Five questions for hospital and healthcare fiduciaries to consider in 2018

2018 is looking like it will be a challenging year for hospitals and health systems. This past December, Moody's issued a negative outlook on the non-profit healthcare sector for the first time in several years, predicting that operating cash flow will decline by two to four percent over the next 12 to 18 months.[1] This contraction will likely be exacerbated by a rise in uncompensated care costs that is expected to result from the repeal in the individual insurance mandate. This could lead to a six to seven percent increase in unpaid hospital bills, as well as increases in overall operating expenses.[2] Moreover, there are a number of provisions in the 2017 Tax Act that will have a major impact on the financials of healthcare organizations. In addition to this instability, we are anticipating several shifts in the markets this year, including three or four interest-rate hikes, a correction in expensive equity valuations, and rising recession risks. These changes can spell trouble for your organization's financial health if they are not managed appropriately.

So, what's a busy CFO to do? We pose five questions you should be considering in 2018, and provide our recommendations on how to address them.

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1. Does your organization have a game plan for implementing the changes mandated by the 2017 Tax Act?

Tax reform is going to have a significant impact on how hospitals and health systems manage their finances. However, some of the changes will be phased in over time to give hospitals and health systems time to adapt. What's more, these changes won't affect for-profit and non-profit organizations equally. For for-profit entities, the new law limits the federal tax deduction that companies can take for the interest they pay on their debt to 30% of earnings before interest, taxes, depreciation, and amortization costs from the earnings benchmark they use for the 30% test. This will lower earnings for the purpose of the earnings calculation, and thus lower the level of interest that organizations can deduct, potentially causing tax bills to increase further.[3] However, the law also slashes the corporate tax rate from 35% to 21%, which could, in fact, be a boon to profitable providers with relatively lighter debt loads. The new law has no direct impact on corporate pension plan funding laws, but by changing the corporate tax rate, it creates a new incentive for companies to accelerate their pension plan contributions to the 2017 plan year. This could in turn lead to improved funded status, updated asset allocations, and further advancement of pension plan lifecycles.

For non-profit entities, the new law has little impact on the pension plans they sponsor. The final law preserves the ability of non-profit hospitals to issue private activity bonds, but it eliminates tax-exempt advance refunding bonds. The new law also requires tax-exempt organizations to calculate income from each unrelated trade or business separately, and prohibits offsetting taxable income from one such activity with losses from another. In short, these legislative changes are going to have a big impact on the financials of both non-profit and for-profit healthcare organizations. Since your investment program is just one component of your organization's holistic financial health, it is important that the tax-related decisions you make within your various asset pools account for the impact that the changes will have on your entire organization. Ensuring that your investment provider, financial team, and regulatory experts are all on the same page about your organization's overall goals and objectives can also help you avoid unexpected risks that could affect your financial health.

2. Are your investment portfolios prepared to weather impending market shifts?

Rising recession risks can impact how you and your provider manage your investment portfolios. Our investment strategists' Business Cycle Index (BCI) model puts the probability of a U.S. recession in the next 12 months at around 25%, a new high for this economic expansion since the 2008 recession. It is not quite at alarming levels, but we advise caution given the age of the expansion. By April, we will be in the second-longest bull market on record. Overall, we think the U.S. economy is still on a path of moderate growth with low probability of recession over the next year, but risks are building at the three-year horizon. To protect against this, you should consider maintaining balanced risk portfolios by opportunistically buying the dips—for example, high-yield bonds—and primarily selling the rallies—such as growth-oriented global equity managers. You should also consider diversifying your return sources to help improve the risk-adjusted returns of your portfolios this year. You could look into a higher allocation to less liquid, return-seeking strategies in your pension plan, or include more illiquid assets in your foundation pool. At the same time, you should make sure to appropriately manage your organization's liquidity needs in your long-term pool so that it can generate cash flows for both short- and long-term projects. That way, you are also taking your long-term organizational objectives into account.

