A DC IPS must provide procedures to ensure that very different investors' objectives and constraints can be addressed.

2. Endowments & Foundations IPS

1. Return Objective

WHAT YOU SHOULD WRITE IN THE IPS FOR THE EXAM	EXPLANATIONS
«NAME's return objective is to generate a total return on an inflation-adjusted basis that will satisfy the following goals: • Maintain annual spending rate • Cover management fees • Maintain inflation-adjusted value of the portfolio"	• Spending rate: can be statutory or decided upon. • Foundations: usually 5% (MV assets) to stay tax-exempt ➔ payout requirement • Endowments: no legal requirement, in order to provide substantial and stable spending distributions; they usually define a spending rule (simple, rolling, smoothing). • Management fees: usually 0,3-0,5% • For inflation, if distribution finances an operating activity, take the IP of the operating activity (hospital expenses, tuition, etc.) If not mentioned, take the CPI[1]
Required return = (1 + Spending Rate) * (1 + IP) * (1 + Mgt fees)	To maintain the real value of the assets, inflation (IP) must be considered in the portfolio, otherwise purchasing power of the assets falls. Need to balance benefits of current beneficiaries and future beneficiaries ➔ maintain real value of assets

If the foundation is short-lived, it can spend all its capital.

2. Risk Objective

Risk is usually above average; high tolerance for risk.

Reasons:

- Very long term horizon, often perpetual ➔ increases risk tolerance
- The minimum spending rule is for taxes; it is not legally enforceable (unlike DBP) ➔ increases risk tolerance

The following variables adjust risk tolerance:

Characteristic	Risk Tolerance
Previous investment returns	If high, it increases risk tolerance.
Role of the distributions in the operating budget of the entity	If crucial role, it decreases risk tolerance. If contractual distributions, it decreases risk tolerance.
Smoothing rule for spending	If applied, it increases risk tolerance. Smoothing or averaging rules dampen the transmission of portfolio volatility to spending distributions. This allows institutions to accept short-term volatility in order to improve long-term returns and thus increases the spent amounts.

IMPORTANT: Spending rules for Endowments:
Before 1972, endowments spent income.
After 1972, endowments spend a % of market value following one of the following rules:

Simple spending rule:

$$Spending_{t} = Spending\ rate \times Ending\ market\ value_{t-1}$$

Rolling three-year average spending rule:

$$Spending_{t} = Spending\ rate \times \tfrac{1}{3}\,[Ending\ market\ value_{t-1} + ending\ market\ value_{t-2} + ending\ market\ value_{t-3}]$$

Geometric smoothing rule (smoothing rate is between 60% and 80%):

$$Spending_{t} = Smoothing\ rate \times [Spending_{t-1} \times (1 + Inflation_{t-1})] + (1 - Smoothing\ rate) \times (Spending\ rate \times Begining\ market\ value_{t-1})$$

3. Time Horizon
Perpetual
Periodical reviews should be put in place.

4. Liquidity
Liquidity requirements are spending rule and management fees.
- Private and family foundations: spending rule is 5% of the 12-month average of asset values in that year; one cannot know in advance how much ➔ Often these foundations keep a cash reserve.
- Cash outflows are predictable: no significant unpredictable liquidity requirements because of no unexpected large liabilities requirements.
- It is possible to invest in non-liquid risky investments: Private Equity, etc.
- Foundations: carry-forwards and carry-backs allowed on spending rule.