The Grasshopper or the Ant: A Review of Endowment Giving Policy Options for the Doris Duke Charitable Foundation Arts Program

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National Arts Strategies
Aesop’s Fable of the Grasshopper and the Ant

In a field one summer’s day a Grasshopper was hopping about, chirping and singing to its heart’s content. An Ant passed by, bearing along with great toil an ear of corn he was taking to the nest.

“Why not come and chat with me,” said the Grasshopper, ‘instead of toiling and moiling in that way?”

“I am helping to lay up food for the winter,” said the Ant, “and recommend you to do the same.”

“Why bother about winter?” said the Grasshopper; we have got plenty of food at present “But the Ant went on its way and continued its toil. When the winter came the Grasshopper had no food and found itself dying of hunger, while it saw the ants distributing every day corn and grain from the stores they had collected in the summer. Then the Grasshopper knew:

It is best to prepare for the days of necessity
**Introduction**

Over the past decade, the Doris Duke Charitable Foundation has undertaken five initiatives with endowment components. (These initiatives are assessed in the November 2006 report to the DDCF from AEA Consulting.) This grant making has distributed significant resource to the performing arts throughout the United States and is nearing the end of a program cycle, giving rise to a policy review question about the impact of continued endowment giving. Without debating the benefits of the past programs, which have been very well received by grantees, for consideration now is future policy. Do endowment gifts most effectively advance the mission of the Doris Duke Charitable Foundation Arts Program going forward?

Written at the request of program staff at the Foundation, this paper is intended to provoke discussion about the tradition, necessity, and benefits of endowment funds in the arts. It provides a point of view about alternatives to endowment funding which are available to arts organizations, and poses questions about how endowments help achieve mission. The paper reflects research and analysis of a broad sampling of the literature on this subject (refer to bibliography), and also reflects the operational experience of the author in the performing and visual arts.

**History and Rationale for Endowment Building**

The issue of how much wealth charities should retain goes back as far as the dissolution of the monasteries under Henry VIII. While today’s donors and even monarchs do not fear the power of charitable wealth in quite the same way, there are still differing points of view about how much money nonprofit entities should be allowed or encouraged to hold. Over the past few years, numerous articles have appeared in publications as varied as the *Wall Street Journal* and *Slate* questioning the benefit to the public of nonprofits such as Harvard holding onto endowments so large that they outpace the GDP of many countries. At the same time the arts, particularly the orchestral world, has in some measure staked its future on amassing enough money in endowments to protect it from fixed costs that increase each year.

In the arts, the model for endowment building came from the world of academia. In the 19th century academic endowments began to be built up with “windfall” gifts and private donations. Unexpected in their timing, these gifts were clearly not intended to be spent in one financial year, and so were put into savings to help ensure protection against the peaks and troughs of earned income and fundraising. Universities in particular saw part of their contract with society as the provision of services in perpetuity. This implied the need to fortify against the volatility of donated income, which at that time was sporadic and unpredictable.

Endowment came to be seen as funding that would serve two purposes: providing consistent income that would lessen the need for annual support, and ensuring that the organization would continue into the future. As Woods Bowman, Professor of Public
Service at DePaul University has noted, endowment came to be seen as the “life insurance policy on the existence of the organization.” The backbone of endowment giving has always been and remains individual donors, and their interests also began to move toward the notion of perpetuity in relation to their giving and its attendant recognition.

The intellectual basis for the talismanic quality that endowments now have in the arts can be traced back to the seminal work on the economics of culture by Bowen and Baumol in 1966. Their book Performing Arts: The Economic Dilemma laid out several precepts that identified an inherent shortfall in the nonprofit arts’ ability to earn income to keep pace with the costs of production. The argument was that the labor-intensive arts could not benefit materially from productivity gains, had price sensitive markets, and ever-increasing donated income would be the only way that the performing arts could survive and prosper. This book, which contains a great deal of extremely valuable information, was a sophisticated argument for government support of the arts. (Interestingly, what made the book so compelling was its forensic economist’s approach, while the entire premise was based on an assumption, never explained or defended, that the arts should be exceptional in an economic system. In other words, they should never be allowed to diminish, but the public benefit in not allowing them to naturally diminish was never explained. This is discussed at cogent length in the paper by Gregory Besharov written for his work at Duke University, detailed in the select bibliography.)

