A FRAMEWORK TO ALIGN INVESTMENT & ENTERPRISE-WIDE FINANCIAL STRATEGIES

SUPPORTING THE FINANCIAL NEEDS OF NON-PROFIT HOSPITALS AND HEALTH SYSTEMS

RUSSELL INVESTMENTS RESEARCH / VIEWPOINT

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A framework to align investment and enterprise-wide financial strategies

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For a non-profit hospital or health system seeking to design effective investment portfolios for its various asset pools, understanding the role of each asset pool is a crucial first step. The organization's goals and exposures can impact every part of its portfolio construction process, from strategic decisions on risk tolerance and return objectives, to more targeted decisions on asset class exposures and investment vehicle preferences. Given that different organizations face their own unique challenges, this paper does not prescribe a specific method of portfolio construction, but instead offers a framework for evaluating asset allocation decisions. We highlight the need to consider and evaluate the following:

- Multiple roles of each asset pool within the enterprise, with a focus on the long-term pool and how its role in supporting the enterprise will drive the risk tolerance and return target of the investment portfolios. This will be impacted by the enterprise-wide financial plan and how that is expected to evolve over the near and long term.
- Market environments in which the stability of the investment pools would become most important.
- Any consideration of the realization of gains and losses on portfolio implementation decisions.

Introduction

The investment programs of most non-profit hospitals and health systems are comprised of multiple asset pools. These can include long-term pools, retirement funds, short-term operating capital, foundation assets, self-insured assets and, potentially, other asset pools. Although the enterprise-level considerations and constraints impact all investment pools, this paper focuses on the asset pools that contribute to key financial metrics for the organization such as *days cash on hand* (DCOH) or debt coverage with an investment horizon of over one year. Historically, this has meant a focus on a singular long-term pool, which could be funded depreciation accounts, board-designated funds or long-term operating accounts. However, we are seeing some movement towards health systems re-organizing a singular long-term pool into multiple pools, with varied time-horizons and purposes.

One of the key challenges in designing and managing asset allocation strategies for these investment pools is effectively constructing them in the context of the goals of the enterprise. This means factoring in the current situation and financial plan of the enterprise. By *enterprise*, we mean all aspects of the hospital or health system (e.g., operations, governance, finance), as well as exogenous factors.

The stability of the enterprise is often thought of as a balancing act—although with three rather than two sides. The three sides of this balancing triangle are the financing capacity, operating conditions and investment strategy of the enterprise. If one side of this

triangle is undergoing stress, it is of greater importance for the other sides to provide strength and stability to the organization. For the long-term success of the organization, operating strength is of the utmost importance. However, strength from investment assets can provide stability during interim periods of operating weakness or during periods where the ability to access debt financing may be limited or unwanted.

There is no one-size-fits-all solution for establishing an asset allocation strategy. The most common differentiators across investment pools are their time horizons and ability to tolerate short-term losses. An understanding of the unique situation of the enterprise—and the role of the investment pools within it—should inform how assets are to be invested and how much risk is to be taken. With such understanding, the investment pools can be more efficiently deployed to support the organization's efforts to achieve its goals. This is an important—but often neglected—part of the asset allocation process. By linking the requirements of each individual pool with the anticipated needs of the organization, fiduciaries may gain greater confidence that portfolio risks are effectively matched to the present and future needs of their enterprise.

In properly aligning the asset allocation strategy to support the organization's financial strategy, it is critical to address the impact of overall enterprise needs on the investment assets across the following three key considerations:

1. Investment risk tolerance and return objective
2. Portfolio construction
3. Portfolio implementation

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1. Addressing the impact of enterprise needs on risk tolerance and return objective

The financing capacity and operating conditions of the enterprise and growth objectives are driving factors in determining the risk tolerance and return objective for the investment assets. In this section, we look to understand how the financial and operating conditions of the enterprise could impact both the return desired and the risk tolerated in the investment assets.

