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Nonprofits Dial Down Alts as Volatility Rises

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With market volatility continuing to weigh heavy on the minds of investors, nonprofit organizations are increasing the diversification of their portfolios by moving money out of illiquid alternatives and seeking out new asset classes, according to a new SEI Quick Poll.

Furthermore, SEI has found that many nonprofit organizations are starting to take an increasingly short-term view of their investments in order to better manage the current market volatility. This shift in strategy has led to an increased interest in outsourcing all, or a portion of, their investments.

Among the findings from the SEI poll: Nearly three-quarters (73%) of respondents said they have added new asset classes to their investment portfolios to decrease volatility; another 40% have increased allocations to inflation-sensitive strategies, such as Treasury Inflation Protected Strategies (TIPS) and commodities; and nearly half of respondents said that they have less than 10% of their portfolios in illiquid investments, while 29% have 21% or more of their portfolio invested in illiquid assets.

“From the client perspective, we are bringing them ideas about finding better ways of managing their portfolios, and they have been much more receptive and captive to new ideas over the last several years,” says Chris LaMarca, nonprofit and healthcare investment director for SEI’s institutional group.

“What they are finding is that the big ‘50-year event’ is now happening every 18 to 24 months. So what they want to do is to no longer just keep a long-term perspective, but also manage investments in the short run so they don’t have this extreme volatility in their portfolios.”

Part of the strategy for decreasing extreme volatility in portfolios, LaMarca says, has been diversifying out of core bonds and into assets such as short-duration corporate bonds, emerging markets debt, inflation-protected strategies and high yield. As for how much money is being moved out of illiquid alternative strategies, LaMarca says that “it depends on the organization and what it is trying to accomplish.

“I think part of it is that they have seen good performance from alternatives over the past decade, but some of these alternatives can have lock-ups that preclude you from accessing your investments,” LaMarca adds. “With the volatility you

need liquidity, or it can create a strain and problems in your portfolio. So now alternatives are being prudently allocated; these nonprofits are managing volatility, not just catching excess returns."

According to the SEI poll, more than half (55%) of respondents said they invest in private equity and hedge funds of funds, making these the most-popular alternative investments. Commodities (44%) and private real estate (40%) were next in line. As for which alternatives they planned to invest in this year, 11% cited private equity and commodities.

The story about the use of alternatives "is not the decrease of its use, but the percentage that is being allocated," says Frank Wilkinson, director of public relations and research for SEI's institutional group. He notes that about two-thirds of respondents indicated that they were using or considering using alternatives.

The crash of 2008 has had a lasting impact on how investors are dealing with liquidity issues in their portfolio, says William Jarvis, managing director of the Commonfund Institute. This, he adds, has led to an increase in cash holdings for many nonprofits – with some having 5% to 7% of their portfolios in cash.

"Many institutions simply decided that they need to have a year's worth of draw and a little extra to cover capital calls because that was another thing that they got caught in when the market froze," Jarvis says.

He adds, "Whether people believed it or not, they behaved as if liquidity was free, and what the crash taught is that it wasn't. If liquidity is not free, then we need to adjust our portfolio, because at some point we may need to access liquidity and it could be hard to do."

As for alternatives, Jarvis says that he has seen "a slowness" to increase less-liquid strategies, such as private equity and venture capital, compared with other alternatives. While he says that commodities do have a role in a portfolio, he says that allocations should be diversified with other real assets.

"We have a pretty dim view of people just loading up on individual commodities," Jarvis says.

The SEI poll also found that the move toward a shorter-term outlook on investments has increased interest among nonprofits to outsource their investments. About 39% of respondents said that they have put a plan in place for short-term management of their portfolio, while 59% said they will evaluate an outsourced approach the next time they consider a change in investment management.

"The outsourcing growth in the space is one of the key drivers of a shorter-term approach to portfolio management," Wilkinson says. "It is being viewed as the

model that is better equipped to provide those shorter-term decisions, especially with smaller nonprofits that can now have the short-term management ability that they never had before.”

The SEI poll surveyed 135 U.S. nonprofit executives and investment committee members responsible for overseeing endowments and foundations ranging in size from $25 million to more than $1 billion. None were SEI clients.