The Down Market and University Endowments: How the Prudent Investor Standard in the Uniform Management of Institutional Funds Act Does Not Yield Prudent Results

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With the adoption of the Uniform Management of Institutional Funds Act (UMIFA) in 1972, endowment fund managers at colleges and universities are able to invest their endowment funds as a prudent investor would manage his funds under similar circumstances. Until the end of the summer of 2000, the ability to manage endowment funds under the prudent investor standard, as well as an attractive capital market environment, enabled eleemosynary endowments to grow significantly. With the downturn of the financial markets in the early 2000s, many endowments suffered significant investment losses. These losses could cause one to question whether the prudent investor standard actually yields prudent results, especially when the veil of an appreciating financial market has been removed.

With the importance of education for the future welfare of our society and the tax deductions given to donors to educational endowments, the regulation of endowment fund managers is extremely important to ensure that these funds will be available for future generations. This Note argues that with the strain on eleemosynary revenues coupled with rapidly increasing expenses, the management standards of educational endowment fund managers has become antiquated and needs to be revised. These revisions should curb the fairly liberal standards which endowment managers are currently under, putting our eleemosynary education system at serious risk.

I. INTRODUCTION

In the past five years, the United States’ financial markets1 have taught us many things. The rise and fall of the “dot-com” age in the late 1990s and into the

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1 Financial markets include the New York Stock Exchange (NYSE), NASDAQ, American Stock Exchange (AMEX), and other similar exchanges.
early 2000s cost investors billions of dollars. More importantly, the downturn in
the economy has not only hurt individual investors, but also decreased state and
local governments’ tax revenues. The recession has forced many state
governments to reduce spending on programs such as education. With an increase
in the cost of education and a decrease in government funding, colleges and
universities have become more dependent on alternative sources of funding. In
order to adapt, many colleges and universities have been forced to increase tuition
or cut educational programs in order to make up for the lack of government
funding, while others have become more dependent on their foundation or
endowment.

With the adoption of the Uniform Management of Institutional Funds Act
(UMIFA) in the 1970s, colleges and universities in a UMIFA adopting
jurisdiction\(^2\) have the ability to invest their funds as a prudent investor would

\(^2\) The following states have adopted UMIFA verbatim or have adopted a similar version:
Alabama, ALA. CODE §§ 16-61-A-1 to 16-61-A-8 (2003); Arkansas, ARK. CODE ANN. §§ 28-
69-601 to 28-68-611 (Michie 2003); California, CAL. PROB. CODE §§ 18500 to 18509 (West
2003); Colorado, COLO. REV. STAT. §§ 15-1-1101 to 15-1-1109 (2003); Connecticut, CONN.
GEN. STAT. §§ 45a-526 to 45a-534 (2003); Delaware, DEL. CODE ANN. tit. 12, §§ 4701 to 4708
(2003); District of Columbia, D.C. CODE ANN. §§ 44-1601 to 44-1609 (2003); Florida, FLA.
STAT. §1010.10 (2004); Georgia, GA. CODE ANN. §§ 44-15-1 to 44-15-9 (2003); Hawaii, 1
HAW. REV. STAT. §§ 517D-1 to 517D-11 (2003); Idaho, IDAHO CODE §§ 33-5001 to 33-5008
(Michie 2003); Illinois, 760 ILL. COMP. STAT. §§ 50/1 to 50/10 (2003); Indiana, IND. CODE
§§ 30-2-12-1 to 30-2-12-13 (2003); Iowa, IOWA CODE §§ 540A.1 to 540A.9 (2003); Kansas,
KAN. STAT. ANN. §§ 58-3601 to 58-3610 (2003); Kentucky, KY. REV. STAT. ANN. §§ 273.510
to 273.590 (Michie 2003); Louisiana, LA. REV. STAT. ANN. §§ 9:2337.1 to 9:2337.8 (West
2003); Maine, ME. REV. STAT. ANN. tit. 13, §§ 4100 to 4110 (West 2003); Maryland, MD.
CODE ANN., EST. & TRUSTS §§ 15-401 to 15-409 (2003); Massachusetts, MASS. GEN. LAWS ch.
180A, §§ 1 to 11 (2003); Michigan, Mich. COMP. LAWS §§ 451.1201 to 451.1210 (2003);
Minnesota, MINN. STAT. §§ 309.62 to 309.71 (2003); Mississippi, MISS. CODE ANN. §§ 79-11-
601 to 79-11-617 (2003); Missouri, MO. REV. STAT. §§ 402.010 to 402.060 (2003); Montana,
MONT. CODE ANN. §§ 72-30-101 to 72-30-207 (2003); Nebraska, NEB. REV. STAT. §§ 58-601
to 58-609 (2003); Nevada, NEV. REV. STAT. §§ 164.630 to 167.500 (2003); New Hampshire,
N.H. REV. STAT. ANN. §§ 292-B:1 to 292-B:9 (2003); New Jersey, NJ. STAT. ANN. §§ 15:18-
15 to 15:18-24 (West 2003); New Mexico, N.M. STAT. ANN. §§ 46-9-1 to 46-9-12 (Michie
2003); New York, N.Y. NOT-FOR-PROFIT CORP. LAW §§ 102, 512, 514, 522 (McKinney 2003);
North Carolina, N.C. GEN. STAT. §§ 36B-1 to 36B-10 (2003); North Dakota, N.D. CENT. CODE
§§ 15-67-01 to 15-67-09 (2003); Ohio, OHIO REV. CODE ANN. §§ 1715.51 to 1715.59 (West
2003); Oklahoma, OKLA. STAT. tit. 60, §§ 300.1 to 300.10 (2003); Oregon, OR. REV. STAT.
§§ 128.310 to 128.355 (2003); Rhode Island, R.I. GEN. LAWS §§ 18-12-1 to 18-12-9 (2003);
South Carolina, S.C. CODE ANN. §§ 34-6-10 to 34-6-80 (Law. Co-op. 2003); South Dakota,
S.D. CODIFIED LAWS §§ 55-14-1 to 55-14-7 (Michie 2000); Tennessee, TENN. CODE ANN.
§§ 35-10-101 to 35-10-109 (2003); Texas, TEX. PROP. CODE ANN. §§ 163.001 to 163.009
(Vernon 2003); Utah, UTAH CODE ANN. §§ 13-29-1 to 13-29-8 (2003); Vermont, VT. STAT.
ANN. tit. 14, §§ 3401 to 3407 (2003); Virginia, VA. CODE ANN. §§ 55-268.1 to 55-268.10
(Michie 2003); Washington, WASH. REV. CODE §§ 24.44.010 to 24.44.900 (2003); West
invest his funds. With the downturn in the financial markets stemming from the recession of 2000, September 11, 2001, corporate fraud and scandals like Nortel Networks, Enron, and Worldcom, and the ongoing mutual fund fraud cases, the importance of being prudent with investments has become more important for both individual and institutional investors.

The decline in the financial markets in late 1999 through early 2003 has resulted in many individual investors losing much of their life savings. The losses have led many potential investors to tighten their purse strings, resulting in fewer individual donations to charities and 501(c)(3) organizations. As a result, charities, including universities and colleges, have become more dependent on their endowment distributions. Most college endowments are invested under a prudent investor standard. Between 1999 and 2003, this so-called "prudent investor" lost a large percentage of the value of his endowment fund, forcing many money-starved educational institutions to increase tuition or eliminate jobs to cover the lack of funding, which the endowment typically provided.

With the increasing costs of education and the importance of education in the lives of all people, I propose that managers of educational endowments should

Virginia, W. VA. CODE §§ 44-6A-1 to 44-6A-8 (2003); Wisconsin, WIS. STAT. § 112.10 (2002); Wyoming, WYO. STAT. ANN. §§ 17-7-201 to 17-7-205 (Michie 2003)). UNIF. MGMT. INST. FUNDS ACT, 7A U.L.A. Tables and References (1999) (Florida and South Dakota do not appear in the Tables and References, but have adopted the UMIFA. Arizona has a statute similar to the UMIFA, see Ariz. Rev. Stat. §§ 10-11801 to 10-11807 (West 2003)).

3 See Eileen Coyne, Nonprofits to Work Harder in '04 as Economy Recovers, COLUMBUS BUS. FIRST, Jan. 2, 2004, at A7 (discussing the tough economy and its effects on support for nonprofits).

4 Endowment is generally defined as "a gift of money or property to an institution ... for a specific purpose, [especially] one in which the principal is kept intact indefinitely and only the interest income from the principal is used." BLACK'S LAW DICTIONARY 433 (7th ed. 2000). Within the framework of educational endowment funds, the National Association of College and University Business Officers (NACUBO) has defined three types of endowment funds based on the legal right to invade the endowment principal. A "true endowment" refers to funds which have been donated to an institution on the condition that the principal be invested and preserved in perpetuity, with only the income to be spent on the activities of the institution. NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS, 2002 NACUBO ENDOWMENT STUDY: EXECUTIVE SUMMARY 62 (2002) [hereinafter NACUBO STUDY]. A "term endowment" is similar to a true endowment except that the principal is preserved for only a designated period of years. Id. Thus, a term endowment works as a true endowment only until the term ends, upon which it becomes a quasi endowment. A "quasi endowment" represents donated funds which the donor has not wished to be invested in perpetuity. Id. These funds are sometimes called current use funds, because they are available for the current uses and emergencies of a college or university. Quasi endowment funds may include some portion of endowment income that has been placed in reserve for a possible decline in endowment income. Also, quasi endowment funds may include the additional income from true endowments when there have been operating surpluses. Since the college or university is not required to preserve the principal, the governing boards generally will invest quasi endowments more aggressively than true and term endowments.
manage their funds within a more conservative prudent investor standard. This standard should shrink the standard deviation of gains and losses, thus allowing educational institutions to be better equipped if a downturn in the financial markets occurs. Forcing endowment managers to be more conservative with their endowments will allow colleges and universities to use donations for long-term goals rather than for short-term emergencies in order to keep the institution solvent. Even though this restraint on endowment investing would not allow endowments to maximize their potential investment gains, the colleges and universities as well as the donors will be able to rest easier. They will rest easier because these parties know that if the financial markets and economy do decline, the colleges and universities will not be as dramatically hurt as in the past. Overall, the risk of hurting our educational system outweighs the benefits of pushing the envelope in order to obtain a few extra percent in investment returns.

This Note addresses the difficulty of funding educational institutions and the importance of a properly managed endowment fund. Part II discusses the historical background of the UMIFA and discusses the major effects the Act has had on endowment fund management. Part III discusses how colleges currently manage their endowment funds by setting investment objectives and goals and spending rules for each institution's endowment fund. Part IV discusses the different factors affecting a university's budget and the importance of proper endowment management. Part V proposes a stricter standard for endowment management that will provide lower returns in an increasing market with the benefit of smaller losses in a down market, forcing endowment boards to make better decisions.

II. THE UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT

Before the 1960s, educational endowment managers were extremely conservative in their investment strategies.\(^5\) During the 1960s and into the latter half of that decade, there was a large amount of controversy between endowment investment officers over the appropriate level of risk-taking when investing their endowment funds. Specifically, many endowment officers felt that investing in capital markets for capital appreciation would allow endowments to maximize their returns. These endowment managers believed that investing to produce larger income growth at the expense of stability in that income was better than their current system of investing to preserve the purchasing power of the endowment.\(^6\) In response to this movement, the National Conference of


\(^6\) Id. J. Parker Hall, the treasurer of the University of Chicago during this time period, was a huge advocate of investing for growth. Id.
Commissioners on Uniform State Laws approved the Uniform Management of Institutional Funds Act (UMIFA) in 1972. The creation of the UMIFA helped solve this controversy and other problems plaguing endowment management. Among these other problems, the UMIFA set guidelines on the delegation of investment authority,\(^7\) the trustees' authority and responsibility for the management of an endowment,\(^8\) and the use of the total return concept in investing endowment funds.\(^9\) In order to appreciate the current legal rules in endowment investing and why such controversies have occurred between endowment managers, a brief look at the historical background of endowment investing is appropriate.