Linking return objective to cost of debt

Typically, we recommend that the return objective for the investment assets should be linked to the cost of debt, plus a cushion to provide for growth. Many systems historically chose to borrow and carry debt, while growing investment assets, given the low cost of borrowing in the 15 years or so prior to 2022. Considering the ability for enterprises to repurpose assets in the long-term pool to pay down the debt, or fund capital projects and avoid borrowing, there must be the implicit assumption that asset returns will be higher than the cost of borrowing. Because of this, we encouraged enterprises to explicitly link this decision with the objectives of investment assets by setting the investment objective to the cost of capital plus a margin of expected outperformance. The higher the expected investment outperformance over the cost of debt is, the more the enterprise is rewarded for issuing debt to fund capital projects or operational costs, rather than using their long-term pool as the source of funding. This assumes they are in a position to make that trade-off.

Given the current level of interest rates relative to the interest rates when most health systems issued the majority of their outstanding debt, it is not difficult to expect to outperform the cost of current debt on a go-forward basis. However, the expected future cost of borrowing has risen rapidly, relative to the current cost of debt already issued. This raises the question of whether or not health systems should seek to outperform their future cost of borrowing? If the answer is yes, this significantly increases the required return for the investment portfolio, unless they are confident that operating results will enable them to avoid issuing new debt. However, it remains the relevant comparison for a healthcare system that is deciding between issuing new debt or using assets available in the long-term pool.

Linking risk tolerance and return objective to credit-rating metrics

For investment pools that are used in metrics evaluated by credit rating agencies (e.g., measures of DCOH and debt coverage), it will be crucial to explicitly consider the potential impact of asset returns and losses on these metrics. Although most health systems are not eager to borrow at today's high interest rates, many have a desire to maintain a strong credit rating to either be well positioned to borrow inexpensively if interest rates fall or to minimize costs to the extent possible, if they are concerned that borrowing may be required. There could also be debt covenants on previously issued debt that need to be considered.

The *level of investment loss* that could cause these metrics to fall below an undesirable or unacceptable level is a direct assessment of the *level of risk that is likely tolerable*. We would recommend stress testing any investment strategy to help ensure that an investment loss would not lead to a threat to the credit rating or a debt covenant breach because of a reduction in DCOH or debt coverage. In this way, the financing conditions don't just impact the investment strategy, but the success—or lack thereof—of the investment strategy can directly impact financing conditions.

DCOH and debt coverage objectives can also impact the return objective. If growth in DCOH is an important long-term goal and the enterprise cannot rely on positive cashflows from operations to aid in that growth, the portfolio objective could also address outperforming expense growth. This would allow the existing investment assets to maintain or grow DCOH on their own. This would likely require a significant premium above broad market inflation due to the extent that healthcare cost growth has outpaced the consumer price index (CPI).

Linking risk tolerance to liquidity needs

If the operating and financing conditions of the organization are strong, it is likely that there are no expected liquidity needs from the investment assets. This would imply an investment portfolio that is better positioned to tolerate higher risk levels and invest for long-term return objectives.

However, the deterioration of operating or financing conditions over time could lead to the potential need for investment assets to fund operating shortfalls, capital projects or debt repayment. This will naturally shorten the investment time horizon and reduce risk tolerance.

Historically, many organizations held the majority of their investment assets in a singular long-term pool and were approximating the risk and liquidity tolerance based on the potential required outflows in the short to medium-term. However, for health systems that believe the investments assets may need to provide funding for the enterprise in the short or medium-term, separating the investment assets into multiple investment pools with varying time horizons often makes the most sense. This allows the long-term pool to remain focused on long-term growth, while ensuring the enterprise will have access to the liquidity it needs, if required. The circumstances of the enterprise will dictate the relative size and risk profile of the additional investment pools. This could include a very low-risk short-term pool that is invested to have funds available for possible cashflow needs in the next 1-3 years, based on known capital projects or expected operation shortfalls. It could also include a moderate risk portfolio based on the expectation of the need to fund capital investments or pay down debt in 4–7 years, with uncertainty as to the funding source. With these other investment pools targeting the potential short and medium-term cashflow needs, the long-term pool can be focused on long-term growth rather than trying to balance the need for risk management in the case of cashflow requirements.

