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Plan for Pooling the Investments of Endowment Funds

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A Plan for Pooling the Investments of Endowment Funds

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THE practice, by a given institution, of investing the resources of its various endowment funds in specific securities, the financial condition of each fund being dependent upon the specific securities held for its account, gradually is giving way to the placing of the investment securities of a large number of funds in a common pool.

The principal advantages of pooling the investments of endowment funds may be stated as follows:

1. To provide through broader diversification for (a) better protection of principal and, (b) greater stability of income, without the necessity either of owning a large number of small holdings of securities, or of distributing large holdings of securities over several funds;
2. To provide for participating funds a means of holding a well rounded group of investments wherein increment as well as satisfactory current return is made possible;
3. To provide a means of investing a larger proportion of total funds available for investment, through the consolidation of relatively small cash balances;
4. To facilitate the sale of securities and to reduce the number of transfers among funds;
5. To simplify the accounting for investments.

The various phases of the inauguration and operation of the pooling plan will be discussed under the following topics: requirements for participation; inauguration of the pooling plan; fund additions and withdrawals; profits and losses on investments; and income from investments. While the pooling plan described herein may be applied wherever endowment funds exist, whether the organization be a college, university, hospital, church, club, etc., the subject will be discussed as if the endowment funds referred to are those of a college or university.

REQUIREMENTS FOR PARTICIPATION

The pooling plan under consideration will be considered as applicable only to endowment funds, that is, funds the principal of which is to be kept intact and the income only expended. Funds the principal of which is to be used for the erection of buildings, acquisition of equipment, etc., but which may be invested temporarily, would therefore be excluded from the pool because (1) the investment requirements would differ from those of endowment funds and (2) withdrawals of funds from the pool should be reduced to a minimum. Likewise, there would be excluded gifts of cash, or securities, to be used for current expenses or without any restrictions whatsoever as to the disposition thereof. However, there would be added to the pool such portions of unrestricted gifts as are allocated to endowment funds by the trustees or other administrative officers either voluntarily or in accordance with agreements with other donors to set aside for endowment certain amounts of unrestricted funds in connection with gifts by such other donors. The effect of this is to confine the pool to those funds as to which the institution is committed to maintain the principal intact. Funds restricted as to principal may, of course, be taken into the pool regardless of whether there may be restrictions as to the use to be made of the income from such funds.

In determining whether a given endowment fund is to enter the pool, the following two factors should be taken into consideration:

1. From the point of view of the fund, it should be ascertained that the provisions of the deed of gift whereunder the fund was established do not preclude, either directly or by implication, the fund's investments being merged with the investments of other funds.
2. From the point of view of the investments, it should be established that the investments to be added to the pool are of such quality as are commonly purchased by the trustees as investments made by themselves, are income producing, and are of such a character as ordinarily to have a current market value.

In the case of funds which are precluded from entering the pool because of the first restriction, it may be possible to obtain consent of the donor to change the restrictive provisions in the deed of gift. Generally these restrictions are of two principal types: (a) the donor has manifested some intention that the principal of the fund shall be kept apart from other funds, or invested separately; (b) the donor has specifically restricted reinvestment either to a certain class of securities such as government obligations, or has required reinvestment to be approved by some person or persons. As to restrictions of the first class, it is believed that in most instances the restriction may have been inserted by the donor in his deed of gift solely in order to protect the identity of the fund as such, without reference to the investments thereof. If such is the case, there appears to be no reason why the donors should withhold their consent to having such funds participate in the pool. It should be borne in mind, however (as will be described in greater detail hereinafter), that while the pooling plan provides for the pooling of endowment-fund investments, it does not contemplate the merging of the accountabilities for the principal of the individual endowment funds. Accordingly, the identity of the capital of the funds is not lost upon pooling their investments.

Funds, the deeds of gift for which do not preclude pooling, may hold investments which because of their character should be excluded from the pool. Thus, ordinarily, it is preferable that real estate be excluded from the pool. Likewise non-income-producing securities or income-producing securities which may have no market value, etc., should be excluded from the pool. It is quite likely that there will be a number of funds which hold largely investments which may be pooled and one or two miscellaneous investments not eligible for pooling. Such funds should be included in the pool as far as possible and real estate or securities excluded from the pool should be held separate and apart from the pooled investments. These funds may be referred to as partially pooled funds.

