<u>Endowment Spending Allowance Guidelines</u>

Approved by the UA Foundation Investment Committee January 17, 2018

The spending allowance has a significant impact on the ability of an institution to maintain the long-term viability of an endowment and, along with the annual endowment fee, is the principal driver of the target return, the asset allocation, and the level of risk in the investment portfolio. For purposes of these guidelines, the spending allowance is the portion of an endowment that is made available annually to the beneficiary for expenditure. A spending allowance advance against future earnings is the portion of an authorized spending allowance in excess of the endowment's available accumulated earnings as of the spending allowance determination date.

The Investment Committee believes that stable and predictable distributions are in the best interest of the University of Alaska, that excessive spending distributions can lead to instability and impaired viability of endowments, that investment returns at times may be substantially muted and inflation low to moderate; and therefore, that the endowment spending allowance and inflation proofing capabilities may be muted also.

The following objectives are intended to guide the implementation and operation of the spending allowance policy, meet the requirements of law, the duties of a fiduciary, and the contractual commitments to donors, as well as the needs of the beneficiaries:

Primary Objective:

Maintain the long-term viability of each endowment;

Supplemental Objectives:

Make a good faith effort to provide for inflation to the extent practicable;

Stabilize distributions to the beneficiary to the extent practicable; and

Keep the process simple and understandable.

<u>*Requirements of Law*</u> - AS 13.65.010 – 13.65.095, the Uniform Prudent Management of Institutional Funds Act (UPMIFA), and AS 37.10.071, regarding fiduciary responsibilities, provide the basic requirements of law. UPMIFA allows the Foundation to maintain its endowments as a pooled fund for investment purposes, but each endowment must be treated separately for purposes of modification of donor restrictions, if necessary, and appropriation.

<u>*Duties of a Fiduciary*</u> - Each fiduciary has a duty of loyalty and a duty of reasonable care. With regard to investment, custodial, or depository activities, loyalty constitutes conducting such activities in the sole financial best interest of the fund and adherence to the intent of the donor. Reasonable care translates to the ERISA prudent expert standard,

"…the care, skill, prudence and diligence … that a prudent person, acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character with like aims."

Contractual Commitments - The Foundation has a clear contractual commitment to the donor to maintain an endowment "in perpetuity," which is based on its acceptance of the gift. The commitment to maintaining the purchasing power of an endowment (intergenerational equity) is more abstract and less likely to be considered a contractual obligation. Under UPMIFA, maintaining the purchasing power is a presumed intent of the donor, but the extent and level of commitment is unclear and subject to the determination of the board unless otherwise stated in a donor agreement or another record. The investment policy provides for a good faith effort to preserve intergenerational equity by providing for the consideration of inflation or deflation in setting the target rate of return for the investment portfolio, but it is not guaranteed in any manner and may not be attainable during periods of market or financial stress.

Needs of the Beneficiary - The beneficiaries have a general need for stable and meaningful inflation-adjusted distributions relatively early in an endowment's life cycle to the extent prudent, and a spending allowance process that is easy to explain to donors.

Passage of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) eliminated the prohibition against the pay-out of spending allowances for underwater endowments. An underwater endowment is an endowment that has negative accumulated earnings or stated differently, an endowment with a current value that is less than its original gift value. In doing so, UPMIFA provides more flexibility for determining and paying out spending allowances, but requires that fiduciaries consider a number of other factors in setting spending allowances, including the purposes of the institution, the duration and preservation of the fund, the general economic conditions, the effects of inflation, the expected total return, the provisions of investment policies, and other resources of the institution.

Monitoring the consistency of expenditures with the purposes of the endowment and the institution is done on an expenditure by expenditure basis at the time each expenditure is authorized. The duration and preservation of the endowment, the general economic conditions, the effects of inflation, the preservation of purchasing power and the expected total returns are addressed by the Investment Committee when setting the target rate of return and the asset allocation as well as in development of recommendations to the Board for the general spending rates. Other resources of the institutions are addressed on an exception basis by providing notice to the beneficiaries of underwater endowments of the status of the endowment and asking them to consider declining the receipt of any spending allowance advances and identifying other resources to fund the purposes of the endowment, including additional contributions from donors. Any declined spending allowances or advances are returned to the endowment's accumulated earnings and invested in the Consolidated Investment Fund.

Each year, as part of the annual spending allowance analysis, the following ratios shall be calculated for each endowment in an effort to monitor its financial health and evaluate its progress toward inflation-proofing:

Viability Ratio – the ratio of Accumulated Earnings to the Current Total Value of the Endowment

Inflation-Proofing Ratio – the ratio of the Excess or Deficiency of the Inflation Provision to the Current Total Value of the Endowment

The Viability Ratio offers a measure of the financial health of each endowment and for the pool of endowments as a whole. The Viability Ratio provides an indication of an endowment's ability to continue making distributions during market down cycles. Only a mature endowment with significant accumulated earnings reserves (40% or more) can sustain market shocks similar to those encountered in the past and continue to pay out spending allowances for very long without impairing its viability. For purposes of evaluating their financial health, endowments may be classified as follows:

Endowment Category	Viability Ratio
Healthy	Above 40%
Maturing	20% to 40%
Fragile	>0% to +20%
At Risk	0% to -20%
Distressed	Below -20%

Based on the current economic and investment environment, continuing spending allowance distributions from an endowment with a negative Viability Ratio will result in serious impairment of the endowment's ability to meet the purposes for which it was established; therefore, spending rates for "At Risk" endowments shall be to 2.0% and for "Distressed" endowments 0.0%.

The Inflation-Proofing Ratio provides a measure of an endowment's progress at maintaining the purchasing power of the historic gift value of the endowment since December 31, 2010 (the year UPMIFA was passed by the Alaska Legislature).

Effective December 31, 2016, annual spending allowances shall be determined in accordance with the following:

1. The provisions of a donor agreement or documented donor intent will take precedence over these guidelines.
2. For endowments established after December 31, 2016, during the first five full fiscal years, only amounts contributed directly to the endowment's spending account will be available for expenditure by the beneficiary.
3. Subject to the following conditions and limitations the spending allowance shall be calculated by applying the applicable spending rate to the average of the total value of the endowment as of December 31 for the previous five years.
4. The maximum spending rate for an endowment shall be 4.0%, 2.0% for endowments classified as "At Risk," and 0.0% for endowments classified as "Distressed".
5. Only annual spending allowances calculated at $250 or more will be available for expenditure.

The Investment Committee may establish special spending allowances for specific endowments or groups of endowments to mitigate adverse impacts that may be associated with unforeseen or unusual circumstances.