A. Historical Background

Before the 1830s, a great majority of college endowment funds were invested in notes, mortgages, advances, and real estate.\(^10\) In 1830, The Supreme Court of Massachusetts began to set forth guidelines for endowment management when it established the "prudent man" rule.\(^11\) The *Harvard College* decision framed a trustee's duty as one of:

> conduct[ing] himself faithfully and exercis[ing] a sound discretion[,] observ[ing] how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.\(^12\)

As a result, during the 1830s, college endowment fund managers began to invest a portion of their endowment in common stocks; however, the amount of money invested was quite small compared to the entire value of the endowment.\(^13\) Following the Civil War, the treasury department issued a substantial number of government and railroad bonds. During the latter half of the nineteenth century, this influx of bond issues caused endowment fund managers to remove money

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\(^10\) Williamson, *supra* note 5, at 97.
\(^12\) LONGSTRETH, *supra* note 11, at 3 (quoting *Harvard College*, 26 Mass. (9 Pick.) at 461) (alteration in original).
\(^13\) Williamson, *supra* note 5, at 97; see LONGSTRETH, *supra* note 11, at 54, 56 (showing the asset allocation of Harvard and Princeton University's endowments from 1830 to 1984).
from equities and place the money into corporate and government bonds.\textsuperscript{14} In the 1920s, endowment fund managers moved money back into high yield corporate stocks while removing investments in real estate and mortgages.\textsuperscript{15} During World War II, endowment fund managers continued to accumulate equities, while removing investments in mortgages and real estate.\textsuperscript{16} During the 1950s, endowment fund managers shifted their funds into dividend paying equities, and removed money from their bond holdings.

Until the late 1960s, college endowment fund managers were forced to apply a conservative investment strategy, because endowment distributions were only allowed to the extent of income produced.\textsuperscript{17} However, during the 1960s, the dramatic increase in the stock markets,\textsuperscript{18} along with many endowment funds highly invested in corporate securities,\textsuperscript{19} caused those endowment fund managers not invested in equities to reexamine their traditional investment policies. College endowment fund managers realized the potential growth in the equity markets; however, the spending strategies imposed on these managers were a serious impediment for a dramatic change in investment policy.

Under a typical investment policy, most endowment fund managers were only allowed to distribute the income produced from the endowment’s investments. As a result, a major shift from bonds and income producing assets into common corporate stock would lead to a significant drop in an endowment’s current investment income. This drop would occur because the dividend payout rate on common stocks was lower than the rates of return available on fixed-income securities. Thus under the old rules, if managers invested for capital appreciation, the inability to make adequate endowment distributions would have caused a significant strain on the budgets of many educational institutions.

In order for endowment fund managers to maximize the benefits of investing in corporate stocks, they had to change their accounting methods. Endowment

\textsuperscript{14} See LONGSTRETH, supra note 11, at 53, 55. In 1884, Harvard University invested 51.9% of their endowment invested in bonds versus 0% of their endowment funds in 1830. Id. Similarly, Princeton University had 3.4% invested in bonds in 1830 and 91.4% in 1884. Id.

\textsuperscript{15} See id. at 53–54. In 1904, Harvard University had 33.1% of their endowment invested in mortgages and real estate and 8.2% in corporate stocks. In 1924, Harvard had 29.4% of their endowment invested in mortgages and real estate and 12.9% in corporate stocks. Id.

\textsuperscript{16} See id. at 53–56. In 1924, Harvard had 29.4% of their endowment invested in real estate and mortgages and 12.9% in corporate stock. In 1940, Harvard had only 6.3% of their endowment invested in real estate and mortgages and 46.3% invested in corporate stock. Similarly, Princeton, in 1924, had 2.7% invested in corporate stocks and 47.2% in 1940. Id.

\textsuperscript{17} Income as used here includes: mortgage payments, real estate payments, dividends, interest payments, etc.

\textsuperscript{18} From 1961 to 1968, the Standard & Poor’s 500 Composite Index rose 80.4%. STANDARD & POOR’S, S&P SECURITY PRICE INDEX RECORD (2002).

\textsuperscript{19} See LONGSTRETH, supra note 11, at 54, 56. In 1960, Princeton had 66.6% and Harvard had 56% of their endowment invested in corporate securities. Id.
fund managers needed to switch from an income-only accounting method to one allowing for total return accounting. Under a total return method, "income" from endowment funds would include not only dividends paid on the shares of corporate stock, but also some portion of unrealized capital appreciation. In 1969, the necessity of a switch was brought into focus by a series of Ford Foundation Reports—two known as the Barker Reports and two by Cary and Bright.

The Ford Foundation Reports showed that endowment fund managers at colleges and universities were investing too conservatively. The authors argued that institutions were forfeiting capital gain returns because of mistaken definitions of prudence. Institutions also had the desire not to lock up capital gains in perpetuity in endowments. Put simply, the income-only rule was leading to unfortunate investment decisions. The UMIFA addressed these decisions allowing endowment managers to use either the traditional income-only rule or a total return standard when making annual spending decisions. The UMIFA also gave endowment fund managers the power to invest under a more liberal prudent person rule.

Once most endowment fund managers had the ability to utilize total return accounting and entered the stock market on a larger scale, the bull market of the 1960s had ended. The declining value of bonds, due to increased interest rates,

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20 For example, suppose C University has an endowment with 1000 shares of XYZ Corporation with a cost basis of $10. Over the past year, XYZ Corporation stock paid $3 a share in dividends and has increased in value to $15 a share. Under an income-only accounting method, C University will have $3,000 of income and depending on its spending strategy will be able to distribute up to $3,000. Under a system of total return accounting, "income" includes some price appreciation in addition to the dividends paid by XYZ Corporation. Thus, C University will have at most $8,000 of income to distribute ($3,000 in dividend income and $5,000 in unrealized appreciation in XYZ stock). Generally, a portion of the $8,000 would be allocated to income in order to allow for inflation and other expenses of the endowment fund.

21 ADVISORY COMMITTEE ON ENDOWMENT MANAGEMENT, MANAGING EDUCATIONAL ENDOWMENTS (1969); ADVISORY COMMITTEE ON ENDOWMENT MANAGEMENT, MANAGING EDUCATIONAL ENDOWMENTS (2d ed. 1972).


23 LORE, supra note 22, at 5. For a history of the various definitions of prudence, see RESTATEMENT (THIRD) OF TRUSTS § 227 (1992).

24 LORE, supra note 22, at 6.


high inflation, and poor stock market performance, caused large losses in the value of many endowment funds.28

Because of these unsatisfactory results, college endowment fund managers felt that they were required to broaden the types of investment vehicles used in order to improve the return on their endowment funds. With the ability to use the more liberal prudent person rule, endowment managers turned to non-traditional investments such as real estate, venture capital, and foreign equities. During the late 1970s, endowment managers continued to invest in other non-traditional investment vehicles, such as shopping ventures, office buildings, and unimproved land.29 Managers also recognized the potential of investing in foreign markets, investing portions of their endowments outside of the United States.30

Until the end of the summer of 2000, the changes in investment strategy provided by the UMIFA and an attractive capital market environment have enabled college endowments to grow significantly.31 As endowment assets have increased, endowment managers have been more willing to invest in alternative investments,32 which are considered riskier and more susceptible than stocks and bonds to have extended losses. For example, Yale University has been a leader in using alternative equity investments. In 1995, the New York Times reported that Yale puts "roughly sixty percent of its portfolio into less-conventional—and generally riskier—investments" while other prestigious colleges have between one-third to one-half of their endowment assets in these riskier assets.33 Similarly,

28 For example, between June 1973 and October 1974 Harvard lost approximately $300 million in their endowment. Michael C. Jensen, From Ivory Tower to Bottom Line, N.Y. TIMES, Jan. 15, 1975, at 86. Also, Dartmouth College's endowment shrunk from $170.3 million to somewhere between $130 and $135 million. Id. Between 1967 and 1978, the endowment of Yale University remained the same, even though the university received more than $100 million in gifts. Yale Buys Interest in Coming Building, N.Y. TIMES, Dec. 10, 1978, at 69.


30 Karen W. Arenson, At Yale, an "Original Thinker" Gets Results, and Attention, N.Y. TIMES, July 24, 1995, at A11 (stating Yale was the leader in investing in foreign markets).

31 From January 1, 1983 (140.64) to August 31, 2000 (1517.68), the S&P 500 was up 1079.12%. STANDARD & POOR'S, S&P SECURITY PRICE INDEX RECORD (2002). See NACUBO Study, supra note 3, at 7 (between 1995 and 1999, endowments averaged double digit percentage returns); Kim Strosnider, Booming Economy Spurs Many Colleges to Trim Rates for Spending Endowment; The Bull Market has Made it Easier to do so Without Inflicting Pain on Campuses, CHRON. HIGHER EDUC., Nov. 14, 1997, at A41 (stating that endowment returns of 20% or more were becoming routine and colleges began to change their spending strategies because of these large returns).

32 Alternative investments include investments in vehicles such as venture capital, hedge funds, private equity funds, oil and gas partnerships, and commodities including timber.

Brown University was invested with Everest Capital Ltd., a Bermuda-based hedge fund, which lost more than $1.3 billion of its $2.7 billion in assets under management in less than eight months.\textsuperscript{34} With colleges' constant need for endowment fund dispersions and the endowment managers' supposed expertise, one may wonder how prudent investing in such risky investments actually is.

B. The Uniform Management of Institutional Funds Act

The National Conference of Commissioners on Uniform State Laws created the Uniform Management of Institutional Funds Act (UMIFA) in 1972.\textsuperscript{35} As of 2002, the Act has been enacted in forty-seven states and the District of Columbia.\textsuperscript{36} The Commissioners designed the Act to establish guidelines for the management of endowments funds held by eleemosynary institutions.\textsuperscript{37} In order for a college to fall under the Act, the college must be organized and operated exclusively for educational purposes, or if the university is a governmental organization the UMIFA applies "to the extent that [the university] holds funds exclusively for [educational] purposes."\textsuperscript{38}

Since the 1960s, college governing boards have become more interested in maximizing the utility of their endowment funds.\textsuperscript{39} Before the UMIFA was created, college governing boards and their legal counsel constantly struggled with questions involving the use of total return investing and related spending of endowments, permissible investments, and the legal authority and responsibility for the management of endowment funds. The UMIFA provided a rational solution to these questions while allowing the use of sound investment policies for college endowments. The Act provided: (1) a standard of prudent use of...

\textsuperscript{34} Lynn Arditi, \textit{Brown University Won't Comment on Endowment's Loss in Hedge Funds}, \textit{Providence J.}, Oct. 7, 1998, at 1F. The amount of Brown's approximately $1 billion endowment invested in the hedge fund was not known. Other university endowments which suffered losses in the Everest Capital funds were Yale University, Emory University, and the University of Iowa. \textit{Id.}


\textsuperscript{36} For a list of the UMIFA jurisdictions, see \textit{supra} note 2.


\textsuperscript{38} \textsc{Unif. Mgmt. Of Inst. Funds Act § 1(1)}, 7A U.L.A. 484 (1999).

\textsuperscript{39} \textit{See supra} text accompanying notes 17–34.
appreciation in invested funds;\textsuperscript{40} (2) specific investment authority;\textsuperscript{41} (3) the ability to delegate investment management decisions\textsuperscript{42}; and (4) a standard of business care and prudence for governing boards exercising their duties under the Act\textsuperscript{43} among other provisions.\textsuperscript{44} This part will discuss the purpose and effects of these UMIFA provisions.

1. Appropriation of Appreciation

Section 2 of the UMIFA applies to the use of money given to colleges on the condition that at least part of the principal cannot be expended and will be invested in perpetuity.\textsuperscript{45} These gifts are called “true” endowments, because the gifts are meant to provide a benefit to the university in perpetuity.\textsuperscript{46} Gifts of “true” endowments comprise a fairly large portion of most endowment funds.\textsuperscript{47}

Prior to the creation of the UMIFA, endowment fund managers tended to invest “true” endowment funds in high-yielding, fixed-income vehicles, because endowment managers were only able to spend the income the endowment produced. This was done in order to maximize the income the endowment fund would be able to produce. Even though these high-yielding investments maximized the endowment fund’s income, these investments usually had very little price appreciation, if any at all. Unfortunately, these high-yield investment vehicles are unable to maintain their purchasing power when the inflation rate is higher than the interest rate of the investment vehicle. Also, “too often the desperate need of some institutions for funds to meet current operating expenses . . . led their managers, contrary to their best long-term judgment, to forego investments with favorable growth prospects if they had a low current yield.”\textsuperscript{48} The UMIFA addressed these problems.

The Commissioners used Section 2 of the UMIFA to allow managers to adapt a more liberal spending strategy.\textsuperscript{49} Section 2 implicitly expands the
definition of income and explicitly embraces the total return method of accounting. Section 2 states:

The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by Section 6. This Section does not limit the authority of the governing board to expend funds as permitted under other law, the terms of the applicable gift instrument, or the charter of the institution.  

Section 2 authorizes the appropriation of the net appreciation, realized or unrealized, of an endowment for spending purposes. The ability to appropriate net appreciation into spending changes the definition of “income” to now include current yield plus any amount of net appreciation that the board determines is prudent to expend. Since colleges and universities are tax-exempt organizations, taxes on capital gains and losses are inconsequential. Thus, it is unnecessary to wait for a specific investment vehicle to be sold in order to determine the net appreciation or loss that can be considered.

