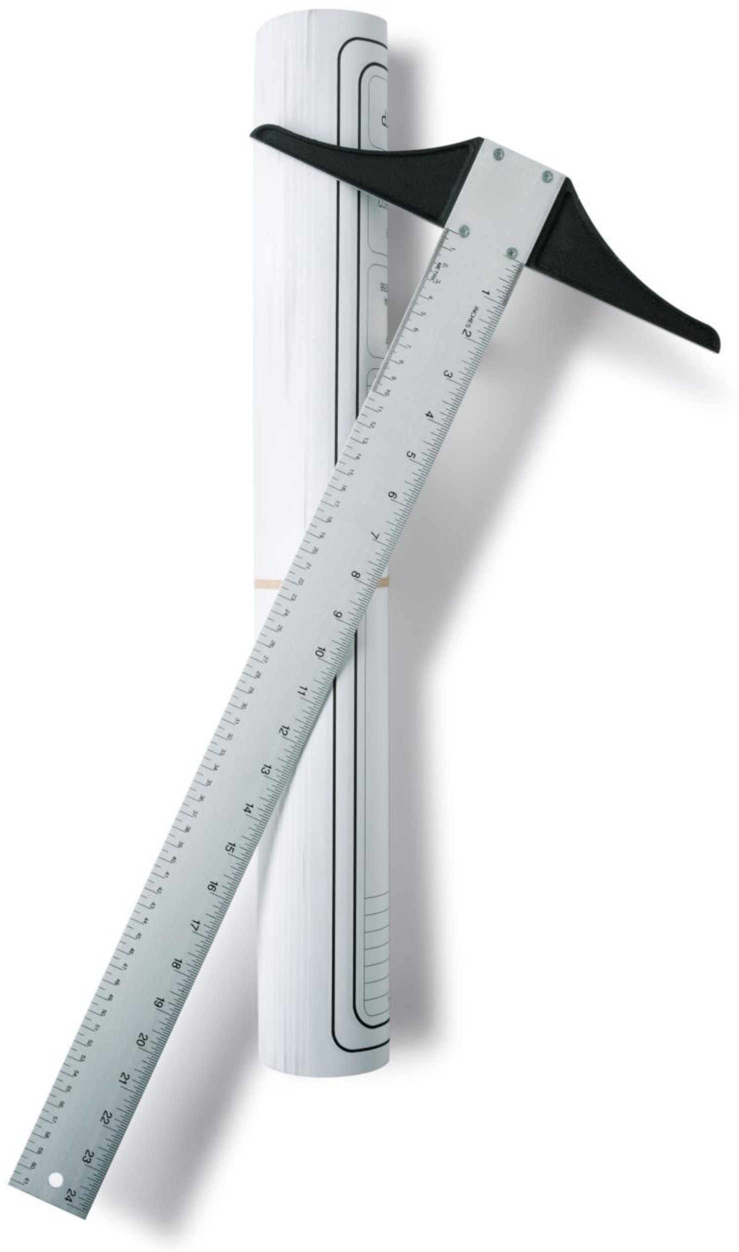
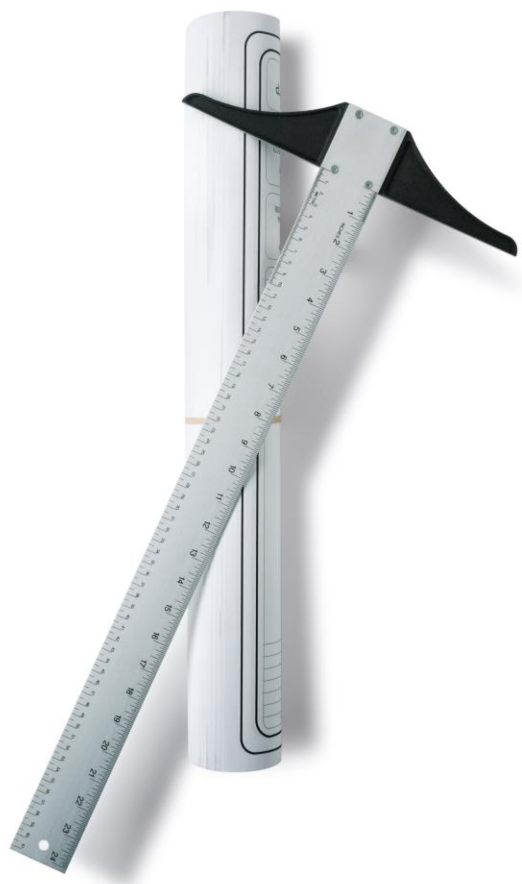
A framework for tailoring investment decisions to the enterprise

