QUEEN'S POOLED ENDOWMENT FUND

SPENDING POLICY & UNITIZATION BACKGROUNDER

OVERVIEW

The Queen's Pooled Endowment Fund (PEF) is a unitized fund consisting of philanthropic gifts intended to provide enduring support to Queen's. Payouts from the PEF support student awards, research chairs, professorships and a diverse range of university programs and projects.

Endowed gifts are pooled together in the PEF for long-term investment. A unitization system (similar in some ways to a mutual fund) is used to track the value of each endowed gift over time. PEF investments are managed under the oversight of the Investment Committee of the Board of Trustees in compliance with Board-approved policies. In order to achieve a high level of spending and also preserve purchasing power over time, the PEF is invested in a diversified portfolio of public and private equities and fixed income, and real assets such as infrastructure and real estate. With an asset mix that is positioned for growth, the portfolio is expected to achieve a high return over time thus achieving the maximum benefit to Queen's over the very long term. Of course, these high return expectations come with embedded risks, which means the PEF will at times experience significant volatility. Portfolio positioning and spending decisions are managed in this context. It is important to understand that return forecasts and target spending rates are affected by market conditions and are subject to change.

PURCHASING UNITS

When a gift is endowed, gift proceeds are used to purchase units in the PEF at the prevailing unit value which is calculated monthly and posted on Queen's website. The PEF unit value represents the total market value of the PEF divided by the total number of outstanding units. Units are purchased at the unit value for the month gift proceeds are received. For example, as of August 31, 2022 the PEF unit value was $3.9280. An endowed gift of $125,000 received in the month of August 2022 would have purchased 31,823 units ($125,000 divided by $3.9280 per unit).

Each endowed gift is added to the capital portion of an "endowed fund" (or establishes a new endowed fund, as the case may be) where the number of units purchased is tracked, along with the book value of the donation (i.e. the donation proceeds). The market value of the endowed fund is based on the latest month-end PEF unit value.

Each endowed fund has a corresponding "income" account, where the annual income is deposited as noted below, and spent in accordance with the terms of the endowed fund.

ANNUAL INCOME

Each year, the Board of Trustees approves a PEF payout (or "spending" amount), the proceeds from which are generally referred to as "income" for each endowed fund. Income is allocated annually in May based on the number of units held on April 30th, representing a prepayment to allow for planned spending throughout the year. Each endowed fund receives the same income amount per unit to support the chosen program(s). For example, the approved payout for the 2022/23 fiscal year (ending April 30, 2023) is 15.75 cents per unit. As such, an endowed fund with 100,000 units on April 30, 2022 (and a market value of $403,020) would receive $15,750 of payout income in fiscal 2022/23. The Spending Policy section below explains the calculation of the annual payout per PEF unit.

While the total annual income is reflected in the income account in May of each year (with pro-rated income reflected during the year for new donations), withdrawal of the cash from the PEF assets generally occurs on a monthly basis throughout the fiscal year.

New donations are allocated the same income amount pro-rated for the number of months remaining to the April 30th fiscal year-end. For example, where \$125,000 was received in August 2022 purchasing 31,823 units (\$125,000 divided by the August 2022 unit value of \$3.9280), a pro-rata payout of \$3,341 (31,823 units x .1575 payout per unit x 8/12) would be received for fiscal 2022/23, representing eight of the 12 months in the fiscal year, paid in advance to allow immediate use of income.

Individual years will vary, but over the long term the expectation is that PEF investment returns will exceed the implied payout percentage rate. This is intentional, as one of the goals is to preserve the purchasing power for future generations, factoring in inflation expectations. The effect is that excess earnings increase payouts for future years.

SPENDING POLICY

The Investment Committee is responsible for establishing the Spending Policy for the PEF, which is detailed in Section 5.07 of the *Statement of Investment Policies and Procedures*, which is approved by Queen's Board of Trustees:

> "The objective of the Spending Policy is to release substantial income while preserving the purchasing power of assets for future generations.
>
> The spending rule for Queen's attempts to achieve these objectives by using a long-term spending rate of 4.0% per annum combined with a smoothing rule that adjusts spending gradually to changes in endowment market value. The amount released under the spending rule is based on a 70% weight applied to the prior year's spending adjusted for inflation and a 30% weight applied to the amount that would have been spent using 4.0% per annum of endowment market value. The spending formula includes a spending cap at 4.5% and a spending floor at 3.5%.
>
> As a consequence of the smoothing rule, the spending payout has a lower volatility than that of the overall fund. The Spending Policy will be reviewed annually by the Investment Committee."

SPENDING FORMULA & MECHANICS

Annual Spending = [70% of prior year spending adjusted for inflation]

+ [30% of unit value at December 31st of prior year x 4.0%]

The spending formula has two implications. First, large market fluctuations are smoothed by incorporating the previous year's spending, enabling the university to plan for the use of endowment proceeds in accordance with the terms of each endowed fund in support of university operations. Second, by adjusting spending toward a long-term target of 4.0% of endowment market values, the rule ensures that spending levels will be sensitive to fluctuating endowment market value levels, providing stability in long-term purchasing power. The spending payout is calculated in advance of each fiscal year, which begins May 1st. The December 31st unit value is used in the spending formula so that the payout for the next fiscal year is known advance. The inflation adjustment in the formula is based on the one-year percentage change to the Consumer Price Index (specifically CPIX, which is one of the core inflation measures), as reported by the Bank of Canada for the previous calendar year.

The spending formula includes upper and lower bands of +/- 0.5% around the 4.0% long-term spending target to prevent over- and under-spending in extreme market conditions. The formula is reviewed by the Investment Committee annually and may be amended as required.

An important aspect of the management of Queen's unitized PEF is the ability to continue funding programs supported by the endowment in times of market downturns, even if the market value of the units falls below the value on the date on the donation (i.e. if the current unit value falls below the unit purchase value). The smoothing of the endowment payout rate allows for the continuity of program support despite market volatility.

GIFT SIZE & ESTIMATED FUTURE INCOME

It is common for donors to want to know how large a gift would need to be in order to sustain a particular annual income level. Unfortunately, due to the nature of the endowment structure this is not something that can be determined with any certainty. However, over the long term the intention is for each gift to provide a level of support that is equal to the long-term target spending rate (currently 4.0%, subject to change). Further, the objective is to grow both the PEF unit value and the payout per unit over time to preserve purchasing power for future generations.

At the time a donor establishes an endowed gift, the actual payout rate may be anywhere between 3.5% and 4.5% of the PEF's previous calendar year-end market value. Given that the actual income will only be known at the time of the donation, using an annual income estimate of 4.0% of the donation is reasonable in determining the size of endowment required to support a program or annual income amount over the long term. Regardless of the actual payout rate at the time of the gift, the expectation over the long term is that the spending amount will converge to approximately the long-term target rate.

REPORTING

The Office of Advancement (Donor Relations) is responsible for annual fund reporting to donors after April 30th, the university's fiscal year end. Where appropriate, some donors receive individualized fund reports which outline the capital and market value of the fund, spending that has occurred in the fund for that fiscal year, the annual income of the fund, the spending balance of the fund as well as impact details for donor-established funds. For more information, please reach out to don.rels@queensu.ca.

Detailed information on the PEF, including the Annual Endowment Report and historical unit values and payout rates, can be found on the Investment Services website.