Section 2 also allows the trustees to expend appreciation subject to a standard of “ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision.” The standard of care is more comparable to that of a director of a business corporation than the more stringent standard of private trustees. The duty of care is “cast in terms of the duties and responsibilities of a manager of a nonprofit institution.”

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51 "Realization" of gains and losses in the context of tax exempt eleemosynary institutions is meaningless because realization is a tax concept for taxable entities only.
56 Id. The comment of Section 6 further states: “Directors are obligated to act in the utmost good faith and to exercise ordinary business care and prudence in all matters affecting
also believed that there was no constitutional objection to making Section 2 retroactive.\textsuperscript{57} The ability to apply Section 2 retroactively allowed the endowment fund managers to invest the endowment funds acquired prior to the promulgation of Section 2, thus allowing all funds, both old and new, to be invested and spent according to Section 2.\textsuperscript{58}

Section 2 has been a prominent reason for the diversification of endowment funds. Because of Section 2, the governing boards of college endowments have been willing to invest more in common stocks and other investment vehicles which tend to provide more capital appreciation than fixed-income securities. Endowment managers are now able to create further capital appreciation by placing a portion of their endowment into more illiquid investments such as venture capital or real estate without having to worry about having enough "traditional income" to expend. Section 2 also allows endowment fund managers to take a longer-term perspective and invest for the future, instead of being concerned only with current income yields.

2. Specific Investment Authority

Section 4 of the UMIFA describes the general investment authority of a college's board of trustees to select investments for endowment funds. It provides that:

\begin{quote}
the management of the corporation. This is a proper standard for the managers of a nonprofit institution, whether or not it is incorporated." \textit{Id.}
\end{quote}


\textsuperscript{58} Section 3 of the UMIFA applies a rule of construction that affects the application of Section 2. Section 3, which is applied retroactively, states: "Section 2 does not apply if the applicable gift instrument indicates the donor's intention that net appreciation shall not be expended." \textit{Unif. Mgmt. of Inst. Funds Act} § 3, 7A U.L.A. 493 (1999). Thus, as long as the documentation of the gift does not explicitly state that the donor does not want the governing board to appropriate the appreciation of the value of the gift, the gift may be invested according to Section 2. \textit{Id.} (stating "[a] restriction upon the expenditure of net appreciation may not be implied from a designation of a gift as an endowment, or from a direction or authorization in the applicable gift instrument to use only 'income,' 'interest,' 'dividends,' [etc.]"). Section 3 also assumes that the donor of a gift to an educational institution:

(1) means to devote to the institution any return or benefit that the institution can obtain from the gift, (2) acknowledges the responsibility of the institutional management to determine the prudent use of the return or benefit over time and (3) usually regards the "amount" of the gift as the dollars given or the dollar value of the property transferred to the institution at the time of the gift.

In addition to an investment otherwise authorized by law or by the applicable gift instrument, and without restriction to investments a fiduciary may make, the governing board, subject to any specific limitations set forth in the applicable gift instrument or in the applicable law other than law relating to investments by a fiduciary, may:

(1) invest and reinvest an institutional fund in any real or personal property deemed advisable by the governing board, whether or not it produces a current return, including mortgages, stocks, bonds, debentures, and other securities of profit or nonprofit corporations, shares in or obligations of associations, partnerships, or individuals, and obligations of any government or subdivision or instrumentality thereof;

(2) retain property contributed by a donor to an institutional fund for as long as the governing board deems advisable;

(3) include all or any part of an institutional fund in any pooled or common fund maintained by the institution; and

(4) invest all or any part of an institutional fund in any other pooled or common fund available for investment, including shares or interests in regulated investment companies, mutual funds, common trust funds, investment partnerships, real estate investment trusts, or similar organizations in which funds are commingled and investment determinations are made by persons other than the governing board.\(^{59}\)

Section 4 shows that the drafters of the UMIFA recognized that new investment vehicles and products are introduced into the financial market continuously, and this Section allows managers of college endowments to invest in these vehicles as they believe prudent.\(^{60}\) A close reading of this Section shows that the lists are not meant to be exhaustive. Thus, trustees are allowed to maintain their ability to use the standard of care provided in Section 6, when choosing new investment vehicles.\(^{61}\)

\(^{59}\) UNIF. MGMT. OF INST. FUNDS ACT § 4, 7A U.L.A. 495–96 (1999). In the Draft Proposal, Section 4(1) is included in 3(h); Section 4(2) is included in 3(j); and Sections 4(3) and 4(4) are not explicitly included, but the drafters stated that “Section 3(h) of UMIFA (200-) authorizes [the investments permitted under UMIFA (1972) §§ 4(3) & 4(4)]. The decision not to include the two provisions . . . implies no disapproval of [the pooled or common investment funds].” Draft Proposal, supra note 35, at §§ 3(h), 3(j), and 3 cmt.

\(^{60}\) This Section also allows trustees to hold property given by a donor even though it might not be the best investment available, usually with the hopes of obtaining further donations. UNIF. MGMT. OF INST. FUNDS ACT § 4, cmt. 7A U.L.A. 496. This Section also allows the trustees to invest in common or pooled investment funds unless it is restricted to do so by the gifting instrument. Id. This includes the example of the Common Fund for Non-profit Organizations. Information about this fund can be found at http://www.commonfund.org.

3. Delegation of Investment Management

The enormous size of many endowment funds, the endowment’s importance to a college or university, as well as the complexity and volatility of the financial markets requires the endowment managers to provide daily attention to the endowment and to have skill in managing these investments. Unfortunately, most educational institutions are not equipped to actively manage the day-to-day operations of their endowments, mainly due to lack of resources, experience, and time. Thus, as a pragmatic solution, college trustees must delegate most or all of their investment responsibilities, and prior to the UMIFA, trustees were unable to do this. The Restatement (Second) of Trusts did draw a distinction when a charitable corporation was involved: “It may be proper, for example, for the board [of a charitable corporation] to appoint a committee of its members to deal with the investment of the funds of the corporation, the board merely exercising a general supervision over the actions of the committee.” Even though there was this distinction, the law was unclear as to whether a responsible officer of the college or an advisor or manager outside of the college could be delegated solely to run an endowment’s investments. There was no substantial authority that prevented a board of trustees from delegating its endowment’s investment responsibilities “to a committee of its board, or to its officers, or to other responsible employees, subject of course to the overall supervision of the board of directors.” Yet there were some authorities on point which upheld the right to delegate, while a Massachusetts case, decided in 1931, did not uphold this right.

Section 5 of the UMIFA addressed the question about the power of a governing board to delegate investment decisions. Section 5 of the Act reads:

Except as otherwise provided by the applicable gift instrument or by applicable law relating to governmental institutions or funds, the governing board may (1) delegate to its committees, officers or employees of the institution

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62 Prior to the enactment of the UMIFA, a trustee, whether of a charitable or private trust, was under the duty not to delegate “acts which the trustee can reasonably be required to personally perform.” RESTATEMENT (SECOND) OF TRUSTS § 171 (1959). Specifically a trustee could not delegate the “power to select investments,” but a trustee was able to solicit advice, especially if the matter concerns “professional skills or facilities . . . not possessed by the trustee himself.” Id. at § 171 cmt. h & d.

63 Id. at § 379, cmt. b.

64 LORE REVISED, supra note 22, at 27.


or the fund, or agents, including investment counsel, the authority to act in place of the board in investment and reinvestment of institutional funds, (2) contract with independent investment advisors, investment counsel or managers, banks, or trust companies, so to act, and (3) authorize the payment of compensation for investment advisory or management services.67

The enactment of this Section grants governing boards the authority to delegate investment management and to purchase investment advisory and management services. However, the governing boards must maintain a standard of business care and prudence when delegating the responsibility of investment policy and the selection of competent investment agents.

Since the enactment of Section 5 of the UMIFA, many colleges have employed outside professional money managers to invest their endowment funds.68 As of 2002, a large majority of the 654 schools NACUBO surveyed outsourced management of more than 50% of their endowment funds to outside money managers.69

4. The Standard of Business Care and Prudence for Governing Boards

Investment vehicles with the greatest potential for capital appreciation generally are the most at risk to incur a loss. Thus, the more an investor invests in venture capital, emerging markets, and hedge funds instead of bonds or money market funds, the more likely the investor will obtain capital gains but only with the substantial risk of sustaining a capital loss. With the board of an educational institution having the discretion to choose investment instruments and investment managers, many questions arise when endowments do not perform up to expectations and suffer losses. These questions include: What are the consequences, other than fiscal loss, when poor investments are made? Who should and can be held liable for such investment decisions?

Prior to the enactment of Section 6 of the UMIFA, courts were split between whether to apply stricter trust standards70 or more lenient business standards71

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67 UNIF. MGMT. OF INST. FUNDS ACT § 5, 7A U.L.A. 498 (1999). In the Draft proposal, the new Section 5 does not address internal delegation of authority, but notes that the institution “must look to other law, typically a nonprofit corporation statute, for the rules governing internal delegation.” Draft Proposal, supra note 35, at §5 cmt.

68 For example, Buena Vista University hired outside money manager Sir John Templeton to manage their endowment. Julie L. Nicklin, A Risky Strategy?, CHRON. HIGHER EDUC., Nov. 17, 1995, at A33. Since Sir John Templeton’s hiring and the writing of the newspaper article, Buena Vista’s endowment grew from $1.7 million to $66 million. Id.

69 NACUBO STUDY, supra note 4, at 3 (stating that only 9% of the schools surveyed had more than 50% of their endowment funds passively managed or in index funds).

70 Under stricter rules of trusts, trustee’s duties were expressed in terms of the “prudent man rule.” Trustees were “under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own
when trying cases against the boards of charitable institutions. This confusion did not allow governing boards or their legal counsel to predict judicial outcomes of certain acts. The enactment of Section 6 of the UMIFA cleared up the confusion stating:

In the administration of the powers to appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.

property, "RESTATEMENT (SECOND) OF TRUSTS § 174 (1959), and were directed "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived." Id. at §227. Under this duty of care, liability can be found under a simple negligence standard. 3 WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 227.1 (4th ed. 1988 & Supp. 1990). The fear of liability caused many trustees to invest ultra conservatively.

71 Under the more lenient standards of corporate directors, a corporate director has two basic fiduciary duties: a duty of care and a duty of loyalty. REVISED MODEL BUS. CORP. ACT § 8.30(a) (1999). The duty of care has been clarified as an obligation to act "with the care that a person in a like position would reasonably believe appropriate under similar circumstances." Id. at § 8.30(b). The comment to this Section states that the removal of "ordinary prudent person" and replacing it with "person" makes mere negligence not the appropriate standard for a corporate director. Id. at § 8.30 cmt. 2. The duty of loyalty requires directors to act "in a manner the director reasonably believes to be in the best interest of the corporation." Id. at § 8.30(a)(2).


73 UNIF. MGMT. OF INST. FUNDS ACT § 6, 7A U.L.A. 500 (1999). In the Draft proposal, the Drafting Committee revised the standards of endowment managers adopting language from the Revised Model Nonprofit Corporation Act (1987) and the Uniform Prudent Investor Act (1994) clarifying that the standards of prudent investing apply to all charitable institutions. Proposed Draft, supra note 35, at §3 cmt. For an explanation of the Prudent Investor Act, see John H. Langbein, The Uniform Prudent Investor Act and the Future of Trust Investing, 81 IOWA L. REV. 641 (1996). The proposed draft also provides a list of duties that the endowment managers must follow, unless the agreement provides otherwise. These include a duty to recognize the donor intent and charitable purpose of the endowment; a duty of care, which includes a duty of good faith and duty of loyalty; a duty to minimize costs; a duty to investigate the management
Section 6 creates a "standard . . . generally comparable to that of a director of a business corporation rather than that of a private trustee, but it is cast in terms of the duties and responsibilities of a manager of a nonprofit institution."74

Section 6 of the UMIFA was developed in part from Proposed Treasury Regulation § 53.4944-1(a)(2),75 which deals with private foundation investment responsibilities.76 Since Section 6 is written in fairly broad terms, it is important to take a closer look at the Treasury Regulations from which Section 6 was partly derived.