By defining the arts as immune to an economic model that would brutally self-correct, Baumol and Bowen framed the problem of high fixed cost operations requiring high fixed income to match. It is clear that their thinking at the time was that the government would provide at least some of this funding.

When this government intervention failed to materialize (the NEA was a long time in coming, and small when it arrived) private foundations stepped up to take a leading role in providing the funds that would ensure the perpetuity of performing arts organizations. In a much publicized program, the Ford Foundation made gifts, restricted in part to endowment, to a number of orchestras, and thereby increased the number of full time orchestras from two to sixteen within their orchestral program during the 1970’s. The psychological link to endowment as the handmaiden of perpetuity was now firmly established, and while the Ford Foundation subsequently launched programs that identified cash flow as the larger problem faced by arts organizations, the link has never been broken. (NB: As the Ford Foundation established the organization that the author of this paper currently leads, it should be noted that their recognition of financial problems within arts organizations has been largely effective and in some cases even prophetic.)
Perpetuity at any price?

Today, a sizeable endowment is the “Holy Grail” for every struggling arts organization in the United States. Falling somewhere between a rainy day fund and the guarantee of immortality, endowment is seen as a way of ensuring that come what may, arts organizations will still be in business. Endowments will allow prices to consumers to remain stable even during times of rising costs. (This is rarely the case. At Harvard, there is no dip into endowment -- ever -- and most universities, museums, and orchestras exhaust every other alternative before using endowment funds at anything more than the most minimal payout. Tuition and ticket prices continue to rise, and fixed costs rise with them.)

While the charge of eroding “intergenerational equity” faced by most universities with sizeable endowments is of small concern to arts organizations, the larger issue of choosing between the present and the future does resonate with funders and leaders of cultural institutions. Yale Law Professor Henry Hansmann has written extensively on this subject for nearly two decades, and also established the generally accepted economic model in which nonprofit structures are part of a contract failure within society. Hansmann notes that saving a dollar today, when that dollar has come our way through the public trust, is in fact making a policy decision that the dollar will be worth more tomorrow than the value it creates if we apply it toward mission now. In other words, he sees the preservation of endowment funds as a clear statement that either the needs of future beneficiaries or our own drive for perpetuity at any price outweigh our obligation to make the maximum progress on mission today.

We have no reliable information on how much capital is actually being held across the entire field, rather than expended for cultural provision and innovation today. A paper funded by DDCF in 2004 and published in the International Journal of Arts Management noted that there are no solid statistics on how much endowment is held in the arts. Unlike the National Association of College and University Business Offices figures (NACUBO), there is no annual report detailing the resources held in full and quasi-endowments in the field of arts and culture. We do know that endowment levels in the arts vary widely, with larger organizations in general holding the most money, orchestras and museums being the wealthiest art forms, and small and medium sized companies finding endowment funds a challenge to acquire. Post 9/11, endowment would seem to be even more emotionally desirable for the arts than in previous decades. The promise of institutional immortality is an old and seductive lure.

Endowment in the Arts: Rewards and Risks

As the cost of producing and preserving the arts is inexorably rising, and as technology gains for handmade art forms are indeed limited, it is logical that some form of revenue risk reduction in the form of fixed income is desirable in the arts. To ensure that managerial energy can be spent on those areas which are most closely linked to mission achievement (creation and effective distribution of artistic work), smoothing out the peaks and troughs of cyclical businesses is well worth doing. The assumption for most governing boards has been that the way to do this is to increase
the amount of money secured in an endowment fund. The average return is usually set in line with academic institution spending policies, which means that most endowments pay out about 3.5 to 5% in income each year. As a return on investment, this is not stellar. However, the relatively low annual return is ameliorated (in the eyes of the board and management) by the security of knowing that at least some percentage of income is fixed. In theory, this lowers risk and makes planning easier for the leaders of the organization. In addition, the establishment of an endowment is seen as securing the commitment to mission. Unless the mission of the organization has the word “forever” in it, this is usually not literally correct. However, fiscal responsibility is an essential part of mission achievement, and managed risk and increased assets are part of this responsibility. The case for endowment is usually made on the basis of these assumptions:

- Fixed costs cannot be adjusted downward
- Increased restricted assets improve annual operating position
- More money in the bank lowers risk

The latter two assumptions only hold true if the organization engages in rigorous income based budgeting. By this, I mean that if the organization first estimates its income realistically and empirically and only then establishes its expenditure budget in line with resources, it is using this fixed income to manage risk. Any other budgetary method actually increases risk when assets are illiquid. This is usually referred to as optimistic budgeting, and is buffered by the sense of not being at risk because there is money in the bank. The problem arises when the bank is a restricted endowment, and the money can’t be withdrawn when the optimistic budget targets are not met.

