Escaping the Perpetuity Mindset Trap

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Over the past 15 years, as their valuations have increased dramatically, many of us have wondered why foundations couldn't be more generous with their payouts. After all, in real terms they had grown far larger. Why should they continue to give only 5 percent of their endowments to charity? Why not increase their annual payout to recognize their windfall? In this spirit, Congress recently considered a proposal to increase U.S. foundation payout rates, but it was defeated after an intensive lobbying effort by the largest foundations.

In response to the payout proposal, foundations argued that they must preserve their assets to serve future human needs rather than spend it sooner in reflexive attention to more current needs. Several motivations drove this refrain. Foundations spoke publicly about their fear of the erosion of their independence and fiscal integrity, declining endowments, and their loss of power in the national policy discourse. In sum, the proposal to increase payouts was viewed as a threat to fundamental foundation prerogatives. This was a shot across the bow of the "doctrine of perpetuity": the underlying and largely unchallenged maxim that compels most foundations to preserve their fiscal lives and power forever.

This article argues that today more aggressive foundation fiscal policies are not only critically needed but that they make long-term social and economic sense. While this article does offer prescriptive strategies, it is intended primarily to provoke discussion. As a rule, foundations are essential, committed, and generally progressive players in the social-capital marketplace. They have been a wellspring of innovation and intervention. Many of those who govern and manage these institutions are accomplished leaders and proud partners of the charities that are their beneficiaries. I am keenly aware of the importance of the work of foundations and have been a beneficiary of their largess.

But current structures and fiscal practices limit the potential of foundations to do their work most effectively. Thus, this article first explains the role of the doctrine of perpetuity in driving foundation behavior. Second, it explains three disabling limitations that result from foundations' unchallenged adherence to this doctrine. Third, it proposes an alternative core doctrine—social-value maximization—to drive foundation fiscal behavior and offers sample strategies that foundations can pursue to maximize their value. It concludes by discussing the implications of today's depressed investment markets and the prospect of severe recession.

The Doctrine of Perpetuity

In practice, the potential of almost every private foundation is constrained by a single, ubiquitous institutional imperative:

> To manage and grow a portfolio of assets to ensure a foundation's ability to pay out annually to charity the inflation-adjusted equivalent of 5 percent of beginning asset value in perpetuity.

As a result, just about any private foundation's books reveal that these institutions invest the bulk of their assets, and hence their potential to effect change, in the same publicly traded equities, real estate, private equity, and debt instruments that you'd find in standard private-investment portfolios. This is often literally the same portfolio of assets that existed before the personal wealth that "made" the foundation become "charitable." Further, after deducting credit for qualifying administrative expenses, the remaining 4-plus percent that a foundation will eventually pay out in grants is dwarfed by a retained endowment that is nearly 25 times that amount. And while percentages vary in years when investment markets trend up or down, most large endowed foundations view 5 percent as not only the minimum requirement but also the strategically determined maximum they expect to spend. The amount granted is therefore determined not by need or opportunity but by an arbitrary, statutory threshold.[1]

A majority of foundations, with a particularly high concentration of large foundations, adhere to this minimum-maximum threshold without a second thought. When you think about the process of creating new foundations, this is not surprising. Professional advisers—tax accountants, trust lawyers, and investment advisers who are trained to perpetuate wealth—are the formative architects of foundations. Because they do what they are trained to do, we cannot fault these advisers individually for this architecture. They may also direct clients to follow the perpetual fiscal practices of other foundations. And once an "experienced" foundation hand takes the helm, which often happens with substantial new foundations, the die is cast. Together, these "best practitioners" construct a nearly impenetrable barrier to fiscal innovation—a perfect storm of perpetuity—that severely limits foundations from adopting more creative and aggressive strategies to make their contribution to society.

The end result is that foundations have become little more than private investment companies that give a signficant portion of their excess cash to charity. We have arrived at this juncture because we are intellectually and culturally constrained by the institutional imperative of perpetuity. It sets a trap that severely diminishes the potential benefit to society of more optimal uses of foundation resources.

The Limitations of the Doctrine of Perpetuity

In establishing an impenetrable wall around foundations, perpetuity imposes three fundamental limitations on foundations' strategic potential.

1. The doctrine of perpetuity immunizes foundations from public accountability. The doctrine enables foundations to operate as self-contained systems, needing little from the outside to operate. In other facets of our national life, institutions are guided by, if not formally governed by, empowered stakeholders. Governments serve voters and constituent beneficiaries; businesses have shareholders and customers; universities have students and alumni; and hospitals have patients. Customers, shareholders, and other stakeholders are the principal means to keep our institutions grounded and responsive.