The Treasury Regulation § 53.4944-1(a)(2) was issued under the Internal Revenue Code (I.R.C.) § 4944.77 I.R.C. § 4944 imposes taxes upon private foundations,78 if the private foundation "invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes . . . ."79 The regulations define that a jeopardizing investment occurs when "the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes."80

The regulations also discuss the standard of care under which Section 6 of the UMIFA that governs the board members of colleges and universities within the UMIFA jurisdictions, was partly derived. The regulations state that foundation managers should "take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio . . ."81 when determining whether to make an investment of foundation funds. The regulations also state that jeopardizing investments will be determined on an investment-by-investment basis and will be compared to the allocation of the entire portfolio and no specific category of investments is a per se violation of section 4944.82 Nevertheless, some types of investments are closely scrutinized when determining whether the

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78 Id. at § 509 (defining private foundations).
79 Id. at § 4944(a)(1).
81 Id. (stating that diversification requires contemplating the "type of security, type of industry, maturity of company, degree of risk and potential for return").
82 Id.
standard of care and prudence are met.\textsuperscript{83} Since an investment is determined to jeopardize the exempt purposes of the foundation at the time of investment, an investment passing the test shall never be considered jeopardizing, even if a loss occurs on the investment.\textsuperscript{84} Finally, the regulations give examples providing guidance as to what is considered outside of the standard of care and prudence of foundation boards.\textsuperscript{85}

Because the standard set out in Section 6 of the UMIFA was partially derived from Treasury Regulation § 53.4944-1(a)(2), in a state that has adopted this section of the UMIFA, the courts should find the Regulation and examples as persuasive authority to help determine whether the managing board of a college endowment has met the required standard of care. Even though the regulations were written for the management of private foundations, the National Conference of Commissioners on Uniform State Laws' use of the regulations in writing Section 6 shows that governing boards of college endowments must comply with the same standard of care and prudence.

Section 6 creates the ability for educational endowment managers to use and reflect on current market and financial strategies in order to invest their endowment funds. Over the past few years, many new investment vehicles and techniques have been created. These new techniques and vehicles have changed the financial markets as well as what could be considered prudent investing. And, with the adoption of Section 6 of the UMIFA, the board of directors of college endowment funds is able to remove itself from the restraints of income-only investing and the prudent man rule and use modern portfolio theory\textsuperscript{86} to maximize the total return on its endowment fund.

III. WHAT COLLEGES HAVE DONE TO MANAGE THEIR ENDOWMENT FUNDS

With the evolution from the prudent income-only investor to one of total return investing, boards of endowments have employed different theories and models in order to maximize both realized and unrealized gains. Many boards are implementing a total return investment strategy utilizing modern portfolio theory

\textsuperscript{83} \textit{Id.} (including "[t]rading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of 'puts,' 'calls,' and 'straddles,' the purchase of warrants, and selling short").

\textsuperscript{84} \textit{Id.}

\textsuperscript{85} 26 CFR § 53.4944-1(c) (2004). Example (1) depicts a situation where venture capital investing is considered a jeopardizing investment practice. \textit{Id.} Example (2) depicts a situation where a venture capital investment is considered prudent and within the standard of care. \textit{Id.} Example (3) shows that an investment of a portion of the investment assets in unimproved real estate will not be considered a jeopardizing investment. \textit{Id.}

\textsuperscript{86} For discussion on modern portfolio theory, see \textit{THE INVESTMENT MANAGER'S HANDBOOK} 160 et seq. (Sumner Levine ed., 1980).
to maximize profits while maintaining an appropriate amount of risk. As Professor Dobris has stated, "[a] current spendable income rule based on total return offers greater flexibility and allows a college to sensibly and efficiently maximize endowment return." 87

The five most important factors that determine the value of an endowment fund are: (1) the investment returns of the fund, (2) new gifts to the endowment fund, (3) the spending rate of the fund, (4) the rate at which inflation of higher education exceeds that in the economy as a whole, and (5) the rate of expenses involved in managing the endowment fund. 88 Because the factors are interrelated, if the board of directors wants to increase the real value of their endowment fund, the board must either cut spending and/or administrative costs or increase the rate of return and/or fundraising efforts. 89 All of these issues should be discussed and a set of objectives and spending rules should be created in order to fulfill the purpose of the endowment.

87 Dobris, supra note 25, at 53.
88 These five factors can be expressed easily in a formula in order to determine the real growth rate of an endowment. The formula uses rates expressed as percentages of the market value of the endowment portfolio:

\[
\text{IRR} + \text{G} - \text{SR} - \text{EIP} - \text{MER} = \text{REG}
\]

\begin{align*}
\text{IRR} & = \text{Total rate of return of the portfolio in real terms adjusted for inflation.} \\
\text{G} & = \text{The rate of gift additions (amount of new gifts / total endowment value).} \\
\text{SR} & = \text{The spending rate (amount of dollars spent / total endowment value).} \\
\text{EIP} & = \text{The excess of the institutional inflation rate over the general inflation rate, or the endowment inflation premium.} \\
\text{MER} & = \text{The rate of expenses on management of the endowment (amount of dollars spent on management / total endowment value).} \\
\text{REG} & = \text{The real growth rate of the endowment fund.}
\end{align*}

Thus, a real total return on investment of 10%, added to a gift rate of 3%, less a spending rate of 5%, an endowment inflation premium of 2%, and endowment management fees at 1% yields real growth of 5% \((10 + 3 - 5 - 2 - 1 = 5)\).

But, one could argue that new gifts to an endowment fund should not be included in this calculation. For instance, if a donor makes a new donation, why should the new donation be used in order to maintain the value of the endowment? If we eliminate new gifts from the equation, then one would be able to better determine how well the objective of the endowment is working. Fundraising efforts should only be used to increase the value of the endowment not to cover for increased costs or poor return on investments.

89 Since most endowment funds hope to maintain the purchasing power of the fund's principal, the real rate of return on the endowment should equal zero. However, one could argue that new gifts to the endowment fund should be removed from the equation in determining the real rate of return. See supra note 88.
A. Setting Goals and Investment Objectives

It is extremely important that the investment objectives and policies of university endowment funds be written down. By writing down the objectives and policies, the board of directors will be able to maintain continuity of policy and ensure that the implications of the policy are continuously recognized.90 A carefully crafted investment policy, after much discussion and debate, creates a "roadmap to steer committees and staff through the maze of difficult and sometimes complicated considerations when implementing investment strategies and evaluating the results thereof."91 Thus, investment managers will have a comparison benchmark as well as a guide so they will not have to guess as to the appropriate investment policy.92

When creating investment policies on endowment funds, the board of directors should make their decisions based on many different factors.93 The relationship between historical and expected returns to inflation is important, because inflation is a prominent concern when attempting to maintain purchasing power.94 The amount of risk and volatility an endowment can weather is another important factor, since consistent returns allow schools to predict the amount of money the endowment will distribute to the institution.95 The policy should reflect the total return goals of the endowment and set out targets and ranges for each investment strategy weighted within the total portfolio asset allocation mix. The policy should also set forth the spending policies, which should be consistent with the institution's needs.

The investment policies of institutions should be viewed as a dynamic document, reviewed periodically, to reaffirm or modify the current policy to reflect contemporary institutional needs and growth assumptions. Many college boards share the expectation that the endowment will provide funding for students both now and into the future. Also, many college boards hope that the endowment generates a spendable income that will keep the same purchasing power for many

90 THE INVESTMENT MANAGER'S HANDBOOK, supra note 86, at 834.
91 COMMONFUND, supra note 47, at 36.
92 THE INVESTMENT MANAGER'S HANDBOOK, supra note 86, at 835.
93 In the proposed January 2005 draft of the UMIFA, §§ 3(f) to 3(k) set forth default rules on managing and investing endowment funds. Proposed Draft, supra note 35, at §3(e). These include economic conditions, inflation, tax consequences, the role of the investment compared to the entire endowment fund, expected total return, other institutional resources, the need for dispersion from the endowment fund, and an asset's relationship to the charitable purposes of the institution. Id. at §3(f).
94 COMMONFUND, supra note 47, at 36; THE INVESTMENT MANAGER'S HANDBOOK, supra note 86, at 834.
95 Large gains in one year coupled with a large loss the next year do not provide much consistency. See COMMONFUND, supra note 47, at 36.
future years. The objective of The Ohio State University’s endowment is stated as follows:

Because endowments are intended by the donors to be permanent enhancements to the University, and because they are intended to fund important programs and activities at the highest levels possible, two important objectives guide the investment of the University Endowment Fund. They are: (1) to preserve and maintain the real purchasing power of the fund’s principal; and (2) to produce a return that would be described as acceptable by conservative money managers when compared to the current marketplace.

Along with endowment investment strategies, boards of directors need to create a preferred asset allocation to obtain the return desired while maintaining the appropriate amount of risk. The asset mix decision should be based on two major considerations: (1) the target level of growth of the endowment fund; and (2) the degree of volatility that is acceptable in the fund. With the complexity of the financial world, there are many ways to determine what the specific asset allocation should be, but having the asset allocation written down allows for managers to have less confusion on how they should invest in troubling times.

B. Spending Rules

The amount of money dispersed from an endowment fund is the most controllable portion of any endowment structure. Nevertheless, the exact amount of money spent is not easily predictable if colleges use a percentage based payout structure. If a college uses a percentage based payout structure, the amount of money paid out depends on the market value of the endowment fund. If a board

96 Inflation in higher education may be as much as 1½–2% a year more than the Consumer Price Index (CPI). THE INVESTMENT MANAGER’S HANDBOOK, supra note 86, at 836. See generally G. Richard Wynn, Inflation in the Higher Education Industry, NACUBO Professional File, vol. 6, no. 1 (1975).


98 See THE INVESTMENT MANAGER’S HANDBOOK, supra note 86, at 839. The asset allocation is based on the current income needs of the university, and the more current income that the university requires will dramatically change the endowment’s asset allocation. The amount of endowment income allocated for distribution, the level of funding from government sources, and the risk tolerance of the board of directors will all effect the level of volatility that the board of directors will allow.

99 Section 4(b) of the January 2005 Draft creates a new section not appearing in the 1972 UMIFA. Section 4(b) imposes that any dispersion in one year that is greater than 7% of the fair market value of the endowment shall create a rebuttable presumption of imprudence. Proposed Draft, supra note 35, at §4(b). The fair market value of the endowment is computed using a three year rolling average. Id. at §4 cmt. The Drafting Committee states that they realize "[e]ndowment spending will rarely exceed seven percent"; however, the Draft allows
does payout a specific dollar amount, then the board would be forecasting the percentage of the endowment to be used, which could create many problems because the payout percentage will be based on fluctuating market values of the endowment.100

For those institutions located in states that have not enacted the UMIFA or a similar set of rules, the boards are required to follow the legal rules of trusts.101 They are simply allowed to spend the income granted by dividends, interest, royalties, and the like, no more and no less. For those states that have adopted the UMIFA, the board of directors is allowed to spend what is considered to be a prudent portion of the total return on the endowment.102 Under the UMIFA approach, the rules ensure that no more than a prudent portion of the endowment is consumed in any period. This approach allows boards to determine how to balance the current and future needs of the institution.103 The major challenge for the board of directors and their investment managers is determining how predictable the levels of realized and unrealized capital appreciation will be and how much volatility the endowment fund can bear. If an endowment fund contributes only a very small amount to the budget of a university, the endowment can bear volatility much higher than a university which is heavily dependent upon the endowment for funding. Regardless of the intended use of the endowment, the spending policy and investment policy cannot be completely independent; both will require periodic reassessment and it is important that the board of directors understands the importance of the interrelatedness of both the investment policy and the spending policy.

institutions to spend more. Id. The Drafting Committee recognizes that the 7% bright-line rule "does not imply that spending below 7 percent is prudent." Id. 100 Hypothetically, let us assume college X has a $1,000,000 endowment fund and chooses to spend $100,000 of the fund every year. If we eliminate new gifts from the equation, the endowment will have to have at least a 10% return each year in order to maintain the current dollar amount. The endowment would probably need to have around a 12–15% return each year in order to maintain a constant purchasing power. In order to attempt to achieve a 10–15% return, the board of the endowment will have to utilize an aggressive, risky strategy, which increases the probability that the endowment incurs a loss. Assuming that a loss occurs, the $100,000 payout could end up being much more than the 10% figure intended to be used. However, if the board used a 10% payout rate, then regardless of how the endowment does, only 10% of the endowment will be paid out each year. Thus, if after one year the endowment value is only $900,000, the board would only payout $90,000 instead of the $100,000 paid out under the former system.

101 States which have not adopted the UMIFA are under standard trust rules or under the Uniform Prudent Investors Act. UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 16 (1999).


103 If current needs were low, the board would allow less of the endowment to be consumed in order to provide for the future, and vice versa. See Strosnider, supra note 31 (discussing how higher endowment returns affected endowment spending).
In order to determine specific spending policies, there are several competing elements involved in the determining how much of the endowment should be spent. These factors include:

[A] desire for a stable flow of [and more] spendable income; . . . a desire to stay even with inflation . . . and to maintain and possibly increase the real value of the endowment; a desire for simplicity in explanation, understanding and operation; a desire to be free of annual argument about what the spending rate from endowment should be; and a desire to follow a course that is comfortable and intuitively correct.