On a holistic level, this might leave the total assets in a similar position, as if they just reduced risk in the long-term pool. However, this approach allows the enterprise to both feel greater certainty in knowing the lower-risk asset pools are there to fund cashflows. It also allows the enterprise to adjust its total risk level more fluidly by re-allocating across asset pools, as it changes liquidity-need expectations, rather than trying to assess what the impact of those changing expectations should be on the risk level in a singular long-term pool.

By building a portfolio that takes potential liquidity needs into consideration, the enterprise can focus on improvements to its operating plan, and it can have greater confidence in the long-term pool's ability to fund liquidity needs as required.

The level of investment loss that could cause these metrics to fall below an undesirable or unacceptable level is a direct assessment of the level of risk that is likely tolerable.

Linking risk tolerance to income statement considerations

If the income statement includes both realized and unrealized gains and losses, the ability to tolerate the impact of investment losses on the income statement could impact the risk tolerance of the investment assets. The lower the investment losses the organization could tolerate on the income statement at any point in time, the less risk should be taken in the investment portfolio. If the income statement only includes realized gains and losses, the impact on the income statement can be considered from a portfolio construction and implementation lens.

Linking it all together

Given the ability of the financing and operating conditions to uniquely impact the above considerations for every organization, there is no one-size-fits-all answer.

For organizations with strong operating and financing conditions, there is often flexibility to take a high level of risk. These organizations typically have low expected liquidity needs and have DCOH and debt-coverage metrics solidly above peers and thresholds, and could seek higher portfolio returns, particularly if there is desire to grow the portfolio to achieve higher levels of DCOH or to fund future organizational growth objectives. This allows for significant investor discretion in determining what the targeted risk and return for the investment assets should be.

Organizations with stressed operating and financing conditions may feel as if there are no good options. The inability to tolerate erosion in DCOH and debt metrics, coupled with potential liquidity needs, would create a low tolerance for investment risk and losses. However, these same conditions could lead an organization to a desire to have investment gains grow DCOH to provide support while improvements in the operating plan are underway. These organizations are typically faced with the most difficult decisions. They will likely need to determine the maximum loss that is truly tolerable and then seek to maximize returns while staying within that risk level.

These are extreme examples. Many organizations exist within these two poles. However, for all organizations, the financing and operating conditions will impact the return that is required and the risk that is tolerable.

2. Construction: Addressing common market exposures across the portfolio and the enterprise

In constructing the portfolio, it is also important to analyze the environments in which the investment assets may be more likely to be relied on to fund cash shortfalls, or to support the credit rating. We do not typically see the operating conditions of healthcare systems as correlated to market returns. However, there are components of the operating and financing conditions of the enterprise that impact the economic environments in which greater strength may be required from the investment assets.

Some of these exposures are examined in **Exhibit 1**. The asset allocation analysis should consider the combined impact to the enterprise of the portfolio and organizational exposure to these factors.

Considering when liquidity needs or the balance sheet are most likely to be stressed is a prudent step in validating that the long-term pool is appropriately allocated for the needs of the enterprise.

The investment pools should be structured in a manner that is mindful of when their strength and liquidity will likely be most beneficial to the enterprise. Considering when liquidity needs or the balance sheet are most likely to be stressed is a prudent step in validating that the long-term pool is appropriately allocated for the needs of the enterprise.

Impact of debt financing costs

An application of this concept is the integration of the impact of changes in interest rates on debt that has been issued and will be issued on the enterprise.

The presence of floating-rate debt within the enterprise, explicitly increases financing costs when interest rates rise. Although issuance of floating-rate debt has been rare over the past five to ten years, as healthcare systems locked into fixed-rate debt when interest rates were low, this could change in the future for organizations that may need to borrow while interest rates are elevated.

