



Alternative Investments Checklist

Introduction

This checklist is a supplement to GFOA’s Best Practice [“Asset Allocation for Defined Benefit Plans”](#) and is designed for state and local government retirement plans to use before entering into each alternative investment transaction.¹ The checklist is not exhaustive – the assets, strategies, and structures associated with alternative investments are both highly individual and constantly evolving. This document also assumes a high degree of familiarity with alternative investments. Retirement plans that cannot answer the questions in this checklist are advised to seek expert guidance before entering into alternative investment transactions.

Background

Retirement plans need to seek external guidance or engage alternative investment advisors, and to conduct governance and stakeholder education, before making a strategic decision to commit capital to alternative investments – that is assets or investment strategies not that aren’t considered “traditional.” Traditional assets are typically publicly traded and available for investment by most investors, such as publicly traded stocks and bonds. Traditional investment strategies involve taking long-only positions in traditional assets, and may be either active or passive. In contrast, alternative assets are typically private and non-traded, such as private companies or farmland. Alternative investment strategies invest in alternative assets or traditional assets and use of short positions, leverage, and derivatives. Traditional investments are typically accessed via commingled funds or separate accounts and feature investor-friendly redemption policies, while alternative investments commonly feature more complex structures with liquidity-limiting provisions.

	Traditional	Alternative
Assets	Publicly traded equities and fixed income	Private and non-traded
Strategy Type	Active or passive	Active only
Strategies	Long only Little or no leverage Minimal derivative use	Long and short Potentially high leverage Potential large derivatives use
Structures	Commingled funds, separate accounts	Limited partnerships are common
Liquidity	High	Typically limited

Alternative investments typically provide diversification benefits, as they generally have low correlations with traditional asset classes. In some cases this is by design (a market-neutral hedge fund takes short positions to limit certain market risks), while in other cases this is a natural feature of the alternative asset itself (earthquake catastrophe bonds are simply not correlated to public markets). For some alternative investments, reported correlations and volatility appear lower than they truly are because of non-market valuations and lagged reporting. Investors need to recognize this and use true economic metrics, rather than reported ones, as inputs to the asset allocation process. While institutional portfolios can realize substantial benefits from including alternative assets, investors need to properly evaluate the additional

¹ If a plan is able to answer questions in this checklist and the use of alternative investments align with its asset allocation strategy, then please refer to GFOA’s Best Practice “Selecting Third-Party Investment Professionals for Pension Fund Assets.”

risks and complexity inherent in the asset class before making an investment. Additionally, retirement plans should confirm whether specific alternative investments are permissible under applicable state law.

Objectives

Investors may choose alternative assets for several reasons:

- To diversify a portfolio using innovative strategies.
- To produce higher returns than may be available from other investments.
- To obtain exposures to assets and strategies that have superior risk-return tradeoffs.
- To reduce portfolio risk by adding assets and strategies that have low correlations to traditional asset classes.
- To increase or mitigate a portfolio's exposure to specific factors, such as inflation.

Types

Although the investments discussed below are commonly classified as alternative investments, each possess a number of unique characteristics.

Venture Capital

Funds formed to provide equity financing for early-stage businesses that have limited or no operating history. Venture capital is a high risk/high return investment. Many or most of a venture capital fund's individual investments fail, but successful investments provide outsized returns.

Private Equity

Funds formed to take equity stakes in more mature private companies, usually taking majority (control) positions and implementing strategies to increase company values. Strategies typically involve cost control, product development, investments in technologies, and expansion via acquisitions. Private equity funds generally exit their investment once their investment goals have been achieved.

Private Credit

Funds formed to lend money to private companies. In many cases, private equity investor use these loans to fund the purchase of a company. These debt investments are viewed as safer than private equity investments, although the returns are lower.

Distressed Credit

Funds formed to purchase existing loans owed by companies that are currently, or expected to become, financially distressed. The funds expect either a financial recovery or to take control of the company via the bankruptcy process.

Real Estate

Funds that make investments directly in real estate properties and real estate debt. These may be "core" investments in fully stabilized properties, or they may involve development or repositioning of existing properties.²

Real Assets

Investments in real assets other than real estate, such as commodities, farmland, timber, oil and gas

² Real estate investment trusts (REITs) are a tax-advantaged structure commonly used to invest in real estate properties and mortgages. Listed REITs are securities traded like stocks on the major exchanges and are not considered alternatives.

reserves, infrastructure, energy, and mining. This category may also include investments in intellectual properties such as patents, copyrights, and music and film royalties.

Hedge Funds

Hedge funds are lightly regulated, privately managed pools of capital that typically employ sophisticated strategies to invest in publicly traded securities. Strategies commonly include the use of short-selling, leverage, derivatives, and other means of seeking alpha³ and hedging risk.

Risks

While alternative investments can serve many beneficial purposes in an institutional investment portfolio, they also have inherent risks. As some alternatives are relatively new, historical return data may be limited. In addition, valid performance benchmarks for comparison may be scarce and challenging to construct. Illiquidity, the inability to easily exit an investment position, is a common feature of alternative investments. Alternative private asset funds typically require investors to commit capital for a fixed period (e.g., 10 years), while hedge funds commonly feature lock-ups and limited periodic redemption opportunities. Lack of transparency and regulation, combined with the use of leverage and other speculative techniques, create an additional layer of risk for most alternative investments.

