WEB FEATURE

EARLY EDITION June 2017

hfm

healthcare financial management association hfma.org

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building a successful investment program in a changing economy

Aligning investment strategy with organizational goals can help healthcare organizations find investment success in the wake of political, financial, and organizational change.

AT A GLANCE

Hospitals and health systems that oversee investment programs should apply four principles for success:
> Ensure the most qualified person is charged with responsibility for deliberate decision making.
> Align investment objectives for asset pools with the organization's financial goals.
> Engage in dynamic portfolio management.
> Give appropriate attention to enterprise risk.

Health care is on the verge of a new economic reality. Change is coming in the wake of political uncertainty, record high U.S. equity prices, narrow credit spreads, and low bond yields. More fiscal stimulus, more inflation pressures, and a more hawkish Federal Reserve Board all can be expected.[a] Health systems should prepare for higher borrowing costs and lower investment returns as they also consider the impact of a changing political and policy landscape.

Many investment committees are finding it difficult to stay abreast of all these issues when they meet only four to six times per year. Meanwhile, the challenges are compounded by healthcare organizations' complex internal decision-making structures, which typically involve professional staff, the board of directors, and investment and finance committees. All these entities oversee distinct aspects of the total investment program.

By applying four fundamental principles, finance leaders can manage their asset pools in a way that aligns their investment strategy with their overall enterprise financial goals and responds dynamically to the market environment:
> Ensure responsibility for deliberate decision making is vested in the most qualified person.

a. Pease, A., Eitelman, P., Wood, S. et al, "2017 Global Market Outlook," Russell Investments, December 2016.

> Align investment objectives for asset pools with the organization's financial goals.
> Engage in dynamic portfolio management.
> Give appropriate attention to enterprise risk.

Decision Making

To ensure a sound decision-making process is in place, healthcare organizations must determine how decisions should be made, who is most qualified to make them, and how those decisions should be monitored. The board, investment committee, finance committee, and staff who manage the investment program at a hospital or health system are the fiduciaries responsible for establishing and monitoring an investment policy for each of the investment pools in their organization. They need to ensure that each pool contributes appropriately to the needs of the entire hospital or health system.

To meet these objectives, finance leaders must make or delegate decisions about the strategic design of the investment program, the management of investment portfolios, and the evaluation

RANKING ENTERPRISE RISKS

		Assessment Factor	Wt.	Assessment Factor	Wt.	Assessment Factor	Wt.	Assessment Factor	Wt.	Impact	
		Likelihood	**0.2**	**Speed To Impact**	**0.2**	**Reputational Severity**	**0.3**	**Financial Severity**	**0.3**	**Weighted Score**	**Rank**
OPERATIONAL RISKS	**OPERATIONAL**										
	Staffing: not enough	occasionally	3	intermediate	3	significant	5	weak	1	3	9
	Audit/accounting: failed audit/weak accounting	rarely	1	intermediate	3	significant	5	moderate	3	3.2	8
	Systems/technology: must upgrade	rarely	1	short term	5	significant	5	significant	5	4.2	4
	FIDUCIARY										
	Regulatory: increasing	occasionally	3	short term	5	significant	5	significant	5	4.6	1
	Reputational	rarely	1	intermediate	3	significant	5	significant	5	3.8	6
INVESTMENT RISKS	**MARKET**										
	Demographic changes: older, immigration	regularly	5	intermediate	3	low	1	significant	5	3.4	7
	Inflation: increasing	occasionally	3	short term	5	significant	5	moderate	3	4	5
	Interest rates: increasing	occasionally	3	intermediate	3	low	1	moderate	3	2.4	11
	Volatility: increasing	occasionally	3	intermediate	3	moderate	3	weak	1	2.4	12
	Currency: volatile	occasionally	3	intermediate	3	moderate	3	weak	1	2.4	12
	STRUCTURAL										
	Systems/technology: risk systems	regularly	5	intermediate	3	significant	5	significant	5	4.6	1
	Transparency: understanding what you own	regularly	5	intermediate	3	significant	5	significant	5	4.6	1
	Liquidity: needs change	occasionally	3	short term	5	low	1	moderate	3	2.8	10