Supporting the financial needs of non-profit hospitals and health systems

Russell Investments



Contents



A framework for tailoring enterprise investment decisions

Mary Beth Lato, CFA, Director, Investment Strategy & Solutions

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 initial broad decisions on risk tolerance to more targeted decisions on asset class exposures and investment vehicle preferences. Given that each non-profit hospital and health system has its own unique situation, 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
- Market environments in which the stability of the individual pools would become most important
- Any income statement implications of portfolio decisions

Introduction

Most non-profit hospitals and health systems oversee multiple asset pools. These can include retirement funds, long-term pools, operating capital, foundation assets, self-insured assets and, potentially, other asset pools. One of the key challenges in designing and managing portfolios for these investment pools is effectively constructing them in the context of the enterprise. This means factoring in broad organizational goals, constraints, capital-intensive projects and expected liquidity needs. Before an asset allocation can be evaluated, the role of each investment pool and the situation of the enterprise must be evaluated.

By "enterprise," we mean all aspects of the hospital or health system (e.g., operations, governance, finance) as well as exogenous factors. For example, projects such as mergers, acquisitions and capital projects can all be major determinants of portfolio design, given the potential cash outflows from the long-term pool. By aligning each portfolio's objectives with the organization's critical financial issues, the system will be better positioned to develop an effective asset allocation for each asset pool.

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 can impact how the return-seeking and risk-reducing portfolios are constructed. 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.

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.

Although the enterprise-level considerations and constraints impact all investment pools, this paper focuses on the long-term pool, which typically includes funded depreciation accounts, board-designated funds and long-term operating accounts. In this paper, we examine how to address the impact of enterprise needs on the long-term pool across three key considerations:

1. Investment portfolio risk tolerance
2. Portfolio construction
3. Portfolio implementation

1. Addressing the impact of enterprise needs on portfolio objectives and risk tolerance

> *In this paper, we examine how to address the impact of enterprise needs on the long-term pool across three key considerations…*

Linking portfolio objectives to enterprise needs

The objective for the long-term pool should be linked to the opportunity cost of maintaining investments in it. Most enterprises choose to borrow and carry debt, while also growing the long-term pool given the low cost of borrowing in the current market environment. Given 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 encourage enterprises to explicitly link this decision with the objectives of the long-term pool by setting its objective to the cost of capital plus a premium. The higher the premium, the more the enterprise can expect to be rewarded for maintaining assets in the long-term pool rather than reducing its debt. However, as the remainder of this section lays out, it is also important to link the asset allocation to the risk tolerance of the enterprise, and as a higher risk portfolio will be needed to target a higher return, the risk tolerance will inform the premium above the cost of capital that could be targeted. The risk tolerance will likely be impacted by a combination of cash flow, credit rating and/or income statement needs.

Linking asset allocation to cash flow needs

The financial strength of the enterprise and its reliance on the long-term pool will have a direct impact on its ability to tolerate risk. If the expectation is that the long-term pool will be called upon to finance capital projects, repay debt or compensate for any cash shortfalls, this will naturally shorten the investment time horizon and reduce risk tolerance. However, if the enterprise has a strong balance sheet, does not anticipate a need to draw upon assets from the long-term pool and expects to have continuous positive cash flows into the future, the long-term pool can be managed with a long-term perspective, perhaps even in perpetuity. Here, the enterprise would be better positioned to tolerate higher risk levels and more volatile markets.

In looking at its overall financial strength, the enterprise should explicitly evaluate the role of the long-term pool in supporting enterprise objectives. Doing so (i.e., deciding whether the focus is on future growth, liquidity requirements or a combination of enterprise requirements) will inform decisions on risk tolerance. Accounting for enterprise-level risk concerns and expected cash-flow requirements in the long-term pool reduces the probability of investment losses that exceed the enterprise's ability to tolerate losses. This also allows the enterprise's board to focus on its objectives. By constructing a portfolio that takes cash flow requirements into consideration, the enterprise can focus on improvements to its main businesses, and it can have greater confidence in the long-term pool's ability to fund necessary cash flows and support debt needs as required.

CASE STUDY A

Client A had a stated objective of high growth above inflation, but a moderately risky portfolio that was not expected to achieve its stated objective. Russell Investments presented an analysis that showed the portfolio required to achieve the stated objective, and portfolios that could achieve different potential objectives re-framed around the cost of capital plus a margin. For all portfolios, Russell Investments then presented analysis on the potential drawdowns in stressed market environments, and if the portfolios could lead to a reduction in days cash on hand that could jeopardize the credit rating along with the impact on the income statement. Client A was most concerned with the potential impact on days cash on hand and the credit rating. Client A moved to a more diversified portfolio, but it was in line with the risk it was currently taking in order to not risk a downgrade. Client A also changed its objective to be based on its cost of capital plus a premium, which the new portfolio was expected to achieve.

