Article | *McKinsey Quarterly*

For nonprofits, time is money

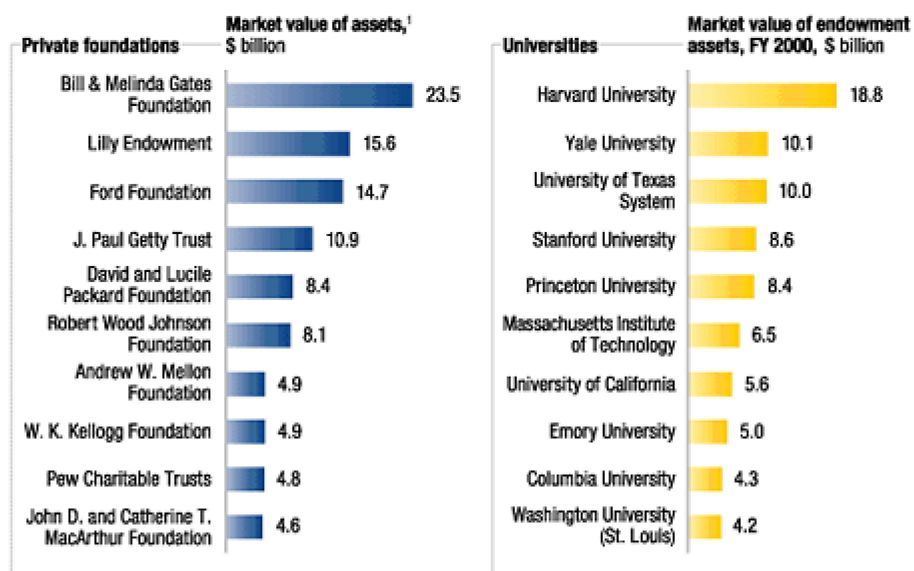
Society pays a price when foundations and nonprofit organizations stockpile their assets. Donors should ask not just how, but how soon, their gifts will be used.

February 2002 | by Paul J. Jansen and David M. Katz

In spite of the current economic slowdown, the US nonprofit sector remains financially strong. Foundations and endowed nonprofit organizations have accumulated almost $1 trillion in investment assets, $450 billion of it belonging to foundations and more than $500 billion to endowed nonprofit organizations.[1] The portfolios of the largest of these institutions top $4 billion (Exhibit 1). Even allowing for a short-term slowdown in charitable giving—a slowdown that many nonprofit leaders expect—an additional $1.7 trillion to $2.7 trillion is projected to flow into the sector over the next 20 years.[2]

EXHIBIT 1

Generously endowed



[1]Bill & Melinda Gates Foundation and Robert Wood Johnson Foundation as of June 2001; David and Lucile Packard Foundation as of May 2001; Andrew W. Mellon Foundation, Lilly Endowment, and Pew Charitable Trusts as of December 2000; Ford Foundation as of September 2000; W. K. Kellogg Foundation as of August 2000; J. Paul Getty Trust as of June 2000; John D. and Catherine T. MacArthur Foundation as of December 1999.

Source: GuideStar; The Foundation Center; National Association of College and University Business Officers

[1] The Foundation Center; IRS Form 990 data.

[2] John J. Havens and Paul G. Schervish, *Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfer and the Prospects for a Golden Age of Philanthropy*, Boston College Social Welfare Research Institute, October 1999, pp. 17–19.

How this enormous wealth should be managed and how fast it should be spent are the subject of debate. To shed light on these questions, we employed a standard financial concept known as the "time value of money." The results of our analysis suggest that the current approach to building and distributing this wealth isn't serving the best interests of society.

Foundations and endowed nonprofit organizations have traditionally been cautious in distributing their bounty. In 1999, foundations took in more than $90 billion in new contributions and investment returns but distributed under $25 billion.[3] Indeed, foundations[4] and endowed organizations[5] have typically distributed about 5 percent of their assets each year—less than their annual investment returns alone. Undoubtedly, the go-slow approach allows foundations to refine their skill at evaluating potential grant recipients, and for operating nonprofit organizations, increasing the endowment has much to be said for it. Large nest eggs free organizations from time-consuming fund-raising, thereby enabling them to focus on their missions, while wise investment strategies increase the resources available for future use.