Assessment Factor Scale

Likelihood: 1 = rarely; 3 = occasionally; 5 = regularly
Speed to Impact: 1 = long term (+10 years); 3 = intermediate (5-10 years); 5 = short term (1 to 5 years)
Reputational Severity: 1 = low; 3 = moderate; 5 = significant
Financial Severity: 1 = weak; 3 = moderate; 5 = significant

of the program's performance against its goals. When resource gaps are evident, some hospitals and health systems are large enough to add professional investment staff, typically led by a chief investment officer; smaller hospitals may find it more financially feasible to outsource this role.

As outlined in the exhibit below, in an outsource situation, the board and the investment committee should focus on making strategic decisions rather than attempt to oversee the day-to-day management of the investment program. Board and committee responsibilities include control of the governance structure and objective setting for each asset pool. These parties also retain final authority over the strategic asset allocation for each investment pool.

Most of the remaining responsibilities of managing the investment portfolio and reviewing its performance can be delegated to the investment officer. The board and investment committee should provide separate decision making and oversight and move quickly to clarify roles and responsibilities where no decision maker is identified, authority is shared, or parties seem overwhelmed.

Investment Objectives

An investment committee may oversee multiple asset pools including long-term assets, pension plans, self-insurance pools, and foundation assets, and managing them can be a balancing act. When setting the investment objectives for each of an organization's asset pools, it's important to frame them in context with the organization's overall financial goals and circumstances. An organization should be able to reach the goal for each pool without negatively affecting the organization's financial goals. For example, the long-term pool is a critical component of the balance sheet, and, accordingly, credit-rating agencies may consider it a significant influence on an organization's credit rating, which will determine the interest rate at which the organization can issue debt. Because fluctuations in asset values may impact the credit rating, the investment strategy for the long-term pool must account for the potential loss it can tolerate in any given year, given any existing debt covenants or the organization's desire to issue debt.

Using the simple process shown in the exhibit below, finance leaders can put their organization's financial goals side-by-side with the investment objectives of their asset pools. Then, they should consider the potential impact that the objectives of each asset pool may have on the other pools, as well as the organization's financial goals. For example, in the case of unexpected pension contributions, assets that were earmarked for operating needs or growth in other areas may need to be pulled from the operating budget and redirected to the pension plan. This move could affect days cash on hand and other important financial metrics. Likewise, losses within the long-term pool could affect an organization's credit rating, leading to increased borrowing costs.

Cooperation among internal stakeholders also is critical to ensuring the organization's investment objectives and financial goals are effectively aligned. The board, CFO or senior finance leader, finance committee, and investment committee all have a part to play in meeting fiduciary

LINKING INVESTMENT OBJECTIVES AND ORGANIZATIONAL GOALS

Asset pool	Enterprise financial goals	Investment objectives
Long-Term Pool	> Maintain/improve credit rating > Fund short- and long-term capital projects	> Achieve investment returns to meet or exceed cost of capital > Minimize realized losses > Manage volatility > Manage liquidity profile
Pension Plan	> Improve funded status of pension plan > Minimize volatility of funded status and contributions	> Achieve asset returns in line with growth of plan liabilities > Manage volatility profile
Foundation Assets	> Meet spending requirements and manage liquidity > Maintain purchasing power	> Achieve investment returns equal to spending plus inflation > Manage volatility > Manage liquidity profile
Self-Insured Assets	> Provide cash flow to pay claims as they come due > Protect value of assets	> Minimize losses > Align duration of fixed investments with expected payouts

obligations and providing clear direction to investment officers or others. To ensure all stakeholders are on the same page, it is important to define the role of each decision-making entity and the decisions they have the authority to make.

Crossover representation among internal decision-making entities also is important. If there are separate committees for finance and investment, some members should serve on both. In addition, each committee should be represented at the board level. For not-for-profit health systems, it is important that volunteer leadership understand the priorities of staff leadership and their role in helping achieve those goals.