But foundations lack these mechanisms of accountability. The doctrine of perpetuity ensures that foundations never have to look outside for approval or resources. Once a foundation's original founders and close associates fade from the picture, it has nothing analogous to "shareholders." As a consequence, foundation boards generally elect themselves, with all the good and bad results that implies. And while charities are the de facto "customers" of foundations, the disproportionate power of foundations in the "transaction" prevents charities from demanding accountability and responsiveness.

Without empowered stakeholders, foundations lack the accountability of other institutions that benefit the public. Regulators and the media periodically uncover fiscal malfeasance by a foundation's board or executives. But such oversight has nothing to do with grantmaking performance or maximization of the value of foundation assets for society. And while foundations conduct excellent work for society, such work is predicated on the sustained goodwill and energy of trustees and foundation managers. That's a difficult and largely elusive proposition. In no other context is exclusively internal oversight deemed adequate. Why here? Given the absence of any obligation to report on performance, foundations are arguably the least accountable institutions in our society.

2. Perpetuity diminishes a foundation's internal accountability, its ability to make consistent performance demands of its grantees, and its ability to optimize deployment of its assets. The unbroken connection of a foundation's endowment to its grantmaking apparatus limits the potential of both these operating components. Grantmaking staff knows it will have 5 percent of an endowment to distribute regardless of the quality or results of the organization's grantmaking. As a result, foundations and their grantmaking staff have little incentive to calculate and communicate the quality of their grantmaking as well as little propensity to share research and information with other grantmakers to establish better grantmaking practices.

The same people that manage a foundation's grantmaking also supervise its endowment. In nearly every other investment context, the owner of a pot of funds selects one or more intermediaries (such as money managers, mutual funds, or stock brokers) to invest the pot and then demands subsequent comparative performance reporting by each intermediary. Certainly that is how foundation trustees handle endowment investments, but not their grants—that is, their social investments. Trustees seldom consider external services to handle endowment grantmaking, and few demand grantmaking accountability.

On the flip side, foundations sometimes establish highly professional, expert grantmaking capabilities in specific subject areas. Yet despite this competence, they continue to view the captive endowment payout as the one and only source of funds to pass through their grantmaking systems. Due in large part to their inherent insularity, foundations with demonstrable grantmaking competencies are blind to the opportunity to attract and distribute philanthropic monies from external sources. With this level of insularity, it is no wonder that foundations fail to leverage the best grantmaking expertise, that they duplicate grantmaking efforts, and that they fail to harmonize charity grant application and reporting requirements.

In this respect, perhaps the most remarkable thing about Warren Buffett's commitment of the proceeds from more than $30 billion in Berkshire-Hathaway shares to the Gates Foundation was that other foundations did not bid for a piece of the Buffett business or catch the significance of the Buffett model and"market" themselves as intermediaries for other new philanthropic capital. If Buffett had put his proposition out to tender, we might hope to have witnessed a flurry of responses by foundations eager to exploit their insights, expertise, and grants' management capabilities with substantial new funds. Instead, I fear that the insulating qualities of perpetuity would have prevented nearly every foundation from recognizing even the Buffett event as an opportunity to lever its own grantmaking competencies.

This insularity of foundations has implications for the performance of charities as well. Foundations are the principal institutional "investors" in charities, and society should expect these investors to establish performance expectations. In fairness, many foundations require grantees to document the outcome of their work. But because foundations are subject to little accountability themselves, it's unlikely that grantmakers will apply performance demands consistently over time or link grantee data to any public assessments of their own grantmaking performance.

3. Perpetuity erodes the real value of society's philanthropic assets. In theory since foundations give roughly 5 percent of their endowments to charities annually, the value of the retained 95 percent has an opportunity to keep pace with or exceed inflation. But as the public waits for each foundation's relatively small annual distributions to charity, there are real costs. In addition to the public's loss of tax revenue from the charitable deduction and lost capital gains taxes thereafter, society suffers when it has to wait to solve pressing problems.

Unresolved problems not only create immediate human costs—a malaria sufferer left to die, a child left unfed—but also increase the future cost of remediation to society. The hundreds of examples of this principle include whether to promote early-childhood education rather than build prisons later; whether to work to prevent AIDS transmission rather than treat terminal patients indefinitely; and whether to limit carbon emissions now rather than allow global warming to continue unchecked. In the case of some unresolved problems, notably climate change, there may be no strategy or price tag for future remediation. Certainly, any nominal appreciation in the value of a perpetual endowment should be discounted by the cost society incurs today (that is, the social cost) of human suffering, environmental degradation, and other problems left unresolved.

