When Should Non-Profits Invest More Adventurously?

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In select cases, alternative assets can help to diversify a charity's portfolio and ease the volatility of returns.

In our previous articles, we looked at how an investment philosophy shapes the strategy and style of charities' investments and discussed what charities should know about stocks and bonds.

This article, which touches on alternative assets, is the seventh in a **series** based on our forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*.

It is undoubtedly the **case** that stocks and bonds should make up the bulk of charities' investment portfolios. And it would be wise for charities to have some cash on hand to meet their short-term financing needs for expected and unexpected reasons.

Charities with growing endowments, however, can have a small selection of alternative assets in their portfolios. This could enhance investment returns through assets other than stocks and bonds.

Alternative assets can include collections of luxury goods such as sports cars, stamps, wine and art. For this article, however, we are focusing on the three largest categories of alternative assets: Private equity (PE), commodities and real estate.

Private equity

PE refers to investments in privately held companies. Professional investment managers form a private equity fund with capital raised from institutional investors and wealthy individuals. With the expertise to find, evaluate and manage prospective investments, these managers build a portfolio with their investment mandate as a guide to investing in private firms in specific industrial sectors, geographical location or at certain stages of growth.

The five main types of PE funds are: Venture capital, growth capital, leverage buyout, mezzanine financing, and special situations or distressed PE.

Unlike publicly listed shares, PE investments are not easily converted into cash. The investment time horizon is typically between seven and ten years because it takes time for companies to grow and generate returns for shareholders.

PE fund managers, unlike passive shareholders, often get involved in their portfolio companies’ strategic planning and operational management.

Compared with stocks and bonds, PE investments carry higher risks and lower liquidity. But charities could enhance their overall investment return by investing in private equity because returns from PE funds have historically exceeded those of stocks by 4 to 5 percent.

Exit strategies are a key consideration for PE investments. PE fund managers can realise investment returns by making partial or full exits from the firms in their portfolio before or after they become publicly listed.

Commodities

There are two main types of commodities: hard and soft. Hard refers to metals and energy products such as oil and gas. Soft commodities are mainly agricultural products such as crops and livestock.

The main reason for charities to invest in commodities is to diversify their investment holdings. Indeed, charities could reduce the overall volatility of investment returns of their entire portfolio with an appropriate amount of commodities and commodity-related stocks.

Commodities have the benefit of being often uncorrelated or inversely correlated with stocks and bonds. The factors that drive the prices of commodities are often different to those of stocks and bonds.

For instance, airline shares may fall because rising oil prices increase airlines' energy costs and damage their profitability. And while weather fluctuations generally do not directly affect the prices of stocks and bonds, they can affect the supply and demand of commodities and, in turn, their prices.

Another benefit of commodities is that they serve as a hedge against inflation. They can help charities to mitigate any inflation-related erosion of their investment portfolio's purchasing power.

While commodities do not deliver interest, coupons or dividends, the potential for price increases make them attractive to investors when interest rates are low.

Real estate

Investing in the real estate market offers charities the benefits of capital gains, stability of returns, inflation hedging and investment diversification. Possible investments include residential, commercial, industrial and land bank properties in the private or public markets.

Direct ownership of properties in these real estate categories provides an income stream in the form of rent payments, and potential capital gains when the properties are sold.

But as many large investors seek direct investment in real estate, it makes little sense for small and medium-sized charities to compete with them. Large charities, in comparison, may opt to directly own a building to house their staff and use it as a marketing tool to draw donors. Small and medium-sized charities can either buy shares and bonds of property development companies, or invest in real estate investment trusts (REITs) via their units or bonds.

REITs are legal entities that invest in income-generating real estate properties such as medical, commercial or industrial buildings. Most REITs are publicly listed and their units are traded in exchanges. REITs are a great way for charities to invest in real estate. It takes little effort to do so and REITs are highly liquid or easily convertible to cash.

Alternative assets are not for most charities

For the vast majority of charities, direct investment in alternative assets is counterproductive and unnecessary. Charities should, as a rule, avoid investing in illiquid alternative assets until their endowments have become significant in size.

Naturally, exceptions can be made for charities that need to have direct ownership of their own real estate to provide services such as hospices or orphanages.

Before making direct investments in individual PE funds, charities should slowly gain experience by investing in funds that only invest in PE funds, or so-called funds of funds. Charities can then better diversify as a large fund of funds may hold indirect stakes in hundreds of private companies in diverse sectors, stages of growth and geography.

Also, charities must broaden their investment expertise because PE funds' range of performance is wider than that of traditional assets. For this reason, it is vital to select the 25 percent best-performing PE funds that are overseen by investment managers with proven track records.

Only very large charities can justify direct trading in real estate and commodities. They need to have the financial strength to create an in-house team of investment professionals to appropriately monitor the trading. Small and medium-sized charities need to wait until their endowments grow.

In our next article, we will look at the role of cash and products offered by the asset management industry.

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About the series

Fund Management for Non-Profits

A series based on the forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*, by Boris N. Liedtke and Peter Lai.

