

# **Kamehameha Schools Bishop Estate**

## **Spending Policy**

**(August 18, 1999)**

**KAMEHAMEHA SCHOOLS BISHOP ESTATE****Spending Policy****I. Introduction**

This memorandum provides a summary of the policy guidelines the Trustees have adopted governing annual distributions from KSBE's investment assets ("the Trust") to support the Trust's tax-exempt purpose to fund educational programs.

The rationale for the proposed spending policy is discussed below in more detail, however, the Trustees considered five critical factors as they developed this policy:

1. KSBE is a perpetual institution, hence it is critical that the value of the Trust net of spending distributions and expenses must at least keep pace with inflation. Real growth in the value of the Trust would enable KSBE to expand its programs over time. This is consistent with maintaining Financial Equilibrium<sup>1</sup> which is a fundamental objective of KSBE's financial policies.
2. The Trust is virtually the only source of revenue for KSBE's educational programs. The Schools charge minimal tuition and receive minimal gift revenues to off-set a possible decline in Trust distributions.
3. Once established, program operating costs are relatively stable while investment market values are volatile. Hence, the Trust's spending policy must enable the Trustees to maintain a relatively stable distribution to programs regardless of market value volatility.
4. KSBE is in the early stages of a significant program expansion that will increase program operating expenses over the long-term and require significant capital investment over the next several years.
5. KSBE is also in the process of revising the Trust's investment strategy. Fully implementing the revised strategy will take several years as many of the Trust's investments are illiquid.

The proposed Trust spending policy recognizes KSBE's perpetual time horizon, the Trust's role as the dominant source of revenues for KSBE's educational programs, the need to moderate the

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<sup>1</sup> Financial Equilibrium is a conceptual framework developed for evaluating the long-term financial stability of non-profit organizations. In summary, an institution is said to be in Financial Equilibrium if it at least satisfies the following conditions: 1) limits spending from its endowment assets to a level that will at least preserve the purchasing power of the endowment over the long-term; 2) spends or reserves adequate funds to preserve the useful life of its physical assets, such as physical plant and equipment including technology; 3) balances its current operating budget, consistent with at least satisfying conditions 1 and 2; and 4) establishes policies to keep the growth of revenues and expenses in balance while still at least satisfying conditions 1 and 2. Over time, a fifth condition has been added to the framework: an institution must invest adequate resources in its program to at least maintain its "Quality" relative to its peer group.

volatility of investment markets and KSBE's need for flexibility to adjust for significant expansion of KSBE's programs and changes in the Trust's investment strategy.

## II. Proposed Trust Spending Policy

KSBE will establish a Spending Policy for the Trust comprised of two components. The first component is to spend all net income from Agricultural and Conservation Lands. The second component is to establish a Target Spending Rate of 4.0% of the average market value of KSBE's "Endowment". KSBE expects that its actual Endowment Spending Rate will vary from year-to-year in a range of 2.5% to 6.0% of the Endowment's average market value.

The Endowment will consist of KSBE's investment assets, including the assets of all subsidiaries and affiliated organizations on a fully consolidated basis, but excluding Agricultural and Conservation Land assets and Operating Reserve and Technology and Capital Expense Reserve funds if established by the Trustees. The Endowment's average market value will be calculated as the average market value of KSBE's Endowment as of the end of the prior five fiscal years ending June 30. Over time, the Endowment's average market value will be calculated based on market values as of the end of the prior 20 calendar quarters. Endowment spending distributions will be cash-basis expenses for capital, operating and administrative costs of KSBE's educational programs, but will not include investment-related expenses. Investment-related expenses will be charged against the Endowment's investment return. **A detailed description of the methodology for calculating the Endowment Spending Rate is attached as Appendix 1.**

KSBE's Agricultural and Conservation Land assets have been excluded from the Endowment and the calculation of the Endowment Spending Rate. These Land assets have earned only a minimal net income or have operated at a slight loss. KSBE will spend all net income derived from Agricultural and Conservation Land assets on educational program expenses. Net income, for the purposes of this policy, will be defined as revenue generated by Agricultural and Conservation Land assets less KSBE's costs related to the management and up-keep of these assets. KSBE may reinvest net income generated in one year if it is required to off-set deficits generated in prior years. The Trustees will periodically review the Agricultural and Conservation Land assets to determine whether they should be reclassified as part of the Endowment.

The Trustees may also create an Operating Reserve fund and a Technology and Capital Expense Reserve Fund to provide working capital for program expenses and to create a vehicle for funding capital expenses on a stable basis over time, consistent with maintaining Financial Equilibrium. If created, these reserve funds will be maintained at reasonable levels necessary to fulfill their purposes. The Reserve funds are not considered part of the Endowment. They have shorter investment time horizons and corresponding investment objectives. Contributions from the Endowment to Reserve funds are considered Endowment Spending, but withdrawals from Reserve funds to pay for program expenses are not considered Endowment Spending (see Appendix 1 for a definition of Endowment Spending).