Many institutions incorporate a system of spending a pre-specified percent of the endowment market value. Thus, the amount of money expended each year is subject to change based on market conditions and investment returns. If each year’s payment is determined based upon the previous year’s return, the volatility of the markets could cause extreme difficulty for academic and financial aid departments, which depend on annual endowment income, to predict how much funding the departments will receive each year. Because of potential single year fluctuations, many institutions have employed “smoothing methods.” Some schools have chosen a “no rule” policy where the board has complete discretion to determine how much to allocate each year.

According to the 2003 Commonfund Benchmarks Study, 78% of all the institutions indicated that they spent a specified percentage of a moving average of the market value of their endowment. Of these institutions, 87% used a three-year trailing average, or 12-quarter trailing average, indicating that this is the common benchmark for most colleges and universities. Smaller institutions are usually the exception.

See generally Dobris, supra note 25.

Id. at 53–54 (footnotes omitted).

When market conditions are good, the endowment value should also increase and thus, the amount of money able to be expended would be higher. Similarly, if the market conditions are poor, the endowment value will decrease and the amount of money able to be expended would also decrease.

Dobris, supra note 25, at 64–65. Some of these smoothing methods include: applying a percentage of the trailing three year average taken quarterly; increasing the payout each year; including the prior year’s payout as a factor for the current year’s payout; using a reserve or stabilization account; or using complex formulas with multiple variables. Id.

Id. at 59.

COMMONFUND, supra note 47, at 11. Spending rates are usually somewhere between 4–6%. In 2003, the average spending rate was 5.1% for all institutions. Id.

Id. at 12.

Id.

Id. (defining smaller institutions as those with endowment assets under $10 million).
each year\textsuperscript{113} or spend all current income, while 16\% could not provide any specific spending policy.\textsuperscript{114}


The first three years of the new millennium have brought many challenges for eleemosynary institutions. For the first time since the bear market of 1973 and 1974, the financial markets were down as a whole for two consecutive years in 2001 and 2002.\textsuperscript{115} When combined with decreases in revenue from other sources, such as state and federal funding, many colleges have gone through radical changes. In 2004, colleges and universities experienced extreme financial pressures. Revenues from educational endowments, educational fundraising, federal grants, state appropriations, and tuition paid by international students are expected to decline, be flat, or rise slightly.\textsuperscript{116} This creates potential problems as the costs of new construction, employee health care, legal services, computer security, and debt service on monies borrowed are predicted to rise.\textsuperscript{117} The combination of these looming problems will force higher-education budgets to be tight. Also, with the increased demand for high school graduates to pursue higher education, colleges and universities are under severe pressure to expand their facilities\textsuperscript{118} while at the same time might not be able to maintain the upkeep of the facilities that currently exist.\textsuperscript{119} Seeking to minimize costs and cut items from

\textsuperscript{113} This is considered the “no rule” strategy, which allows fiduciaries to have the ability to use their complete discretion. See Dobris, supra note 25, at 59.

\textsuperscript{114} COMMONFUND, supra note 47, at 12.

\textsuperscript{115} From January 2, 2001 (1320.28) to December 31, 2001 (1148.08), the S&P 500 was down about 13\%. STANDARD & POOR’S, S&P SECURITY PRICE INDEX RECORD (2002). From January 2, 2002 (1148.08) to December 31, 2002 (879.82), the S&P 500 was down about 23\%. Id.


\textsuperscript{117} Id.

\textsuperscript{118} For an example of a college using an expansion of facilities to attract students, see Lawrence Biemiller, A Minimalist Campus Goes Tubular: An Illinois Institution Hopes a New Building’s Whimsical Design Will Appeal to the Xbox Generation, CHRON. HIGHER EDUC., Dec. 12, 2003, at A22.

their budgets, colleges and universities have closed portions of campuses,\textsuperscript{120} laid off employees,\textsuperscript{121} and many other things.\textsuperscript{122} In order to determine how eleemosynary institutions can be better equipped for another potential economic downturn, it is important to look at what portions of a college budget colleges and universities are able to control or at least have some control over.

A. Revenue Sources Which Colleges Cannot Control

Colleges and universities have very little control over state appropriations and federal grants. Both are controlled by sources other than the college or university, yet must be considered when planning occurs with factors which can be controlled. For this discussion, it is important to take a quick look at the current state of both state appropriations and federal grants.

1. State Appropriations

Researchers have predicted that state appropriations would decrease slightly in 2004.\textsuperscript{123} If this occurs, it would be the first time since 1993 that state funding has decreased from the previous year.\textsuperscript{124} Since each state government has the ability to act independently of other states, certain areas of the country are having better times than others when it comes to state appropriations for eleemosynary


\textsuperscript{121} Pulley, supra note 116. See MIT, supra note 120; Ron Nissimov, Donations to University Decline with Stock Markets, HOUSTON CHRON., Mar. 13, 2003, at A23 (discussing hiring freezes at many Texas universities because of endowment losses).

\textsuperscript{122} See Pulley, supra note 116 (noting that hiring freezes are being used and some schools are just raising tuition to deal with the problem).


Nevertheless, when state economies improve, higher education will stand in line behind many other state financed programs. Therefore, once the economy begins to turn, state appropriations for colleges will be in the hands of state legislators and not in the hands of the institutions themselves.

2. Federal Grants for Research and Financial Aid

The large growth of federal monies for academic research over the past five years is likely to end in 2004, as federal appropriations for academic research are projected to be smaller. This could cause problems since the previous years were extremely robust because Congress had doubled the budget of the National Institutions of Health (NIH) between 1998 and 2003. For the 2004 fiscal year, Congress is supposed to approve an appropriations bill, which would provide $27.98 billion for the NIH and $5.6 billion for the National Science Foundation (NSF). For fiscal years 2005 to 2008, the Bush administration has proposed budget increases between 1.8 and 2.5% for both the NIH and NSF. While the increases are minimal, the proposals do provide some guidance for most colleges and universities. As a result, in order to increase research spending and to retain the best scholars, colleges and universities will have to produce funding from other sources.

See Hebel, supra note 123. Regions like the Pacific Coast, North and South Carolina, and the Great Lakes region are doing fairly poor while Northeastern, Rocky Mountain, and Southeastern states are doing well. For example, at The Ohio State University, the Board of Trustees does not expect to receive any percentage increase in State funding. The Ohio State University, Current Funds Budget 2004-2005, at 1.1 (predicting state appropriations to be $472 million in fiscal year 2004-2005 and showing a budget for State appropriations to be $472 million in fiscal year 2003-2004) [hereinafter OSU Current Funds Budget]. Also, some states are creating line-item appropriations to colleges in order to accomplish certain state wide goals. Id. at 7. As an example, The Ohio State University Board of Trustees budgeted for state appropriations totaling $7.164 million in fiscal year 2004-2005 for completion of the “Research Challenge”, which recognizes success in securing sponsored research from external sources. Id. at 7, III.1.

Other programs like Medicaid and restoring elementary and secondary schools might take higher priority.


Id. The National Institutes of Health budget increased annually by about 15% a year from 1998 to 2003. Id.

Id. (noting that this is an increase of 3.7% or $1 billion over 2003).

Id. (noting that this is an increase of 5.3% over 2003).

Id.

Funding could come from cutting other department's budgets; however, this option would create dissention amongst faculty, especially those which are not federally funded. Other
Similarly, federal funding of student financial aid is also supposed to remain fairly constant. For example, in 2004, cash flow from the Pell Grant program, the primary source of financial aid for low-income students, was supposed to increase about 6%, granting nearly $12.1 billion in government grants.\(^{133}\) The current maximum grant is $4,050 for the 2004–2005 award year and has remained fairly stagnant since the 2001–2002 award year.\(^{134}\) President Bush has proposed increases to the Pell Grant Program. However, the program currently has a $4.3 billion deficit which needs to be fixed.\(^{135}\) Also, President Bush’s proposal still might not cover the increasing costs to attend college.\(^{136}\)

Other federal programs are available to all students who meet their requirements.\(^{137}\) Yet, unless students get federal grants, they will most likely be required to assume federal loans. The availability of any educational loan only defers education expenses until a later time.\(^{138}\) With college prices consistently growing\(^ {139}\) and possibly forcing students to take on more educational debt or

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options might include increasing endowment spending, increasing fundraising, or tuition increases, all of which have their own repercussions.

\(^{133}\) Brainard & Burd, supra note 127 (noting that this is an increase of $713 million).


\(^{135}\) Associated Press, Administration Seeks to End Loan Program, Feb. 5, 2005, N.Y. TIMES, at A12. President Bush has proposed mandatory increases to the maximum to $4,550 from $4,050 over the next five years. Id. If passed, this would provide an extra $1,000 for students entering college in the 2005–2006 academic year. In order to pay for it, President Bush wants to reduce subsidies currently paid to banks to encourage them to make low-interest loans to students and to agencies that insure these loans. Id.

\(^{136}\) Steven Burd, President Bush Calls for Increase in Pell Grants, CHRON. HIGHER EDUC., Jan. 28, 2005, at A25 (arguing that even though students would receive an extra $1,000, it has little effect on the ability for low income students to pay for the increasing costs of a college education).

\(^{137}\) See STUDENT GUIDE 2005-2006, supra note 134, at 18–23. Some of these programs include the Federal Supplemental Educational Opportunity Grant Program, the Federal Work Study Program, the Federal Perkins Loan Program, the Federal Family Education Loan Program, and the William D. Ford Federal Direct Loan Program. Id.


\(^{139}\) See infra Part IV.C.2 for a discussion on effects of increased costs of college on families.
additional jobs, the increased cost of a college education needs to be slowed or supplemented by a program that would allow education to be more affordable.

B. Expenses of a Post-Secondary Educational Institution

Colleges and universities have necessary expenses required to run the institution. Some of these expenses include: computer security, health care for employees, labor costs for faculty and staff members, construction of new buildings and maintenance on existing facilities, repayments on debt, and insurance expenses. For the current discussion, it is important to take a brief look at the state of each of these expenses.

1. Computer Systems and Security

With the lack of revenues, colleges have been forced to make many budget cuts which have placed colleges in a technological bind. Colleges could spend their limited revenues on either new systems or on network and computer security, but most colleges have decided to cut back on updating computer systems while spending more on network and computer security.140 Kenneth Green, founding director of the Campus Computing Project, conducted a survey of 559 colleges and found that 41.3% said budget cuts would cause them to defer improvements to academic computer systems.141 Green also found that the deferrals were more likely to occur in public institutions than in private institutions.142 The deferral of computer system improvements will frustrate students who do not own their own computer as well as faculty and staff who must use the older computer systems. Similarly the deferral could also frustrate students who are accustomed to paying bills, downloading music online, or researching topics online for school projects.

Even though there has been a deferral of spending on computer systems, many funds have gone toward security of the networks. The expenditure of funds on security shows that administrators are concerned about computer viruses,143 spam, identity theft, and federal compliance in keeping medical and financial


142 Foster, supra note 140.

records private.\textsuperscript{144} Green found that nearly 50% of the institutions surveyed said that funds for computer security increased since 2002, while less than 10% of colleges had to decrease the funding to spend on computer security.\textsuperscript{145} With the importance of technology in education today, these expenditures are crucial to the education of today’s students and should be funded properly.

2. Costs to Maintain and Hire New Employees

Health care costs have increased steadily over the past seven years; however, these costs increased by double digits in 2001, 2002, and 2003.\textsuperscript{146} According to The Kaiser Family Foundation study of public and private companies, health insurance premiums have increased by 13.9\% from 2002 to 2003.\textsuperscript{147} Many employers have attributed the increases in health care costs to higher spending for prescription drugs, hospital stays, and an aging population.\textsuperscript{148} With the increased health care costs, it has been difficult for some institutions, especially state institutions, to attract the best faculty and administrators or to increase the pay of the employees they currently employ.\textsuperscript{149}

With pressures to attract and retain excellent faculty, many universities are feeling the need to provide excellent health care benefits and salaries. According to the American Association of University Professors, faculty pay rose 3\% in 2002–03 which keeps pace with inflation.\textsuperscript{150} Similarly, a survey conducted by the College and University Professional Association for Human Resources reported

\textsuperscript{144} Foster, supra note 140; see, e.g., David Jenkins, Hiding the Hurt: Privacy Act Puts Twist on Obtaining Injury Reports, CHATTANOOGA TIMES FREE PRESS, Sept. 12, 2003, at D5 (discussing HIPAA and how it affects sports medicine and college athletes).

\textsuperscript{145} Foster, supra note 140; see Campus Computing Project, supra note 141, at 3.


\textsuperscript{147} EMPLOYER HEALTH BENEFITS, supra note 146, at 18.

\textsuperscript{148} Id. at 18–19.

