Wespath
Investment Management

The Case for Alternative Investments in a Diversified Portfolio

by Brian Boyer, CFA

This Wespath Investment Management white paper examines two types of alternative investments—real assets and private equity—along with best practices for administering these alternative investments in public equity portfolios. We also describe how Wespath's alternative investment strategies add value to our public equity portfolios, and how the Wespath investment team has established a solid track record in both real estate and private equity investments.

A search of Investopedia (a popular Internet-based investment dictionary) for a definition of "alternative investment" surfaces this: "*An investment that is not one of the three traditional asset types (stocks, bonds and cash). Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of their complex nature, limited regulations and relative lack of liquidity*."

Interestingly, the first part of this description defines an alternative investment by what it is not. The second part suggests alternatives are not likely to be owned by the average investor due to their complexity and lack of liquidity. In fact, alternative investments encompass a broad range of investment strategies but principally include: real assets (i.e., private real estate, timberland, farmland, energy and infrastructure funds), private equity and hedge funds. Today, Wespath Investment Management invests in two of the three alternative asset categories—real assets (primarily private real estate) and private equity—to enhance returns and increase diversification of the U.S. Equity Fund (USEF) and International Equity Fund (IEF). (Wespath Chief Investment Officer Dave Zellner will explain our rationale for not investing in hedge funds, the third alternative asset class, in a future white paper.)

Brian Boyer

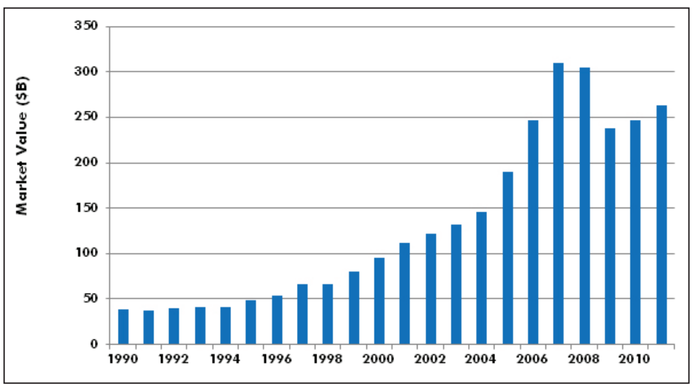
Brian Boyer joined the General Board in September 2003 as the director of equities in Investment Management. He is responsible for managing public equities and alternative investments, including asset classes of private equity and private real estate. Previously, he spent 15 years with First Analysis Corporation, a Chicago-based investment firm, where he was responsible for developing public equity research coverage and making venture capital investments in various technology sectors, including telecommunications products and services. He holds B.A. and B.E. degrees from Dartmouth College and an MBA from The Wharton School at the University of Pennsylvania. He also is a CFA Charterholder.

Real Assets

Commercial real estate as a separate asset class for institutional investors has grown dramatically since the property recession of the early 1990s. The following chart depicts commercial real estate growth as represented by the increase in the National Council of Real Estate Investment Fiduciaries (NCREIF) property index—

a proxy for the market value of private real estate held by tax-exempt organizations, including pension funds, endowments and foundations. Most large institutional investors have a separate allocation for real estate, which may include publicly-traded real estate securities (REITs) and/or private real estate. Private real estate consists of ownership in the debt or equity securities of privately held commercial real estate properties, such as office buildings, hotels, warehouses, retail malls and apartment complexes. While Wespath does invest in public REITs, this paper focuses on Wespath's investment in private real estate through commingled illiquid fund vehicles, such as closed- or open-end limited partnerships.

NCREIF Property Index



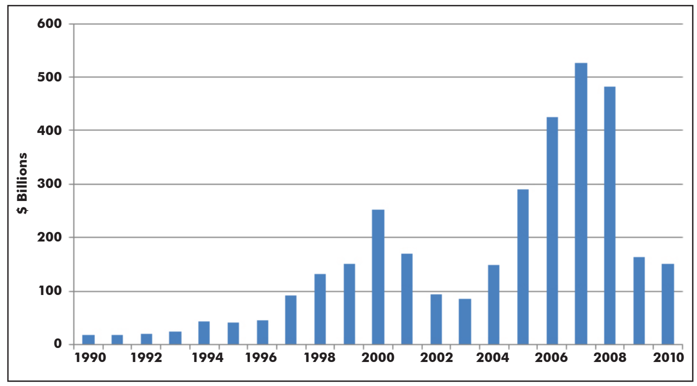
Source: National Council of Real Estate Investment Fiduciaries (NCREIF)

Wespath began an active program in equity alternatives in the early 2000s that has carried through to the current year. During the previous decade, Wespath made commitments of nearly $800 million across 25 different real estate funds. The general partners of those funds have deployed the capital in a variety of property types, including office buildings, industrial warehouses, retail stores, apartment buildings, single-family homes and hotels.

