INVESTOR EDUCATION SERIES

UNITED CHURCH FUNDS

Alternatives: the what, the when, the why

Investors are always looking for an edge, an opportunity to improve the returns on their portfolios beyond what a traditional allocation to equities and fixed-income might anticipate. Of course, that drive to do a little better has led many into dangerous territory, investing disproportionately in higher-risk asset classes or believing claims that are just too good to be true.

But for years, large institutional investors like the nation's venerable universities and largest foundations have relied on alternative investments to give their portfolios just that edge. In addition to their holdings of stocks and bonds, balanced among the same asset classes available through United Church Funds' family of funds, these institutional investors include investments in alternatives — hedge funds, real assets and private equity — in order to strengthen their returns over the long term.

What are alternatives?

Just as the most elaborate knitted sweater relies on variations on two basic stitches, investing relies on variations on two basic types of assets: equity (stock) and debt (bonds). From those basic elements, an entire world of options opens, with varying degrees of risk and reward possibilities. Investors in the UCF's nine funds invest in various classes of these types of assets: from US government bonds to the stock of companies in emerging markets halfway around the world. But the investments that comprise the UCF funds are all publicly traded, quickly bought or sold, and easily converted into cash.

In a sense, alternative investments operate a step or two away from the underlying stock and bond markets, representing variations on the theme. Not publicly traded nor easily bought or sold, alternatives are generally made available only to wealthy or institutional investors who must meet certain legal and economic criteria before they may make an alternative investment. And the alternatives themselves? They run the gamut of innovative and unconventional strategies, but fall into three general categories — hedge funds, real assets and private equity.

KEY POINTS

- Alternative investments fall into three general categories: hedge funds (which pursue specific market strategies), real assets (like real estate) and private equity (like venture capital).
- While considered higher risk, alternatives can mitigate the volatility in a portfolio and provide opportunities for higher returns.
- Alternatives can increase overall performance while at the same time reducing overall portfolio risk.
- Some alternatives require lengthy "lock-up" periods and are generally not liquid.

Hedge Funds

Bernie Madoff may have given hedge funds a bad name, but these investment options can give investors an edge in the race for higher returns. The word "hedge" refers to mitigating or hedging against risk while investing in less conventional, but often quite profitable, strategies. Hedge funds take advantage of market opportunities that are not permitted for mutual funds like futures, short sales, leverage, arbitrage and derivatives. An inherently higher risk investment, a well-managed hedge fund nevertheless can enhance a portfolio's return and "hedge"it against market volatility.

Real Assets

As Mark Twain said, "Buy land, they're not making it anymore." For generations, investments in real estate and related real assets have been considered important parts of a portfolio. For many investors, however, ownership of investment real estate lies out of reach. Enter the Real Estate Investment Trust (REIT), one type of alternative investment that at its most basic can be considered a real estate mutual fund. Different types of REITs hold different real asset-related investments, perhaps owning office or apartment buildings, industrial properties or shopping malls. Investors benefit both from the income paid by tenants of the real estate and from the value of the property when it is eventually sold.

Private Equity

You've heard about the venture capitalists who have funded some of the last decade's most fascinating innovations, from internet start-ups to biomedical engineering concepts. Venture capitalists are private equity investors — groups that bring together a pool of funds to invest in a start-up or privately-held business in exchange for an ownership stake. Private equity investors may also assist with leveraged buy-outs, as when the employees buy the company for which they work, taking it from a publicly- to a privately-held business. These investors can make amazing profits, but they also take considerable risks. A high degree of research, also known as due diligence, is required before making a private equity investment.

Why incorporate alternative investments into a portfolio?

The irony of the popular conception of alternative investments: while they are generally considered quite risky, alternatives often mitigate the risk for a well-managed portfolio — and contribute to the prospect for improved returns. A portfolio that incorporates 20% alternatives into its overall asset allocation can improve the expected return of the portfolio by as much as 80 basis points (.80%), while also reducing risk by 40 basis points (.40%). (Summit Strategies Group, September 2009)

From where is this advantage drawn? While most investors depend on the value of their underlying stock to increase over time as a result of good management of the corporation in which they have invested, a hedge fund manager focuses on the market itself. Depending on their particular expertise, managers pursue tightly-controlled strategies that seek a profit in, say, selling a stock short when they believe a corporation's stock is headed for a fall. When managing millions of dollars, even a few pennies of change in a price can mean big profits for the savvy manager.

As institutional investors dedicated to a long-term view, churches can often benefit from consideration of alternatives for their endowment portfolios. Alternatives, however, are not for everyone. Some churches may prefer to maintain a more conservative risk profile, while others always want the option to "cash out" should an emergency arise. Investments in some alternatives are often "locked in" and are by necessity not liquid — sometimes for as long as five to ten years.

If your church wants to consider adding alternatives to your portfolio, talk to United Church Funds. We can help you think through your church's risk profile and assist you in developing the questions your investment committee should discuss. For more information, give us a call at 877-806-4989.