TO: Finance and Audit Committee
RE: ALA Endowment Fund Spending Policy

ACTION REQUESTED/INFORMATION/REPORT:

Revision to ALA Endowment Fund Policy (Spending) 8.5.1¹.

ACTION REQUESTED BY:

ALA Endowment Trustees

DRAFT OF MOTION:

1. The Endowment Trustees recommend to the Finance and Audit Committee approval to revise the annual spending formula in ALA policy 8.5.1 to a range of “3% to 5% of the annual five-year rolling average of each funds fiscal year end net asset balance.”

Note: The annual spending rate will be subject to an annual review and assessment by the ALA Endowment Trustees and the Finance and Audit committee of the ALA Executive Board.

2. The initial recommended rate for application to the FY 2013 budget is 4%.

PURPOSE OF RECOMMENDATIONS:

1. Provide certainty from a budget and planning perspective, on the amount of funds from the Endowment fund to support scholarships, awards and other programs of the Association.

2. To increase the amount of dollars available for scholarships, awards, program initiatives and general expenses.

DATE: April 9, 2011

BACKGROUND:

The American Library Association (ALA), through its senior management, Divisions, Roundtables, units, various interest groups and member leaders, has had a long history of supporting the granting of scholarships and awards for various purposes from earnings generated from the Long-Term Investment Fund (Endowment Fund). The Endowment Trustees and the Executive Director have supported this use and have explored numerous ways to prudently

¹ ALA policy 8.5.1 – see Exhibit 1
increase the number of scholarships and awards given each year. Additionally, in view of the endowment’s growth, which has increased from approximately $3.0 million in 1990 to $32.1 million today (1-31-11), there is the opportunity to utilize a greater portion of the earnings generated by the Endowment Fund. The current spending policy has been reviewed and modifications are recommended in light of available current “Best Practices.” The amount of funds available for scholarships, awards, program support, initiatives and general operations is of critical importance. These policy adjustments are being contemplated within the context of not negatively impacting the overall return of the portfolio and its future sustainability.

Why the Change in Policy? By way of ALA Policy 8.5.1, stewards² of all scholarships, awards and related operating projects can budgeted net interest have two options with respect to utilizing gains from the endowment. These options are as follows:

- Net Interest – total interest and dividend income less total expenses or
- Five Year Moving Average of total market value³ (50%) – includes capital appreciation and interest & dividends

The net interest approach currently used by ALA has served the Association well as demonstrated by the growth in the Endowment over the last ten years. Interest over the last five years has averaged approximately 2.7% ($778,321) of the beginning net asset fund balance. Note: project expenses and awards have been 1.0% ($270,934). Additional reasons for a change in the spending policy include the following:

- Certainty in budget planning in that management needs a more manageable draw down calculation – the calculation resulting from policy 8.5.1 is limited in the amount of earnings available for primary activities (scholarships/awards & some operating) and difficult to predict as it is based on an estimate of future earning (net interest) activity

- Recently instituted changes in ALA’s endowment reporting structure – principal and spending accounts for reporting endowment activity has been replaced with a new reporting structure to comply with endowment related FASB requirements i.e. standard auditing requirements

- Closely related to the above is the timing. Budgeting for expected net interest for the upcoming year is captive to how the market performs. As such, there is no good way to accurately estimate what the net interest will be.

- Need to contemporize the draw down policy for maximum programmatic benefit – making more funds available expands the potential uses for a broader base of programmatic efforts and benefit to the Association

Spending Policy Considerations - Spending and investment policies generally operate with conflicting goals. As such, the first order of business is to devise a spending policy that will balance the competing objectives of supporting programs and the need to preserve the endowment’s purchasing power for future generations.

In order to achieve a balance between the two policies and develop a strong spending policy the following objectives are considered:

² Includes the ALA Executive Director, Division Executive Directors and Round Table/Unit liaisons.
³ This is for each individual endowment or area of responsibility.
1. Maintaining the purchasing power to ensure that endowment distributions keep pace with inflation.
2. Maximizing total investment return within appropriate risk constraints
3. Achieving smooth and predictable spending distributions
4. Maintaining a fair distribution of intergenerational equity and recognize the sensitivity to donor wishes.

ALA’s spending policy should both be responsive to changes in endowment value and minimize year-over-year fluctuations in spending. The ideal spending policy will act as a shock absorber, providing short-term spending stability while gradually allowing changes in endowment values to filter into changes in spending. A properly functioning shock absorber will allow ALA to pursue investment strategies that generate positive returns over the long term.

