounding over time, and investment returns. The board also must understand its role in reporting and monitoring investment results.

The total return on endowment assets represents all the investment earning—both income and realized and unrealized capital gains, minus investment expense. Modern investment portfolio theory centers on controlling risks. The most important portfolio risk-reduction techniques are diversification and asset allocation. Diversification is the process of reducing specific risks. Asset allocation is the process of distributing investments among different classes of assets, such as stocks, bonds, and cash to reduce market risk.

Today's legal and investment environments also require that board members be familiar with the "Prudent Investor Rule." Some state statutes have modified the rule to be more restrictive in the choice of investments a fiduciary may make for a client. Simply stated, the rule dictates the board's requirement to preserve capital and generate current income and capital gain. It also requires the board to establish a solid process to make investment decisions, analyze the prudence of each investment decision, and be mindful of the overall impact of inflation on portfolio performance.

Finally, a charity may choose to select an investment advisor to manage its endowment portfolio. If the portfolio is large enough, the charity may engage several advisors to manage selected portions of the endowment assets.

The Community Foundation—Alliance or Adversary

Community foundations are one of the most rapidly growing segments of U.S. fund raising. By their very nature, community foundations serve as endowment vehicles for local citizens interested in community projects. Health care fund-raising programs that do not have established endowment programs may find their donors turning to community foundations instead to meet their investment and charitable needs. Too, as donors become increasingly aware of the changing nature of the health care industry, many believe such foundations and/or local trust companies offer greater stability and permanence in the management and distribution of their funds. Health care organizations must respond by positioning their institutions and foundations to be the gift recipient—and managers/administrators—of choice.

Step 4—Developing a spending formula

As mentioned earlier, the spending formula defines the annual maximum spending limits for your charitable mission. Generally, spending formulas are designed to be conservative to allow for the reinvestment of a portion of the earnings to at least keep up with inflation.

There are three basic methods to determine maximum spending:

1) percentage of fair market value;
2) percentage of interest income earned in the previous year; and
3) percentage of total return from the previous year.

The first method applies a percentage to a determined baseline of the fund's fair market value. Typical spending formula baselines are the balance at the end of the fiscal year; a three-year running average; and a trailing 12-quarter average. For example, if you assume a $10 million baseline and a 5 percent spending formula, the total dollars spent in a fiscal year would be $500,000.

Method Nos. 2 and 3 are based on fixing a percentage to the previous year's performance, more specifically to the interest income earned that year. The percentage of total return focuses on both interest and capital gains.

Whatever method is used, it is important to ensure that a portion of what is earned is reinvested into the fund. An appropriate spending formula would thus be your total rate of return minus the rate of inflation. This approach prevents your fund from being eroded by inflation. The current industry standard is 5-6 percent of fair market value.

Step 5—Building a budget surplus

Just as donors need to know that your organization's "family" supports a capital campaign, your charity must demonstrate its support of your endowment. One method is to have the parent organization transfer a portion of its year-end surplus into the unrestricted endowment. A second method is to underwrite the expenses of the development office. Although the latter method is indirect, it accomplishes the same result as the first, particularly if the parent organization considers the subsidy a "gift" to the endowment fund.

For further information on endowment building and/or sample protocols, contact the authors.

ENDNOTES

1) *Case Management Reporting Standards, Standards for Annual Giving and Campaigns in Educational Fund Raising.* Council for the Advancement and Support of Education, Washington, DC, February 1996.

2) Robert P. Fry Jr. *Creating and Using Investment Policies: A Guide for Nonprofit Boards.* National Center for Nonprofit Boards, Washington, DC, 1997.

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- Murray, J. Richard, James McDiarmid, Michael L. McGrael, and Harold Melser. "Endowments for Hospitals," *A Healthcare Paradigm: Predicting Change for Healthcare and Philanthropy* (Falls Church, VA: AHP, 1993), pp. 103–115.

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