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# Harvard Rule

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When it comes to investing, remarkable little attention is ever paid to spending. Yet spending can have a disproportionate influence on investment results. In fact, an investor's spending decisions should probably precede consideration of any other factor.

While these guidelines were originally developed for institutional investors, they are equally instructive to individual investors interested in developing their own spending rules.

The "Harvard Rule" comes from Harvard University. Caught between accelerating costs, decreasing government support, and weakening financial markets, the university in 1973 adopted a set of basic operating assumptions and guidelines for its endowment fund that have come to be collectively known as the "Harvard rule".

The Harvard rule is really quite simple. It is based on several assumptions that were originally summarized as follows:

- The long-term inflation rate will average 4%, but the university's costs will accelerate by 6% per year.
- The endowment's target total return will average 8% (this was based on the university's experience and expectations assuming a portfolio more heavily invested in equities—a 65% equity and 35% bond portfolio is one reasonable benchmark).
- Gifts and bequests to the endowment will average 2% annually.

- The endowment will distribute 4% of its total market value annually.

These four points outline the university's investment and spending program. The program was designed to preserve over time the real value of the endowment and its spending power. It set spending equal to 4% of assets and the expected growth rate in spending at 6% per year. The 6% growth rate was to be met through the retention of the endowment's investment return and gifts and bequests of 2% each year.

Because the Harvard rule bases its annual spending targets on the prevailing market value of assets, spending will tend to fluctuate with market price swings. To ensure a steady and more predictable level of spending, the university created a stabilization fund to smooth its spending. The fund captures the excess earnings generated in stronger market years and distributes them in weaker years.

For an individual's purposes, the Harvard rule can be further simplified by assuming that costs will match the inflation rate and that there will be no benefit of additional income. With these modifications, an 8% total return target, 4% spending policy, and 4% inflation rate forecast will ensure that the real value of assets and spending will be preserved over time. While these assumptions were first formulated in 1973, they appear equally valid today.

Harvard University's spending rule is aimed at preserving real spending power and asset value into the distant future. But the lessons from this spending rule are clear. The rule stresses conservative spending policies and investment policies that emphasize equities.

Example:

- Total Return Goal: 8% per year
- Available for spending and taxes: 4% of market value
- 8% return should be achievable if portfolio is invested approximately 65% in equities and 35% in bonds, based on historic returns.
- Portfolio (and thus amount available for spending and taxes) should increase in amount in excess of inflation rate, thus allowing retiree to maintain purchasing power.

## Summary

Like all investors, retirees face difficult investment decisions. Among these is the choice of spending policy. Because this single decision will influence a retiree's standard of living as well as his investment strategy, it is best addressed in the context of his overall financial plan.

While, this spending rule may not be precisely appropriate for every retiree, the guidelines are instructive:

- It argues for a healthy commitment to equities and a fairly conservative level of spending;
- It yields relatively steady levels of spendable income over time; and,
- It serves as an effective discipline to control spending.

*The above are excerpts from article titled "A Look at the Spending Side of the Investment Equation", by Steven P. Somes, in the February 1991 issue of AAII Journal. Steven P. Somes is a vice president at State Street Research & Management Co., a Boston-based financial management firm. He is also chairman of the firm's asset allocation committee.*