Inauguration of the Pooling Plan

Prior to the inauguration of the pooling plan, all deeds of gift should be reviewed by counsel, to determine which funds are precluded by the provisions of the deeds of gift from entering the pool. Of course, due regard must first be given to the laws of the state in which the institution is located with respect to the investment of trust funds to determine whether the establishment of an investment pool would be legal.

Likewise, the investments portfolio should be reviewed by those responsible for the investment of endowment funds, in order to determine which funds are precluded from participating entirely in the pool because of unfavorable investments held. The investments which are eligible for admission to the pool should be valued at market values as of the date of the inauguration of the pool. In the absence of a market quotation, real-estate mortgages and notes may be admitted at face values (unless there is information available which would make admission at face value inadvisable), or at appraised values. The funds entering the pool would be credited with the value, determined as indicated in the foregoing, of the investments contributed to the pool plus uninvested cash at the date of inauguration. A separate account should be maintained for the principal of each of the participating funds, so that, although the funds lose all claim to individual investments, the identity of the funds as such is not lost.

To adjust the carrying value of investments from cost to market in order to establish a pooling plan may at first appear to be heretical, inasmuch as any departure from cost, especially in an upward direction, usually is viewed with disfavor by accountants. It is doubtful, however, whether any more equitable basis could be devised and still be practicable. The individual funds are entitled to all increment in the value of their investment holdings up to the date of contribution to the pool. Similarly, depreciation in the value of securities up to the date of entering the pool is chargeable against the individual fund. The procedure, therefore, is equivalent to a sale on the open market as of the date of inauguration of the pool of all the investments of the funds to participate in the pool, and a contribution of uninvested cash to the pool, thereby establishing the principal amounts of the respective funds, and to a purchase on the open market for the benefit of the pool of securities similar to those held by the individual funds. The effect of the preferable procedure advocated herein is to have all the funds participating in the pool share in the profits realized and losses sustained by individual funds prior to the inauguration of the pool. Although no sale is made to outside interests, the effect is the same inasmuch as individual funds lose all claim to specific securities.

Parenthetically, it may be mentioned that occasionally the counter suggestion is made that funds should be admitted at book values, no change being made in the carrying value of the investments. While this suggestion appears to have the merit of leaving undisturbed the carrying value of the investments, it is objectionable in that changes in the values of the investments from the time of acquisition to the date of inauguration of the pool would then be absorbed by the pool rather than the individual funds.

At the time of the inauguration of the pool, there may be funds which, because of depreciation in the value of securities held, will enter the pool at a value less than the original amount of the fund and the deeds of gift may provide that income on the fund investments is first to be used to maintain the original principal intact. Such cases usually must be treated according to individual circumstances. It may be desirable under certain circumstances to appropriate from the general endowment funds a sufficient amount to restore a substantial deficiency in any principal account rather than to accumulate income in accordance with the deed of gift. This is best done, if authorized, as an adjustment of the principal accounts in the pool immediately after the inception thereof.

Fund Additions and Withdrawals

Additions to the pool may be made at any time, by way of increase in the principal amount of an existing fund participating, due to additional gifts, or by way of an entirely new fund, provided, of course, that no conditions exist requiring exclusion from the pool. Such increases will share in income from the common investments from the date of their affiliation with the pool. Gifts of cash should be invested in due course and present no difficulty, the contributing fund receiving credit for the amount of cash contributed to the pool. Gifts of securities may be taken into the pool, the contributing fund receiving credit for the market value of such securities as of the date of their admission to the pool, provided the securities are of such a nature that those responsible for the purchase of investments would be justified in holding them as an investment. If securities received as gifts are not considered desirable investments for the pool, they should be held separately by the related fund until such time as they may be disposed of to advantage, when the cash realized from their sale may be taken into the pool and credited to the contributing fund.

It is unlikely that withdrawals will be made from the pool as a regular occurrence inasmuch as endowment funds are intended to have a permanent existence. In case withdrawals ever become necessary, they may be made at any time, the withdrawing fund or portion thereof ceasing to draw income as of the date of withdrawal. In the event of withdrawal, the question arises as to whether the fund withdrawn should share in the accumulated profits and losses on investments and the undistributed income from pool investments (discussed hereinafter). Each case should be treated according to the circumstances surrounding it. Ordinarily the purpose at hand will be served by withdrawing cash equivalent to the principal of the fund. In order to avoid dissatisfaction or the possibility of litigation, it would be advisable to give consideration to the matter of accumulated profits and losses on investments and the undistributed income from pool investments.

