

Should Your Nonprofit Build an Endowment?

by Mark A. Hager

WAIT A MINUTE—THE FIRST question should be, “What’s an endowment?” Unless you work under a rock, you probably have a common-sense understanding of the term, but if you are going to bandy it about with accountants or regulators you need to understand that the word has a technical meaning that doesn’t always square up with common usage.

In everyday use, people talk about an *endowment* as money in the bank that earns interest and dividends they can use for operations. But technically, the term refers only to that portion of your investment pot that is “permanently restricted” because the donors said that they do not want you to spend the money, or because you collected it with the understanding that it was a permanent investment reserve. Management or a board of directors can set aside additional reserves for the purpose of investment, but technically this money is not endowment—accountants sometimes call this “quasi-endowment.” Now, this distinction often doesn’t matter, especially if you’re just interested in how interest and dividends help your cash flow. But it does matter when you’re doing your accounting, and it also matters when a cash-strapped organization starts thinking about paying for operations from those cash reserves.

Should you build an endowment? Well, there is little debate that you should set aside money for a rainy day—a cash reserve that can help to smooth out the ups and downs in your operations. Just as investment advisors recommend that individuals have six months of emergency funds tucked away in a savings account, nonprofits should also strive to have cash on hand to hedge against uncertainty. This isn’t endowment, or even quasi-endowment—it’s just operating slack that you might need when, say, your donations take a hit one year, or you have an unexpected legal expense.

An endowment is established when you and your donors consciously build a reserve for the purpose of creating a financial bedrock for the organization. You can’t spend the principal unless the donor or a court says so, but the income from that principal is usually fair game. This investment income is golden, because you don’t have to earn or solicit it. Some gift agreements specify how interest income should be spent, but it typically comes with no strings attached. There is no magic figure at which your pot is large enough to call it an endowment, but it isn’t a serious asset unless it is roughly twice as large as a typical year’s operating expenses. If you’re only earning enough interest each year to pay for a board luncheon, you aren’t yet in the endowment game.

Organizations that *are* in the endowment game, however, reap the benefits of solidity and unrestricted income. An endowment can also be a very positive symbol that shows the community and potential donors that your organization is not a fly-by-night operation. It signals that yours is a flush organization that plans to be around for a very long time—this alone can bring large donations to your door.

So, then, why do donors give to endowments? We know that many donors cringe at the idea that their donations are going to anything besides delivery of services, so why would somebody give money that purposely is not going to be spent? Well, we should not overlook the generic “power of the ask”—endowment campaigns are visible community events that give donors a new reason to contribute to an organization that seems to be serious about planning for the future. But there are two other reasons about “the future” that motivate some donors to contribute to endowment.

The first is the idea of perpetuity. This is the same motivation that causes some patrons to create private foundations. In addition to whatever philanthropic motivations drive them, many people who spend a lifetime building an empire and a reputation for beneficence want that empire and reputation to live forever. The impulse for some part of us

ENDOWMENT PROS	ENDOWMENT CONS
YOU GET UNRESTRICTED INVESTMENT INCOME.	MONEY IN THE BANK MEANS LESS MONEY TO SPEND ON TODAY'S MISSION.
WORTH SAYING TWICE: UNRESTRICTED INCOME!	THE REAL VALUE OF A FIXED ENDOWMENT DECLINES OVER TIME.
YOU SEND A SIGNAL THAT YOU'RE SOLID AND PERMANENT.	ENDOWMENTS TAKE TIME AND MONEY TO MANAGE RIGHT.
YOU CAN TAP INTO DONOR DESIRES FOR PERPETUITY	YOU CAN'T SPEND IT EVEN IF YOU NEED IT.
YOU DEVELOP A LIFELONG LINK WITH YOUR DONORS.	SOME DONORS WILL THINK THAT YOU DON'T NEED FUTURE CONTRIBUTIONS.

to live on forever isn't a negative one—some say it is the same deeply seated psychological impulse that drives humans to have children. When we give contributions to operations, we get a warm glow from knowing that the money is going to be used soon to further a charitable mission. When we give contributions to endowment, we experience the glow of perpetuity. Our money will undergird a community institution long after we're gone. That's a powerful motivator, and one that has generated billions of dollars in investable assets in the nonprofit sector.

The second motivator is similar, and that's the drive for elites to control community institutions.¹ This doesn't apply to the average donor, but there are a few people in every city who both have money and are prominent movers in the community. Transferring money and property across generations is one thing, but transferring standing in the community is another. Making big contributions to endowments of elite institutions (like museums or private schools) is one way families seek to transfer status to their children. Heirs can gain standing in community institutions based on the contributions their family has made to these institutions. If you are one of these institutions, this is another motivation you can tap into to generate endowment.