The first assumption above ignores the possibility of any radical change in the delivery system for the art form. This is a highly controversial area, but as technology and consumer patterns change dramatically, assuming that cost priorities today are identical to those of tomorrow could allow art forms to drift away from the demands of the audiences they serve and perpetuate delivery systems that may make them irrelevant in the future.

The matching element of endowment giving is often seen as a way to generate or leverage funding from others. The acceptance of a matching grant and its promise of additionality bear a price that may not be immediately apparent: a resource allocation decision has been made that the leadership priority is to generate more restricted income, rather than spend limited time and resources on generating unrestricted income.

The Nonprofit Finance Fund has done some very strong work on demonstrating how restricted assets secured by spending unrestricted assets result in a weakening of the operating position. Their arguments are detailed in papers on capital structure. In short, NFF makes the case that when a nonprofit board and management use discretionary money to chase restricted money, they lower the tensile strength of the organization financially. Using an operating budget in which one can spend money as one chooses to secure money that can only be spent in limited ways not only reduces the nimbleness of the organization, it increases its financial risk. This is because the organization cannot
then flexibly use the capital it holds to either respond to extraordinary circumstances, or to strengthen its position by increasing the quality or reach of its work. It has made its assets less liquid. In personal finance terms, this equates to being “trust fund poor,” or having an asset you cannot access. On paper, you are well off— in practice, you cannot meet current demands.

If endowment funds have hidden risks as well as benefits, does this mandate that no arts organization should have savings or resources? Clearly not.

**Alternatives to Endowment**

Nonprofits need to balance the natural appetite for security (of boards and donors alike) with the benefits and mission achievement of spending funds now. Keeping in mind that all resources in a nonprofit are honor bound in law to be expended on mission achievement, then finding ways to improve financial security and still be responsive and flexible are of great importance. Permanently restricted endowment may be too blunt an instrument for many arts organizations to achieve this, but is often the default decision for boards with no access to other capital instruments such as debt or stock flotation.

Most organizations have a greater operational need for liquidity (being able to meet all current commitments in a timely way) than they do for other types of financial security with regard to achieving mission. They also need to link all of their resources with their mission, by having a consistent business strategy. Large and flexible working reserves will achieve this for many organizations, depending on their expressed mission.

In a Chronicle of Philanthropy interview in 2004, Will Rogers, President of the Trust for Public Land in San Francisco, noted that despite their size they do not have an endowment. “Given the urgency of the need for what we do, we feel that we can use our money most effectively by buying as much land as we can.” The Trust has recognized that holding back any money for the future is counterproductive for their mission, as land values rise over time, making property more expensive to purchase tomorrow. They have asked the Hansmann question of value today vs. value tomorrow, and have a compelling answer.

By contrast, the Nature Conservancy has the largest endowment among environmental groups: $633 million in late 2004. Their mission is to purchase land to preserve the land they purchase, so their stewardship goal requires that they save 20% of the money they raise to buy land to look after it. The nature of their business is different from the Trust as the Conservancy both manages and purchases land, and so an endowment makes sense for them as it is essential to achieving their mission.

The key to prudent financial planning is always to consider the need for endowment through the lens of mission achievement. The nature of arts organizations varies: museums must be able to preserve and protect the objects they house for future generations, and this would suggest that some level of endowment is required. The performing arts usually seek endowments as a way of offsetting the liability of large
buildings and payrolls, and their issues around endowment can be more complex. It is possible for too large an endowment to “anesthetize” an organization to the needs of its market, although there are very few if any arts organizations that grapple with this problem. Michael Klausner, Law Professor at Stanford, has written that too much immunity to market and donor realities may blind organizations to the need to adapt to a changed environment.