Linking asset allocation to credit rating needs

Many non-profit hospitals and health systems rely on debt financing for cash flow needs instead of the long-term pool due to the low cost of borrowing in the current market environment. However, since the strength of the long-term pool is often an important factor in their credit rating and, therefore, their cost of debt, upcoming capital projects or acquisitions are likely to still impact risk tolerance even if they don't directly result in outflows from the long-term pool. For long-term pools that are used in metrics evaluated by credit rating agencies (e.g., measures of days cash on hand and debt coverage), it will be crucial to explicitly consider the potential impact of asset losses on these metrics. The asset allocation should be tested to assess the likelihood that negative portfolio returns could stress the long-term pool and cause the metrics to potentially breach the thresholds needed for the rating agencies to assign a desired credit rating. For organizations in stronger financial positions, this analysis could reveal that they can take on more risk as they seek to maximize returns, whether or not their goals require them to take such risk. It could also show those in weaker positions that they need to reduce risk in order to maintain their credit rating. Regardless of the initial financial position of the hospital or health system, this framework allows the organization to seek an appropriate level of return while securing its credit rating to minimize the cost of debt.

If growth in days cash on hand is an important long-term goal, the portfolio objective could also address outperforming expense growth.

> *this framework allows the organization to seek an appropriate level of return while securing its credit rating to minimize the cost of debt.*

CASE STUDY B

Client B had built its portfolio to achieve the return objectives required to grow the asset base, with the goal of supporting a future capital project. However, its credit rating was at risk, and Client B knew that its unrestricted reserves over the long-term debt ratio were just above the median recommended level to maintain its credit rating. Russell Investments put together an asset allocation analysis that assessed the probability that Client B's unrestricted reserves over the long-term debt ratio would breach a predetermined floor. We then assessed the probability of the client reaching its long-term growth targets. Because maintaining its credit rating was Client B's primary objective, it reduced its portfolio risk to minimize the likelihood of jeopardizing its balance sheet ratios, while acknowledging that it would now be more difficult to meet its long-term growth targets.

Linking asset allocation to income statement needs

An additional, important consideration that some enterprises will be giving attention to, and additional planning for, is controlling how the long-term pool could impact income statements. This may drive decisions about investment implementation vehicles and the rebalancing of portfolio allocations. Hospitals and health systems for which coordination with the income statement is a critical factor may either be seeking to avoid stating losses from the long-term pool or actively seeking to generate income from the pool.

The interaction between the needs of asset allocation and income statement will depend on whether the enterprise reports both realized and unrealized gains from the long-term pool on its income statement, or whether it only reports realized gains. In either case, if the enterprise is looking to increase the long-term gains, it will be drawn towards a more aggressive asset allocation with higher expected long-term returns. However, if the enterprise is concerned about the potential impact of losses on the income statement in a negative market environment, the implication for asset allocation will depend on whether unrealized gains and losses are included on the income statement. If unrealized gains and losses do not impact the income statement, then the managing of annual gains and losses can be an implementation question, which is addressed later in the paper. However, if unrealized losses flow through to the income statement and an enterprise is concerned about the long-term pool having a negative impact on the income statement in any given year, it will need to address that concern through asset allocation. The enterprise will need to stress test potential portfolio losses and ensure the potential impact on the income statement is something that the enterprise could tolerate—and otherwise reduce risk in the long-term pool.

The enterprise will need to stress test potential portfolio losses and ensure the potential impact on the income statement is something that the enterprise could tolerate—and otherwise reduce risk in the long-term pool.

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

Mitigating market environment impact

In constructing the portfolio, it is also important to analyze the environments in which the long-term pool may be more likely to be relied on to fund cash shortfalls, or to support the credit rating in the case that additional debt is undertaken. Some of these environments are examined in **Exhibit 1**.

In a typical market environment, we do not generally see the cash needs and revenue generation of healthcare systems as correlated to market returns. This did not appear to be the case during the market sell-off related to COVID-19 in the first quarter of 2020, as markets fell at the same time healthcare systems experienced revenue declines. Fortunately for healthcare systems in 2020, markets rebounded from their lows prior to the end of the fiscal year removing the possibility of reporting large losses on the income statement and prior to most healthcare systems actually requiring cashflow due to a combination of governmental relief programs and other sources of cash. Despite this occurrence in 2020, we do not have tailored asset allocation for the healthcare sector[1] like we might have for an investor in the oil and gas industry to mitigate exposure to commodities.

The long-term pool should be structured in a manner that is mindful of when its strength and liquidity will likely be most beneficial to the enterprise. An example could be the significant exposure to private real estate that non-profit hospitals and health systems may maintain 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 hospitals' and health systems' balance sheets and long-term pool, to help avoid losses on multiple balance sheet items in the event that 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 hospital's direct real estate holdings.