But in some cases, building the endowment appears to have become an end in itself. A large endowment helps attract top talent and increases the prestige of the institution. Donors perpetuate this syndrome by showering their gifts on well-endowed institutions. The question of how much is enough often appears to be overlooked.

Today's low distribution rates amount to an implicit decision to hold back funds in the expectation that worthier causes will appear in the future. But many current social needs are already overwhelming. Numerous foundations and endowed nonprofit institutions ought to spend their wealth sooner rather than later, and donors should favor organizations that put their gifts to work straightaway. Viewing these issues from the perspective of the time value of money shows why.

---

[3] The Foundation Center.

[4] The Foundation Center.

[5] Stanley Kogelman and Thomas A. Dobler, *Sustainable Spending Policies for Endowments and Foundations*, Goldman Sachs, November 1999.

Sooner is better than later

Given the choice of receiving $100 now or in a year's time, most people would take the money now. By doing so, they acknowledge the time value of money. Indeed, the concept explains many of the financial relationships we see every day. Banks, for example, must pay interest that is higher than the inflation rate in order to persuade depositors to postpone their consumption. When asked to choose between receiving a donation now or in 12 months' time, the managers of nonprofit organizations whom we interviewed indicated that to accept a delay, they would need an implied interest rate as high as 50 percent because they could use those additional resources today to address pressing social needs.

When managers in the for-profit world are considering whether to make an investment, they first calculate the present value of its future returns by discounting those returns at a certain rate to reflect the time value of money. Only an investment whose future returns have a present value that exceeds its initial cost makes sense. Companies typically use their weighted-average cost of capital (the blended cost of their debt and equity funds) as the discount rate. In some cases, they also employ a higher "hurdle rate" to reflect the limited supply of funds and the possibility of earning high returns from alternative investment options. The discount rate chosen has an enormous impact on present value: a low discount rate boosts the worth of future cash flows; a high rate reduces the attractiveness of even investments with large future returns.[6]

Applying this methodology to nonprofits is admittedly complicated, since their return on investment accrues to society rather than to the donor and comes in the form of hard-to-quantify social benefits. In addition, deciding the appropriate discount rate isn't straightforward, since the nonprofits' funds are mostly donated, not borrowed or raised from investors. Nonetheless, we can make a reasonable attempt.

First, assume that nonprofit investments generate some amount of social benefit (however measured) per dollar invested. This assumption allows us to discount these benefits. We make it even though certain nonprofits produce better results than others, because our aim here is to understand the effect of time on investments, not to focus on

[6] For example, the present value of $100 received three years from now is $86 using a 5 percent discount rate but only $68 using a 20 percent discount rate.

issues of relative performance. We can also make an educated guess about the appropriate range of discount rates for nonprofits.

In the for-profit world, a discount rate is chosen to reflect the cost of the funds or perhaps the expected return from an alternative investment. A donor, foundation, or endowed organization always has the option of investing its funds and distributing them at some point in the future, so at a minimum the discount rate should be the expected long-term return of a financial portfolio—about 10 percent.

If, however, you believe that nonprofit investments produce social benefits worth more than 10 percent and that attractive, unfunded nonprofit projects can be found, a higher discount rate is appropriate. Several organizations have tried to quantify the social returns from nonprofit investments and have come up with figures in excess of 20 percent.[7] This is good news for donors and suggests that a discount rate of 15 percent would thus be a conservative estimate for the upper end of our range of rates.

Applying those discount rates to the financial flows of a hypothetical foundation yields intriguing results. Exhibit 2 shows the disbursements, investment income, and administrative costs of a foundation before the time value of money is considered. A gift of $1,000, over a 50-year period, would produce $6,355 in grants, with $1,271 in administrative expenses—an apparently positive outcome. But if future grants are discounted at the 10 percent rate, the present value of the stream of grants falls to just $830, which is smaller than the initial gift. At a 15 percent discount rate, the present value of grants would be just $500 (Exhibit 3). Almost half of the present value of the initial gift is lost to holding and administrative costs. Meanwhile, worthy social causes are left short of funds.