The Endowment's actual spending rate is expected to vary annually around the 4.0% policy target depending on program needs and changes in the Endowment's average market value. For example, capital expense needs may result in higher expenses in some years than in other years and the spending rate will likely increase during periods of low or negative investment returns and decrease during periods of above-average investment returns. **However, KSBE will make**

**every effort to ensure that actual spending from the Endowment in any one fiscal year will not fall below 2.5% or exceed 6.0% of the Endowment's average market value.**

The Trustees will review this Policy at least every five years to ensure that it continues to achieve its intended objectives.

### III. Discussion

KSBE has adopted an Investment Return Objective for its Endowment of inflation plus 5.0%, net of investment-related expenses. Long-term historical investment return data suggest that this is a relatively aggressive objective, particularly for a fund with a large allocation to long-term land leases. If KSBE is to preserve the real value of the Endowment and maintain Financial Equilibrium, the average spending rate from the Endowment must not exceed the Endowment's average annual real investment return.

The proposed Target Spending Rate of 4.0% is 1.0% below the 5.0% real Investment Return Objective for several reasons. A lower Target Spending Rate provides an opportunity for modest real growth of the program activities over time. It also provides a hedge against the possibility that the Endowment's actual investment returns may fall short of the 5.0% real return objective or that expenses for KSBE's programs may increase somewhat faster than the general rate of inflation for a sustained period. Finally, adopting a Target Spending Rate somewhat below the Investment Return Objective is appropriate, as the Trust is virtually the sole source of revenues for KSBE's educational programs. Unlike most of its peers, KSBE charges minimal tuition and does not receive donations from its alumni.

KSBE expects that actual spending from the Endowment will vary from year to year around the Target Spending Rate reflecting fluctuations in program expenses, especially capital expenses, and volatility in the Endowment's average market value. Hawaiian real estate values have been quite volatile, rising rapidly in the 1980's and falling in the 1990's. Even diversified college and university endowment fund average real returns have been volatile over rolling five-year periods, ranging from about -4.9% per year in the FY 1973-74 period to 11.9% for the FY 1994-98 period (sources: National Association of College and University Business Officers and Cambridge Associates, Inc.). Reflecting the possible volatility of expenses and investment market values, the proposed policy includes upper and lower limits on annual spending distributions of 6.0% and 2.5% of the Endowment's average market value. **KSBE will commit to make every effort to ensure that the Endowment Spending Rate falls within the 2.5% to 6.0% range each fiscal year.**

### IV. Conclusion

The proposed Endowment Spending Policy reflects an appropriate balance between supporting current educational programs and preserving the Endowment's ability to support future programs in perpetuity. The Endowment Target Spending Rate of 4.0% is appropriate as the Trust is essentially the only source of revenue for KSBE's educational programs. The policy spending rate range of 2.5% to 6.0% provides a reasonable level of flexibility for KSBE to adjust to changes in program needs and investment market conditions.

KSBE has initiated a substantial expansion of its educational programs and is evaluating additional initiatives. However, the Trustees are also cognizant of their responsibility to preserve the ability of the Endowment to support KSBE's future educational programs in perpetuity. The proposed Endowment Spending Policy provides a reasonable framework for the Trustees to balance the needs of current and future generations of students consistent with a policy of Financial Equilibrium.

## Appendix 1

### Endowment Spending Rate Methodology

#### 1. General Description

The Endowment Spending Rate for a given fiscal year will be calculated by dividing the Endowment Spending Amount for that fiscal year by the Endowment's Average Market Value over the preceding five years.

The Endowment Spending Amount is the amount withdrawn from the Endowment to fund educational program expenses during a fiscal year. Educational program expenses will include operating, capital and administrative support expenses related to program activities. Only investment-related expenses will be excluded. Expenses will be calculated on a cash-basis.

The Endowment includes all of KSBE's investment assets on a fully-consolidated basis except for Agricultural and Conservation Land assets, and Operating Reserve and Technology and Capital Expense Reserve Funds that may be created by the Trustees to maintain Financial Equilibrium. The Endowment investments generally will be valued at the most recently available market values as of the valuation date less any debt used to finance Endowment investments. The average of the Endowment's market values over the most recent five years will be used as the denominator in calculating the Endowment Spending Rate.

#### 2. Endowment Spending Amount

The Endowment Spending Amount is defined as all withdrawals from the Endowment during a fiscal year to fund program-related expenses. Program-related expenses include all operating, capital and administrative support services related to KSBE's program objectives. In general, program-related expenses are all KSBE expenses except those required by investment activities. Investment-related expenses should be charged against the Endowment return and not treated as Endowment Spending. Support service expenses (computer, legal, personnel, accounting/budgeting etc), fringe benefits (medical, FICA, retirement, etc.) and any other indirect expenses should be allocated between program and investment functions using a consistent, fair methodology, such as staff headcount, estimated staff time allocations and office space utilization.