For the performing arts, boards need to carefully consider the opportunity costs of raising permanent endowment funds (which are more expensive in time and money to raise) to the need for substantial reserves which are unrestricted. The need to take artistic risks, to fail on occasion, is ever-present for the performing arts as they concurrently inform and respond to public taste. Significant unrestricted reserves give them access to capital when they need it, rather than forcing them to choose conservative programming as a lower risk alternative. New York University is rare among universities in making this an explicit and controversial strategy; in an LA Times article in 2000 it was noted that NYU spent 85% of $2 billion raised in order to improve all aspects of their educational work and institutional performance. As a massive repositioning exercise, it has been unquestionably successful. The increase in the prestige of this university has resulted in far greater numbers of high quality applications from all over the world, and has allowed them to recruit faculty of the highest caliber.

**Funding policy and endowments**

From a funder perspective, one-time large gifts that have the promise of perpetuity are attractive, but may be illusory in their effectiveness in helping organizations. If the goal is to assist organizations in achieving mission, then endowment gifts need to be carefully analyzed by both funder and funded to determine if they offer the best alternative for this purpose. Are they the best use of capital in strengthening an organization? Giving money that is hard to get from other sources may not be sufficient reason to give it.

The Independent Sector endorsed a statement for funders in 2005 intended to improve the performance of funders in the funder/nonprofit relationship. In this statement, which was the result of an intensive study by members who are funders themselves, IS noted that restricted funding of all types (project funding in particular) is so problematic and undermining of nonprofits that the funders should always seek to opt for general operating support over project support when feasible. Endowment gifts are a very specific form of project funding, and carry the same risks for the funded as other project grants: they lessen the maneuverability of the organization in times of trouble, they do not cover the full overhead costs of managing the grant activity, and they may take leadership time and attention away from core activities.

It would be flawed to say that arts funders should consider endowment unnecessary in all cases. However, it may be that endowment grants should be the gift of last resort, rather than the first. Consideration should be given to the organization’s capacity to manage an endowment, to the need for appropriate cash reserves before the accumulation of an endowment, and to the specific gain in mission achievement that endowment makes
possible for an organization. Dennis Young at NCNE has noted that in the nonprofit world, institutional preservation should not be an end in itself.

Helping organizations look at their asset intensity ratios and how they may be eroding (how many dollars are tied up to earn a new dollar?) is a helpful and informed conversation that funders can initiate with grantees before granting endowment gifts. Attached to this paper is a series of financial indicators, developed by National Arts Strategies, that help analyze the financial capacity and challenges for an arts organization. Consideration of the full financial health of the organization will help funders make better decisions about the best use of the money they have to give, and help to establish funding priorities for the grantee.

Unplanned growth in any area of an organization, even in assets, often results in a capacity challenge that the organization is ill prepared to meet. Lester Salamon reported in a Council on Foundations study in 1992 that small nonprofits and foundations neglect to employ modern portfolio management strategies, and usually fail to achieve market rates of return or even maintain the value of assets overtime. Any funding policy with regard to endowment giving should look at the overall capacity of the organization.
Recommendations for the Doris Duke Charitable Foundation

The following considerations may be useful in determining future policy at the Doris Duke Charitable Foundation with regard to endowment gifts. Acknowledging that each case should be individually considered, a series of questions about the grantee may help clarify if the gift of endowment funds creates the greatest value for, and through, the arts organization.

Does the organization have the capacity or access to the expertise to manage an endowment effectively?

Does the organization understand its current liquidity needs?

Does the restriction of an endowment gift offer greater risk to the organization than is immediately apparent?

Does the organization have or need working reserves at a level appropriate to its size and the nature of its core activities?

Does an endowment risk “crowding out” annual giving, as it lessens the perceived need of the organization?

Does an endowment gift directly assist in the achievement of mission, rather than the achievement of perpetuity?

Does an endowment gift meet the first priorities of the organization?

Clear and candid discussion of these issues will result in a greater degree of partnership for creating value and assisting in mission achievement for grantees, and a greater degree of mission achievement for the Foundation. There are many ways to help arts organizations prepare for the days of necessity.

RYWT
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