[7] The Roberts Enterprise Development Fund, a Roberts Foundation program focused on creating businesses with social goals, calculates its projects' financial returns to society by measuring factors such as the reduction in government services consumed by clients, the increase in taxes paid by them, and a reduction in rates of incarceration. Roberts figures suggest rates well over 20 percent.

EXHIBIT 2

At first blush, a good deal

Cash flows of hypothetical foundation over 50-year period,[1] $

Year	Total assets	Investment income	Grants	Administrative costs
1	1,000	94	50	10
2	1,034	97	52	10
3	1,069	101	53	11
4	1,106	104	55	11
5	1,143	107	57	11
6	1,182	111	59	12
7	1,222	115	61	12
8	1,264	119	63	13
•	•	•	•	•
•	•	•	•	•
•	•	•	•	•
49	4,977	468	249	50
50	5,146	484	257	51

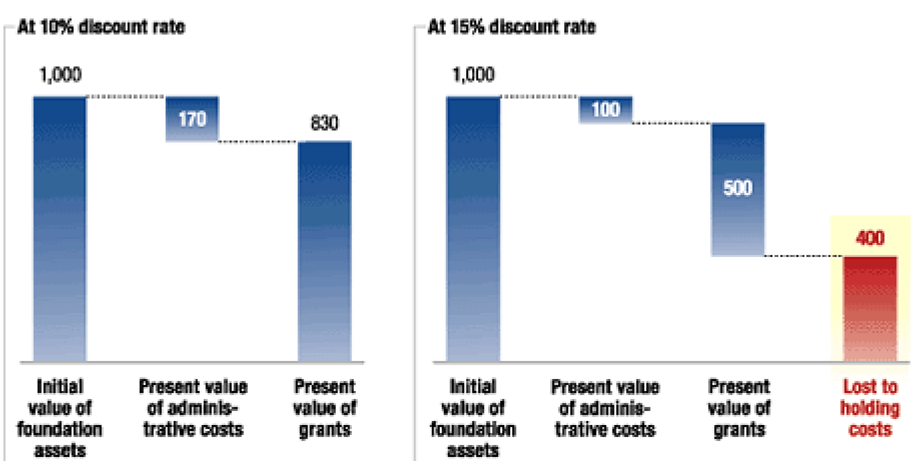
Year 50	
Total grants	$6,355
Total administrative costs	$1,271

[1]Assumes annual disbursement of 5% of assets, administrative costs of 1% of assets, and return on investment of 10%.

EXHIBIT 3

The high cost of waiting

Discounted value of foundation grants and costs over 50-year period, $



This analysis suggests that the foundation manager has decided either that no projects are worth funding beyond those covered by current disbursement rates—a headline in itself—or that projects appearing in the future will have substantially more value than those available today. If neither of these explanations is correct, current low disbursement practices are responsible for a significant loss of value to society, and the generous gifts of donors aren't producing anything close to the maximum social benefit.

Of course, the value lost to delay could be offset by the skills of foundation managers in identifying the most deserving and effective recipients of charity. But foundation grants would need to be about *twice* as valuable to society as the donations of individuals to eliminate the loss of value at a 15 percent discount rate and almost 20 percent more valuable than individual donations at a 10 percent discount rate. Foundation boards and leaders should make a hard-nosed comparison of the relative returns produced to the value lost to holding costs—and foundations that demonstrate superior grant-making ability should share their insights with others.

Getting more bang for the buck

If foundations or other endowed institutions are going to deliver benefits whose value to society equals that of the original tax-deductible donation, they will need to reconsider their payout strategies. Lifting payout rates above the current 5 percent is essential. A 7 percent payout rate, for instance, would increase the present value of grants in the example above to 58 percent, from 50 percent, at the 15 percent discount rate. Although this would not close the value gap, such a shift would inject an additional $9 billion into the nonprofit sector each year.