Private Equity

While real estate is an investment with which the majority of Americans have some familiarity through home ownership, private equity is an asset class solidly situated in the province of the institutional investor. Private equity investing as an asset class has existed since the mid-20th century and has been characterized by a series of boom-and-bust cycles. Private equity as an asset class has grown dramatically over the past 20 years, reaching a peak in 2007 with nearly $520 billion raised globally. Private equity consists of two primary investment strategies: the funding of companies prior to a public offering (venture capital), and the acquisition of well-established companies through the use of a combination of equity and debt capital (leveraged buyouts).

Private Equity Capital Raised Globally



Source: Adams Street Partners

Wespath began committing to private equity in 2003 and has deployed roughly $350 million through this year. In contrast with private real estate, in which Wespath invests directly in the underlying funds, Wespath has chosen to invest in private equity through so-called "fund-of-funds" structures. Under this arrangement, Wespath makes a commitment to a private equity fund-of-funds (or manager-of-managers), which in turn makes commitments to underlying private equity funds, creating a blended portfolio of both leveraged buyout and venture capital funds. Effectively identifying qualified general partners and conducting the requisite due diligence, along with the extensive effort required to negotiate partnership terms, requires extensive and expensive resources. The advantage of a fund-of-funds vehicle is that it allows an institutional investor to leverage the expertise and negotiating capabilities of a dedicated manager and provides exposure to a broad array of underlying general partners that have been vetted extensively by the fund-of-funds manager. Given a long investing history in the asset class, a fund-of-funds manager can develop relationships that provide access to the most sought-after, top-performing funds.

Alternatives Provide Diversification

In private equity and private real estate, Wespath invests in commingled vehicles, which means Wespath "pools" its capital alongside other institutional investors. This structure creates a much larger investment, giving the fund-of-funds manager the ability to drive better investment terms and create a more diversified portfolio of underlying assets.

Given that the life of an alternative investment fund typically extends beyond 10 years, Wespath's history with these asset classes can be considered relatively short. Despite this brief tenure, it is useful to review the value added by Wespath's alternative investments along two dimensions: diversification and performance. A 2010 internal study of five-year returns for the Wespath U.S. Equity Fund revealed that its investments in private real estate and private equity lowered portfolio volatility and provided diversification by reducing the overall risk of the fund relative to the fund's benchmark, the Russell 3000 Index.

> **"In private equity and private real estate, Wespath invests in commingled vehicles, which means Wespath "pools" its capital alongside other institutional investors. This structure creates a much larger investment, giving the fund-of-funds manager the ability to drive better investment terms and create a more diversified portfolio of underlying assets."**

Looking at private real estate separately, other studies confirm private real estate's correlation with public equity indices is less than 30%. Part of the explanation for this low correlation with public equity markets is that private real estate utilizes appraisal-based valuations, which are much less sensitive to short-term market volatility than daily public equity market valuations.[1]

Real Estate Diversification

Wespath provides diversification within its real estate portfolios in several ways. First, Wespath achieves diversification across fund managers, employing 11 general partners. Second, Wespath often invests in multiple funds from the same general partner, but the individual properties purchased by the general partner are spread out over different vintage years. This vintage year mix ensures the real estate portfolio is diversified across market cycles. Third, with a few exceptions, the real estate general partners invest across geographic regions and property types (i.e., office, industrial, retail and multi-family).

Private Equity Diversification

Wespath's private equity portfolio provides diversification in two ways. First, private equity incorporates two diverse strategies:

- *leveraged buyouts,* which are typically characterized by later-stage, more mature companies; and
- *venture capital,* which are typically early-stage, perhaps even start-up firms in rapidly growing industries, such as computer software, social media and biotechnology.

Second, Wespath's fund-of-funds approach to private equity provides diversification across underlying fund general partners and industries. For example, Wespath's private equity portfolio includes investments in more than 1,000 companies.