Portfolio Management

The goals of the organization and the investment objectives come together in the long-term strategic asset allocation (SAA) for each asset pool. The SAA guides how much is ultimately allocated to asset classes within each pool. It also can be used as a guidepost for the ongoing management of the investment program during times of market turmoil or committee transition.

An SAA should be focused on progress toward the organization's broader financial goals, not simply beating a return benchmark. This focus will help ensure the expectations set for each asset pool are aligned with the critical financial metrics, such as maintaining or improving the organization's credit rating or improving the pension plan's funded status.

Two types of input have an impact on the SAA for an asset pool. Organizational inputs reflect the unique characteristics of a hospital or health system and are, to some degree, within a fiduciary's control. Capital market inputs, on the other hand, depend on the broader economic environment. Common organizational inputs for a long-term pool, for example, are the cost of capital, liquidity needs, risk capacity, and regulatory requirements. For pension assets, the inputs include measures such as funded status and liability cash flows.

Capital market inputs typically are provided by the organization's investment officer, and it is important for the investment committee to understand how these inputs are generated. Key questions include the following:

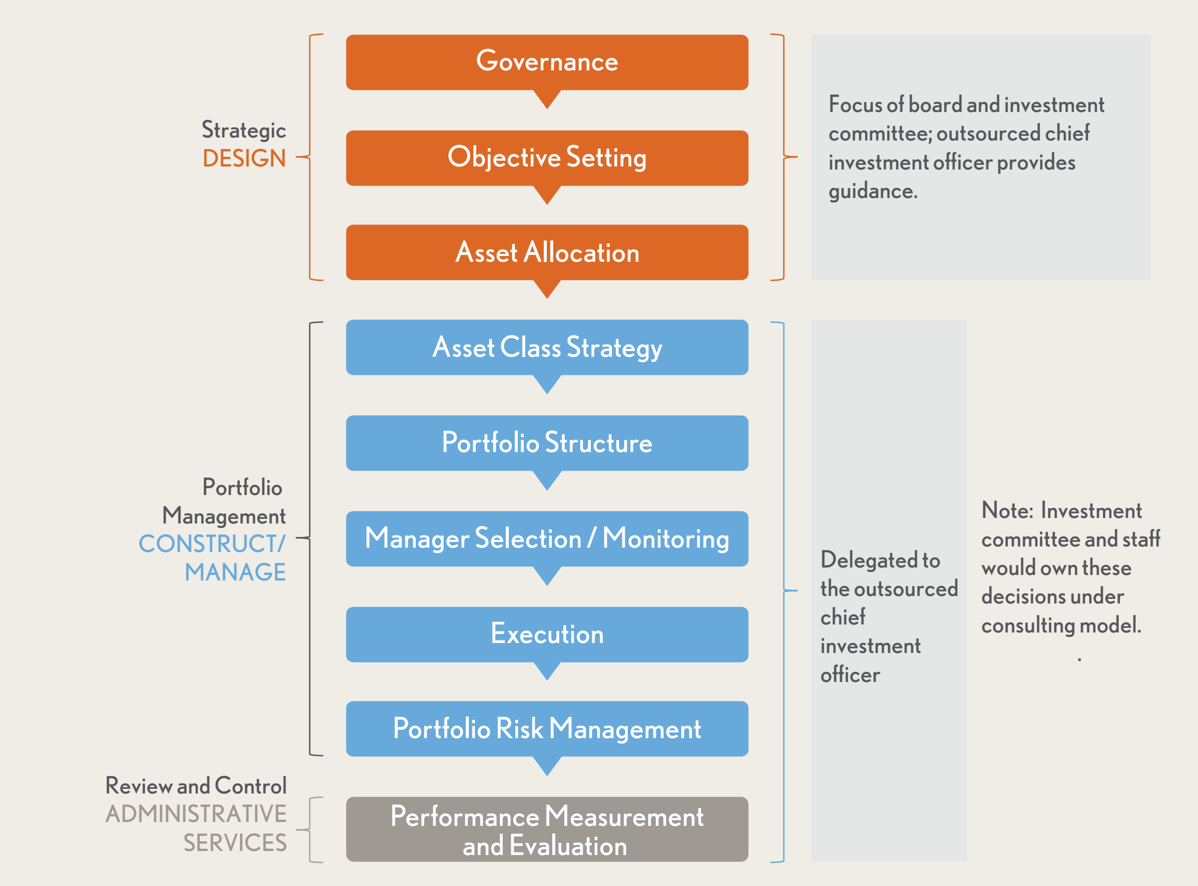
> Are the forecasts based on short-, medium-, or long-term views?
> Are the forecasts historical (i.e., based on past performance) or do they account for likely changes in market conditions and asset classes in the future?
> What is the current view on market volatility, and how should that be managed within the portfolio?
> What is the forecast for inflation, and what impact might that have on assets being recommended for portfolios?
> Are currency risks and opportunities being incorporated? (Changes in the relative value of currencies impact investment portfolios, and they can represent risks or opportunities, particularly when a portfolio has invested in assets spanning the globe.)
> What is the forecast for interest rates, and how is it being incorporated?

