CAPTRUST

Alternative Investments for Endowments and Foundations

In an unpredictable market like the one we've experienced so far in 2022, alternative investments often prove worthwhile for endowments and foundations to consider. In CAPTRUST's 2021 Endowments and Foundations survey, even among organizations not allocating to alternatives, 91 percent of respondents see a benefit to including them in their portfolios. Before a nonprofit's investment committee or board adds them to the portfolio, there are a few factors to consider.

Based on our survey, the two biggest concerns for not utilizing alternatives were liquidity and portfolio size to invest in these assets. Our survey confirms that larger organizations allocate to this asset class at a much higher rate. In fact, every respondent with more than $500 million in investable assets reports using alternatives.

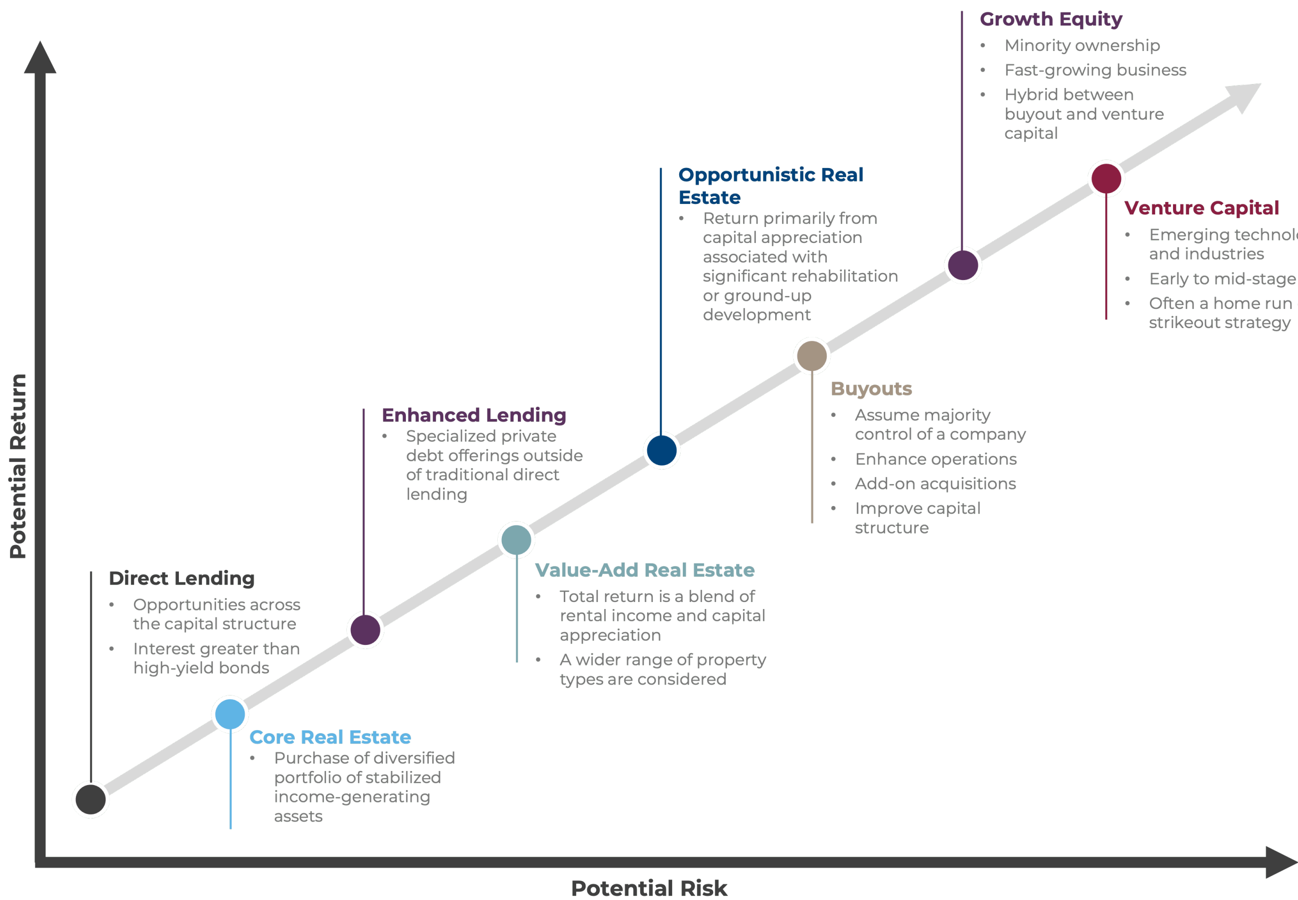
Regardless of a nonprofit's size, however, there appears to be proven success in bringing alternatives into the mix. Our survey also shows that, across the spectrum of nonprofits, every entity using alternative investments reported an increased return on their investment.