But in light of our current depressed economic conditions, shouldn't we perpetually warehouse philanthropic capacity to ensure that we have resources to provide grants to future generations or to deploy resources on a rainy day? No! Even if we ignore the cumulative social cost of waiting to solve long-standing problems, deferral is a valid strategy only if future generations become less philanthropic or the philanthropic capacity of the economy declines. Over any meaningful time period, however, neither condition has presented itself. In practice, individuals have become increasingly philanthropic, and society has always expanded its philanthropic capacity.

There is little justification for foundations to save now to prevent a contraction of assets in the future, and it is a pity that foundations did not address some of the world's most pressing problems when they felt richer. But there's no point in bemoaning the past. Despite and because of our difficult economic circumstances, foundations should persist in addressing today's problems, even at the risk of exceeding perpetuity-sustaining payout levels.

When compelling, unserved current needs stare us in the face, the idea that foundations should save resources to serve a theoretical future need makes little sense. Despite all the good work of foundations, their perpetuity-at-all-costs mindset ensures that endowments are a depleting social asset.

An Alternative Core Doctrine: Social-Value Maximization

What strategies can we pursue to preserve foundations' flexibility and unfettered philanthropic function but also help these institutions become more accountable and social value–maximizing? One obvious strategy is to require all foundations to stipulate a formal strategy to pay out their assets in grants over a prescribed time period that fits the circumstances. This strategy might encourage an internal accountability and time-pressured acuity, causing foundations to deploy assets to solve problems more quickly and intelligently as well. Alas, this blanket prescription is not politically possible. And it may not always be the best solution. Nonetheless, we must escape the *perpetuity mindset trap* and compel foundations to follow a revised institutional imperative. Without bias for perpetuity or immediate payout, trustees should consciously follow this alternative doctrine:

> To manage a foundation's financial and human resources and to maximize their value for society.

On its face, accepting this new institutional imperative should not be difficult. Most foundation trustees assume they already follow this principle. Indeed, some may argue that because it preserves maximum philanthropic capacity for future generations, managing a foundation's endowment for perpetuity and restricting payout to the statutory minimum best maximizes a foundation's societal value. But given the cost to society of deferring philanthropy, it is not plausible to assume that even in a minority of cases perpetuity maximizes social value. If foundations were to follow this new social value–maximizing imperative faithfully, in addition to generally higher payout levels, we would observe more foundation operating strategies such as the following:

1. The use of mission-related investments (MRIs) in endowment portfolios. MRIs are made in profit-seeking enterprises that work in areas that mesh well with the mission and objectives of a foundation. Theoretically, their double–bottom line return (social and financial) mitigates a portion of the "social cost of capital" discount applied to retained endowment assets.

2. The application of a calculated annual "social cost of capital" to discount the value of assets retained in endowments. Application of a calculated social cost of capital would compel foundations to reconcile the cost of waiting to solve problems through their annual payout policy. Despite its imprecision, this exercise is important. It focuses trustee attention on the implicit erosion in the social value of a foundation's endowment over time.

3. The separation of the endowment and grantmaking components of foundations to create accountability and improve performance. Yes, in virtually every substantial foundation, different personnel manage the organization's endowment and grantmaking. Nonetheless, there is no practical separation for the automatic flow of the annual payout from the endowment into the grant's budget. If the components were truly distinct, it would be an endowment manager's job to ensure that a foundation's annual payout is granted as effectively as possible, and as is the case with any external grantmaking alternative, it would be the grantmaking manager's job to prove his team's work was effective and deserving of subsequent grantmaking responsibilities.

Without consideration for the quality of grantmaking, when tens of thousands of "pots" of foundation funds are dispensed through captive grantmaking services, inefficiency and low quality are inevitable. To prevent these problems, a foundation's policy could provide that if the endowment management were dissatisfied with the conduct of grantmaking, it should choose a competing grantmaking service. By segregating endowment and grantmaking and considering alternative grant-delivery mechanisms—either through dedicated grantmaking intermediaries or the grantmaking departments of other foundations—we could make all grantmaking more effective and efficient.

4. The pursuit of capital from other sources (new to philanthropy and other foundation endowments) to process through existing foundation grantmaking services. This paradigm-shifting strategy is the flip side of the previous strategy. Once the two foundation operating components have been separated, a newly liberated grantmaking service within one foundation could compete to provide grantmaking services for the endowment manager of another.

5. The enhancement of the accountability of foundation boards by establishing a broad-based foundation membership to elect them. These "stakeholder" electors can include practitioners, beneficiaries, experts, and independent thinkers who care about the work of foundations and the utility of foundation assets. A culture of performance and accountability must extend beyond a foundation's staff to its board.