*Spending Option considerations* - There are generally four types of spending based policies – income, total market return, inflation adjusted and or a hybrid. Below are a number of spending options initially considered by the Endowment Trustees:

- No more than 5% of the annual market value of the Endowment @ 12-31-XX as determined by (Trustees, Executive Board or Management)
- 4% of the annual market value of the Endowment @ 12-31-XX
- 4% of the three moving average of the Endowment @ 12-31-XX
- 4.5% of the five year moving average of the Endowment @ 12-31-XX
- Prior year’s spending adjusted for inflation with a floor (3%) and ceiling (4.5%)
- Weighted average of the prior year’s spending adjusted for inflation (70%), and the trailing four quarter average market value of the endowment (30%) multiplied by a target percentage (4%)

Note: Adopting any of the options above may require a review of the recently approved performance requirement, which is currently 4% + inflation. Additionally, whatever the rate or options chosen it should be applied on a one year lag basis, similar to how the indirect cost rate is applied. Example – the FY11 or calendar year 2011 results will be applied to the FY13 budget.

*Other Spending Options* – Alternatives to the above mentioned spending solutions could include things like spending based off of the interest generated, historical spending in relation to endowment balance etc. They are as follows:

- Use of rolling averages – generally 3-5 years
- Use of a 5 year average of CPI’s to calculate inflation and maintain purchasing power
- To project inflation use an applicable index i.e. CPI from the US Dept. of Labor
- Under UPMIFA you can have losses in assets during the individual quarters and still spend endowment earnings as long as the fund’s purchasing power is prudently maintained
Recommendations

After consideration of the options listed, as well as, some internal financial modeling, the following recommendation was deemed the optimal solution for meeting the goals of providing greater access to the gains realized from the long-term growth in the endowment:

Action

To revise the annual spending formula in ALA policy 8.5.1 to a range of "3% to 5% of the annual five-year rolling average of each fund’s fiscal year end net asset balance."

Additionally, the following conditions will also apply:

- The spending rate will be subject to an annual review by the ALA Endowment Trustees and the Finance and Audit committee of the ALA Executive Board.
- Withdrawals will still be limited by any current or future imposed donor restrictions where applicable.
- The first use of this recommendation will be applied to the FY 2013 budget starting with the calculated FY 2011 year end results. Additionally, the draw down rate needs to be reviewed and recommended by the ALA Endowment Trustees annually for budgeting.
- The determined 4% factor will be transferred into the appropriate operating accounts at the end of each fiscal year during the year end closing process, as an offset against expenses. This will occur after notification from the finance department and the responsible manager notifies the Controller of the amount to be transferred – up to 4% of the calculated figure.
- There will be no “Clawback” provision. At the end of each fiscal year all endowment fund stakeholders will have the opportunity to determine the disposition of funds available for withdrawal:
  1) Transfer to the operating net asset balance
  2) Remain in the respective endowment fund’s net asset balance.

As a result, stakeholders will have the opportunity to use all, none or some percentage of the designated funds available for withdrawal/expenditure.

Benefits of Recommended Changes - Each of these recommendations will do two very important things from the perspective of senior management and the unit managers:

1. It will provide a degree of clarity and certainty from a planning perspective that has been difficult to realize with the endowment as a revenue source. The volatility of the market is accounted for and neutralized.

2. It will make available more dollars for awards and scholarships, special projects and initiatives, as well as, general day to day operations.
Other Endowment Operating Practices – Although the recommendations will fundamentally change the mechanism used for spending out of the endowment fund, current operating practices need to be reaffirmed. This involves the use of total return for the Spectrum fund and the discretionary uses for the ALA General Scholarship funds.

In the spring of 2002 the Executive Board approved the use of earnings (interest) from the Leo Albert fund and the Giles fund as an additional supplement to the funds provided for scholarships by the Spectrum fund. In view of the growing importance of the goals of the Spectrum program, its growing national attention and its ground level support, it is management’s belief that this relationship needs to be maintained.

ALA’s General Scholarship is one of the Association’s primary stopping points for members to make small donations, particularly at dues renewal time. Over the past six years certain named ALA scholarships i.e. Gavers, Hornback, Leisner, Clift, Drewes etc. have not on a standalone basis been able to consistently cover their stated annual award ($3,000) commitment. As a result of the long time relationship with these funds, it was decided that funds from the ALA General Scholarship fund would be used to cover any shortfall in the ALA named scholarships. This relationship should also be continued.