4 KEY ISSUES TO CONSIDER IN A CHALLENGING ENVIRONMENT

The pandemic may no longer be the all-consuming crisis it once was, but health care fiduciaries are now dealing with beasts of another sort

Lisa Schneider, CFA, Managing Director, Head of Client Solutions

As the darkest days of the COVID-19 pandemic begin to recede, hospital and health system fiduciaries are forced to contend with another unpalatable reality: There is no rest for the weary. In addition to lingering challenges from the pandemic, healthcare finance leaders are now dealing with beasts of a different sort: Historic inflation and aggressive rate hikes, which are feeding the skyrocketing expenses, plunging revenues and volatile operating margins that have dogged hospitals and health systems since the pandemic. And, with increasingly diminished chances of a soft economic landing by the Fed, there is a higher probability of recession in the next 12 months. Healthcare leaders are, in short, under pressure to preserve the financial health of their organizations.

Due to the complexity of the organizations they serve, hospital and health system fiduciaries are already maintaining a delicate balancing act between their operations, finances and investment strategy. In this precarious environment, where challenging investment returns pose another complication on top of higher operating expenses, effectively integrating these three levers is even more critical to meeting mission goals, increasing the productivity of assets and managing ongoing risks. Now is a good time for healthcare fiduciaries to reassess their investment portfolios and ensure these are aligned to support their organization's near-, medium- and long-term financial plans—as decisions about the operating, retirement and affiliated asset pools are all closely tied to the financial situation.

In the current inflationary environment, actions should not necessarily center on shoring up the portfolio against inflation, but rather how to ensure that the asset pools are positioned in such a way that they protect the overall organization against the impacts of inflation. This includes reviewing return targets, risk levels and required liquidity. Here's how you and your team can aim to stay afloat and ahead of the curve.

1. As the cost of capital increases and stress on operations rises, consider making appropriate changes to your investment strategy

If events over the past two years have materially impacted your organization's finances, you should revisit your investment strategy and confirm whether it still aligns with your overall financial goals. If it still does—great. If not, you will need to make appropriate changes, preferably in concert with your investment provider. Take a step back and determine whether your investments match your risk tolerance, and whether the amount of risk in your investment strategy is aligned with what you can afford in your broader financial plan. This means determining whether you can still tolerate the level of risk within your self-insurance pool, discerning whether the funded status of your pension plan has improved enough that de-risking should considered, and reassessing whether your foundation assets are still positioned to deliver on mission objectives.

As an example of how to put this into practice, one of our clients was restructuring their financial plan and balance sheet and needed to significantly reduce risk within their long-term portfolio. We worked with them to reduce exposure to risk assets within the portfolio and then set up a schedule to gradually re-risk the portfolio over time in line with improvements in key operational metrics. As operational metrics improved, the organization was able to re-risk so they could reset themselves going forward.

If you have a pension plan, you may want to look at how your funded status has changed, as discount rates have crept up due to rising equities. Additionally, if you do not have a liability-driven investment strategy, now is a good time to think about incorporating one

> *In the current inflationary environment, actions should not necessarily center on shoring up the portfolio against inflation, but rather how to ensure that the asset pools are positioned in such a way that they protect the overall organization against the impacts of inflation.*

2. Review capital market expectations for your investment strategy to ensure they still support your long-term goals

You should also check to see whether your asset allocation still delivers the rate of return you were expecting it to, and whether this takes the latest capital market expectations into account. For example, one important area to reassess is fixed income, to which many hospitals and health systems have relatively higher allocations, typically around 30-50%. While just two years ago, persistently low interest rates meant depressed bond yields and low borrowing costs, as well as lower long-term capital market forecasts, the situation has shifted dramatically today, with rising interest rates creating less favorable conditions for debt financing. Hospitals and health systems may have enjoyed the last two decades of declining interest rates, reaching into debt markets for financing needs and structuring investment portfolios that could reliably beat a cost of capital of 2-3%. However, in today's less-favorable environment, holding off on debt, if possible, may pay off as debt markets level out 12-18 months from now. In the event that central banks are forced to pause or cut rates in the face of recession in the future, debt markets may become more attractive and bonds can serve as a useful diversifier.