Today the consensus of professional forecasters is a 2.5 percent return over the next 10 years for an inflation-adjusted portfolio consisting of 60 percent equity, with fixed income accounting for the other 40 percent.[b] The 2.5 percent rate of return is half the rate predicted in the 1990s, and lower returns are projected across all asset classes in the years ahead. In this environment, investors should not ignore investment strategies that may offer incremental returns, take risks for which they do not expect to get paid, or ignore implementation efficiency. It also is essential to adapt investment portfolios to quickly to capture short-term market opportunities or manage risks. This kind of dynamic management can help ensure an organization meets its desired investment outcomes.

Working with an investment officer or in-house investment staff can help ensure dynamic

b. Santo, W.A., and Schneider, L., "Healthcare Fiduciary's Handbook," Russell Investments, May 2017.

DELEGATION OF TASKS TO OUTSOURCED CHIEF INVESTMENT OFFICER



portfolio management; however, the activities of that person should be monitored and guidelines set. The finance committee should set trading bands around the SAA for each asset class in a portfolio and give the investment officer discretion to implement decisions in real time. Likewise, investment officers should be strongly capable of researching managers and have license to hire or fire managers and adjust manager weights within a portfolio. Investment officers also should have systems that allow portfolio managers to see all portfolio risk exposures in real time, with the ability to adjust when required.

Enterprise Risk

Organization leaders should be prepared to account for risks in the organization that may affect the investment program, and vice versa. A key first step in managing the interaction of risk throughout the enterprise is to build a framework that helps identify and categorize those risks.

Risks can be grouped into two broad categories—operational risks and investment risks. At the operational level, there are fiduciary risks that arise directly from the governance structure of the organization and operational risks that stem from day-to-day operational needs. At the investment level, there are structural risks that come from how the investment portfolio is built, and market risks arise from the capital markets, economy, and geopolitical environment.

Using the examples shown in the exhibit below as a starting point, finance leaders can talk with their investment or finance committee and board of directors to identify their own enterprise risks.

A fundamental challenge to enterprise risk management is identifying the biggest risks and avoiding those that are unlikely to have a significant impact on the organization as a whole. Organizations can prioritize and rank risks based on which have the greatest potential to derail organizational goals. Risks can be assessed by different factors such as likelihood, speed to impact, reputational severity, and financial severity. Then, those factors can be combined to achieve a weighted score for each risk.

Regulatory and financial uncertainty is likely to continue rising for hospitals and health systems, making it imperative for finance leaders to acquire the necessary resources and knowledge to manage the multiple investment pools that the organization relies on for financial success. An investment officer can be an indispensable resource not only to oversee this effort, but also to share with finance leaders and others the insight and perspective to help ensure their organizations are equipped to meet the investment challenges that lie ahead. ■

About the author

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