Exhibit 1: Impact of potential enterprise-level risk exposures

POTENTIAL ENTERPRISE- LEVEL RISK EXPOSURES	IMPACTS ON ENTERPRISE	HOW TO ACCOUNT FOR ENTERPRISE-LEVEL EXPOSURES IN THE INVESTMENT PORTFOLIO(S)
Significant floating rate debt	Higher cash outflows required when interest rates are higher	Decrease exposure to longer-duration fixed income (except within the defined benefit plan), where investments experience negative returns in rising rate environments, and introduce exposure to short duration, absolute return and/or floating rate fixed income.
Significant expected borrowing needs over next few years	Desire to use investment pool to finance projects and/or higher financing costs if interest rates are high	
Significant real estate holdings	Enterprise already exposed to fluctuations in real estate values	Minimize holdings in private real estate that are correlated with the real estate already held by the enterprise. This should not necessarily rule out real estate holdings in the long-term pool as investment vehicles that operate differentiated exposures may be available.
Credit rating impacted by liquidity profile of investment pool	Credit rating downgraded or put on warning if the liquidity profile of the investment pool is in breach of certain levels	Maintain an allocation to liquid investments to satisfy the requirements of the credit rating agency. If illiquid investments are held, evaluate the likelihood that in stressed market environments, the proportional allocations would increase above thresholds and strategically target an allocation below threshold levels. This concern could also be alleviated by the approach of maintaining multiple investment pools tailored to potential cashflow needs and therefore illiquidity focused in the long-term pool that is not expected to require liquidity.

A similar sensitivity might be held by systems that expect to have cash needs due to upcoming capital projects or maturing of existing debt. Unless there are large enough positive cashflows from operations, this will require either issuing new debt or cashflows out of the investment assets. If interest rates rise further, there is the increased likelihood that the investment assets will be used to fund the liquidity needs due to the high cost of borrowing. On the other hand, if interest rates fall, they will be relieved by the ability to access financing at lower costs. Even though this organization has not issued floating rate debt, it would have higher cashflow needs if interest rates rise and should consider that sensitivity in portfolio construction.

Organizations with these concerns might consider investment portfolios with fewer long-duration fixed income investments, in favor of shorter-duration and floating-rate fixed income, as they do not want to experience investment losses if interest rates rise which already has negative implications for the enterprise. If interest rates fall, there will be the opportunity cost of lower gains in the investment portfolio, but the enterprise will likely have lower financing costs, which reduces the pressure on the investment portfolio to provide strength.

Impact of real estate holdings

Many non-profit hospitals and health systems may maintain significant real estate holdings on their balance sheets, in the form of buildings they own and operate. These enterprises should consider the potential impact of private real estate exposure on their balance sheets as well as their long-term pool, to help avoid losses on multiple balance sheet items if real estate markets fall. In many cases, it is still sensible for hospitals with direct real estate holdings to include an allocation to private real estate in the long-term pool. This is because of the diversified and differentiated exposures within a private real estate fund relative to a healthcare system's specialized direct real estate holdings.

In many cases, it is still sensible for hospitals with direct real estate holdings to include an allocation to private real estate in the long-term pool.

Impact of credit-rating agency concerns

Although there are often no specific rules or guidelines to consider, in many instances the credit rating agencies may have concerns on the level of illiquid assets in the investment portfolios. We recommend addressing this in two ways.

One is open two-way communication between the health system and the rating agency to discuss the benefits that the enterprise sees in including less liquid investments in the portfolio and the concerns that the credit rating agency has. This will hopefully create a dialogue that allows for the rating agency to be more open to less liquid investments, while also ensuring that the healthcare system understands the concerns and thresholds that the rating agency may have so that they stay within the bounds deemed acceptable to maintain their credit rating.

The second way is the bifurcation of the investment portfolio away from a singular long-term pool into multiple asset pools, with different time horizons is a second option that may aid in this process. This allows less-liquid investments to be concentrated in the investment pool with the longest time horizon, while the investment pools that may need to support short or medium-term cashflows remain liquid. This visibility into the purposes of the different investment pools could help alleviate any concerns by the rating agency that the inclusion of less liquid assets impairs the ability to support the liquidity needs required to support their debt.

This is important due to the extent to which we believe that including private markets in the long-term pool can aid in long-term return enhancement and is something we are recommending to our clients that can tolerate that illiquidity.