Higher financial returns on foundation assets would also permit an increase in distributions, but such returns are difficult to sustain. If a hypothetical foundation increased its return on assets by one percentage point, it could make a greater number of grants whose present value would rise to 54 percent at the 15 percent discount rate. If the foundation could maintain the 14.4 percent return that US grant-making foundations averaged over the past 20 years, the present value of grants would jump to 77 percent at a 15 percent discount rate. These returns were earned by foundations during an extraordinary bull market and are probably unsustainable in the long run, but that doesn't make it impossible to improve on them: returns of 14.4 percent were nearly two percentage points lower than those earned by the S&P 500 in the same period. Foundations, with their long time horizons, can afford to adopt aggressive investment strategies that maximize long-term results. Overly conservative strategies have a real cost, since each percentage point lost in financial returns decreases the present value of grant making by about 8 percent.

Surprisingly, the reduction of administrative expenses, which have risen to the equivalent of about 25 percent of the grants made in the late 1990s, provides relatively little benefit. Even halving average expenses would increase the present value of grants from 50 percent to only about 52 percent—not much leverage at all considering the depth of the cuts. The reason is that expenses, like grants, are spread out over many future years. While it is always prudent to control expenses, too much control can undermine effective grant making and defeat its purpose altogether.

One of the most valuable steps a foundation can take is arguably the most difficult: deciding not to continue forever. Perpetual entities have very real costs in present-value terms because the desire to preserve the real value of the assets indefinitely limits current disbursements. If the size and number of grants of our illustrative foundation rose sufficiently to exhaust its assets after 25 years, the present value of those grants would jump to 65 percent (assuming a 15 percent discount rate) or roughly 90 percent (assuming a 10 percent discount rate). Undoubtedly, such a decision would be a radical departure from conventional practice—and would in many cases be precluded by the foundation's charter. But several bodies, including the John M. Olin Foundation and the Whitaker Foundation, have taken this step, to society's benefit.

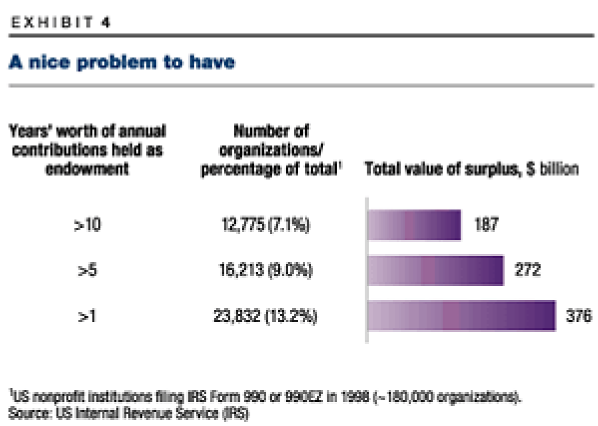
The challenge for endowed organizations

For private universities, hospitals, museums, and similar organizations, a large endowment has many benefits: freedom from the constant battle to raise funds and protection from volatility in other revenue streams and in expenses. As we have said, financially secure organizations can be more aggressive in confronting difficult social problems or pursuing controversial missions, and the best talent tends to be attracted by a healthy endowment. But having one exacts a price.

Harvard University is an extreme example of the challenge that more than 16,000 endowed nonprofit organizations now face. Over the past decade, Harvard enjoyed remarkable investment and fund-raising success. By the end of fiscal year 2001, the university's endowment was worth almost $20 billion—four times its size in 1991. Although Harvard increased its disbursements by 11 percent a year from 1991 to 2001, disbursals as a percentage of the total endowment have declined. While the average annual rate was 4.4 percent from 1971 to 1999, payouts amounted to less than 3.5

percent of assets in fiscal year 2001.[8] The time value of money suggests that Harvard must find ways to raise its distributions, but these increases would, admittedly, have to be truly enormous. If the university raised no new money and ramped up its annual disbursements to upward of $1.3 billion by the end of the decade—more than double the figure today—its endowment would still be worth more than $30 billion by 2010.[9]

While the struggle to find ways to spend ever-growing amounts of money might rank high on the list of problems we would all like to have, the picture this paints of charitable organizations is disconcerting. Depending on the way "excess" is defined, some 12,000 to 24,000 organizations now hold endowments that are most likely larger than they need, and the excess is worth from $187 billion to $376 billion (Exhibit 4). The time value of money demonstrates that holding these vast sums of wealth is inefficient from the standpoint of serving society and achieving an organization’s mission.