Profits and Losses on Investments

Profits and losses arising from sales of securities should be carried in a collective "profit-and-loss principal" account provided for this purpose, in order to eliminate frequent adjustments of the book value of the principal of individual funds which would be involved if realized profits and losses were to be distributed among the funds. The aggregate of the investments held in the pool at any time, including uninvested cash, should be equivalent to the aggregate principal of the participating funds, plus the net profits accumulated or minus the net losses sustained to that time on sales of investments.

As has been stated previously, in the event of the withdrawal of a fund from the pool, it may be necessary to analyze the profits and losses on sales of investments in order to determine the portion thereof applicable to the withdrawing fund.

As long as the profit-and-loss principal account has a credit balance, it is in the nature of a principal reserve. In case a large credit balance is built up over a period of years, consideration then may be given to the distribution of a portion thereof among the participating funds. In this connection it is interesting to note that the annual report of one educational institution states that such a "dividend" of approximately 15 per cent was declared in connection with the operation of that institution's pool. Similarly, in case losses should materially exceed profits on sales of securities over a period of years, consideration may be given to levying a capital assessment against the participating funds.

Although it is quite customary among educational institutions which pool their fund investments to treat profits and losses on sales of investments in the manner described above, it is this feature of the plan which is most frequently criticized. A new fund entering the pool will receive the benefit of profits which it had no part in earning and be penalized for losses incurred prior to its participation in the pool. Neither is any recognition given to unrealized profits or losses at the time a new fund enters the pool.

Inasmuch as this criticism also affects the distribution of income further consideration of it will be deferred until the accounting treatment of income from investments is described.

Income from Investments

Income from the pooled investments (including as income any interest received on bank balances representing pool cash awaiting investment) should be shared pro rata by the participating funds. Income received should be credited in the first instance to a collective income account which may be entitled "undistributed income from pooled investments." In determining the amount of income to be distributed to the participating funds, consideration is given to the estimated income to be received during the ensuing fiscal year, the balance in the undistributed income from pooled investments account at the beginning of the fiscal year, and the amount desired to be left as a balance in the undistributed income from pooled investments account at the end of the fiscal year. Having determined the estimated amount of income to be distributed, the rate of distribution is determined by dividing the estimated amount of income to be distributed by the aggregate principal of the participating funds. The following plan may be followed in distributing income to the participating funds:

1. Credit the income account of each fund with an amount computed by applying to the principal of each fund a rate of distribution established prior to the beginning of the fiscal year, charging the total of such credits to the undistributed income on pooled investments account.
2. Leave the excess of income actually realized over the aggregate amount distributed at the fixed rate in the undistributed-income on pooled-investments account to be used in maintaining the distribution rate in years when the actual income realized falls below the total amount distributed to the participating funds at the fixed rate.

To illustrate the scheme of distribution, assume that the total resources of the pool amount to $25,100,000, represented by investment securities of $25,000,000 and uninvested cash of $100,000; the aggregate principal of the participating funds is assumed to be $22,000,000 and the balance in the profit-and-loss principal account is $3,100,000. Based on a rate of expected return of 4 per cent on the cost of investments, the estimated income will be $1,000,000 (in actual practice the income should be estimated by specific investments). A desired rate of distribution of 4.25 per cent would require $935,000, leaving an estimated amount of $65,000 to be added to the undistributed income from pooled investments account. Actual figures obviously might differ from the estimates because of additions to the pool, investment changes, etc. While some institutions endeavor to distribute all income to the participating funds in the year in which received, a preferable procedure is to distribute somewhat less than the total income received, leaving a balance to be carried forward for future use. It will be seen that if the sales of securities result in an accumulation of profits in the profit-and-loss principal account, the annual rate of distribution of income might exceed the average annual rate of return on the book value of the investments without necessarily using all the income actually received.

As a practical matter, additions to the pool during the year may share income from the first of the month following entry into the pool, rather than from the actual date of entry. This procedure will allow time for gifts in cash to be invested.