Alternatives Contribution to Fund Performance

Having considered diversification and the important role alternative investments play in Wespath's equity portfolio, it is also useful to evaluate Wespath's return experience with alternatives. Although there is still significant life left on many of the alternative funds in which Wespath has invested, internal rates of return (IRRs) can be calculated on the aggregate private real estate and private equity portfolios. Using a five-year horizon from January 1, 2006 to December 31, 2010, Wespath's private equity portfolio has had an annual return of 8.6% (compared with a 2.8% return for the Russell 3000 equity index used to benchmark USEF.) The private equity funds in which Wespath invested are at least five years from liquidation, so returns can vary from these interim results.

Source:

[1] *"Is Real Estate Still a Good Diversifier?",* National Real Estate Investor*, August 1, 2011, found at www.nreionline.com/finance/news/real_estate_diversifier_0801*

Alternative Investment Returns in Wespath Funds

	5 Year Return (1/1/2006-12/31/2010)	10 Year Return (1/1/2001-12/31/2010)
Wespath Private Equity	8.6%	–
USEF Benchmark – R3000	*-2.7%*	–
Wespath Domestic Private Real Estate	-1.3%	8.2%
USEF Benchmark – R3000	*2.7%*	*4.3%*
Wespath Non-US Private Real Estate	52.1%	–
IEF Benchmark – MSCI ACWI ex-US	*5.3%*	–

Ten-year returns are available, given the longer investment history with private real estate. Wespath's domestic private real estate portfolio has outperformed the Russell 3000 over a 10-year time frame ending on December 31, 2010 (8.2% vs. 4.1%), but has underperformed the Russell 3000 over a five-year time frame (-1.3% vs. 2.8%.) Near-term real estate valuations were particularly impaired during the "Great Recession," which began in 2008. However, the returns of private real estate as an asset class generally lag public equities, due to property rental rates trailing the economic recovery. Also, many of the funds in which Wespath has invested are still several years away from liquidation, and returns can change dramatically over the remainder of the fund term.

With respect to international private real estate, investment returns have been well above benchmark, although on a relatively small allocation (1%) in the International Equity Fund. Because of the nature of these investments (i.e., real estate companies operating in emerging markets), Wespath's international private real estate portfolio actually produced a 52.1% annual rate of return (compared to the fund's benchmark return of 5.3%.) Thus, across all of its funds, Wespath has had a mostly positive investment return experience with alternatives over a ten-year time frame.

Best Practices in Alternatives Investing

With more than 10 years experience in alternative investments, Wespath strives to implement "best industry" practices in managing and administering its program. Wespath employees attend industry conferences, meet frequently with existing and prospective general partners, and network with peer organizations to gather information that may be incorporated into current operating policies and procedures. The following list represents activities Wespath management considers part of a "best practices" alternative investment program along three key dimensions: selection, monitoring and termination of alternative fund managers.

Fund Manager Selection

- Conduct extensive due diligence: Wespath believes thorough upfront due diligence is key to making good general partner hiring decisions. With its 10-year track record of alternative investments in more than 25 funds, Wespath has developed a comprehensive questionnaire that covers topics such as evolution of the fund strategy and the investment team, likely success of fund strategy in light of economic conditions, composition of the fund general partner's investor base, and whether fund terms are consistent with market conditions. The Wespath team has developed a deep network of peer contacts at other large institutions that can provide useful history and objective references on the key fund principals.

"Adhere to socially responsible investment practices, where possible ... (i.e., exclude investments in dedicated gambling operations)."

- Focus on alignment of interest: Since Wespath's capital is committed for an extended period and is illiquid, it is important to ensure the fund managers' interests are aligned with the fund investors' interests. This often involves an assessment of more subjective issues such as the general partner's dedication of time and resources to the proposed fund, fund team participation in the ownership structure of the general partner's parent company, and the fee arrangement (for example, whether it is weighted toward asset-based management fees or ultimate fund profits).

- Adhere to socially responsible investment practices, where possible: While the ability to screen alternative investments is difficult as it applies to private equity, Wespath requires its private real estate general partners to follow the same screening criteria as the firm's public REIT managers, (i.e., exclude investments in dedicated gambling operations).

Fund Manager Monitoring

- Participate in advisory board membership: A well-managed alternative investment fund seeks to engage its investors in an ongoing dialogue. One mechanism by which this is accomplished is by establishing an investor advisory board, typically a subset of the larger institutional investors in the general partner's fund. Wespath is an advisory board member on approximately two-thirds of the funds in which it has invested. Advisory boards frequently opine on critical issues, such as prospective conflicts of interest, changes in the fund's strategic direction and other administrative details (e.g., whether or not to extend the life of the fund).

