

Alternative investments

Do potential gains outweigh the risks?

“No pain, no gain,” may be true when it comes to your fitness routine, but is it really a sound investment strategy for your organization’s nest egg? According to a Harvard Business School study, the answer could be “yes.”

It’s not academic

An October 2007 research paper, “Secrets of the Academy: The Drivers of University Endowment Success,” found that between 1991 and 2005 the average college’s or university’s investments grew 268%. By contrast, the university endowments at a group of top-tier schools, including Harvard, Yale, MIT and Duke, saw their \$1 billion investments grow 488%. Much of this higher return is attributable to investments in alternative vehicles, such as hedge and private equity funds.

Even outside of academia, alternative investments are attracting the attention of nonprofits that want to maximize their return potential and diversify their portfolios. Research by the Commonfund Institute found that the organizations it studied put 23% of their investable funds into alternative investments in 2006 — up from 21% the prior year.

Considering the alternatives

An alternative investment is defined broadly as any investment that isn’t publicly traded. Typically, investors participate in hedge, private equity or venture capital funds. Other alternatives include direct investments in real estate, energy, natural resources, private companies and the development of new technologies.

A typical nonprofit alternative investor has a considerable amount to invest — at least \$1 million to allocate to this part of its portfolio. You also must have a high tolerance for losses, including understanding that your organization could lose its entire amount in one of these investments. And, accept that these investments don’t receive the same kind of regulatory scrutiny — and aren’t held to the same reporting standards — as market-traded securities. So they’re more vulnerable to fraud and illegal practices.

The fine print

If the risks seem tolerable, consider these issues before joining the ranks of alternative investors:

Liquidity. Many alternative investments are thinly traded. You may be prohibited from removing money in the first year and, after that, able to sell or otherwise access funds only at certain intervals. Also, some alternative investments require a steady investment of new cash. Make sure you’re prepared to live up to the terms of the investment’s agreement.

Transparency. Alternative investments aren't subject to the stringent reporting requirements of traditional investments, making it more difficult to track performance and current value. Your investment manager may report to you on only an aggregate basis, which can become a problem at audit time when alternative investment holdings must be confirmed on a security-by-security basis. You'll likely have to research the investment details yourself. So be sure to include the time and cost required to find this information in your investment-selection process.

Fee structures. Alternative investment fee structures often are higher than those of more traditional investments. In a typical arrangement, the investment manager receives 2% of assets, plus a whopping 20% of returns each year.

Don't invest blindly

Every type of investment requires you to do your homework; alternative investments just require you to do more. Don't even think about buying in until you have a thorough understanding of an investment's strategy and feel comfortable with its managers. Your research and analysis should cover the investment's:

- Trading policies, selection processes and risk-management practices,
- Performance record, particularly how well it has navigated the peaks and valleys of multiple business cycles, and
- Documentation, including offering letters, legal agreements and financial statements.

You also should meet face-to-face with the key players and visit their offices at least once. Ask about management turnover and how personnel changes are handled. You need to know if the departure of a key strategist will result in a period of chaos and poor returns or a change in investment philosophy. Finally, check all references provided to you, and conduct an independent background check of the principals.

Minimize pain, maximize gain

Any investment strategy you follow — whether alternative or traditional — should be designed both to maximize the upside and minimize the downside. Alternative investments probably aren't appropriate for smaller organizations, but they're worth investigating if you're willing to accept the risks and have the resources to conduct thorough due diligence.