

How Nonprofit Investment Committees Can Take Advantage of Illiquid Asset Classes

by Bradford J. Stephan, CFA

As nonprofit investment committees consider new asset classes and investment strategies, the capital markets have responded with increased access to dozens of offerings that had previously been reserved for many of the larger endowments and foundations. Many of these strategies would be classified as illiquid asset classes as they often require extended lock-up periods, in turn forcing many investment committees to try to gain a better understanding of their organization's tolerance for illiquidity. This summary provides a high-level outline of the advantages of these asset classes as a means to obtain additional sources of return and diversification.

What illiquid asset classes are being considered by nonprofits?

A recent SEI survey of nonprofit investment committees showed that a large portion (60%)¹ are already invested in private real estate, one of the more popular illiquid asset class for nonprofits. In the past few years, investments in energy, timber, farmland, and even infrastructure have piqued the interest of nonprofit investment committees as a way to possibly hedge against inflation. In addition, more and more private equity and venture capital firms are trying to convince nonprofit endowments and foundations to invest in their funds, which provide investment committees with yet another illiquid option.

What types of nonprofits should be considering movement into illiquid asset classes?

Illiquid asset classes possess many attractive characteristics for nonprofit organizations that state a longer-term time horizon or have the capacity to tolerate periods of time where no returns are made from these investments. While larger nonprofits with assets exceeding \$100 million have been traditionally first to take advantage of illiquid asset classes, smaller nonprofits stand to benefit equally. The challenge for smaller organizations is the actual size of their asset pools limits access to many of these investment products which require minimums. To add to the challenge, these organizations often do not have the internal resources necessary to gain an understanding and build strong strategies. In response, many smaller nonprofits are reevaluating their investment models to find ways to provide greater access.

Why do investment committees need to develop a formal liquidity policy for their organizations?

Illiquid investments present a challenge in forecasting long-term return expectations partly because they are not valued the same way liquid assets are valued. An additional burden is the non-normal cash flow patterns generated through private, or direct, investments. In many cases, illiquid investments will experience a 'J-Curve' effect, which is when over the first several years portfolio assets are "called" to make investments in these underlying private opportunities, resulting in a series of negative cash flows. As each investment matures and produces income or appreciation, the manager will distribute gains back to the original investor. Each cash flow pattern will differ based on the type of investment, the attractiveness of opportunities, and the overall market conditions during the investment period. The final performance of the investment, or internal rate of return (IRR) for illiquid investments, can vary just as a public investment would, ranging anywhere from a distribution of less than the initial investment to a distribution many multiples of what was originally committed. The combination of this non-normal cash flow pattern as well as the extended lock-up periods associated with these types of investments warrants the need for nonprofit organizations to develop a formal liquidity policy.

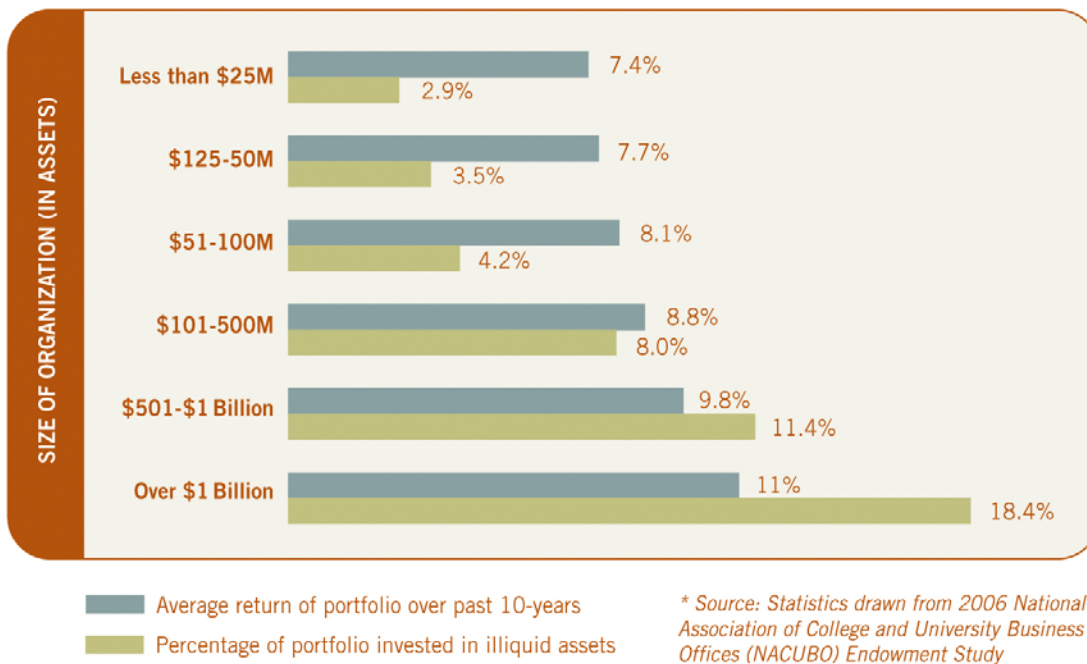
¹ SEI Quick Poll "Nonprofit Investment Committees Challenged When Implementing Inflation Protection Strategies." May 2007

How do investment committees determine what the formal liquidity policy should be?

As an aspect of the investment policy statement, nonprofit institutions should incorporate a framework for governing the accessibility of the portfolio by establishing a target allocation to illiquid investments. The development of such a target should be based upon a formal and periodic review of both investment characteristics as well as institutional financial requirements that, when combined, should establish an organizational tolerance for illiquidity. Investment committees should consider a number of crucial variables when completing this analysis. These variables include Total Portfolio Value-at-Risk (VAR), spending policy, fundraising expectations and the investment committee's ability to complete the necessary oversight and due diligence required.

What are the potential benefits of allocating assets to illiquid investments?

One piece of evidence alluding to the benefits of allocating to illiquid investments is best seen through data compiled in the 2007 NACUBO Study focused on the practices of educational institutions. The chart below indicates the average ten-year returns and average allocation to illiquid asset classes for educational institutions segregated by size. The data highlights the correlation between performance and illiquid assets. Larger institutions were the earliest to access these areas, but the maturation and proliferation of these strategies has enabled organizations with lower asset values to take advantages of these opportunities. Other common potential benefits of using these classes include increased diversification, return enhancement and inflation protection.



Conclusion

To effectively invest in illiquid assets, investment committees need a solid understanding of the movement of these classes, the lock-up periods and the organization's tolerance for illiquidity. For many nonprofits, the hurdle remains the lack of resources necessary to gain this knowledge. In some cases, it is also the lack of access to these products because smaller asset pools do not reach minimums. While these obstacles are valid, the benefits suggest that investment committees may want to find holistic investment management solutions that enable the organization to take advantage of these asset classes.

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