Consider also looking beyond publicly traded bonds and diversifying your return sources to help improve your portfolios' risk-adjusted returns. Private debt is an area ripe with opportunities. Typically, hospitals and health systems don't have high allocations to illiquid assets, especially if there is concern regarding the impact this may have on the organization's credit rating. However, private debt can help achieve higher returns, with a shorter lockup of six to eight years and less illiquidity than private equity, which could have a lockup of 10-12 years. Additionally, foundation pools can typically withstand a higher level of risk and illiquidity, as most have longer-term time horizons and have cash flows coming from donations

3. Be aware of key drivers of risk in your current strategy

You should be aware of key drivers of risk in your current investment strategy. These might include equity style factors such as growth versus value, country exposure (such as U.S. versus non-U.S. equities), or duration, credit, etc. Here are a few questions you might ask yourselves to check on your appetite for risk and whether you are comfortable with your risk exposures:

- Does your portfolio have a bias for growth equities, and have you considered the potential rotation in the markets toward favoring value equities?
- Many U.S. institutional investors have a home-country bias toward U.S. equities. How well has this been doing, and how comfortable are you that this trend will be here to stay?
- While U.S. equities may have outperformed non-U.S. equities in the last 10 years, will this continue?
- What is the duration of your fixed income, and the relative weights between Treasuries, government bonds and credit?

> *Lastly, you should make sure that you are holistically approaching enterprise risk management and appropriately balancing resources across your operating, financing, and investing activities, across various time horizons.*

4. Adopt a holistic, multi-time period approach to enterprise risk management

Lastly, you should make sure that you are holistically approaching enterprise risk management and appropriately balancing resources across your operating, financing, and investing activities, across various time horizons. This means determining your liquidity needs, aligning these with your risk tolerance and other investment resources, stress-testing a range of potential outcomes to inform your investment decision-making and utilizing a tactical approach to managing the recognition of realized gains.

To start, determine your liquidity needs over various time periods, whether short-term (i.e., in the next 1-2 months), medium-term (3-5 years) or long-term (the next 10 years). One way to do this is to have a short-term pool that is very liquid (i.e., daily cash); a short-to-medium-term pool (3-5 years) in less liquid return-seeking assets that are not as low-risk as daily cash; and a longer-term pool that can take on additional risk and less liquidity. Overall, this is intended to align your liquidity needs with your risk tolerance and create a buffer as you wait to issue debt.

Additionally, you should stress-test different outcomes that might happen over the next 2-3 years, 3-5 years, and 10+ years, so that you know where you're taking risk and are comfortable withstanding that 1-in-20-chance downside event when it happens. Lastly, with regard to earnings on your investments, you should have a purposeful and tactical approach to the recognition of investment gains. If you haven't harvested gains yet (which is likely, as the past two years have been a down market), there can be some potential gains that can be harvested to balance operating loss in your balance sheet.

As always, we think it is critical for senior finance leaders of hospitals and health systems to carefully consider the impact of their investments on the financial and operational health of their organizations. Your investment decisions are vital to keeping both your patients and bottom lines healthy.

Moreover, it's important to ensure your team is aligned on these decisions now, so that in case of another significant dip in the markets, your organization's key financial metrics don't take a big hit.

> *Your investment decisions are vital to keeping both your patients and bottom lines healthy.*

Connect & Follow us

Call Russell Investments at **855-771-2966**

Visit **russellinvestments.com/healthcare**

About Russell Investments

Russell Investments is a global asset manager with a unique set of capabilities that we believe is essential to managing your total portfolio and to meeting your desired outcome. At Russell Investments, we stand with you, whether you're an institutional investor, a financial adviser, or an individual guided by an advisor's personalized advice. We believe the best way to reach your desired outcomes is with a multi-asset approach that combines: asset allocation, capital markets insights, factor exposures, manager research and portfolio implementation.

Important information

First used: October 2022 AI-29470-10-25