\textsuperscript{149} Basinger, supra note 146.

\textsuperscript{150} American Association of University Professors, Unequal Progress: The Annual Report on the Economic Status of the Profession 2002–03, available at http://www.aaup.org/surveys/03z/zrep.htm (noting that most faculty at state institutions did not receive any increase in pay relative to their counterparts at private institutions because of state and federal budget cuts). At The Ohio State University, “[p]ay increases for faculty in [fiscal year] 2005 averaged 3.3\%.” OSU CURRENT FUNDS BUDGET, supra note 125, at 16. The Board of Trustees also notes that departments had to reallocate their budgets or increase revenues in order to increase the salaries to compete with each department’s benchmark institution. Id.
that median salaries for college administration rose 3.5% in 2002–03. With the increased costs of health care and increases in salary outpacing inflation, many college and university employees must face the burden of these increased costs by having to pay higher premiums or co-pays.

3. Construction of New Buildings and Maintenance on Existing Facilities

When funding is available most of the spending for facility upkeep and construction is being spent on construction of new facilities, rather than upkeep of current facilities on college campuses. This deferred maintenance has built up to a point where there exists more than $26 billion in needed repairs. There has also been pressure on officers of colleges and universities to continue building in

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151 See Basinger, supra note 146 (citing the College and University Professional Association for Human Resources Survey). At The Ohio State University, the staff pay was increased between 3.1% and 3.2% across the university. OSU CURRENT FUNDS BUDGET, supra note 125, at 16. The University notes that the “[pay] increases [were] partially funded by a reallocation of [the] existing budget[,] by not filling vacant positions, . . . by using internal funding sources or by reducing operating costs.” Id.

152 See Basinger, supra note 146. Another potential problem involves the increasing gap in pay packages of certain employees at a college. For example, many college presidents and athletic coaches have had their salaries sharply increased during the past three years and this could cause many problems over the next few years as the gap between faculty, staff, and administration pay and the pay of presidents and athletic coaches increases. Id.

The pay packages of some endowment managers has also caused problems both in the university setting as well as with potential fundraisers. Specifically, Jack R. Meyer, Harvard’s endowment manager, was paid $6.9 million in 2003, which has caused some alumni to stop donating until Harvard decides to place the management of its endowment up for bid. Stephanie Strom, Harvard Money Managers’ Pay Criticized, N.Y. TIMES, June 4, 2004, at A18 (noting that alumnus Dr. Terry M. Bennett has campaigned to his fellow classmates to stop donating money to Harvard’s endowment until the management is put up for competitive bid). However, Harvard defends the pay packages, because the managers are paid based on their ability to exceed the return of a comparable index. Charles Stein, Harvard Pays 2 Top Money Managers $25M, Endowment’s Salaries Down From Last Year; Critics Call System Lavish, BOSTON GLOBE, Nov. 23, 2004, at D1 (noting that part of the pay structure of Harvard’s endowment managers includes a clawback, which forces endowment managers who perform well in one year and poorly in the next, to pay back a large portion of the previous year’s bonus). The Harvard endowment manager’s pay has also caused problems between the staff and endowment managers. Diane E. Lewis, Janitors at Harvard Protest for Full Time Endowment Managers’ Pay Prompts Action, BOSTON GLOBE, Feb. 7, 2004, at E1 (discussing the reaction of Harvard’s janitors to the pay packages of the endowment managers).

153 Audrey Williams June, Facilities: Money for New Buildings, Little for Upkeep, CHRON. HIGHER EDUC., Dec. 19, 2003, at A13 [hereinafter June, Facilities] (citing the College Planning & Management magazine which showed that 69% of the $11 billion that colleges expected to spend on construction went towards new buildings with the remaining 31% “evenly split between adding on the existing buildings and renovating or upgrading others”).

154 Id.
order to deal with the “baby boom echo,” which has caused large freshman classes. This building boom has also resulted in increased competition between schools, in order to attract some of the best students with amenities, such as health centers, new dormitories, medical centers, and more. Even though there is a desire to maintain the best campus with the best facilities, this lack of maintenance causes a great deal of waste. This waste is unnecessary, especially when funding is at such a premium.

4. Repayments on Debt

With the lack of funding, some colleges have turned towards borrowing money in order to pay for the current necessities of the institution. This increase in borrowing coupled with revenue worries has caused colleges’ credit ratings to fall. Through the third quarter of 2003, Moody’s Investors Service had downgraded the debt ratings of twenty-two private colleges and one public college. The downgrades in debt ratings force colleges to pay higher interest rates when borrowing additional money. Because colleges will be required to pay more in interest when borrowing additional funds, the costs involved in taking out a loan might be too expensive to be considered a viable source of funding. Without the ability to borrow funds, colleges will be under an even larger revenue strain, especially those colleges which are extremely dependent on student tuition to cover costs.

5. Insurance Expenses

With thousands of students on a college campus at any given time, there are many opportunities for institutional liability. Some of these liabilities could derive

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155 For a discussion on the effects of the baby boom echo, see GROWING PAINS, supra note 119.

156 See, e.g., Michael Lovell, ISU Planning $100 Million-Plus Campaign, DES MOINES BUS. RECORD, Aug. 11, 2003, at 1 (noting Iowa State University using improvements specifically to attract students); Tom Witosky, Kinnick Renovation to Cost $88.5 Million: Iowa Officials Seek OK to Add Suites, Club Seating and Rebuild South End Zone Stands, DES MOINES REGISTER, Dec. 10, 2003, at IC (discussing the expansion of the University of Iowa’s Kinnick Stadium where their football team plays).

157 June, Facilities, supra note 153 (noting ease and cost effectiveness to just tear down a building and start from scratch).


159 Id.; see, e.g., Yvette Shields, Iowa: Clarke Junked, THE BOND BUYER, Jan. 22, 2003 (announcing the downgrade of Clarke College’s $7.8 million of outstanding debt to below investment grade); Tedra DeSue, Louisiana: College Downgrade, THE BOND BUYER, Mar. 20, 2003 (announcing the downgrade of Centenary College in Shreveport, Louisiana).
from drug and alcohol abuse, sexual assaults, athletic injuries, suicide, or disgruntled employees. Over the past couple of years, the insurance market has changed from a "hard market" to a "firm" one where insurance premiums are only expected to increase between 10 and 20%. Also, property insurance is expected to maintain its current level, or possibly decline due to a lack of natural disasters.

Many colleges and universities are taking training on sexual harassment and discrimination for employees more seriously in order to lower insurance premiums. Colleges and universities are also expanding the size and scope of their legal staffs. The goal of this expansion is to identify and handle the potential liabilities before they become problems. While insurance will always be a necessary expense for colleges and universities, the control of these expenses by providing classes and workshops or increasing legal departments, is a better and cheaper alternative than taking money from other sources to pay for large lawsuits which could have been prevented.

C. Revenue Sources Which Educational Institutions Can Control

Even though there are many sources of revenue that colleges and universities have relatively little control over, there are some sources which are under the jurisdiction of college and university boards of trustees. For instance, institutions have control over bond revenues, tuition levels, and the management of their endowment fund. These sources are controlled by the officers of the university and are generally considered in conjunction with uncontrollable revenues and expenses during fiscal planning sessions. For the purposes of this discussion, it is important to take a quick look at the current state of each factor.

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161 Id. (quoting Janice M. Abraham, president and chief executive officer of United Educators Insurance).

162 Id. Other schools are having problems obtaining property insurance. See Becky Orr, Lack of Dorm Sprinklers Affects LCCC Insurance, WYOMING TRIBUNE-EAGLE, Feb. 2, 2005 (noting that Laramie County Community College is having difficulty obtaining property and liability insurance due to a lack of fire suppression sprinklers in its dorms).


165 Id. Craig W. Parker, general counsel of The Catholic University of America who maintains the Campus Legal Information Clearinghouse, an online resource for higher-education law, stated that "[his college is] committed lock, stock, and barrel to the preventive approach." Id.
1. Bond Revenues

A quick and easy method for obtaining more revenue is to assume more debt. However, this has many residual problems because the more debt one incurs, the higher it costs to repay the debt.\textsuperscript{166} Borrowing money creates a double-edged sword; money is received now, but it has to be repaid later along with interest. Yet with interest rates currently extremely low, it may be wise for colleges to assume more debt because the money received is relatively cheap.\textsuperscript{167} As a result, many colleges and universities have issued bonds in order to refinance outstanding debt.\textsuperscript{168}

A recent Moody’s Investors Service survey reflects that there is a slowdown in volume of bond issues.\textsuperscript{169} But as long as interest rates remain low and there is a demand for new facilities, it can be assumed that more debt will always be an option should a college or university want to fund projects. This is true at least until the college or university has issued so much debt that its cost of borrowing funds has increased because its credit rating has decreased, making it too expensive to just borrow funds.

2. Tuition and Fee Levels

Another way for colleges and universities to increase funding is to raise the price of tuition or other fees.\textsuperscript{170} Raising fees is a fairly quick and dirty method to increase revenues at a university. For example, if there are 5,000 students at a college and tuition and fees increase by $1,000 per student, the college would have an extra $5 million to spend. However, there are many other concerns associated with increasing the price of college tuition.

Between 2003 and 2004, the average tuition and fees for a four-year public college have jumped by 14.1\% , which is an increase of $579, raising tuition to

\textsuperscript{166} See \textit{supra} Part IV.B.4. for a discussion of the expenses involved in repaying debt.

\textsuperscript{167} Goldie Blumenstyk, \textit{A Time to Borrow: With Interest Rates at Their Lowest in Decades, Colleges Rush to Refinance Their Debt}, \textsc{Chron. Higher Educ.}, Nov. 8, 2002, at A27.

\textsuperscript{168} See \textit{June, Debt, supra note 159.}

\textsuperscript{169} \textit{Id.} (noting a $3.8 billion of debt rated in the third quarter of 2003 versus $5.5 billion in the first quarter).

\textsuperscript{170} See generally, \textsc{Arthur M. Hauptman, The College Tuition Spiral: An Examination of Why Charges Are Increasing} (1990) (describing the increased costs associated with the increase in college charges). For a discussion on the increases in tuition at colleges and universities in Connecticut, see \textsc{Harlan J. Levy, The Price of Admission Is on the Rise, N.Y. Times}, Sept. 26, 2004, at CT3.
$4,694 per year. Tuition and costs at private colleges grew by 6%, which is an increase of $1,114, raising tuition to $19,710 per year. These increases are not projected to end anytime soon. College administrators often state that an increase in tuition prices is a result of a lack of state funding, increasing enrollments, costs of health insurance, and lower returns on educational endowments. Another possible reason for the increase in tuition is fewer foreign students are attending American colleges, and these students normally pay full rates and only receive limited financial aid.

As a result of these tuition increases, students are bridging more of the college budget gap between revenues and expenses. Between 1990 and 2000, tuition at four-year public institutions has risen from 45% of total revenues to 51%. In an attempt to fix the constant increases in tuition and fees, some colleges have implemented a tiered system, where future classes of students pay

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172 College Board, supra note 171, at 3; see Press Release, supra note 171.

173 Meline, supra note 171 (quoting Sandy Baum, co-author of the College Board’s report on college pricing, “[i]t will take a couple of years for the economy to have an impact [on tuition increases]”).

174 See supra Part IV.A.1 for a discussion on state appropriations.

175 See supra Part IV for a discussion on increased enrollments and the costs associated.

176 See supra Part IV.B.2. and Part IV.B.5 for a discussion on increased costs of health insurance.

177 See supra Part IV.C.3 for a discussion on endowment returns.

178 Meline, supra note 171 (citing the Institute for International Education study on international enrollment). When foreign students pay full fees it creates what is known as the “Robin Hood effect.” Id. The “Robin Hood effect” occurs when college officers take money from students who pay the full price of their education to help support those who do not pay full fees. Id. For a more thorough discussion of the “Robin Hood effect,” see Kim Strosnider, A University Relies on Its Endowment to Cover the Costs of Financial Aid: Washington and Lee Avoids “Robin Hood effect,” in Which One Student’s Tuition Subsidizes Another’s, Chron. Higher Educ., June 12, 1998, at A37.