The market compensates investors for these risks with a higher expected return. State and local government retirement plans that use alternative investments should carefully evaluate the associated risks in achieving the desired returns. Analysis of net return is critical as management fees are typically much higher (1-2% of assets) than those associated with traditional investments. Many alternative investments also feature performance fees and other manager compensation such as carried interest.⁴ Investing in alternatives via fund of funds structures⁵ typically creates an additional layer of fees. Fee structures also continue to change with new investment products and changing market conditions.⁶ Retirement plans should also evaluate how alternative investment net returns and fees, and other manager compensation incurred to realize those returns, will be fully disclosed.

Alternative Investment Due Diligence

Alternative investments are complex and unique, making them difficult to understand and gain the acceptance of trustees, staff, plan sponsors, and the general public. Alternative investments may require additional staff and consultant expertise, increased due diligence,⁷ and careful attention to controls. Manager selection is arguably the most critical factor in successful alternative investing. Key factors to consider include the manager's experience, investment process, risk controls, track record, and strategies.

³ The term alpha can be defined as earnings above risk-adjusted market returns.

⁴ Carried interest is a share of future profits. Investors typically provide managers with carried interest as an incentive.

⁵ A fund of funds allows an investor to invest in a portfolio of funds and thus diversify by investing across multiple managers. A fund of funds also permits an investor to rely on the expertise of the fund of funds manager for additional due diligence and underlying fund selection.

⁶ See the GFOA Best Practice, "Investment Fee Guidelines for External Management of Defined Benefit Plans."

⁷ See the section on "Additional Considerations About Alternative Investments" in the American Institute of Certified Public Accountants' *State and Local Governments - Audit and Accounting Guide*.

In selecting alternative investments, a retirement plan should consider the following:

- Whether available alternative investments are consistent with the return objectives, risk tolerance, time horizon, and liquidity needs, and whether they will enhance the current portfolio in achieving these policies and objectives.
- Whether it's possible to identify investment managers who have the capacity to find and make desirable investments.
- Whether it's possible to agree on acceptable terms that align the interests of the retirement plan and investment managers to ensure a high probability that good investment decisions will be consistently made.
- Whether the investment structure ensures limited liability for the system.

Checklist Items

Internal Use of Alternative Investments

A plan should be able to answer key information about the internal use of alternative investments, including:

1. Investor Information
 - What is the name of the governmental investor?
 - What are the names of personnel responsible for procuring investments?
 - What are the names of personnel responsible for monitoring investments?
 - What is the name of the independent advisor, if any?
2. Authority
 - Has the retirement plan's general counsel provided an unmodified opinion on the retirement plan's authority to enter into the investment?
3. Asset Allocation
 - Is the retirement plan's investment policy current, and does it include an allocation to alternatives?
 - Does investment policy allow alternative investments of the proposed type?
 - Has an asset class for the proposed investment (e.g., private equity, real assets) been identified?
 - Asset class target weight in investment policy statement
 - Asset class actual weight
 - Asset class uncalled capital
 - Has a benchmark to measure performance been identified?

Alternative Investment Details⁸

The following information on the alternative investment has been obtained and reviewed, including:

4. Investment Description
 - The strategy employed by the manager or fund under consideration
 - The geographical target of the manager or fund, especially if it's non-U.S.
 - The types of assets to be invested in

⁸ If selecting a third-party, please refer to the GFOA Best Practice, "Selecting Third-Party Investment Professionals for Pension Fund Assets," <https://www.gfoa.org/selecting-third-party-investment-professionals-pension-fund-assets>.

5. Manager

- Name of manager
- What is the general manager's background:
 - Ownership structure
 - Depth of manager team
 - Turnover/notable departures
 - Succession planning
 - Composition of investor base
- Is there sufficient operating history?
- Is there a sufficient history of clean audit opinions?
- Have any key persons been subject to any legal actions in last ten years?
- Would the investment expose the retirement plan to headline risks?
- Is a placement agent involved? Who is paying the fees? Are placement agent fees allowed?
- Does the manager have any history or current practice of engaging in pay-to-play?
- Have references been provided?

6. Due Diligence

- Is there a list of responsible retirement plan investment staff and dates the manager or fund review was conducted?
- Is there:
 - Security and Exchange Commission Form ADV, Parts I and II
 - Private placement memorandum
 - Limited partnership agreement
 - Investment management agreement
 - Subscription agreement
 - Due diligence questionnaire
- Do the investment documents ensure that the manager assumes appropriate fiduciary obligation?

7. Fund Details

- What is the fee structure?
- How do management fees compare to those of similar funds?
- What is the preferred return?
- Is there use of leverage?
- What is the catch-up provision?
- What is the clawback provision?
- What are the monitoring and director fees and related offsets?
- Is there an expense allocation disclosure?
- What is the cash flow waterfall?
- What is the general partner commitment (i.e., cash or non-cash)?
- What is the prior fund commitment?
- Is there a key-man provision?
- What is the no-fault termination?
- What is the investment period?
- What is the partnership term?
- Is there a cap on organizational expenses?

- What are the details of the advisory board, including:
 - What is the composition of the board?
 - Will the retirement plan receive a seat? Does participation impinge on the retirement plan's ability to act as fiduciary to the plan?
- Is the fund's financial statement self-prepared, or is it prepared by a third-party?
- Are financials statements to be generated within a timely period after the year's end, along with a certified opinion?
- What is the valuation policy?
- Who is the fund auditor?