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The Nonprofit Minute

by E. Todd Truitt

**Alternative Investments and Nonprofits:
The Danger of Oversimplifying Asset Classes.**

Now more than ever, institutional investors are being urged to allocate funds to alternative investments. The conventional wisdom is that this kind of portfolio diversification will improve future returns, since returns from these non-publicly-traded investments are not correlated with those of conventional asset classes. While it is true that in many cases, asset classes within the alternative investment universe have significantly outperformed equities and fixed income without obvious evidence of increased risk, it is also true that there is no free lunch: Investments promising outsized returns are always associated with significant risks that may or may not be appropriate. The key to deciding whether to make an allocation to an alternative investment asset class is a strong understanding of what is available and of the nonprofit organization's ability to understand the product.

Alternative Investments

Most investment professionals lump any investments that are not publicly traded stocks or bonds into the alternative investment category. Using this definition, some alternative investments have a relatively extensive history. Private equity funds, commodities, and even real estate are often deemed alternative investments. In fact, most assets with infrequently determined prices and valuations likely would fall into this category.

This lack of price transparency evidences the lack of consistent inves-



tor interest in a product, which poses significant risks for investors. For this reason, access to these asset classes has traditionally been limited to very sophisticated investors, including the largest institutions.

Over the last decade, more and more investors, including pension funds, endowments, and universities, have gained access to alternative investments. More recently, absolute return strategies, commonly referred to as "hedge funds," have become a major part of the investment markets. Eager to earn higher returns, institutions have hired managers that use extremely complicated strategies. Among these strategies, quantitative model-driven approaches, shareholder activism, and strategies that borrow money or use derivatives to enhance returns have become both popular and a source of concern. Absolute return strategies, the newest and most esoteric form of alternative investments, likely pose the greatest risk to a nonprofit and are the most difficult to understand.

Balancing Promises and Perils

Where should a nonprofit look for efficient returns? What does a nonprofit

need to know about alternative investments before approving an allocation to the category? Both are important questions. The simple answer is that alternative investments are often inappropriate. Where use of the products is appropriate, research and the education of all responsible fiduciaries is important. When considering an investment, it is critically important to understand any and all strategies, have clearly defined contractual obligations, and demand timely, detailed disclosure. To achieve higher portfolio returns without increasing risk beyond tolerable levels, stewards must fully comprehend all risks associated with specific types of investments.

Failure to understand the risks associated with alternative investments is not deemed by the American Institute of Certified Public Accountants as a valid excuse if mistakes are made. Even the SEC has been pushing for restrictions designed to ensure that all parties involved are capable of understanding strategies and their risks.

In the end, most alternative investment managers promise excess returns because they claim to have a superior understanding of particular markets. In some cases, the purported intellectual advantage is overstated, or the manager loses whatever edge he or she had exploited to produce high historical returns. If this happens, stewards could be held accountable.

Another purported advantage of alternative investments is the lack of correlation to publicly traded, more traditional investments. Due to this historical lack of correlation, it is difficult, if not impossible, to model and predict future returns based on historical performance. Consistent with Wall Street's admonition that "past performance is not a guarantee of future results," nonprofits should always remain mindful of the fact that there are currently no proven tools to forecast returns or predict consistency of returns going forward.

In addition to the lack of disclosure and understanding, the lack of uniformity of alternative investments contracts is a unique source of risk. Contracts are usually designed to limit investors' ability to exit an investment. Knowing when and under what circumstances invested funds can or will be returned is extremely important. Some funds, especially private equity funds, often reserve the right to request additional investments in the future. In these situations, nonprofits may be committing to stay in an investment even if future events negatively impact return expectations. For some nonprofits, the inability to demand the return of invested funds increases the risk of violating

a debt covenant or internal policy. These are important considerations in the decision to allocate funds to alternative investments.

The Nonprofit Factor

Many absolute return managers demand secrecy and loose disclosure. This creates serious potential problems for nonprofit investors. Most nonprofits have financial reporting requirements that require timely disclosures of investment valuations and returns. Many managers' strategies are so esoteric that timely financial disclosure is difficult. Some take months to send valuations. Oftentimes, the data that are disclosed are vague and ambiguous. Over the past two years, the inability to determine the real value of some investments has led to magnified losses as managers were forced to inform investors that estimates of the values of investments were mistakenly high. In other cases, the lack of potential buyers and sellers of certain investments held by the fund created unexpected rapid declines in value. These cases demonstrate some of the significant risks borne by investors.

Should a nonprofit invest in nontraditional assets to enhance returns? The answer lies in the organization's ability to fully comprehend the various risks. For a well-qualified board with a full understanding of selected strategies and the associated risks, exposure to alternative investments may be appropriate. However, alternative investments are not for every investor. Nonprofits should make sure they have been properly educated and are comfortable with all associated risks before venturing beyond traditional asset classes.

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