

Spending Rate Methodology

Nonprofits, particularly those managing endowments or investment funds, use different spending rate methodologies to determine how much money can be spent annually while maintain a long-term financial sustainability. Here are the most common types:

- **Fixed Dollar**

- Description: A specific dollar amount is spent each year
- Pros: Predictable and easy to budget
- Cons: Doesn't account for changes in market value of inflation

- **Fixed Percentage**

- Description: A set percentage (e.g., 3 to 5%) of the endowments average market value
- Pros: Simple and automatically adjusts to changes in asset value
- Cons: Can lead to volatility in actual dollars spent if the market fluctuates

- **Rolling Average Method**

- Description: Applies a fixed percentage (e.g., 3 to 5%) of the average market value of the fund over a period (typically 3 to 5 years)
- Pros: Reduces spending volatility caused by short-term market fluctuations
- Cons: May delay the effect of recent gains or losses on spending

Spending Rate Methodology continued

- **Inflation Adjusted Spending**

- Description: Starts with a base spending amount and it increases it annually based on inflation (e.g., CPI)
- Pros: Maintains consistent purchasing power over time
- Cons: Not responsive to large changes in fund value

- **Hybrid Model**

- Description: Combines elements of different methods, e.g., a weighted formula such as:
 - 50% of last year's spending adjusted for inflation + 50% of a percentage of market value
- Pros: Balances predictability and responsiveness
- Cons: More complex to administer

- **Income-Only Spending**

- Description: Spends only interest and dividends, not capital gains
- Pros: Preserves principal
- Cons: Can severely limit available funds during low-interest periods

No spending rate policy is perfect, but it is important to select a methodology that is appropriate for your organization and stick with it.