Do the rewards of using alternative investments outweigh the risks? Should you consider these diversifying investments for your organization? Read on for an overview of alternative investments and what to consider based on your organization's liquidity needs and portfolio size.

What Is an Alternative Investment?

An alternative investment is any asset that is not categorized as a stock, bond, or cash. This could include vehicles that invest in private markets, like private equity, private real estate, or private credit funds. As Figure One shows, the term *alternative investments* represents a broad range of investment types, including debt, equity, real estate, and venture capital, that range across the risk-return spectrum.

Figure One: Risk-Return Characteristics of Private Market Alternatives Investments



Why include alternatives in your organization's portfolio? CAPTRUST Senior Research Specialist Will Volkmann says that alternatives are a way to not only diversify a portfolio but may additionally increase returns for an endowment or foundation due to their long-term investment horizons. "In general, endowments and foundations can take advantage of private markets," says Volkmann. "There's an expected illiquidity [return] premium you get when you invest in private assets with time restrictions on accessing your money."

A Range of Liquidity Options

Alternative investments are available in vehicles across the liquidity spectrum—from daily liquid mutual funds to less-liquid strategies to illiquid limited partnerships or direct investments. "Each option comes with its own characteristics, including fund structure, risk and return targets, minimum investment size, tax reporting, and investor accreditation requirements," says Volkmann. "Regardless of the liquidity category, private real estate serves as the most popular alternative investment."

Despite hesitations about liquidity, alternatives can deliver benefits for organizations with a long-term investment timeframe.

Liquid Investments

Liquid alternatives can be a good fit for nonprofits or organizations looking for a substitute to fixed income strategies or to reduce interest-rate risk. "These are daily liquid mutual funds that most closely resemble traditional hedge fund strategies," says Volkmann. Liquid alternatives usually have low minimums for entry, making them a lower-risk option for an endowment looking for diversified alternatives exposure, income-generation, or both.

Illiquid Investments

On the other side of the spectrum are illiquid investments. These typically require a significant amount of capital to invest and are often best suited for large endowments or foundations, starting with portfolios that have at minimum around $25 million in assets, says Volkmann. Despite the financial buy-in, illiquid alternatives reap potentially huge rewards. Illiquid investments—like a growth equity or venture capital fund—frequently require seven- to ten-year-plus commitments but offer higher return expectations.

According to Volkmann, investing in this space doesn't happen overnight and takes time and thoughtful planning. "In order to build an allocation, you must pace multiple investment commitments over time," he says. "It could be several years before you reach the allocation target."

Less-liquid Investments

A possible happy medium for alternatives, less-liquid assets are ideal for organizations that don't want to lock up their capital for the long term and want to have the option to redeem if they need cash, says Volkmann. While semi-liquid strategies invest in illiquid assets, these strategies offer the potential to redeem quarterly or multiple times throughout the year. Private real estate and private debt funds are commonly targeted for less liquid vehicles; they also typically require less capital than illiquid assets. "These less-liquid solutions mostly capture the beta of private markets, and depending on strategy, will target returns above the public market equivalent," he says.

Consider the Risk and the Reward

When considering alternatives for a nonprofit, it’s important to know that not all alternatives—or liquidity options—are alike: Some have more considerations than others, and all require deeper due diligence. There’s also the question of your organization’s time horizon, so it’s helpful to consider how long a nonprofit plans to remain invested and can have the assets locked up. Keep in mind that the longer the money is kept in the alternative investment, the greater the return potential.