2019 healthcare outlook

Russell Investments

Bolstering your organization’s financial health

Declining credit conditions and shifting financial markets could spell trouble ahead for non-profit hospitals and health systems. According to the Moody’s 2019 outlook[1] for the non-profit healthcare sector, operating cash flow is projected to be flat or to even drop by as much as 1% this year. Bad debt will likely grow by 8% to 9% due to mounting unpaid medical expenses and a potential increase in the number of uninsured patients visiting hospitals for care as ACA enrollments taper off. To top it off, while expense growth may slow down, it is still set to outpace revenue growth. Moreover, Fitch Ratings noted that credit downgrades outweighed upgrades during 2018, and predicted that that pattern is likely to continue into 2019.[2]

Combine these deteriorating sector fundamentals with a volatile, low-growth investing environment—and this will create considerable pressure on overstretched CFOs to keep their patients and their bottom lines healthy. With 2018’s market volatility continuing into 2019, historically low U.S. equity returns projected for the next decade, and one interest rate hike anticipated this year (which will raise the cost of debt), non-profit healthcare fiduciaries have their work cut out to successfully manage both their financing and investing strategies. The rising cost of debt issuance could increase the overall cost of borrowing for mergers and acquisitions and other capital projects. Lower expected returns from the market could also trigger an increase in required cash contributions to the pension plan if an asset / liability matching strategy has not been implemented yet. This might mean that assets earmarked for operating needs, or for growth in other areas, may have to be diverted to the pension plan to help maintain funded status. Ultimately, all of these pain points could negatively affect your financial metrics including days’ cash on hand and / or earnings from investments, potentially impacting the organization’s credit rating and its overall financial health.

For your non-profit hospital or health system to survive and thrive in these adverse conditions, you’ll need to wield all the tools available in your toolkit and take control where you can. In environments where every basis point or dollar counts, minimizing implementation slippage in your investment program can strengthen the organization’s overall financial health. In our experience, fiduciaries who don’t efficiently implement their investment strategy, run the risk of leaving money on the table—in terms of potential returns lost, costs unsaved, and risks left unmanaged.

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[1] Source: Moody’s Investor Service. Not-for-profit and public healthcare—2019 outlook remains negative amid glimmers of stability. 3 December 2018.
[2] Source: Becker’s Hospital Review. “Fitch: Healthcare profit margins will face pressure in 2019.” https://www.beckershospitalreview.com/finance/fitch-healthcare-profit-margins-will-face-pressure-in-2019.html. December 2018.

Benefits of implementation efficiency

Often, a greater focus on implementation can help you identify, measure, and explicitly manage hidden costs and risks. For example, consider a $5 billion pension fund. If you can save 25 basis points through better implementation, that's $12 million that the sponsor would otherwise have to contribute at some point. And this is not a one-off gain; the savings would compound year after year to add up significantly over time.

We believe the following points illustrate the aspects of implementation that can best steer healthcare fiduciaries towards organizational success.

- **Managing changes effectively**—investors make many changes to their portfolios—for example, changing managers, switching between asset classes, and managing cash flows. All of this can involve changes to a variety of investment allocations, ranging from physical securities (e.g., equities, bonds, and cash) and currencies, to more complex strategies (e.g., derivative exposures). In many cases, there are more cost-effective options available to investors relative to the methods that they currently employ to manage changes. Transition management and interim portfolio management can help investors effectively manage these changes.
- **Reducing deviation from target asset allocations**—investors spend a lot of resources determining their strategic asset allocation (SAA). However, without the proper monitoring, it can be easy to introduce unintended exposures at the total portfolio level. When asset allocation weights drift as a result of market movements, discrepancies between actual allocations and target allocations can detract value relative to an investor's strategic benchmark. We believe this asset allocation risk can be easily managed by frequently monitoring exposures and implementing a systematic program to align actual assets with target asset allocation. Overlay services and currency management both help investors maintain target exposures and avoid unwanted and uncompensated risk.
- **Improving execution quality**—it's not always easy to have visibility into transaction costs within all parts of an investor's portfolio. Visible or not, these costs exist and managing them helps to ensure more assets stay in the fund rather than eroding away. Quality execution preserves performance. An example of such transaction costs frequently mentioned in the press over recent years is foreign exchange costs. Execution services, transition management, commission recapture, and agency foreign exchange (FX) all work together to help improve execution and minimize transaction costs.

Aggregated across multiple areas, cost savings can quickly add up. For example, Russell Investments' portfolio management team helped a large health system increase its implementation focus across a number of areas on a centralized platform of specialist implementation services. Through this greater focus on implementation, our **client saved a total of 64 basis points in transaction costs** over an eight-year period, and **reduced portfolio tracking error by 70%**.[3]

Outside help

At Russell Investments, we have state-of-the-art, in-house trading capabilities and implementation strategies that we have been using to help our clients improve returns, reduce costs, and reduce risks for over 30 years.[4] Recent expectations of lower forward-looking market returns and declining healthcare sector fundamentals further amplify the need for efficient and effective portfolio management. In today's adverse investing environment, teaming with an investment partner skilled in implementation could help you improve your organization's finances in 2019.
That way, you can keep your patients—and your bottom line—healthy.

[3] Case study provided for discussion purposes only. Individual client results will vary based on individual circumstances and market events. There is no guarantee that all clients will experience the same positive results.

[4] In 23 out of 27 most recent quarters, Russell Investments Implementation Services, LLC has been ranked as a top-tier broker in *Pensions & Investments*' Tradewatch report based on the quality of its trade execution (most recently in *P&I's* December 2018 issue).

For more information

Call Russell Investments at **800-426-8506** or visit **russellinvestments.com/healthcare**

Important information

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