The above method of distributing income has the following merits: (1) the amount of income applicable to a given fund for a given year may be determined beforehand (in the absence of gifts increasing the principal of the fund during the year) and this information may be used in the preparation of the annual budget and in planning the year's activities; (2) the annual income available for various specific purposes may be equalized over a period of years. While the rate of distribution might be fixed after the results of the year are known, or the entire income received in each year distributed, it is believed that such a procedure is unnecessary and would be less serviceable. Therefore, it is suggested that the undistributed income from pooled investments not be allowed to accumulate any more than is necessary to stabilize rates of distribution during periods when interest is defaulted, dividends are reduced or omitted, etc. As a matter of principle, the funds participating in the pool are entitled to share in the income received, insofar as it is expedient, at the time the income is received. The application of this principle should not be impaired by undue accumulation of income. The rate of distribution of income may be increased at any time that the undistributed income from pooled investments becomes excessive.

The method of distributing income, advocated herein, possibly may be subjected to criticism in that it treats all participating funds upon the same basis as regards distribution of income, although some of these funds may have been participants in the pool for many years and, therefore, may be thought to be entitled to a larger share in the annual income than those funds which entered the pool more recently. This is due to the fact that these older funds have a larger interest in the accumulated profits realized on security sales, etc. (which have been reinvested and are producing income), and a larger interest as well in unearned increments in value of the investments held over a longer period of time. With respect to unearned increments, it may be stated that any attempt to classify unrealized profits with realized profits is not regarded generally with favor among accountants. It would introduce a feature which would make the plan so cumbersome as to be impracticable. With respect to realized profits, the profits resulting from sales of pooled securities may well be regarded as a reserve against future losses from investments held in the pool. As has been stated previously, in case the amount of such profits accumulated becomes excessive, consideration may be given to the distribution (constituting a distribution of principal) of a portion thereof among the participating funds. In the opinion of the writer, the circumstances which would require a distribution of net profits, or an assessment against the participating funds for net losses, should be rare and, of course, in each instance the procedure followed should be approved by counsel. The investment pool may be viewed as being administered for the benefit of the largest number of funds and, therefore, for the benefit of the institution as a whole. A new fund would receive the benefits of any credit balances in the profit-and-loss principal account and the undistributed income from pooled-investments account immediately upon entering the pool, and any fund withdrawing from the pool would automatically cease to have a right to such benefits, or any part thereof.

General

The operation of any pooling plan involves problems which must be considered wherever endowment funds exist, whether or not pooled. Some of these problems are the accrual of income on investments, amortization of premiums, accumulation of discounts, stock dividends, and stock rights. Without going into an extended discussion of the reasons therefor, the writer's opinion on these matters is that:

1. Income on investments of nonprofit institutions need not be accrued (for the reason that accrued income on investments is not a resource avail-

able for the payment of obligations);

2. Premiums should be amortized preferably on a straight-line basis over the life of the bonds;
3. For practical purposes no consideration need be given to accumulation with respect to discounts on bonds (this view is supported by adequate investigation and is consistent with respect to conservation of principal);
4. Dividends received in stock on investments held in the pool, if not disposed of, should be added to the pool and taken into income generally at market value (stock split-ups should be added to the pool without book entry except as to the number of shares received; if stock received as a dividend is disposed of, the profit or loss should be computed in accordance with the recognized method of computing such profits or losses, and taken into the profit-and-loss principal account, the investment account being relieved of the portion of the cost of the investment applicable thereto);
5. In the case of the exercise of stock rights received, no entry need be made except to increase the carrying value of the investments in the amount of the outlay made upon exercising the rights; in the case of the sale of stock rights received, the profit should be computed in accordance with recognized procedure, unless the amount involved is inconsequential, in which case the entire proceeds of the sale may be applied to the reduction of the carrying value of investments.

In most institutions there will be funds outside of the pool, as well as funds participating in the pool. Occasionally it will be desirable to transfer investments from the pool to the individual funds invested separately, or vice versa. Such transfers should be treated as purchases and sales, the investments being transferred at market value as of the date of the transfer, proper entries being made for accrued income. Likewise, the exercise by the pool of stock rights received by a fund invested separately, or vice versa, should be treated as a sale and purchase of the rights at current market values.

It is believed that the pooling plan described above is relatively simple in both inauguration and operation. Any plan, of necessity, will be subjected to attack on the ground of theoretic inexactitude, but the test of a plan should be its practicability. Experience has demonstrated that any theoretic objections to the present plan are eclipsed and rendered immaterial by its practical advantages.