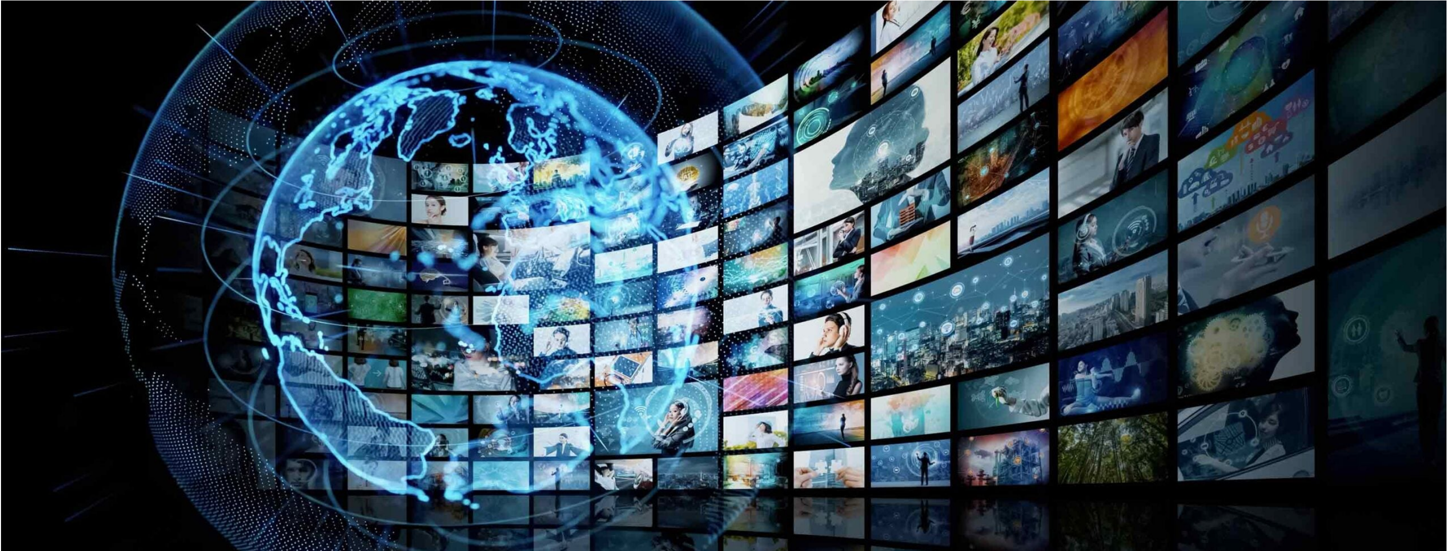
CAPTRUST



Alternative Investments for Endowments and Foundations

Smaller organizations may hesitate to use alternative investments, listing concerns such as liquidity and portfolio size. But endowments and foundations may benefit from pursuing alternative investments to help diversify their portfolios, enhance returns, or generate income.

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 isn't 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 the figure shows, the term alternative investment 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

Growth Equity
- Minority ownership
- Fast-growing business
- Hybrid between buyout and venture capital

Opportunistic Real Estate
- Return primarily from capital appreciation associated with significant rehabilitation or ground-up development

Venture Capital
- Emerging technologies and industries
- Early to mid-stage firms
- Often a home run or strikeout strategy

Enhanced Lending
- Specialized private debt offerings outside of traditional direct lending

Buyouts
- Assume majority control of a company
- Enhance operations
- Add-on acquisitions
- Improve capital structure

Direct Lending
- Opportunities across the capital structure
- Interest greater than high-yield bonds

Value-Add Real Estate
- Total return is a blend of rental income and capital appreciation
- A wider range of property types are considered

Core Real Estate
- Purchase of diversified portfolio of stabilized income-generating assets

Potential Return

Potential Risk

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 they 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.

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

Liquid Investments

Liquid alternatives can be a good fit for nonprofits or organizations looking for a substitute for 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—typically starting with portfolios that have at minimum around $50 million in assets—but can depend on a number of factors, says Volkmann. Despite the financial buy-in, illiquid alternatives reap potentially huge rewards. Illiquid investments—typically held in a limited partnership fund structure—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. “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. Less-liquid fund structures also typically require less capital than illiquid drawdown funds. “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.