FOUNDATIONSOURCE

WEBINAR:

Alternative Assets in Private Foundations

Given the long investing time horizon that many private foundations enjoy, leveraging alternative asset strategies may offer distinct advantages. The benefits can include the ability to deliver higher returns than assets that require a liquidity premium and a higher degree of predictability in uncertain markets.

Josh Stamer, Senior Managing Director at Foundation Source recently hosted a panel discussion with **Ben Durrant, CIO and co-founder of Provenio Capital** based in Newport Beach, California, and **Jeannea Varrichio, Foundation Source's Legal Services Director,** to discuss the legal and tax implications that foundations must consider as they explore and allocate to alternatives.

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Josh Stamer: Our data shows that as foundations grow in size, they're more likely to utilize alternative investments. Why is this strategy potentially more powerful now, and how does it maximize protection and growth of capital?

Ben Durrant: If you think about your traditionally allocated 60/40 portfolio in equities and bonds, it's performed extremely well over the last decade or two. But if you look at the type of environment we're going into now, it's going to become necessary for foundations to utilize a higher degree of alternative investments to achieve goals like preserving capital and growing the corpus of the foundation over time.

So, how do we build a robust portfolio that's going to perform relatively well regardless of what kind of economic regime we go into? Typically, in this type of environment, foundations are looking to the utilization of alternative strategies where there's a higher level of predictability and less correlation to the market, less reliance on market performance, and less reliance on the continued performance of fixed income assets to create reasonable risk-adjusted returns.

For a foundation, if we can generate an 8% to 12% return over time with as little correlation to the market as possible, then we believe we've done a pretty good job. Increasing utilization of alternatives within a foundation portfolio serves to protect the capital. It insulates it from dislocations in the market and, via utilization within strategies like real estate, private credit, and real assets, you can actually generate a yield on the portfolio that can achieve north of the 5% spending policy that most foundations face.

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Stamer: What are some strategies you use when you think about short-term versus longer-term planning?

Durrant: In terms of asset allocation, it's important to understand how much the client plans to give away. If it's a lot up front, they can't tie up large portions of money in private equity or longer-term assets. Getting the right mix is important.

Stamer: Alternative investments bring a host of compliance issues not found in other investments. What should foundations be aware of?

Jeannea Varrichio: Foundations can invest in any type of asset but there are certain prohibited transactions. In particular, a private foundation is not allowed to engage in the transfer of assets, the sale, the borrowing of money, or anything of financial nature between itself and its insiders. The easy insiders to identify are officers, directors, substantial contributors to the foundation, and close family members of these individuals.

Where it gets tricky is that self-dealing also encompasses transactions with companies that are more than 35% owned by individuals who are considered insiders. So, when a foundation and an insider are co-invested in an alternative asset, it's very important to be aware of the ownership levels of the insiders before the foundation adds its money to the pool.

Foundations also need to consider liquidity in their investments as it relates to their annual minimum distribution requirement [MDR] that they're supposed to meet in making grants or other charitable distributions throughout the course of the year. That 5% amount is determined based on your investment asset average from the prior year. You need to make sure that you have a steady cash flow in order to meet those distribution requirements because a private foundation that holds an illiquid asset still has to meet the distribution requirement attributed to that ownership.

Durrant: It's important to note that there are investment strategies that can provide liquidity to meet that minimum distribution requirement. For example, if you have a strategy within the asset-backed credit profile, that's a capital call structure, where the capital gets called down over 18 to 24 months and gets invested into a portfolio of senior-secured, asset-based privately negotiated loans. It's an illiquid strategy, but it distributes anywhere from 9% to 15% annualized on a quarterly basis. And, it does so with what I believe to be a high level of predictability and very little, if any, correlation or reliance on the market or spread compression to perform.

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Stamer: What areas of alternatives do you think fit best within a private foundation's asset allocation — with today's marketplace in mind?

Durrant: One area is private credit. An example would be a manager that's going to make, over a course of two years, 15 to 20 privately negotiated loans. These would be senior-secured, top-of-the-credit structure loans, collateralized by some form of hard asset collateral, such as real estate or other form of hard asset that can be valued.

With asset-heavy businesses, the loan-to-value on the senior-secured loan facility can be around 50%. So you're the first money out, and you're getting paid a double-digit yield for that credit, and you are protected at a 50% loan-to-value by the assets underwriting those loans. For us, that strategy has generally produced somewhere between a 10% and 12% return, which is distributed on a quarterly basis.

Another area we think is really interesting is real asset leasing strategies. So, we have a manager that owns 40,000 rail cars, which are one of the cheapest ways to move non-discretionary goods around the country. That portfolio generates around a 7% yield and a 10% to 12% total return. We have a manager that owns 1,600 massive, floating bathtubs that move non-discretionary goods, like corn, soybeans, and petrochemicals, up and down the Mississippi River. The yield on that portfolio is about 11.6% net to investors, with very little, if any, correlation to the market.

Stamer: How do donors' strategies for their personal portfolios differ from strategies in their foundation?

Durrant: I'm actually surprised how ignored some foundation portfolios are. A lot of folks that we work with are very engaged in the giving, but not as engaged in the asset allocation. They almost ignore the asset allocation within the foundation versus their taxable accounts. But they should also have a higher risk appetite within a foundation because there's a longer-term view there.

A lot of people feel comfortable being in liquid assets, but there can be a false sense of security there. We are trying to get people to be more proactive and look at the investment landscape and see that owning fixed-income assets today just doesn't make sense.

