FOUNDATIONSOURCE

KEY TAKEAWAYS:

Alternative Investments in Private Foundations

In the current market environment, interest continues to grow in alternative investments that may be able to provide outsize returns and downside protection to private foundations. These strategies could enable individuals, boards, and corporations to expand their mission, grow their asset base, and align a spirit of entrepreneurship within their foundation.

Alternative investments may hold additional appeal right now when compared to traditional investments, which would need to overcome significant challenges in order to continue producing the returns that they've delivered for the past 15 years. **Foundation Source** recently hosted a panel discussion with **Ben Durrant, CIO and co-founder of Provenio Capital,** an investment advisor specializing in alternative investments, and **Jeannea Varrichio, our legal services director,** to discuss the challenges and opportunities that foundations should keep in mind when considering such investments.

Here are three key takeaways from the panel discussion, "Strategic Synergy: Alternative Investments and Private Foundations."

1 Power Player

Nontraditional assets can play a key role in funding a long-term philanthropic mission when used through private foundations, and as foundations grow in size, so does their use of alternative assets. There are several benefits that alternative assets may provide to foundations:

- Higher returns
- Low correlation to public markets
- Less sensitivity to interest rates or inflation
- More predictable returns
- Capital preservation

Foundations have a wide range of latitude and flexibility when it comes to selecting assets for their portfolio. They're also uniquely positioned to take advantage of illiquid assets since they typically have a longer time horizon for their investments.

Alternative assets are any investments other than cash, publicly traded securities, and bonds, and they're an important diversifier for foundations' portfolios. While traditional, 60/40 stock/bond portfolios have delivered solid returns for decades, the current market environment makes it unlikely that the run can continue. A key benefit of alternative assets, especially in a volatile market with rising interest rates, is that they often perform independently of public markets.

Alternative assets might include tangible property, real estate, private credit, asset-backed lending, real asset leasing (such as barges or rail cars), and cryptocurrency. However, the most commonly used alternative assets among foundations are hedge funds and private equity. These types of investments allow foundations to maximize their power to make grants while also preserving their capital and growing their corpus over time.

So, for many foundations, it might make sense to consider replacing some portion of their fixed-income allocation with alternative assets. While some foundations may have concerns about the liquidity of such investments, working with an advisor can help surface strategies, such as real asset leasing strategies or private credit, that throw off enough cash to offset the liquidity premium.

2 Mindful of MDR

Since compliance is a priority for foundations, they must understand the implications around minimum distribution requirements (MDRs). Foundations must make grants and other qualifying charitable distributions worth at least 5% of the value of their assets based on the previous year. So it's important to strategically balance a portfolio with enough liquid assets that the foundation has the cash flow to meet that requirement.

The goal is to avoid being in a situation where a foundation owns an illiquid asset and is forced to sell it earlier than planned, or at a loss, in order to meet its minimum distribution requirement. That said, some alternative investments may offer more liquidity than philanthropists realize. Asset-backed alternative credit investments, for example, while illiquid, might distribute 10% on an annualized basis with a high level of predictability. Given their low correlation to market performance, such investments might prove an advantage for foundations concerned about their MDR in volatile markets.

The 5% MDR also comes with a five-year carry forward, meaning if a foundation distributes more than 5% in a given year, the excess would carry forward toward the following year's obligation. So, if a foundation wanted to take a more active investment strategy, they could potentially make greater distributions in a strong-performing year and less in years when investments are down.

3 Distinct and Different

Alternative assets are unique and may come with some equally unique challenges—as well as opportunities. Here are some things to keep in mind as you are developing your philanthropic and investment strategies:

- **No self-dealing:** Foundations may not engage in any transaction with "insiders," including officers, directors, and close family members, or with companies that are more than 35% owned by insiders unless those transactions fall into one of the very limited exceptions to the self-dealing rules.
- **Active businesses:** Foundations typically need to limit their investment in active businesses. That's because they and the foundation's insiders may not collectively own more than 20% of an active business without running afoul of the excess business holdings rules.
- **Unrelated business income:** Income generated by any active business holdings would be considered unrelated business income and is subject to for-profit corporate tax rates.
- **Cryptocurrency:** As philanthropists increasingly use digital assets to fund all or part of their foundation, they must understand the complexities of valuing such a volatile asset. One approach is to treat it as you would publicly traded securities, for the purposes of valuation, using a monthly average to determine an average for the year. Foundations should work with a tax advisor to determine their best approach.

- **Program-related investments:** Investments that align with the foundation's mission and meet certain other technical requirements may qualify as a charitable use asset and count toward meeting the organization's MDR, which is one way to use funds sustainably, allowing some or all of the investment to return to the foundation for use in future grants.
- **Real estate:** Depending on how the property is put to use, real estate can be part of a foundation's investment strategy or a charitable use property. If it's the former, the investment would be included in the asset average for purposes of calculating the 5% payout. If the latter, however, the purchase and any associated expenses would be considered qualifying distributions and go toward meeting the payout requirement.

To learn more about these three takeaways and other important insights, check out the full discussion.

If any of your client conversations involve philanthropic planning and you would like further information, we're here to support you. **Schedule a call or contact us at 800-839-0054.**

ABOUT FOUNDATION SOURCE

Foundation Source empowers people and companies to create a better world through philanthropy. We make giving easier for more than 2,000 foundations with innovative technology backed by philanthropic expertise.

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