3. What is your exposure to interest-rate risk?

This year marks an inflection point in U.S. monetary policy as it shifts from an expansionary stance to a more contractionary tilt, putting upward pressure on government bond yields. This shift is important for healthcare fiduciaries to consider because rising interest rates impact pension plan liabilities, cost of debt, and returns on long-term investments. Therefore, we believe it is vital to manage interest-rate volatility through a balanced, holistic approach. For instance, you could maintain overweight positions to the financial sector, which has tended to benefit from higher interest rates—and you should adjust your portfolios now before rates rise further. Rising rates can also help improve funded status if your pension plan is underfunded. However, in order for this to happen, interest rates need to meet or exceed the cost of capital. And cost of debt issuance may rise, increasing the overall cost of borrowing for capital improvements or merger-and-acquisition projects. Furthermore, investment strategists are predicting that returns from the market alone in coming years won't be enough for your portfolios to hit this benchmark. This may adversely impact your long-term pool, which requires returns greater than the cost of capital to fund projects.

Clearly, betting on market returns alone isn't enough. Therefore, you need to incorporate investment strategies that can offer incremental returns, avoid uncompensated risks, and ensure efficient implementation. At the end of the day, you should take a step back and assess your interest-sensitive exposures across the total financial picture, not just within each investment silo.

4. Are the equity portfolios within your various asset pools geographically diverse?

U.S. equity valuations are at an all-time high, and the Shiller P/E ratio, which is a reliable long-term valuation measure, is currently at 30x. That's the most expensive level ever outside 1929 and the late 1990s. We believe U.S. equities can climb higher over the first half of the year with the short-term boost of tax reform, before facing headwinds in the second half as markets factor in rising recession risks. Said another way, U.S. equities are approaching bubble territory. To protect against this, we have positioned our clients' portfolios to significantly tilt away from U.S. equities in favor of non-U.S. exposures, particularly in Europe, Japan, and, to a lesser degree, emerging markets equities given the 30% YTD return they already experienced in 2017. We recommend—if you haven't already—diversifying into these regions, as extremely expensive U.S. equity valuations make the domestic market vulnerable to unwelcome news.

Enhancing your organization's financial health starts with your governance and delegation structure—both of which should be revisited. And to help ensure success, your investment committee and CFO need to focus on the high-level strategic decisions that will deliver long-term value to your investment program.

5. Are you doing everything you can to keep your organization financially healthy?

This year we see risks coming from all angles—declining industry fundamentals, a changing regulatory landscape, and shifting financial markets. To overcome these adverse conditions, and to optimize your organization's financial health, you need to cover all of your bases. And 2018 may be the year you ask for some help. The implications of tax reform alone will keep you busy, which leaves you precious little time to monitor the markets and manage your investment portfolios. Enhancing your organization's financial health starts with your governance and delegation structure—both of which should be revisited.

To help ensure success, your investment committee and CFO need to focus on the high-level strategic decisions that will deliver long-term value to your investment program. This means your team should set a robust dynamic asset allocation strategy to guide the tactical positioning in your investment program, and should think about delegating the implementation of those decisions to an outsourced CIO (OCIO) provider. An OCIO, through efficient and effective manager selection, implementation, and dynamic portfolio management, can save you valuable incremental basis points. We would encourage you to put these items on your first committee meeting agenda for 2018 to ensure you have the best possible chance of keeping your balance sheet strong, your days cash on hand substantial, and your credit rating healthy.

[1] Source: https://www.moodys.com/research/Moodys-US-not-for-profit-and-public-healthcare-outlook-changed--PR_376421

[2] See above.

[3] Source: https://www.wsj.com/articles/downside-of-tax-bill-hits-dell-other-heavily-indebted-companies-1513852200

FOR MORE INFORMATION:

If you'd like more information about how Russell Investments can help you strategically position your investment program in 2018, we'd love to have a conversation with you.

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