In my opinion, there are other asset classes that make a lot more sense and have a much higher level of predictability and generate significantly higher multiples and higher returns than you can get in fixed income assets today without having to experience the kind of downturn you would see from a normalization of rates. In terms of risk appetite, it should be higher in foundations, but I think that ends up getting skewed by the need for liquidity or the comfort that liquidity provides investors.

Varrichio: A lot of private foundations also look to impact investing, mission-related investments, and program-related investments. One benefit of impact investments is that they align more closely with the foundation's charitable goals and, in many cases, can allow the foundation to explore somewhat riskier investment options.

Program-related investments are like renewable money that counts toward your payout requirement. So, for example, if you make a loan to a public charity for a nominal interest rate, that's not going to bring massive returns, but it gets treated like a grant because it does generate some small, modest income stream.

Especially for smaller foundations that are looking for ways to be sustainable and have longevity without putting their foundation's corpus at significant risk, that can be a toe into the waters of alternative investments that really pays big dividends to the foundation because it provides them with an opportunity to continue to benefit the organizations that they want without just sending money out with nothing coming back.

"I THINK ALTERNATIVES HAVE TO BE A CONSIDERATION IN THIS ENVIRONMENT. YOU CAN MAKE THE ARGUMENT THAT EQUITIES LOOK FAVORABLE VERSUS FIXED INCOME, BUT EVEN IN EQUITIES, IT'S LIKELY THAT THEY'RE GOING TO STRUGGLE TO PRODUCE ANYTHING LIKE THE RETURNS THEY'VE PRODUCED OVER THE LAST 15 YEARS."

Stamer: Cryptocurrency is growing in importance. What should foundations know?

Varrichio: While the IRS is slow to keep up with innovative development, we do know that they consider cryptocurrency to be property. So, it's the same as donating a piece of real estate or a piece of art or anything else to your foundation. That means donors are entitled to the lesser cost basis or fair market value for their charitable deduction. And, if it's worth more than $5,000 at the time of the donation, you're required, as a donor, to file Form 8283 to substantiate your charitable deduction.

Foundation Source's Chief Legal Officer has worked closely with our outside counsel to look at the regulations that apply to cryptocurrency and determine the best way to value crypto in the spirit of the regulations without exposing the foundation to unnecessary risk. So, for purposes of MDR calculation, we value cryptocurrency in the same way that we handle publicly traded securities. We look at the end-of-month average and then the average of those over the prior year, either for the full 12 months or prorated based on when the asset moved into the foundation. We have found this to be a more equitable approach.

Of course, that's only for the purposes of the MDR calculation. If a foundation has cryptocurrency or other NFTs and sells it, we would look at the value on the date of the sale and calculate the gain or loss based on that value. Also, if a foundation donates cryptocurrency to a public charity, the private foundation is entitled to a fair market value qualifying distribution as of the date of the contribution. That's another tool that foundations can use to help navigate volatility in that space.

Durrant: From an investment perspective, cryptocurrency is often misused. To me, you have to think from a diversification perspective – how much Bitcoin and Ethereum does it make sense to hold within a portfolio from an asset allocation framework? Our opinion, given the current state of the volatility within those asset classes, is that a reasonable allocation is somewhere between 1% and 3%.

I started out skeptical on cryptocurrency, but when you look at the Bitcoin market today versus what it was five years ago, it's huge, and the institutional adoption of digital assets is still in its infancy. We are getting to the point now where it's almost becoming irresponsible not to have some exposure to these asset classes. The key is how much exposure should you have in your portfolio and in what vehicles?

Stamer: Real estate is another important alternative asset. What should foundations consider?

Varrichio: Real estate is an investment-use asset that would be included in your asset average for purposes of calculating your 5% payout requirement. Any income stream would be investment income, and any expenses associated with maintaining or improving the property would be considered investment-related income and go towards calculating your net tax liability. But if you can use the real estate for charitable purposes, such as using it for some charitable program meeting spaces, then the purchase would be considered a qualifying distribution and go toward meeting your payout requirement and the value of the property would be excluded from your asset base for purposes of calculating your annual distribution requirement.

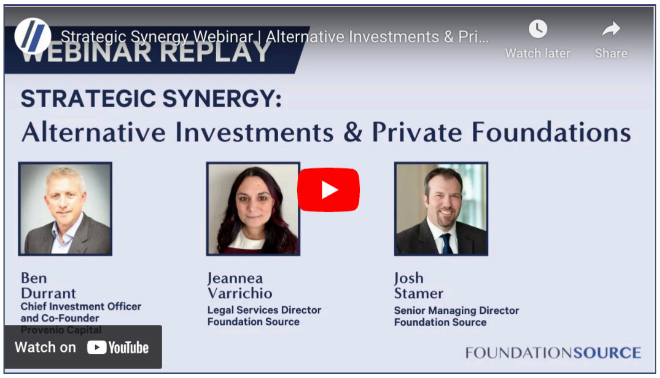
STAMER: What's your best advice for foundations just getting started in alternatives?

Durrant: I think alternatives have to be a consideration in this environment. You can make the argument that equities look favorable versus fixed income, but even in equities, it's likely that they're going to struggle to produce anything like the returns they've produced over the last 15 years. Alternatives are something that foundations should be discussing with their advisors.

It's not a simple problem to solve, but generally, alternatives can be significantly less risky than what you face in equity and fixed income markets today. Whether it's in private credit, real asset leasing, or real estate, you can build a portfolio that has a much more secure profile than a traditionally allocated portfolio.

Interested in viewing the full conversation between Josh, Ben and Jeannea?

You can watch a replay of the webinar here.



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