The Endowment Spending Amount is generally defined as cash-basis withdrawals from the Endowment to fund program-related expenses during a fiscal year. Program expenses funded by net income from Agricultural and Conservation Land assets, tuition, gifts or other non-endowment sources are considered spending for program purposes but are excluded for the purposes of calculating Endowment Spending under this policy as defined.

If KSBE borrows funds to pay program-related capital or operating expenses, principal and interest debt service payments would be considered part of the Endowment Spending Amount at the time those payments are made. However, program-related expenses paid with the proceeds of the borrowing would not be considered Endowment Spending.

Payments made for program purposes by the Endowment in the form of in-kind exchanges are considered Endowment Spending. For example, if KSBE exchanges land held as an investment in

the Endowment for land to be used for educational programs, the value of the land exchanged should be considered Endowment Spending. Investment land donated by the Endowment directly to educational programs for program use should also be considered Endowment Spending.

Contributions from the Endowment to create or supplement an Operating Reserve or a Technology and Capital Expense Reserve fund would be considered Endowment Spending in the year these transfers are made. Withdrawals from these Reserve funds to fund program expenses would not be considered Endowment Spending. For example, the Trustees may decide to make regular contributions to a Technology and Capital Expense Reserve which will then be drawn down to fund educational technology and physical plant renewal expenses. The transfer from the Endowment to the Reserve fund would be considered Endowment Spending at the time it is made, but the withdrawal from the Reserve to fund the plant renewal expense would not. Transfer of surplus funds from a Reserve fund back to the Endowment would be deducted from Endowment Spending in the year the transfer is made. Reserves shall be maintained at levels adequate to maintain Financial Equilibrium, but excessive Reserves will be avoided.

### 3. **Endowment's Average Market Value**

The Endowment's Average Market Value will initially be defined as the average of the Endowment's Market Value as of June 30 of the prior five fiscal years. For example, the spending rate for FY2000 will be based on the Endowment Spending Amount for FY2000 divided by the average of the Endowment's market values as of June 30, 1995, 1996, 1997, 1998 and 1999. Over time, the definition will change from five annual market values to the average of the most recent 20 quarterly Endowment Market Values ending on December 31 of the year preceding the fiscal year. The purpose of ending the averaging period six months prior to the start of the fiscal year is to facilitate the budgeting process.

The Endowment includes all of KSBE's investment assets on a fully consolidated basis, excluding only Agricultural and Conservation Land assets and Reserve funds created by Trustees. Assets used for or designated for program-related activities, such as educational plant and equipment, administrative office space and land designated for educational program use are not considered to be investment assets.

The Endowment's Market Value is calculated netting out all debt used to finance Endowment investments.

All Endowment assets will be valued at, or as close as practicable to, their current market values as of the valuation date. Guidelines for valuing various types of investments established by the Association of Investment Management and Research should be adhered to as closely as possible and will be consistently applied. Since most of KSBE's land assets have been valued in the past based upon tax-assessed values, there will necessarily be a transition period before all assets can be reported at fair market values. During this transition period, KSBE will move as quickly as practicable towards fair market values based upon independent appraisals and other appropriate methods.

In general, marketable security assets should be valued at their most recent selling price. Restricted securities or large block positions may be discounted from the most recent selling price with the size of the discount depending on the nature of the restriction and the size of the block. Private venture capital investments (which generally do not have established earnings) should be valued at the lower of cost or market value determined by the General Partner responsible for the investment. The General Partner may reduce the carrying value of a venture capital investment if it is performing

poorly relative to its business plan, but may not increase its carrying value until a transaction with a third-party has validated a higher valuation. Private equity investments in established businesses should generally be valued using the same criteria as applied to venture capital investments. However, in the case of longer-term private equity investments with established asset values and/or earnings, the carrying value may be increased by the General Partner based on a conservative assessment of comparable public valuations of similar enterprises. Real estate investments should be valued at the most recent appraised value provided by a qualified, independent appraiser. The General Partner responsible for the investment may reduce the carrying value between appraisals if the property's performance or market conditions deteriorate.

It may not be practicable for KSBE to commission appraisals for all of its Hawaiian real estate assets. KSBE will have its Commercial properties appraised every three years and will evaluate the feasibility of appraising its larger income producing land investments. Adjusted Tax Assessed valuations may be used for assets that are not appraised. Private real estate mortgages, or purchase money mortgages, may be discounted from their carrying values based on their current income yield, credit quality and liquidity. Mainland real estate investments will be valued at the lower of cost or market value estimated by the responsible General Partner until these assets can be appraised by a qualified, independent appraiser or sold. Mainland real estate assets that are intended to be held as long-term investments should be appraised every three years.