So, endowments are built through the union of an organizational commitment to building an investment reserve

and a relationship with donors who believe that this is a good investment in the future, for their community, and for themselves. When the union is a healthy one, the result can be an endowment large enough to generate investment income that can be used for a variety of organizational and community purposes. Who wouldn't want to be sitting on a big pot of money?

Before you run out and start cultivating your endowment, though, you should know that there's a flip side. Endowments are not good for all organizations, and not everyone loves them. The biggest argument against endowments—and the one that comes up in almost every deliberation about whether to start one—is that endowments shortchange today's charity for an unknown future.² There are two related concerns here: one having to do with addressing current needs, and the other having to do with the declining value of money.

Current needs is the one that at least one of your board members will bring up, and is very possibly the reason why your board will vote not to have an endowment. "Why should we put a million dollars in a bank account when we can use that to serve a million more lunches?" Or buy a hundred thousand more books. Or facilitate a thousand more adoptions. Or renovate the façade of the theater. Many nonprofits are in dire need of more money, and most can at least think of an immediate way to use more. Therefore, it isn't surprising

that some people will value the use of contributions to meet current needs rather than build an endowment. And it isn't just your board members who might feel this way—it might well also be your patrons, clients, elected officials, and local newspaper. Some people go so far as to say it's not ethical to lock money in the bank when there are so many necessary ways to spend it now. Before you know it, you have bad press and declining donations—and you wish you'd never thought of raising an endowment.

The issue of the declining value of money has to do with the growth of the economy over time. When a charity spends my \$100 contribution now, it gets \$100 worth of good out of my money, whether that's in operations, administration, or future fundraising. But just like \$100 was worth more in 1960 than it is today, that \$100 in 50 years (or even next year) will be worth less than it is today. Contributions to an endowment have less and less real dollar value over time. Endowments might keep up with inflation if they reinvest some of their earnings, but most nonprofits value their endowments because they get to *spend* those earnings. Consequently, nonprofit endowments face a never-ending battle against time.

There are a few other issues to consider, too. Endowment building is a strategic decision that requires management attention and a relationship with donors. As such, organizations need to be prepared to commit resources for managing both money and people. Organizations with the largest endowments (private universities, usually) have staff members whose only job is to manage the endowment and maximize its investment potential. Large endowments also open the potential for more sophisticated investment strategies and greater diversification, both of which tend to help large endowments perform better than small ones. You can stick your endow-

ment in a money market account, but you'll do better when you actively manage your money, or pay a professional to do it. That takes time, money, and commitment that nonprofits without endowments don't have to worry about. Management and fundraising expenses can be huge.

Another concern to consider when you're thinking about building an endowment goes back to that technical definition we started with. "Permanently restricted" is a phrase that should trouble managers who understand the value of staying flexible in an ever-changing environment. "Permanently" means forever beholden to the wishes of the donor. The donor cannot exert direct control over the money (or you), but you promise not to raid that money—even if you can no longer make budget. That's the "restricted" part. An endowment-rich organization can be cash poor, with big assets and not enough additional money to run its programs. Just as too many suburban homeowners have hefty mortgage payments that leave them short on their food and clothing budget at the end of the month, too many nonprofits have hefty endowments that throw off money to keep on the lights but don't relieve the need to raise funds to run programs at full speed. "Permanently restricted" can be a noose around the neck.

Without putting too fine a point on it, nonprofits with and without endowments are different animals. A big endowment can open up your financial options, but it might also limit your ability to change with the times. Some have suggested that privation feeds the nonprofit soul—organizations without endowments are more frugal, more innovative, and more responsive to their communities. All the quotes about the dangers of money apply here. As P.T. Barnum said, "Money is an excellent servant, but a terrible master."

That brings us to the flip side of the endowment serving as a symbol of solidity and permanence in your com-

munity. While this reputation can inspire some donors to dedicate their contributions to your permanent future, it can cause others to shy away. When the local museum solicits my \$100 for renovations, I might be inclined to think, "Why do they need my money? They have \$50 million sitting in the bank that they aren't using." It's hard for a well-endowed nonprofit to make the case to average donors that the organization still needs regular donations to maintain operations. If endowment income can't keep pace with a decline in donations, it might end up being a drag on your operations rather than the cure-all you expected.

There are good reasons to have an endowment, and good reasons to not have one. The only way for a nonprofit to decide whether to pursue an endowment strategy is to fully educate your board of directors and have them hash it out. There is no obviously correct decision. Best wishes in making the one that is right for you.

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Endnotes

1. This idea comes from reading Paul DiMaggio's history of Boston cultural entrepreneurship. If you want a citation, e-mail the author.
2. Henry Hansmann has developed this argument in an article about university endowments.

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