> *This visibility into the purposes of the different investment pools could help alleviate any concerns by the rating agency that the inclusion of less-liquid assets impairs the ability to support the liquidity needs required to support their debt.*

> *If both realized and unrealized gains and losses impact the income statement, that can only be managed through asset allocation. However, realized annual gains and losses can be managed through implementation and rebalancing decisions.*

3. Implementation: Addressing enterprise investment income needs and investment implementation preferences

Optimizing portfolio implementation for enterprise finances

As discussed earlier, for many enterprises, the impact of investment gains and losses on the income statement is closely watched. If both realized and unrealized gains and losses impact the income statement, that can only be managed through asset allocation. However, realized annual gains and losses can be managed through implementation and rebalancing decisions. This section is only applicable to enterprises that care about the impact of realized gains and losses on the income statement or for debt covenants.

We look at the ability to both avoid realizing losses and gains as beneficial. If an organization has strong operating results, it is likely to want to avoid realizing investment gains, so that those gains can accumulate and be realized when operating conditions weaken. While if an organization is experiencing operating difficulties, it is likely that it will also want to avoid realizing losses from investments during the same period, while ideally having accumulated gains they can realize.

We delve into the primary implementation choices and compare them in **Exhibit 2**.

An enterprise looking to manage the realization of gains and losses would look for a unitized investment vehicle to minimize the actions that would result in the realization of a gain or loss. This can allow the avoidance of realizing losses if investment losses coincide with poor operating results. It also increases the likelihood that investment gains may have accumulated over multiple years—and when operating results were strong and income didn’t need support—to be realized when operating results are poor.

Exhibit 2: Investment vehicle comparison

POTENTIAL INVESTMENT VEHICLES	EVENTS THAT TRIGGER GAINS AND LOSSES	TO WHOM IS THE VEHICLE MOST ATTRACTIVE?	DISADVANTAGES
Separate accounts	• Any trading of underlying securities • Rebalancing • Tactical tilts • Dividend and coupon payments • Cashflows out	• An enterprise that has priorities other than managing income/gains from investments. • An enterprise that is not restricted from *wash trades* that wants to realize consistent income and has an investment provider that can use algorithms to reach year-end targets through wash trading.	• Constant realization of gains and losses makes separate accounts unattractive from the perspective of managing gains and losses, especially if the investor prefers not to utilize *wash trades.* • Underlying portfolio managers might require sophisticated techniques at year-end to adjust the trading of securities to match the desired realized gains or losses.
Unitized funds	• Rebalancing • Tactical tilts • Cashflows out	• An enterprise that wants some level of flexibility in determining when to realize gains or losses.	• Realization of gains and losses could impact the ability to rebalance and tactically tilt the portfolio if the enterprise wants to avoid the realization of those gains or losses.

A trade-off still exists between rebalancing to strategic weights or re-allocating toward a new strategy and actively managing realized gains and losses. To avoid potential conflicts, it is important for these enterprises to set guidelines in advance regarding the extent to which controlling gains and losses may supersede the need to bring the portfolio allocation to strategic targets. There may also be a preference to prefer a multi-asset unitized fund to reduce the need to rebalance and increase the ability to tactically tilt the portfolio without triggering the realization of gains and losses.

Additionally, if there are short-term liquidity requirements for the long-term pool, sufficient assets should be held in low-risk investments (e.g., cash or short government bonds) to help ensure that cash can be provided by these vehicles without the organization sustaining realized losses during down-market environments. If other investments have built up sufficient gains that the probability of falling into losses is low, the need for low-risk investments to fund liquidity would decrease. However, from an asset allocation perspective, the cashflow needs of the portfolio still impact the recommended risk posture.

Conclusion

We encourage our non-profit hospital and health system clients to manage their investments based on a thorough understanding of the planned and anticipated financial needs of their enterprises. This is impacted by both operating and financing conditions. In a properly managed investment portfolio, portfolio design will account for common market exposures across the enterprise and portfolio, and risk tolerance will be determined by the enterprise's needs, goals and financial position. Portfolio implementation decisions will then be influenced by the enterprise's needs regarding the management of realized gains and losses.

In short, the goals and circumstances of the organization can significantly impact its investment portfolio's design, risk tolerance and method of implementation. Therefore, it is vital for fiduciaries to weave these elements into their investment programs.

QUESTIONS?

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