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ABSTRACT

An endowment in an aggregation of assets invested by a college or university to support its educational mission in perpetuity. The endowment allows donors to transfer their private dollars to public purposes with the assurance that their gifts will serve these purposes as long as the institution continues to exist. This brochure contains frequently asked questions and answers about endowments. The sections describe: (1) what an endowment is; (2) who has endowments and in what amounts; (3) how an endowment is created; (4) how institutions with endowments balance the present and the future; (5) how endowments are invested; (6) how endowments are managed; (7) how endowments are used; (8) questions and answers; and (9) an endowment fact sheet. (SLD)

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Understanding College & University Endowments

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

American Council on Education

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American Council on Education

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What is an endowment?

An endowment is an aggregation of assets invested by a college or university to support its educational mission in perpetuity. 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 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 schools follow guidelines ("spending rates") that are intended to produce a relatively stable stream of income. Since principal is not spent, endowments generate earnings 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 faculty positions, innovative academic programs, libraries, and student aid.

- **Leveraging other sources of revenue.** In recent years, as institutions have dramatically increased their own student aid expenditures, endowments have allowed institutions to respond more fully than they could have without these resources. 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. Without endowments or other private gifts, institutions would have to cut back on their programs, raise their prices to students, or obtain additional public funding to maintain current programs at current prices. Colleges and universities use other revenue sources beyond tuition to provide students with more than they pay for; students

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at institutions that have endowments benefit to an even greater extent than students at comparable institutions that do not have endowments.

- **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. Such innovation and flexibility can lead to entirely new programs and to important discoveries in science, medicine, education, and other fields.

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.

- **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 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 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 15th and 16th 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 performing arts groups.*

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 no, or only nominal, endowments (although they may receive significant state subsidies, which typically are not available to private colleges and universities). Two-thirds of private institutions have endowments of less than $5 million. The median endowment at private colleges and universities is roughly

$10 million, which at a typical spending rate of about 5 percent would support an annual expenditure of only about $500,000. Of the nation's 3,706 colleges and universities, only 368–or 10 percent–have endowments over $50 million. Of the 34 institutions with endowments exceeding $1 billion, 26 are private and eight are public (Texas, California, Texas A&M, Michigan, Virginia, Minnesota, Purdue, and Ohio State). Of the 100 largest endowments, roughly a third are at public institutions.

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, and much of this spending is restricted to specific programs, departments, or schools for which particular endowed funds have been designated. *Endowments are frequently described as if they were a single fund when, in fact, they are an aggregation of 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. At Duke University, for example, less than a third of its endowment is available to support Duke's two undergraduate colleges, while the rest of its endowment is restricted to its other schools and programs, including its medical center and hospital.

Most colleges and universities have only modest endowments or none at all.

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 to select the educational purposes to be served, but it is still restricted to spending only the income.

There are occasions when 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 or classrooms. 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.

Future generations depend on the current one to balance the claims of the future against the claims of the present.

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 $50,000 of spendable income each year (increasing annually at roughly the rate of inflation)–enough to help support one professor, two graduate students, or some of the costs of library materials and research.

If the university chooses to invest the gift, it will be "functioning as endowment." Among all higher education institutions, 61 percent of invested funds are reported as endowment and 39 percent are classified as funds functioning as endowment. While institutions retain some flexibility to redesignate 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, even in the face of rising costs. There is always a temptation to increase current spending to meet the very real needs of today's students and faculty. But this generation could not be supported at today's level of spending 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.

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 Uniform 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. Thirty 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 1968 would have generated more than enough 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.

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Many colleges and universities have established spending rates under which they spend endowment earnings each year equal to about 5 percent of the value of their endowment. If the institution achieves a total return of 9 to 10 percent (which for most of the past century would have been reasonably ambitious), it can reinvest the 4 to 5 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 4 to 5 percent 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.

In the exceptionally strong financial markets of recent years, many endowments have achieved returns much higher than 9 to 10 percent. While this has led some institutions to adopt spending rates higher than 5 percent, others have chosen an alternative strategy of making periodic upward adjustments in the amounts spent without changing their basic policies. This strategy allows institutions to apply some of the unusually high earnings of recent years to current needs while recognizing that recent rates of return are not likely to continue indefinitely. In other words, today's students and faculty have benefited from higher spending levels than otherwise would have been the case, but some of the strong earnings of recent years have been held in reserve for future years when the financial markets may provide returns, as they have in the past, of less–perhaps even far less–than the traditional 9 to 10 percent target. In the year ending June 30, 1999, the average return for all college and university endowments was 11 percent. The ten-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. Every year, while some endowments significantly outperform the averages, others lag behind or may even lose value depending on their particular investments.

Just as families need reserves to protect against unexpected expenses, so do institutions.

Just as families need reserves to protect against unexpected expenses, so do institutions. They need reserves against future economic downturns or declines in enrollment, donations, or government support, and to pay 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 not met, but being cautious enough so that the institution is prepared to weather serious reversals in the national economy or such unanticipated budgetary pressures as the skyrocketing energy costs that took colleges and universities by surprise–along with the rest of the country–in the 1970s.

How are endowments invested?

Before the 20th century, real estate was a primary endowment asset for educational institutions. Today's endowments are invested most heavily in domestic stocks, bonds, and other liquid 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 1999 study by the National Association of College and University Business Officers (NACUBO) found that whereas the average institution had invested 95.3 percent of its endowment in marketable securities in 1990, by 1999 this percentage had declined to 86.5 percent, with 7.2 percent in nonmarketable securities (including venture capital, buyouts, and oil and gas), 4.1 percent in noncampus real estate, 0.5 percent in campus real estate, and 1.8 percent in other investments.

Each institution adopts its own strategies and rules to maximize its endowment's capacity to support both current spending and future needs.

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. This strategy is 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.

For private—and increasingly for public—colleges and universities, endowments provide stability, flexibility, and a degree of confidence for 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 and their families, and for 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 make commitments to senior faculty, increase student aid, 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.

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 characteristically American 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.

Questions & Answers

• 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 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 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.

• 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 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 when the costs of high-quality education and research are likely to be even greater than they are now.

Endowment Fact Sheet

Size

- Most public colleges and universities have no endowments or only nominal amounts.
- Two-thirds of private institutions have endowments of less than $5 million.
- The median endowment at private colleges and universities is roughly $10 million, which at a typical spending rate would support an annual expenditure of only about $500,000.
- Of the nation's 3,706 colleges and universities, only 368–about 10 percent–have endowments over $50 million.
- Of the 34 institutions with endowments exceeding $1 billion, 26 are private and eight are public. Of the 100 largest endowments, roughly one-third are 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, 61 percent of invested funds are reported as endowment and 39 percent as funds functioning as endowment.

Spending Rules

- If an institution believes that its costs are likely to increase, on average, by 5 percent a year (inflation plus new programs) and expects its endowment to grow, on average, by 10 percent a year (dividends plus appreciation), it may establish a rule under which it reinvests 5 percent of the value of the endowment each year to keep pace with rising costs and spends the rest of what it earns (the other 5 percent) to help meet current needs.
- 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 decade of the 1990s, the average return for college and university endowments was 12.9 percent; in 1994, the average return was as low as 3.0 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 make commitments to senior faculty, increase student aid, 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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