LANCASTER POLLARD

The Nonprofit Minute

WINTER 2004

About the Firm

Lancaster Pollard Investment Advisory Group, an SEC-registered investment advisor, helps nonprofit organizations create the financial means to last the life of their missions by managing *total* financial risk rather than just investment-associated risk. Lancaster Pollard Investment Advisory Group shares common ownership with Lancaster Pollard, a leading provider of investment banking and mortgage banking services for the senior living, health care, affordable housing and private education sectors.

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How Much Endowment is Enough?

Lancaster Pollard is frequently asked, "How much endowment does a nonprofit organization need to ensure it will last forever?"

The simple answer is that an adequate endowment is one that generates enough funds to support your spending policy and bridges an appropriate gap between operating revenues and expenses.

For example, an organization with $4 million in revenue and a spending policy of $1 million would cover $5 million in short-term expenses. But is the endowment fund, currently generating $1 million from the spending policy, large enough to allow growth of the mission or to ensure the organization will last forever? Probably not. An adequate endowment also must account for future events.

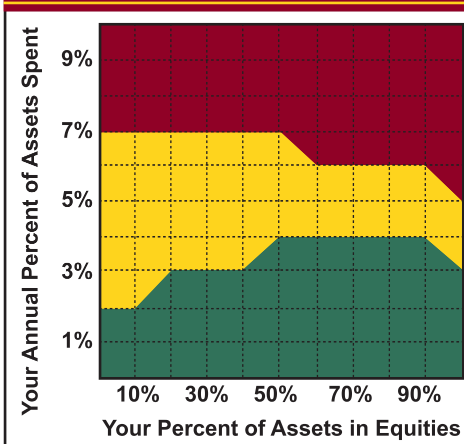
Nonprofit organizations are assumed to last forever and must plan accordingly. Therefore, spending policies and investment strategies must be regularly reviewed and updated. Today's endowment may not be enough to handle tomorrow's obligations.

What Makes It Not Enough?

Several constituent groups impact an organization's spending policy and could create the need for a larger endowment. Also, changes in the economic or political environment can create the need to reevaluate the endowment.

The board has the most impact on an organization's expenditures

Do Your Assets Support Your Spending?



Danger! Assets cannot support spending. How do you preserve your assets?

Caution! Spending supported by assets. What decisions could put you in the red?

Congratulations! Assets support spending. Why might you adjust spending levels?

and, therefore, has the most influence. One of the satisfying attributes of serving with a nonprofit is the ability to perform the organization's mission. A large endowment often gives board members the overconfidence to excessively spend money to further the organization's mission. Doing so often leads to a tendency to lose focus on the bottom line. This is what happened in the case study to the right.

Internal forces such as pressure to increase wages or departmental funding also can threaten the endowment.

Pressure from the local government also can impact spending. The federal government encourages and subsidizes nonprofit organizations by granting them tax-exempt benefits. However, local governments have been known to ask nonprofit institutions, particularly hospitals and private education organizations, to make contributions in lieu of taxes.

Changes to federal policies can create the need for larger endowments. Under HR 7, Congress is considering raising the required spending policy for private foundations from 5% inclusive of its own management costs, to 5% exclusive of its own management costs.

Focusing on Operations is the Key

An endowment is just one piece of the financial puzzle. Spending policy and endowment development efforts are part of an integrated plan that includes a strong focus on operations. Boards need to balance the desire to further the mission with the need to make sensible financial decisions.

Lancaster Pollard can help. We help organizations plan to last forever by working with them to develop and follow sustainable and prudent integrated financial governance plans.

Case Study:

An organization with a 140-year history and mission of caring for senior women had a rapidly growing $15 million endowment in the mid-1990s. Over time, its mix of residents changed to include more Medicare and Medicaid recipients. The government's reimbursements did not cover their cost of care. Each time they added a new resident, the organization lost money. The board did not make adjustments when staff compensation and expense ratios grew to exceed industry averages. The board did not worry because the endowment was growing, and the staff was providing great care. They believed they were fulfilling the organization's mission.

The problem was the organization was relying too much on its endowment. It produced an operating deficit of $1.5 million each year and covered it by spending 12.5% of its endowment. When the market turned, its operating deficit was still $1.5 million a year, but it now was losing $2 million a year in the market. In 2003, the organization closed its facility.

While the desire to spend money on the mission is understandable, the chart on the previous page demonstrates the idea that regardless of asset allocation, spending 12.5% of the endowment is unsustainable and arguably a violation of the board's fiduciary duty.

For help in determining the appropriate size of your organization's endowment, please contact William M. Courson at wcourson@lancasterpollard.com

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