## Some Thoughts About Endowments

## Dennis R. Young

The endowments of nonprofit institutions have been much in the news lately. On Sunday June 24th, the *New York Times Magazine* ran a story on Harvard's \$19 billion endowment and how it could be used. On Wednesday of the previous week the *Plain Dealer* (PD) in Cleveland ran a front page article on the Western Reserve Historical Society which noted that WRHS was "borrowing" part of its endowment to pay for planning a new waterfront site for its automobile and aviation collection. The newspaper questioned the wisdom of this use of endowment funds. Another PD story on Saturday noted that the Cleveland Clinic had 82% of its endowment invested in the stock market and asked if that was too aggressive a position in light of market volatility.

While not every nonprofit organization is so blessed, many nonprofit institutions do establish and maintain endowment funds, and need to make decisions about building them up, spending them, and investing the funds. In this article, I'd like to touch on two interesting aspects of this challenge not much discussed elsewhere.

The first issue has to do with the question of when it is wise for a nonprofit institution to build up its endowment versus maintaining its value or spending it down. During the Spring semester I invited Steve Hoffman, then Executive Vice President of the Jewish Federation of Cleveland, to visit with my undergraduate class on the economics of nonprofit organizations. The Federation is a large federated fund raising and social services system that serves the local Jewish community as well as other clients in the Cleveland area. Steve justified, in an interesting way, the explicit decision of the Federation to build up its current endowment: He noted that the Jewish population in Cleveland was declining and that funds needed to be raised now and put into endowment so that future needs could be served.

I puzzled over that reasoning. If the population was declining, wouldn't their needs be declining as well? If so, why tie up current funds into endowment to ensure future income? But Steve is a wise man and I think what he was suggesting was that the Federation, while fairly confined to the Jewish community in terms of its ability to raise funds, saw itself as part of the permanent social services landscape, there to serve non-Jews as well as Jews. Overall, those wider needs could be expected to remain constant or perhaps even grow over time.

Generically, this reasoning suggests the following schema: endowments should increase where future funding will become more difficult and/or needs will

grow; and endowments should decrease when future funding will be easier and/or future needs will diminish. The remaining combinations present more ambiguous choices:

	Needs will Increase	Needs will Decrease
Funding Base will Increase	No clear implication for changing endowment	Decrease Endowment
Funding Base Decrease	Increase Endowment	No clear implication for changing endowment

In the case of the Federation, the challenge is to clarify its mission with respect to serving Jews versus others. The decline of the future donor base is not sufficient reason to increase endowment now, just because the getting is good. Institutional growth or preservation should not be an end in itself. If the future mission were to focus narrowly on the social service needs of Jews, the Federation would find itself in the lower right hand box of the table and there would be no clear indication to increase endowment. However, if the future mission is to serve everyone, it is more likely that the Federation would find itself in the lower left hand box and should justifiably build up its endowment.

Another interesting issue arose in the Harvard case. According to the *New York Times* article, some trustees suggested that Harvard consider becoming "fully endowed". That is, the endowment might be even further increased so as to ensure that all students could attend tuition free. Would that be a good thing? How should one think about that option?

Certainly there are precedents for such a policy. Cooper Union in New York City is a very fine private college that is fully endowed and charges no tuition. Admission is highly competitive and it has a reputation for producing outstanding graduates. The Cleveland Museum of Art is heavily endowed and levies no charges for visitors to its regular collections. Such a policy can have certain advantages as well as disadvantages. The principal advantage for Harvard would be that ability to pay could be eliminated from the criteria of admission. Harvard could admit students solely on the basis of merit without the temptation to balance outstanding students that require major financial help with less than sterling students who can pay the full ride. In reality, of course, Harvard would still be influenced by the gifts that could be given by the families of well-to-do students, aside from tuition payments, but a zero tuition policy would probably change the incentives significantly.

A disadvantage of a fully endowed institution would be the opportunity costs associated with alternative uses of the funds that underwrite free tuition. Could Harvard accomplish more in research, advanced scholarship, or community programming, for example, if students paid something and part of what would have been used for full tuition endowment were invested in new laboratories, libraries, professorships or service programs? Suppose that such investments were likely to lead more quickly to a cure for cancer or cheaper sources of energy? And, would students better appreciate their education, and better invest their time in its pursuit, if they had to pay something for it?

Similar issues would be faced by any nonprofit institution that considers building up a large endowment in order to lower the cost for its users - whether in health care, the arts, or elsewhere. Such a policy allows these institutions to serve lower income groups more extensively, and to provide their services strictly on merit, but it may also present significant lost opportunities to accomplish other things.

In general, endowments must be tied closely to a careful articulation of the institution's mission. There is no "one size fits all" approach to endowments. As illustrated by the forgoing examples, optimal endowment size depends on interpretation of mission, present versus future needs, present versus future prospects for fund raising, and the opportunity costs of using endowment funds in alternative ways. Ultimately, endowment policy must be designed to allow the institution to accomplish its goals in the most effective manner.

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