Institutions blessed with large endowments need to be as bold and creative in spending their largesse as they have been in accumulating it. At the very least, they should consider funding their own capital projects. (Endowment disbursals typically go toward operating expenses.) Alternatively, such institutions might interpret their missions more broadly. A university might, for example, establish a satellite campus or invest in the

[8] Financial report to the Board of Overseers of Harvard College, fiscal year 1999–2000.

[9] This calculation assumes that distributions rise linearly to 4.4 percent by 2010, that the return on assets is 10 percent, and that expense ratios are constant.

educational projects of other institutions; after all, building a huge endowment isn't the ultimate goal of most of the school's donors.

A change in giving

The time value of money also suggests that donors should reconsider the common practice of earmarking gifts for specific uses or programs. More than 80 percent of the funds in the Harvard endowment, for example, are restricted.[10] This practice destroys much of the value of gifts by making nonprofits unable to allocate funds to the most urgent needs or valuable causes of the time.

Donors sometimes specify that gifts become part of the endowment—in effect, making only the interest on them available each year. In addition, gifts earmarked for specific programs or causes are often disbursed more slowly than unrestricted ones. Donors should recognize that gifts to effective organizations that put their money to work quickly will achieve far better results than those with strings attached. Donors who understand this are also likely to encourage endowed nonprofits to speed up disbursements. At present, many givers ask *how* their contributions will be put to work, but few ask *when* they will begin generating benefits for society.

Public-policy options

Government policies have a significant influence over the way foundations and endowed nonprofits manage their assets. The investment earnings of US foundations are subject to an excise tax of only 1 to 2 percent, while the investment earnings of endowed nonprofit organizations are exempt from US taxes altogether. In 1999, this benefit amounted to almost $25 billion.[11] Is that tax-exempt status appropriate if the revenues the government forgoes are not devoted to delivering social benefits but rather accumulated for years on end?

Current law requires foundations to disburse a minimum of 5 percent of their assets each year. In practice, this minimum has become the maximum. The rate was set in 1981

---

[10] Financial report to the Board of Overseers of Harvard College, fiscal year 1999–2000.

[11] In 1999, foundations had a return on assets of about $60 billion, which implies a tax obligation of $13.2 billion at the approximately 22 percent effective tax rate paid by US corporations. They paid only $500 million in excise taxes—a $12.7 billion subsidy. Endowments had a return on assets of $55 billion, implying a tax obligation of no less than $12 billion, which was entirely waived.

in response to the erosion of foundations' assets by inflation and stagnant financial-market returns during the 1970s. Since such conditions have hardly characterized the past two decades, perhaps the minimum should be raised or tied to investment returns. Another option would be to stop foundations from counting "qualifying" program expenses[12] toward the minimum: that alone would increase annual disbursals in the United States by roughly 0.5 percent of assets—or nearly $2.5 billion a year.

At the very least, the federal government should disclose how foundations and endowed nonprofits manage and use their assets. Currently, all foundations and nonprofits with annual revenues of more than $25,000 use IRS Form 990 to report information on their investment-securities holdings, investment returns, and distributions. The problem is that the information isn't published in a timely fashion or in an easily accessible format. The IRS should publish the size of the endowment of every such organization, its investment returns, its payout rates, information on the way its distributions are used, and perhaps even the discounted value of the assets under current practices. This change alone could have a powerful effect on both disbursal strategies and donors' behavior.

The time value of money shows that delaying investments in the social sector exacts an enormous cost. US nonprofit service organizations do valuable work, and many are underfunded. With more timely support from foundations and donors, they could do even better work. Managers of foundations and nonprofits have become highly skilled at allocating resources among projects. By respecting the time value of money, these managers could become similarly skilled at allocating resources over time.

About the authors

Paul Jansen is a director and **David Katz** is a consultant in McKinsey's San Francisco office.

---

[12] Foundations can count a variety of program and administrative expenses toward the 5 percent minimum distribution rate.