6. The shattering of the benefactor-supplicant condition endemic to grantmaker-grantee relationships to encourage more honesty, feedback, and safe criticism. The foundation serves as "banker" to a grantee "customer." The nature of this relationship should be acknowledged, and foundations should be reviewed regarding the quality of "customer service" they offer. In this respect, the Center for Effective Philanthropy's Grantee Perception Report is an important model. But because it is conducted for only voluntarily participating foundations and its results remain sealed, its impact is limited.

7. The alignment of foundation compensation and expense indices with comparable practitioners in relevant fields. Not surprisingly, foundations generally establish their compensation policies using data from other foundations. Because perpetuity insulates foundations from market and other pressures to contain expenses, use of other foundations alone as comparables in salary administration is a prescription for spiraling costs, declining grant budgets, and eroding social value. Including salaries of all practitioners in the foundation's field, staff at nonprofits, intermediaries, government officials, business actors, and so on would help create needed discipline.

8. The regular recruitment of new program officers from the practitioner ranks rather than from among grantmaking professionals. Staying grounded in a foundation's field of interest and limiting grantmaking positions to discrete terms allows it to remain nimble, informed, responsive, and efficient.

9. Counting only actual grants or direct-program activities as qualifying against payout requirement. If foundations were unable to count administrative expenditures toward annual payout obligations, they would have greater incentive to control excessive expenses and preserve the social value of their assets.

These examples underscore the limitations of the simple "perpetual" construction. But escaping the perpetuity mindset trap does not mean that a foundation must spend down its assets. Foundations have huge financial and human capabilities. They face vastly different challenges. But at the same time, their ability to use resources most effectively must not be constrained by an institutional imperative of perpetuity at all costs. Perpetuity should be viewed as only a possible strategy rather than as an inviolate precondition.

Implications of the Economic Downturn

But hasn't the recent market downturn vindicated the caution of foundations in conserving their assets? Doesn't it argue for further caution? I argue no. Certainly, we face a truly momentous economic moment: a recession or, worse, a situation in which personal wealth has declined, millions of jobs have been lost, and opportunity has diminished. If we seek to engage society most effectively and heroically, this is our opportunity; *this is the proverbial rainy day*. It will be instructive to see how foundations respond. After all, in real terms, asset values have probably returned to the levels of the mid-1990s.

I predict that foundations' first reaction will be to preserve capital, restrict grantmaking, and reduce discretionary administrative expenses. Certainly the decline in valuations has been deeper than anyone could anticipate. So it is easy to understand the fear of fiduciaries.

But after foundations gain perspective on the downturn, let's hope for more from the second round of foundation reactions. Maybe more will conclude that the time to grant is now and that despite declining resources, continuation or expansion of grant- or mission-investment programs is paramount. While foundations had more to give before the economic downturn, it still makes sense to give now while the need is so great.

Ultimately, society's philanthropic capacity resides in the larger economy. Over time, new philanthropists will emerge. As the economy grows, our capacity to give will grow, as will the interest in creating new foundations. If we apply any socially determined discount rate to philanthropic assets, the cost to society of the indefinite retention of endowment in a growing economy is immense. And if the economy continues to stagnate, there is even less justification for holding onto declining assets. We do need policies that ensure that professional, well-capitalized institutions of philanthropy will endure. But these institutions need not be permanently endowed. As they demonstrate their utility, over time they can compete for funds from new donors. Even with the most aggressive payout and value-maximizing endowment strategies, we will experience little, if any, impact on our future capacity to give. But such strategies will surely help those left unserved and make the job easier for tomorrow's philanthropists.

Now more than ever, we face economic, environmental, and human conditions that require foundations to maximize the value of their resources for society. They must become as creative, resourceful, and accountable as the organizations they support. It is only when foundations escape the perpetuity mindset trap that they can reach their full potential to contribute to a sustainable future.

Note

1. For recent research on this topic, see Richard Sansing, "Distribution Policies of Private Foundations," *Nonprofit Economics and Management: The State of Research*, by Bruce Seaman and Dennis Young, (eds.), 2008, which shows higher average payouts during the down-to-stagnant 2000–2003 investment period versus payout practices during the late-1990s growth period. The same study found significant variation in payout policies among foundations but also confirmed that the largest 1 percent of foundations holding 60 percent of assets made only 50 percent of grants and adhered to payout rates in the 5-percent–plus range. The latter observation conforms more closely to the conclusions of Akash Deep and Peter Frumkin, "The Foundation Payout Puzzle," *Taking Philanthropy Seriously: Beyond Noble Intentions to Responsible Giving*, by William Damon and Susan Verducci (eds.), 2006, who in an examination of 169 large foundations during the 1972–1996 period found strikingly little deviation from the legally required minimum distribution.

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