179 Meline, supra note 171. For example, students at the University of Arizona are paying 39% more in 2004 than in 2003. At The University of Arizona, $14 million, which is 50% of the new tuition money, will go directly to financial aid. Id. At The Ohio State University, student fees made up 19.1% of the fiscal year 2005 budgeted resources. OSU Current Funds Budget, supra note 125, at I.1, I.2. However, if you remove the amount of revenues from the health systems, student fees represent 28.2% of all the revenues in the FY 2005 budget. Id. at I.1.
more than current classes.\textsuperscript{180} Other universities have decreased prices of certain courses that are offered at unfavorable times in order to attempt to get more students enrolled.\textsuperscript{181} Even with all of these attempted alternatives or compromises to increasing tuition and fees, there is another important factor to consider when increasing tuition. When do fees become so high that it will keep low-income students from pursuing a college education?\textsuperscript{182}

When colleges and universities increase tuition and fees, this causes many residual problems.\textsuperscript{183} Many parents hope and plan on being able to help pay for the higher education of their children.\textsuperscript{184} In fact, Congress has created college savings plans and other tax wise methods to help parents and students fund a college education.\textsuperscript{185} Nevertheless, increased tuition has forced many families to

\textsuperscript{180} Meline, supra note 171. These colleges include The Ohio State University, Indiana University, and the University of Illinois system. \textit{Id.} For a description of Ohio State's tiered system, see OSU CURRENT FUNDS BUDGET, supra note 125, at 8.

\textsuperscript{181} Meline, supra note 171 (noting the University of Oregon tried this practice). Another way to lower tuition increases is to cap enrollment, but this causes many other residual problems. \textit{Id.}

\textsuperscript{182} For a discussion of the seriousness of this problem, see Michael Amone, \textit{250,000 Eligible Students Shut Out of College, Group Says}, CHRON. HIGHER EDUC., Jan. 30, 2004, at A21.

\textsuperscript{183} See Matthew Daneman, \textit{Straining to Afford a College Education}, ROCHESTER DEMOCRAT AND CHRONICLE, Nov. 23, 2003, at 1A (discussing the struggles of paying for an education); Robert Dodge, \textit{Soaring Tuition Hits a Political Nerve; Colleges Fault Economy for Big Spike, but GOP Sees Extravagance}, DALLAS MORNING NEWS, Oct. 22, 2003, at 1A (discussing increased tuition and political reactions); cf. Dave Curtin, \textit{State's Colleges Decry Finances: Students, Staff Point to Effects From Crumbling Buildings to the Departure of Prized Faculty, Some Say Funding has Reached a Crisis Point}, DENVER POST, Dec. 20, 2004, at 1A (noting that the inability to increase tuition at some Colorado colleges has led to a number of negative effects, such as program cuts and overcrowded classrooms).

\textsuperscript{184} See Eileen Ambrose, \textit{Be Smart: Put Retirement Savings Ahead of Kids' College}, BALT. SUN, Jan. 23, 2005, at 1C (noting that parents tend to save for their children's education before saving for their own retirement, which may cause problems for some parents later on).

\textsuperscript{185} 529 Savings Plans and HOPE deductions are examples of Congressional actions. For a description of 529 Savings Plans, see Jane J. Kim, \textit{A New Method to Save for Pricey College Tuition}, WALL ST. J., Feb. 20, 2003, at D2. See generally http://www.independent529plan.com (giving more information on 529 Savings Plans).
find alternative ways to finance their children's educations, or have forced students to increase the amount of their personal student debt.

With parents increasing their desire to want to pay, or at least help pay, for the education of their children, this could lead to many problems other than fiscal problems. If parents disagree on the amount of or the method of payment for the college education of their children, the disagreement could easily cause fighting, depression, or in the most extreme cases, familial separation. The desire to provide for their children has forced many parents to take on additional jobs or work extended hours in order to help pay for their children's educations. Unfortunately, the increase in fees has no beneficial effect on the families of the students and is not an optimal way to increase revenues for colleges and universities.

If a student's family is unable to provide enough funding for a college education, the student is usually able to obtain some alternative form of funding. Educational funding for a student can be easily broken up into two forms: grants or scholarships and loans. Grants or scholarships are not required to be paid back after graduation. Loans come in many forms and are required

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186 For example, there are commercials discussing how parents can take out home equity loans in order to have money for their children's college education. For a professor's perspective on the pressures of paying private college tuition for his three daughters, see Michael Kryzanek, Commentary: The Pain of College Tuition has a Big Payoff, PATRIOT LEDGER (Quincy, MA), Dec. 11, 2004, at 27.

187 Greg Winter, Public University Tuition Rises Sharply Again for '04, N.Y. TIMES, Oct. 20, 2004 (noting that students are becoming more dependent on loans and that loans make up nearly 50% more of the total financial aid pool than grants do).

188 For low income families the total charges of a college education for four-year institutions represents 71% of the family income of the lowest quintile (up to $25,207 in 2003) for a public institution. COLLEGE BOARD, supra note 171, at 16. For private four-year institutions, the percentage increases to over 170%. Id. See Scott Jaschik, Match the Mission To the Tuition, WASH. POST, Oct. 26, 2003, at B1 (discussing the hardships of tuition increases on families and political reactions).

189 See Mary Leonard, Survey Finds Jump in Public College Tuition and Fees Sees Drop in Grants to Students Who Need Aid the Most, BOSTON GLOBE, Oct. 22, 2003, at A3 (discussing increases in college fees while grants to the neediest students have decreased); cf. Shannon Buggs, Affordability Remains a Key Issue in Higher Education, HOUSTON CHRONICLE, Oct. 27, 2003, at Business 1 (discussing the “Carolina Covenant” for students from poor families who are able to attend the University of North Carolina at Chapel Hill for free without taking on any debts).

190 For simplicity, grants or scholarships should include federal work-study funds. Under federal work study, students work in order to obtain funding. Once the funds have been earned, students are not required to pay back the university or the federal government. For an explanation of the Federal Work Study Program, see STUDENT GUIDE 2005-2006, supra note 134, at 18.

191 Federal Perkins Loans, Federal Direct Stafford Loans, Federal Direct Parent Loans For Undergraduate Students (Plus Loans), private bank loans, and loans directly from the college or
to be paid back upon graduation. When a student receives his or her financial aid package, scholarships or grants are preferred because they do not need to be repaid, but usually the amount of these grants or scholarships do not cover all of the fees for an education. Thus, students will usually have to assume some form of debt in order to fund their education.

Granted, the assumption of debt to fund a college education is clearly a form of personal investment, which the student will pay-off through the value of their college degree, but at what cost is this to a student and his or her family? If college fees continue to grow, at some point, the benefits of taking out loans for college will not outweigh the benefits of a college education. Additionally, as more people obtain a college degree, the value of the benefit of receiving a college degree will decrease. Since increasing bond and fee revenues both have negative effects, the college or university’s educational foundation or endowment, the last major source of revenue, should be managed properly in order to provide continued funding for an educational institution.

3. Management of Endowment Funds

A properly managed educational endowment fund can benefit a college or university greatly. Endowment funds provide what could be considered "free university are all examples of types of loans which students can acquire for funding. See Loan Programs—The Ohio State University, at http://sfa.osu.edu/loans/ (last visited Mar. 4, 2005).

192 If students continue their education after undergraduate school, they are able to defer their loan repayment until they have completed their eleemosynary education. For an explanation of deferment of loans, see STUDENT GUIDE 2005-2006, supra note 134, at 27.

193 See Kathleen Porter, The Value of a College Degree, ERIC DIGEST (2002), available at http://www.eric.ed.gov/ERICDOCs/data/ericdocs2/content_storage_01/00000000b/80/2a/37/98.pdf; Board of Regents of The University System of Georgia, News Release, New Study on Value of a College Degree in Georgia Shows Payoffs for Graduates, State; Highlights Disciplines in Demand, Nov. 5, 2003, available at http://www.usg.edu/news/2003/110503.phtml; see also COLLEGE BOARD, supra note 171, at 4 (stating that median annual earnings of those with college degrees are 60% higher than those without a degree; but that as more people go to college, the amount of people with college degrees will increase and thus, the value of the degree will probably decrease).

194 See Louis Uchitelle, College Degree Still Pays, but It's Leveling Off, N.Y. TIMES, Jan. 13, 2005, at C1 (noting that obtaining a college degree is slowly losing its long-term wage benefits).

195 If a college or university does not have a large enough endowment, the college or university must rely on other sources of income. See Mike McAndrew, Meager SU Nest Egg Keeps Tuition Up Because SU's Endowment Does Not Generate A Large Income, The University Relies on Tuition to Pay Its Bills, POST-STANDARD (Syracuse, N.Y.), Apr. 8, 1996, at A1 (discussing Syracuse University and the consequences of having a small endowment fund). Fundraising is also important to grow endowments; however, many donors are creating more and more restrictions on how these endowments should be spent. Greg Winter & Jonathan Cheng, Strings Attached: Givers and Colleges Clash on Spending, N.Y. TIMES, Nov. 27, 2004,
money" in the sense that properly managed money reproduces on its own. Nevertheless, there are issues which endowment fund managers need to consider when deciding how to invest their endowment funds. These issues include: (1) how long is the time horizon on each investment, (2) how important is the conservation of capital, and (3) if the endowment can withstand market fluctuations with the incorporation of large risk. Each endowment board should consider these issues when deciding how much to disperse out of their endowment funds in order to best support their educational institution. For those institutions located in states that have adopted the UMIFA, Section 6 allows them to allocate their endowment funds under the ordinary prudence of a businessperson. As evidenced by the stock market bubble burst and downturn in the economy between 2000 and 2002, endowments on average suffered losses for two consecutive years.

With increased sophistication in investing, many new ways of investing have been created which are now considered to be prudent. Venture capital funds, hedge funds, and other alternative investments that maintain a fairly high degree of risk in order to maximize returns have become a standard in many eleemosynary endowment funds. Endowment managers argue that the increased utilization of alternative investment strategies is a method of diversification. The boards argue that in order to maintain consistent endowment returns, the investment strategy needs to be as diverse as possible removing unsystematic risk. Opponents contend that endowment fund managers have become more aggressive in their investing in order to obtain bragging rights at A1 (discussing how some donors are putting more restrictions on their donations as well as donating in installments to make sure that, before making their next donation, the endowment fund managers and colleges are using the money properly).


197 NACUBO Study, supra note 4, at vi (noting that in fiscal year 2002, the average endowment decreased by 6.0% and in fiscal year 2001, the average endowment decreased by 3.4%); COMMONFUND, supra note 47, at 10 (noting that in fiscal year 2002-2003, the average endowment decreased by 6.0% and in fiscal year 2001-2002, the average endowment decreased by 3.0%). See John L. Pulley, For Investment Managers, Boom Years Are Over, CHRON. HIGHER EDUC., Jan. 25, 2002, at 23 (discussing endowment returns for many colleges and the differences between the boom years of the 1990s and the early 2000s).

198 COMMONFUND, supra note 47, at 18 (32% of endowment funds are invested in alternative investments). Some venture capital companies are no longer accepting investments from public educational endowments because of open-records laws, which do not allow the venture capital companies to maintain sensitive information in their portfolios. Goldie Blumenstyk, Some Venture Capitalists Shun Public Universities' Money, CHRON. HIGHER EDUC., July 2, 2004, at A24.

199 See William C. Symonds, How to Invest Like Harvard; There's "Not Much Plain Vanilla" in the University's Portfolio, BUS. WEEK, Dec. 27, 2004, at 118 (discussing how Harvard's endowment strategy obtains diversification through alternative investments).
or to increase their salary.\textsuperscript{200} As a result, the focus of many endowment fund managers has departed from the goal of maintaining the same purchasing power and consistent growth of the endowment.\textsuperscript{201} The focus has moved towards a more of an aggressive model allowing the managers of educational endowments to attempt to make higher gains while increasing the risk similar to the goals of mutual fund managers. But, what happens when this aggressive strategy backfires and causes endowment funds, which are meant to be kept in perpetuity, to significantly decrease in value?

Between 1999 and 2002, the U.S. economy experienced a recession. As could be expected, the value of endowments has followed the same ebbs and flows as the economy has as a whole.\textsuperscript{202} With the endowment boards of many eleemosynary institutions utilizing the prudent businessman rule, endowment boards continued to prudently invest heavily in aggressive growth vehicles. Since almost all investments in a capital market bring together a willing buyer and a willing seller, almost all methods of investing could be considered prudent because a rational buyer would expect the investment to appreciate, while a rational seller believes that there are better alternative investments. Thus, any transaction in a capital market could be considered prudent.

As a result, many investment strategies, which in hindsight would be considered irrational and poor, would pass the ordinary businessperson rule. And even if these irrational decisions have lead some endowment funds to lose money, endowment managers tend to characterize the loss of endowment funds as a short-term problem and that over the “long-term” their investment strategies will maintain proper returns.\textsuperscript{204} However, when so many parts of society rely on


\textsuperscript{201} For a discussion regarding the prudent management versus greed of endowment fund managers, see Ben Gose, \textit{Prudent Management or Outright Greed? Critics Ask How Big Endowments Should Be}, CHRON. HIGHER EDUC., May 27, 2004, at B9 (discussing the benefits and pitfalls of having a large endowment and how those funds should be managed).

