



## **Guidelines on Underwater Endowment Accounts**

**Revised October 2007**

### Overview

These guidelines address Caltech's method for the management of and accounting for its consolidated endowment pool and the impact of changes in the investment climate.

### Background

Consistent with modern endowment management practices, Caltech's investment and spending policy utilizes the total return concept. As such, funds are included in a consolidated endowment pool and invested in accordance with an investment strategy authorized by the Board of Trustees. The objective is to maximize long-term total investment return, maintain and grow the purchasing power of the principal and produce stable and predictable spending that is maximized and increases over time. Individual gifts made to the endowment purchase shares in the consolidated pool and share proportionately in the total return. The annual spending allocation is calculated as a percentage of the moving average market value over the twelve prior quarters. The purpose of the averaging is to smooth out the effect of short-term market volatility. The spending allocation is funded out of the income and realized gains components of the total return and distributed to the individual participants on a per share basis. Any net surplus of earned income and realized gains over the spending allocation for a given year is recorded as a layer of unrestricted net assets, subject to donor designations. Should a current year shortfall exist (spending allocation is greater than earned income and realized gains), the prior cumulative excess of income and realized gain covers the balance of the spending allocation.

### Issue

In a down market, newer participants in the consolidated endowment pool may temporarily have a lower market value than their historical dollar value (gift corpus) and thus be "underwater". There has been some discussion that these accounts should not receive their full share of spending allocation. The argument revolves around the interpretation of UMIFA. UMIFA states "The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent..." The question is whether or not we view "endowment fund" as each individual fund

or as the pool. In Caltech's case, the pool should always be in a net surplus position. Our contention has been that the intent of the pooled approach for investing and accounting for endowment assets is to view the pool as a whole and the related investment and spending strategy is a long-term position. If we were to apply UMIFA to each fund, we would not distribute income to many funds that are critical to the mission of the Institute. To limit the spending allocation for certain accounts would be programmatically impractical and be contrary to the goal of producing stable and predictable spending. However, the recent white paper issued by PricewaterhouseCoopers LLP provides interpretation and guidance that in the case of an underwater fund, payout should not be made beyond current year income and on a fund-by-fund basis. Based on this, we have implemented the following approach, beginning in FY2003.

1. Caltech's policy is to distribute payout annually (at the end of the fiscal year). However, during the fiscal year, as new endowment gifts are received, an estimate of the payout will be **budgeted** to the fund's spending account. This budget is based on the number of quarters the new fund will be participating in the pool. At year-end, the full payout will be distributed to all funds, even if underwater, so long as the entire pool is not underwater.
2. An annual review of underwater accounts will be performed each fiscal year-end. A report of individual participant true endowment accounts with market values less than historical dollar values will be produced. If the payout amount exceeds their share of income for the year, a supplement will be required.
3. A portion of the Institute's unrestricted quasi-endowment cumulative excess realized gains and income will be used to supplement the net cumulative excess payout calculated in item 2 above. Should the cumulative gains and income be insufficient, quasi corpus will be liquidated to cover the balance. This supplement will be a loan to be repaid as the realized gains in the endowment account recover sufficiently.
4. Should the unrestricted quasi-endowment accounts not be sufficient to cover the net cumulative shortfall in underwater accounts, the annual payout will be adjusted appropriately.
5. **(2007 revision)** Any gifts that enter the pool which establish new accounts after 10/1/07 and subsequently become "underwater" will only receive payout to the extent of the investment income distributed. Exempt from this policy are new accounts created as the result of a split of an existing endowment account; however, new accounts created with the transfer of money from existing gift or unrelated endowment pool accounts will be treated as new accounts. As an example, let's look at how a \$50,000 gift received in the first quarter of FY2006 would be treated under current practice vs. this new revision:

Current Practice

\$50,000 receives payout in its first year of \$2,438 which is 75% of 6.5% of the \$50,000, regardless of whether or not the fund becomes underwater.

Revision

If it's determined that the fund has become underwater at the end of the first quarter, payout would be calculated based on the rate of income/effective shares. In this case, the rate for the first quarter of FY2006 was 0.08508320 (Income of \$3,260,735.40 divided by 38,324,079 total effective shares in the pool). The income number is provided by the Treasurer's Office.

In our \$50,000 example, payout would be calculated as follows:

(A)  $\$50,000 \times \$38.18$  (MVPS in 1<sup>st</sup> quarter FY2006) = 1,310 full shares

(B)  $1,310 \text{ full shares} \times 75\% = 983$  effective shares for 1<sup>st</sup> quarter FY2006

(C)  $1^{\text{st}} \text{ quarter FY2006 income of } \$3,260,735.40 \div 38,324,079 \text{ total effective shares} = 0.08508320$

(B x C)  $983 \text{ effective shares} \times 0.08508320 = \$84.00$  payout to be distributed.

6. **(2007 revision)** Any accounts that existed prior to 10/1/07 and were not “underwater” at 10/1/07 but become “underwater” in the future will also only receive payout to the extent of the investment income (dividends and interest only) distributed. No loans will be made to supplement the current income on underwater accounts.