- Attend all annual meetings and fund update conference calls: Wespath is a firm believer in the importance of attending annual meetings and other fund-sponsored events, such as conference calls and webinars. Through these events, Wespath is able to obtain the most current macroeconomic and industry information affecting the progress and performance of its investments.

- Review all quarterly financial reports and maintain an active dialogue with general partners regarding fund activity: In addition to face-to-face interactions with alternative investment general partners, Wespath scrutinizes the monthly, quarterly and annual financial reports distributed by fund management. Frequently, Wespath identifies questions from the financials that provide an additional opportunity for dialogue and information-gathering with the alternative general partner.

- Maintain a proactive valuation process: In recent years, the accounting profession has enacted standards that encourage all participants in the alternatives industry to adjust investment valuations at least quarterly, and more frequently in the event of significant market volatility. Financial reports from alternative general partners arrive 45 to 60 days after the quarter's end and, in some cases, 90 days after the year's end. Therefore, there is a substantial lag between the end of a financial reporting period and the receipt of financial statements, and a corresponding delay in the speed with which valuation adjustments are recognized. For private real estate general partners, this lag is usually greatest at year-end, when properties undergo an appraisal process. To ensure timely reporting of alternative valuations in the year-end pricing of Wespath's equity funds (USEF and IEF), Wespath surveys all alternative general partner and managers during December to capture estimated valuation data ahead of the quarter's end. Wespath effectively "short-circuits" the valuation adjustment lag by proactively approaching its alternative managers for early feedback on results. Wespath has received acknowledgement from its auditor that its valuation process is a "best practice" among its institutional audit clients.

- Diligently monitor alternative allocation targets: Wespath's investment policy sets allocation targets of 5% respectively for private real estate and private equity in Wespath's USEF. However, market volatility can cause the actual alternative investment allocations to deviate from the target. Some flexibility (+/-3%) around the target is permitted, but Wespath management is diligent in using a variety of available mechanisms to keep the alternative allocations within the specified range and as close to the target as possible. This assures Wespath fund investors that their risk exposure to alternatives is prudent and consistent with published policies.

Fund Manager Termination

- Forego recommitting to fund managers if concerns arise: Most alternative investment funds are structured as "closed-end" vehicles that terminate at the end of a specified time frame. Alternative fund contracts allow the fund general partner to initiate a new fund after the current fund has been fully invested, but before it is liquidated. It is not uncommon for an alternative investment general partner to be operating several funds at different stages in their lifecycles. Since investor capital in a "closed-end" fund is only distributable at the fund manager's discretion, alternatives are considered illiquid investments. Therefore, the fund re-commitment window is the only opportunity for alternative investors to perform a comprehensive review of a given general partner's effectiveness. Wespath must often make a new fund investment decision before the performance of the prior fund is fully evident. It also represents one of the few situations when the fund general partner's interest may not be aligned with the investors' interests. For example, the fund general partner is motivated to quickly raise the next fund to maintain a flow of new deals, keep staff (and investors) from defecting to another fund general partner and ensuring a steady stream of investment fees to pay the operating expenses of the business. The alternative investor is motivated to make the best possible investment decision, which may mean not re-committing to the fund general partner. Wespath is aware of the importance of the re-commitment decision and has, in certain cases, chosen not to re-commit where concerns arose (such as adverse changes in fund general partner ownership, team, strategy and target market attractiveness).

Conclusion

Wespath believes that alternative investments are a beneficial addition to a broadly diversified investment portfolio. As an institutional investor with a 10-year history of alternative investing and over 100 years of investment management experience, Wespath is well-qualified to provide clients with appropriate exposure to the asset class.

If you would like to discuss how your institution can benefit from Wespath's investment philosophy and focus on ESG, please contact Derek Casteel or Brian Coker at 1-847-866-4100 or via e-mail at **investmentinfo@wespath.com**.

Wespath provides UMC-affiliated institutional investors with access to well-managed investment programs that historically have delivered competitive performance while honoring United Methodist Social Principles. Wespath is a division of the General Board of Pension and Health Benefits of The United Methodist Church, a century-old institution with a well-regarded reputation for delivering returns aligned with values.

Wespath is an established investment manager with approximately $18 billion in assets under management.

Our name honors John Wesley, the founder of Methodism and a leader in establishing social principles that outline the tenets of socially responsible business practices. Wespath reflects this heritage, along with the idea of putting clients on the right path to financial growth with a commitment to values-driven investing.

Wespath

Wespath Investment Management
1901 Chestnut Avenue
Glenview, IL 60025-1604
1-847-866-4100

wespath.com

4323/010213