\textsuperscript{202} See supra note 197.

\textsuperscript{203} Endowment funds use hedging strategies, traditional strategies, and even chaotic models in their investing. A monkey throwing darts at a newspaper method could also be considered prudent investing.

\textsuperscript{204} Jane Stancill, \textit{University Endowments Hold Almost Steady}, NEWS & OBSERVER (Raleigh, NC), Oct. 31, 2002, at B3 (quoting Michael Mandl, Duke University’s vice president of financial services as saying “[w]e know those years of 50 percent gains are also going to be followed by some negative years . . . this is a long term investment and a long term game”); Philip Walzer, \textit{Stock Market Slump Hits Virginia College Endowments}, VIRGINIAN–PILOT (Norfolk, VA), Aug. 24, 2002, at D1 (quoting Larry Dantzler, the chief financial officer of Regent University as saying “[y]ou take a long-range perspective on the endowments, . . . so we certainly won’t be in the scenario where we’re making a knee-jerk reaction on one- or two-
higher education, the length of "long-term" is a crucial issue. Educational endowment funds need to be invested in a manner that maintains growth prospects, while limiting severe fluctuations in investment performance.

V. A NEW MODEL

In order to create the most efficient system of investing educational endowments, an investment manager must match the investment strategy to the desired results. This is why investment managers recommend that older investors, who have the intention to preserve their wealth, utilize more conservative investments in order to maintain their retirement funds, and why investment managers promote more aggressive strategies for those investors who want to grow their corpus at a more rapid rate while taking on more risk. In general, the boards of educational endowment funds invest in order to maintain the real purchasing power of the principal for perpetuity. Nevertheless, many endowment managers are taking their money out of what would be considered conservative investments and placing the money into alternative, riskier investments. Other than for diversification and maximization of the endowment's total return, there are really no justifications for doing this. Risk and return must be balanced properly in order to accomplish the endowment's investment strategies. If the investment boards get too aggressive, they will disturb the proper mix of risk and return, creating the possibility of substantial losses to the endowment's principal.

For those colleges under the UINFA, Sections 2 and 6 grant endowment managers the power to invest endowment funds in new investment vehicles deemed prudent under an ordinary prudence standard. However, as the investment community becomes more sophisticated and newer, unproven and typically riskier investment vehicles become more accepted, endowment managers will be able to quietly shift into a riskier investment strategy in order to year market returns. But if one were to continue to have negative returns, then one would have adjustments to accommodate that").

205 For a discussion on how managers create a strategy, see supra Part III.A.
206 See, e.g., Cornerstones Endowment Report, supra note 97, at 2.
207 COMMONFUND, supra note 47, at 19. From 2001 to 2003, alternative investments in the average endowment fund has increased from 24% to 32% while investments in domestic equities have decreased from 40% in 2001 to 32% in 2003. Id. Moreover, from 1998 to 2002, alternative investments have increased from 4.1% in 1998 to 7.5% in 2002, while investments in equities have decreased to 57.4% from 63.5% in 1998. NACUBO STUDY, supra note 4, at 5. For example, Harvard recently acquired 408,000 acres of timber rights in New Zealand. Bill Barnhart, Harvard's Timber Play Cuts Across Investment Grain, Chi. Trib., Feb. 29, 2004, at C5 (discussing Harvard's quest of obtaining diversification through investments in commodities, such as timber).
208 See UNIF. MGMT. OF INST. FUNDS ACT § 2, 7A U.L.A. 491 (1999); id. § 6 at 500.
make higher profits. Even though this would be legal under the prudent investor standard, with so many people and elements of our society riding on the investment decisions of a group of investors, I propose that we restrict the investment strategies of investment boards and focus more on consistent, predictable growth while maintaining an appropriate level of risk. This new standard would fall between the old standards of trust management and the ordinary prudent investor rule presented in the UMIFA and will ensure that our higher education system will be able to properly function into the future.

A. How Should University Foundations and Endowments be Managed in Order to Maximize the Goals of a University?

In order to maximize the efficiency of an endowment, the investment board needs to correctly match the amount of funding necessary for the university and the amount of risk that the endowment can maintain. There are many factors affecting the investment strategies of endowment boards, including size of the endowment, amount of new principal expected, building projects, and dependency on the endowment as a source of revenue. These factors will allow the endowment managers to create a spending and investment strategy which will encompass the desire of the college which the endowment supports. Unfortunately, with the difficulty of obtaining new revenues, endowment managers are trying to maximize their endowment returns—this drive for returns can easily be pushed towards the forefront, instead of the primary focus of consistency and capital preservation.

For example, suppose an endowment fund has the following standard objectives: (1) to preserve and maintain the real purchasing power of the fund’s principal, and (2) to produce a moderate long-term return. Read literally, these objectives are fairly specific: maintain principle and return on investment. However, these objectives are in actuality extremely loose, because if a very risky investment can produce large returns, then the investment accomplishes both (1) and (2). Thus, the standard set of objectives could create overly aggressive endowment management. Also if endowment returns are poor, the endowment managers can use the excuse that fluctuations are normal and endowment funds invested for the “long-term” usually perform better than cash.
With the sophistication of capital markets and the fact that the stock market is a free market, investments are made at the price where a willing buyer would pay a willing seller. Thus, every investment will have investors who believe that the value of the investment will increase, as well as investors who expect the investment to decrease in value. Therefore, under Section 6 of the UMIFA, looking at all the facts and circumstances surrounding a college and university combined with the prudent business person rule, every investment could be prudent, unless the investment is 100% destined to fail.\textsuperscript{212} Also, if an investment goes awry, investment managers can always use the defenses of diversification and “long-term” investment strategies.\textsuperscript{213} Thus, under the current standards of Section 6, in combination with Section 2 of the UMIFA, there is nothing limiting the “carte blanche” authority of the endowment managers to make investments.

B. Why Should the Government Get Involved?

When the success of our society depends on the education of our citizens, there are many social benefits to ensure a citizen’s proper education. Therefore, the government should be allowed to regulate the manner in which educational endowments are invested.\textsuperscript{214} In our society, higher education affects many facets of our societal equilibrium. Families are affected because of the higher wages paid for those who are better educated, which perpetuates the proper upbringing of children. The research and development for new technology and medicines will be affected if educational research funding decreases.\textsuperscript{215} The higher education system is also an employer of many people and without proper funding, jobs will be lost and the best faculty will pursue more lucrative offers.\textsuperscript{216} Without the education of our citizens, our free market economy will turn to other places for educated persons to perform work. With the upcoming “baby boom echo,”\textsuperscript{217} governmental interaction is necessary to ensure that college and university endowment managers do not destroy the endowment funds that they run. Therefore, with so many facets of society depending on the education of our

\begin{itemize}
\item \textsuperscript{212} Purchasing stock of a company which is about to be cancelled would be an example of an investment that has a 100% chance of being worthless. See supra Part II.B.4.
\item \textsuperscript{213} See Sommer, supra note 211.
\item \textsuperscript{214} Press Release, supra note 171 (“College Board President Gaston Caperton stressed the importance of a higher education [stating that] ‘[t]hose who oversee America’s colleges and universities believe their institutional importance to economic recovery is undeniable, and they are, in large measure, correct.’”).
\item \textsuperscript{215} See supra notes 127–32 and accompanying text.
\item \textsuperscript{216} See supra Part IV.B.2.
\item \textsuperscript{217} The baby boom echo is expected to hit in 2009. See GROWING PAINS, supra note 119, at 27 (predicting an increase from 14,345,000 college students in 1997 to 17,261,000 in 2009).
\end{itemize}
citizens, the government should get involved to ensure that investment managers are properly investing their endowment funds.

Other than the direct societal benefits which would come from properly managed endowment funds, all taxpayers are in essence subsidizing any donations made to educational foundations. Since higher education foundations fall under 26 U.S.C. § 501(c)(3), Congress has declared that the best interest of our society would be to help aid institutions supporting higher education. Thus, Congress has allowed taxpayers to obtain "subsidies" on their tax returns when taxpayers gift money to education foundations. These "subsidies" are granted at the expense of other taxpayers who are not taking similar deductions. Since the government has decided to allow donors, who make gifts to higher education foundations to take deductions, the government has an interest in regulating the manner in which these funds are managed.

Since higher education has an influence over society and donors to eleemosynary institutions receive a tax deduction, the government needs to get involved to ensure that the boards of directors of these endowment funds are properly managing their funds. Endowment funds need to be invested in a manner that almost guarantees consistent returns while maintaining the purchasing power of the principal. Even though, in practice, this may be impossible because of the ebbs and flows of the economy and stock market, under the current standards of the UMIFA, endowment managers are able to hide behind an increasing stock market, making endowment management relatively easy. However, once the market turned downward in the early 2000s, endowment managers were unable to use the veil of a growing market. Endowment managers have used excuses such as "long-term" strategies, diversification, and the ordinary businessperson rule to protect movement from more conservative, predictable investments towards riskier investment strategies, but the movement towards riskier investments, while having the ability to obtain higher returns, has the ability to destroy endowment funds if none of the investment decisions work.

C. With All These Effects, Colleges and Universities Should Have a More Conservative Management Standard

Since colleges and universities drive our society in many ways, the government needs to regulate the management of eleemosynary endowment funds by creating a new standard which is more conservative than the standards

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218 Since most educational endowments are set up under IRC § 501(c)(3), donors obtain deductions from their tax burden. This deduction in essence is a subsidized payment of the donor's tax burden by other taxpayers.

219 See supra Part IV.C.3.

220 Id.
under the UMIFA,²²¹ but more liberal than the standards under old trust management.²²² By creating a new standard, the government will ensure that endowments will be managed in a manner which will produce consistent results allowing institutions to maximize the utility of their endowment funds while preserving their capital, regardless of the state of the economy. With a more conservative system, the goal of obtaining large endowment returns will be usurped by a management style that will encourage slightly smaller, yet consistent endowment fund gains benefiting not only students today but also students into the future.

Under the current standards of the UMIFA, the prudent businessperson standard that looks towards the facts and circumstances of the institution and allows boards to manage their endowments to maximize profits, similar to how most mutual funds are managed.²²³ Because our society runs on a free market economy, every investment is made at a price that a willing buyer would pay a willing seller. Theoretically there should be an equal number of people who believe that the investment at that price will appreciate in value and those who believe that the investment will depreciate in value. Thus, every investment vehicle should satisfy the business judgment rule absent fraud or an investment in a guaranteed worthless vehicle. So the desire to risk today’s gains for future, speculative gains can always be justified. But, if investment strategies obtained consistent growth, there would be no need to risk today’s money for future gains.

The new standard should not be so strict as to go back to the standard of trust funds and income-only investing. Since the stock market on average has a higher average return than cash, there are many ways to obtain a higher return than cash equivalents under the income-only investment strategies, while maintaining the goal of consistency. A standard of endowment investment management which lies somewhere between the businessperson standard of Section 6 of the UMIFA and trust management will allow endowments to weather economic downturns and still maintain adequate results in an growing economy.

The UMIFA was created in order to capture the gains which were lost due to income-only investment standards. Since the inception of the UMIFA, the financial markets generally have had consistent growth, making the standards under the UMIFA adequate. However, after this past downturn in the economy, clearly the UMIFA has no safeguards against a slowing economy and a declining stock market. The endowment managers under the UMIFA have the ability to justify their investment decisions placing them under the ordinary businessperson rule of Section 6 of the UMIFA, while making riskier decisions with the endowment funds. If the government does not curtail this movement towards

²²¹ See supra Part II discussing the UMIFA.
²²² See supra note 70.
²²³ See supra Part V.A. (explaining how endowment managers are investing their funds similar to mutual fund managers attempting to maximize returns).
riskier investments, then the government is keeping our society vulnerable to a possible dramatic loss in the ability to fund our higher education system without having to increase taxes. In order to maintain the best economy in the world, there is a need to move towards a more conservative strategy of endowment management.

VI. CONCLUSION

The way educational endowment funds are currently managed could lead to potential problems in the near future. Endowment managers are investing legally under the UMIFA. However, the current standards do not protect endowments during economic downturns. When an endowment manager makes an investment decision, there are an equal number of people who believe that the investment vehicle is worth more than he paid and those who think the investment vehicle is worth less money. Therefore, under the standards of Sections 2 and 6 of the UMIFA, endowment managers have almost complete control to make any investment decision they want.

With the educational system being an engine of the economy, the government should step forward and create a set of standards that is stricter than the UMIFA, but more liberal than older trust investment standards. The educational system is too crucial to the long-term livelihood of our society to allow endowment fund managers to make riskier investments with funds that were previously conservatively invested. In a growing economy, the current system works fine, but when the economy slows down, the current system causes too many problems which should be addressed today rather than tomorrow.