rustee committees charged with managing institutional endowments and approving their annual budgets appropriately devote much deliberation to the question What amount should be expended from the endowment to support next year’s budget? For decades, most boards of trustees have subscribed to the total-return concept of managing endowments—that is, expending not only interest and dividends earned on the endowment, but also returns that come in the form of capital appreciation as well. While a few colleges and universities insist that current earnings should constitute a certain fraction of the total payout, most institutions employ a “payout formula” that is not geared to current return, but rather is based entirely on total return.

How, then, should trustees think about endowment payout? A widespread consensus has developed that they must balance two competing “goods”: first, support of current operations—preferably in a manner that dampens year-to-year volatility—and, second, preservation of endowment to serve future generations. That is, trustees should strive to achieve so-called intergenerational equity. They must balance the short term and the long term, ensuring that the endowment appropriately benefits future generations of students and faculty as well as the current generation.

It generally is true that college and university administrators—and faculty budget committees—lean in the direction of favoring current spending (higher current payout rates) while trustees’ fiduciary responsibilities push them in the direction of endowment preservation (lower current payout rates). And now that equity market forecasters are suggesting that common stock returns over the next decade are likely to be much lower than those enjoyed over the past two decades, fiduciary responsibility looms even larger in trustees’ minds.

The fundamental question that arises from this tension is Have we been equitable . . . both to the future and to the present? Several questions flow from that one; their answers shed some light on the issue of intergenerational equity.

QUESTION 1

Are we maintaining intergenerational equity?

Unquestionably, endowment payments over the past two decades have been too low, particularly at the highest-profile institutions. We need only look at the amazing run-ups in total endowment values at Harvard, Stanford, Princeton, and other well-endowed institutions for evidence. Those vast increases have been abetted by unprecedented levels of philanthropic inflows, but robust market performance coupled with conservatively low payout rates have been the prime movers.

The principal argument for holding down spending rates is the need to “save for a rainy day.” Ignoring the possibility of hard times ahead certainly would be imprudent; however, the actual spending rates of wealthier institutions over several cycles in the securities markets suggest excessive conservatism. Consider, for example, Stanford’s spending rates over the past 35 years: since 1969, the average actual spending rate has been 4.31 percent of average annual endowment values (excluding the effect of new gifts) compared with the target rates of 4.75 percent for most of that period and 5.0 percent for the past 15 years. Although the period includes the bear market of the 1970s, the payout rate exceeded 5 percent in only six of the 35 years. During the decade of
the 1970s, the average annual payout rate was 5.08 percent—hardly an extravagant rate during a period of poor market returns. It is likely that other wealthy universities were similarly conservative during that decade.

Moreover, recognizing that there are many highly restricted funds that do not actually use the full payout in a given year and instead reinvest their earnings, the actual payout used for operations is probably closer to 4 percent. Clearly, many large endowments, such as Stanford’s and those of similar institutions with payout rates in the range of 4 percent, are favoring the future at the expense of the present.

**QUESTION 2**

Who cares if we’re being equitable—and why?

Several critical constituencies should care whether trustees are biasing endowment payouts in favor of the future. Obviously, donors care. Their gifts are given to be used, not simply to be appreciated. Future generations of students and faculty care as well. Future generations will benefit from investments today in improved quality, and they will suffer if institutional quality deteriorates for lack of current spending. As Henry Hansmann notes in his seminal paper “Why Do Universities Need Endowments?” (1990), when a university adds a dollar to its endowment for the purpose of an intergenerational transfer, it is making the judgment that it will have a higher rate of return invested that way than in educating a student, doing research, or adding books to the library today.

Stanford provides yet another pertinent example. In the early 1990s, when the U.S. government chopped Stanford’s indirect cost recovery rate from the mid–70 percent range to 55 percent, Stanford faced a budget crisis. Excessive preoccupation with future generations would have demanded that Stanford cut its operating budget accordingly. Fortunately, wiser heads prevailed, recognizing that such a drastic budget cut would harm the quality of Stanford’s teaching and research immediately and harm future generations as well as the current generation. After all, rebuilding institutional quality is a long and expensive task. Stanford’s trustees bumped its endowment payout rate by about two percentage points (and amortized that bump over a number of years) in response to this crisis. Surely the bump up in spending was wholly consistent with the notion of intergenerational equity, by ensuring that Stanford’s quality was maintained for those future generations.

**QUESTION 3**

What can be done to address the practice of intergenerational inequity?

Practical suggestions include these:

Educate boards. Since boards have to make decisions about payout, it is important to educate them about their past actions and about the implications of those actions for the future.

Move away from the constant-growth-payout smoothing formula. A number of universities use an endowment smoothing formula that simply grows the payout by an inflationary factor, subject to not violating a preestablished floor or ceiling actual payout rate. Over a long period in which markets are performing reasonably well, the effect is that actual payout rates will be relatively low. This so-called
constant-growth smoothing formula, or snake-in-the-tunnel smoothing formula, is helpful in terms of providing budgetary stability. However, over the long term it biases endowment management toward reinvestment.

Calculate how much has been reinvested and track it. For institutions whose actual payout rates have been below their target rates, it would be a safe bet that most don’t know how much has been reinvested. It is important to know that number and to track it. It is also important to consider establishing funds where the excesses are made available for onetime projects or to address extraordinary conditions. Yale’s deferred maintenance challenge (a long-term problem); Harvard’s Allston campus initiative (an opportunity); expenditures to recover from a hurricane, earthquake, or other natural disaster (an emergency) are examples of extraordinary conditions.

Address accumulated restricted funds buildup. In some institutions unspent endowment income has accumulated in highly restricted funds. Universities need to be creative and aggressive in trying to use such funds. In some cases this may mean going to court. More likely, however, it means being proactive in reviewing the accounts and their accumulated balances.

**QUESTION 4**

Is the intergenerational equity argument still relevant?

Of course it is. It has to be an important touchstone for any fiduciary. However, given the experience of the past 35 years, intergenerational equity ought to play a lesser role in the deliberations of trustees and officers. While one clearly needs to be prudent, the fact is that colleges and universities are well positioned to help address many pressing problems through their teaching and research programs. Rather than favoring the future, the focus should be on what our institutions can do now that will ensure a better world for coming generations.

A legitimate argument for holding down spending rates—an argument not heard often in higher education circles but discussed in the business world—is that institutions simply don’t have attractive opportunities for spending or investing all the funds they have available. Under such conditions, businesses increase their dividends or repurchase their stock; colleges and universities don’t have those opportunities. Rather than spend funds in frivolous or extravagant ways, higher education trustees are responsible for holding down spending rates and challenging the administration to develop strategic initiatives that offer average or above-average educational returns—for the existing or an expanded student body, or for the institution’s research enterprise.

In sum, the time is ripe for a hard look at whether intergenerational equity is truly equitable.

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Has the significant growth in endowments at wealthy institutions optimally served both general societal interests and specific institutional interests? Voters and politicians eye with suspicion—and perhaps with taxation in mind—endowments in excess of, say, $10 billion at major research universities or $1 billion at small liberal arts colleges. Do such institutions really need enormous stockpiles of resources when they have no announced intention of serving a broader segment of society or more students? A decade or more ago the higher education community beat back a legislative initiative for a “tax on capital” aimed at endowments. At a time when the top five managers at Harvard Management Company are paid $100 million in a single year and the additional revenue that federal, state, and local governments would generate from a 1 percent tax on Harvard’s endowment—approximately $220 million—is widely understood, we in the academy will have an increasingly difficult time arguing that we are not greedy. Greedy institutions and individuals are politically vulnerable.