Alternative investment strategies continue to offer the potential for unique sources of enduring diversification. To more fully understand this potential, it may be helpful to examine the growth of alternatives during the past decade using information gleaned from the National Association of College and University Business Officers (NACUBO)–Commonfund Study of Endowments.

Figure 1 shows the growth in the use of alternative investments by endowments between 2002 and 2015. By June 2015, endowments had allocated 52 percent of assets under management to alternative strategies. Figure 2 shows the alternatives allocation breakdown in 2015: 2.7 percent to hedge fund strategies, 9.3 percent to private equity, –13.3 percent to energy and natural resources, 9.9 percent to private equity real estate, 15.1 percent to venture capital, and 5.4 percent to distressed debt.

According to the report (page 20):

> Alternative investment strategies are included in a portfolio to enhance returns, reduce risk, or both. They are fundamental to the structure of the so-called ‘endowment model’ of investing, which concludes that long term asset pools ... can outperform investors with shorter term time horizons by providing capital to less efficient, more complicated, and illiquid sectors of the capital markets.

Real assets increasingly have played a critical role in the success of some of the largest endowments and foundations worldwide. With many financial advisors seeking to emulate the endowment model with their individual clients, strategies have flourished in the past few years. Liquid-alternative funds manage a cumulative $446 billion, according to fund tracker Lipper, up from $83 billion at the start of 2009.

Some of the top-performing endowments are allocating 20–25 percent to real assets (see figure 3), and investors are asking whether they should be allocating to liquid or illiquid real assets.

Harvard Endowment: Case Study in Illiquid Investing

In 2008 not even Harvard’s endowment was immune to the financial crisis. Harvard’s portfolio declined 22 percent in value between July 1 and October 31, 2008, in stark contrast to its historical 15-percent average annual return since 1980. Harvard President Drew Faust and Executive Vice President Edward Forst were shocked to see more than $8 billion in asset value disappear within 90 days.

The financial statement for Harvard Management Corporation, the funds manager of the endowment, showed 55 percent of the portfolio in hedge funds, private equity, and private real assets. Only 30 percent was in liquid developed-world equities and fixed income; the remainder was in emerging-market equities and high-yield bonds that all afforded liquidity.

Harvard faced five choices in 2008:

1. Liquidate a portion of the endowment. But a lot of the endowment is illiquid and cannot be sold without a secondary transaction, and the going offers were for 50 cents on the dollar for the limited partnerships interests of private funds interests.
2. Cut expenses. But universities are like government bureaucracies—big, bloated, and inefficient. You can hardly fire anyone, so there is a limit to how much can be cut.
3. Increase donations. But it’s embarrassing to ask for funds to replace those lost as a result of mismanagement.
4. Increase other revenue. Harvard could rescind its need-blind financial-aid policy, but it turns out this doesn’t save much money.
5. Borrow.
Harvard took option 5, issued $2.5 billion in bonds, and more than doubled its leverage ratio between 2008 and 2009.

Today’s investors are faced with volatility, uncertainty, complexity, ambiguity, and similar concerns about liquidity. Low bond yields and potential equity volatility have investors looking for new ways to complement traditional asset allocations. Real assets can help, but the challenges as to how to incorporate them—and how much to incorporate—should be tailored to each investor’s needs.

Investors in Australia and Europe have been incorporating private and listed real assets in portfolios to diversify across the liquidity spectrum and prepare to face the next great financial crisis. Blending both listed and unlisted real assets affords a multitude of benefits (see table 1).

Listed real assets, which span the continuum of global listed infrastructure securities, commodities, global real estate securities, and natural resource equities, are capable of generating returns similar to equities yet include inflation protection and potential diversification benefits.

Real assets can fulfill different investment objectives, but not all real assets are created equal. Advisors must prioritize objectives and construct the portfolio with this hierarchy in mind. Some objectives cannot be achieved simultaneously. For example, if one wanted to achieve short-term inflation protection while maximizing long-term return potential, one of these objectives would need to be compromised to achieve the other.

In evaluating primary objectives (inflation hedging, portfolio diversification or risk reduction, and return), financial advisors must make tradeoffs because distinct real assets are desired for different objectives. For example, commodities and Treasury inflation-protected securities (TIPS) may be utilized to incorporate short-term inflation hedging. But these instruments are inappropriate if the objective is long-term inflation protection or maximizing long-term return potential.

There are roughly 1,500 real asset securities within the listed real asset spectrum, including private equity-type funds with closed-end structures and open-end structures, as well as direct real asset investments. These options all require a specific skill set to source, analyze, and transact in the private markets space. Specialist real asset private fund managers are a growing field in private markets.

Note, however, that one size does not fit all. If we examine the real asset allocation of most individual investors, we see small allocations, in the neighborhood of 5–10 percent. Given the low-yield environment of the next 5–10 years, together with investors’ focus on minimizing equity risk in their portfolios, advisors are recommending an increase in real asset allocations toward the 15–25 percent level, and we have seen the trend toward emulating the endowment model where allocations are between 20–25 percent (see figure 3).
As we have seen recently, publicly traded real asset markets can be volatile, but volatility can be viewed as an opportunity if managed appropriately. Calculated investment decisions combined with proper portfolio risk management may provide an opportunity to capture some of the recent value opportunities created in master limited partnerships, commodities, and real estate investment trusts.

Michael Underhill is founder and chief investment officer of Capital Innovations, LLC. He is author of *The Handbook of Infrastructure Investing* and contributes exam material for the CFA examinations. Contact him at munderhill@capinnovations.com.

**Endnote**