Another application of this concept is the presence of floating-rate debt within the enterprise, and the need to ensure that the investment pool can withstand rising interest rates—and, therefore, support debt repayments when they are at their peak. Although floating rate debt is rare in the current market environment, this could change as market conditions change.

Enterprises with this concern might design investment portfolios with fewer long-duration fixed income investments, in favor of shorter-duration and floating-rate fixed income.

Considering the enterprise’s financial circumstances

Considering when cash-flow needs and/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.

Exhibit 1: Impact of potential enterprise-level exposures

<table>
<tr><th>POTENTIAL ENTERPRISE- LEVEL EXPOSURES</th><th>IMPACTS ON ENTERPRISE</th><th>HOW TO ACCOUNT FOR ENTERPRISE-LEVEL EXPOSURES IN THE INVESTMENT PORTFOLIO(S)</th><th>HOW TO ASSESS THE IMPACT OF THE EXPOSURE</th></tr>
<tr><td>Significant floating rate debt (not typically seen in current market environment given low fixed rates available)</td><td>Higher cash outflows required when interest rates increase</td><td>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 absolute return and/or floating rate fixed income.</td><td rowspan="4">If possible, asset allocation analysis should incorporate both the asset pool and the enterprise exposures to capital market movements.</td></tr>
<tr><td>Defined benefit pension plan</td><td>Higher cash contributions to the pension plan likely if interest rates decrease and/or equity markets decline</td><td>Potentially increase exposure to longer-duration fixed income and/or reduce allocation to equities based on existing enterprise-level exposures. However, those investment concerns should be addressed directly in the asset allocation for the pension plan asset pool.</td></tr>
<tr><td>Significant real estate holdings</td><td>Enterprise already exposed to fluctuations in real estate values</td><td>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.</td></tr>
<tr><td>Credit rating impacted by liquidity profile of investment pool</td><td>Credit rating downgraded or put on warning if the liquidity profile of the investment pool is in breach of certain levels</td><td>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.</td></tr>
</table>

3. Implementation: Addressing enterprise 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. For those that report both realized and unrealized gains on the income statement, this can only be managed through asset allocation decisions. However, for enterprises that only report realized gains and losses, the annual impact on the income statement can be managed through implementation and rebalancing decisions. This section is only applicable to enterprises that only report realized gains and losses on the income statement.

A trade-off exists between rebalancing to strategic weights 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 rebalance portfolio allocations to strategic weights. We delve into the different types of investment vehicles in the rest of this section and compare them in **Exhibit 2**.

> *…for enterprises that only report realized gains and losses, the annual impact on the income statement can be managed through implementation and rebalancing decisions.*

Exhibit 2: Investment vehicle comparison

POTENTIAL INVESTMENT VEHICLES	EVENTS THAT TRIGGER GAINS AND LOSSES	TO WHOM IS THE VEHICLE MOST ATTRACTIVE?	DISADVANTAGES
Separate account	• Any trading of underlying securities • Rebalancing • Tactical tilts • Dividend and coupon payments	• An enterprise that has priorities other than consistent income from the long-term pool	• Constant realization of gains and losses makes separate accounts unattractive from the perspective of managing gains and losses • Underlying portfolio managers might require sophisticated techniques at year-end to adjust the trading of securities to match the desired realized gains and/or losses
Commingled asset class funds—income reinvested in the fund	• Rebalancing • Tactical tilts	• An enterprise that wants to generate near-term income, but also wants flexibility in determining when to realize income	• 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
Commingled asset class funds—income paid out of the fund	• Rebalancing • Tactical tilts • Dividend and coupon payments	• An enterprise that wants to generate consistent income	• When income is constantly recognized, it is less likely that gains will accumulate within the funds • Realization of gains and losses with any trade could impact the ability to rebalance and tactically tilt the portfolio if the enterprise wants to avoid the realization of those gains or losses
Multi-asset class funds	• Rebalancing between multi-asset funds and other funds	• An enterprise that wants to avoid losses • An enterprise that doesn't need current income, but sees the advantage of accumulating income for future use • An enterprise that wants its portfolio to be dynamically managed	• If this is a new investment, or if gains were recently realized, it is less likely that there will be gains to be realized later

Avoiding realized losses

An enterprise looking to avoid realized losses from the long-term pool should seek as broad an investment vehicle as possible, in terms of asset classes included. This would help enable the portfolio to react dynamically to changes in the market environment without the enterprise worrying that selling investments at a loss would trigger recognition of an accounting loss. Multi-asset investment vehicles allow for dynamic tilts across asset classes without triggering recognition of gains and losses when trading is completed within a commingled fund structure. It is important to note that in seeking a multi-asset investment vehicle, the quality of investment opportunities must not be compromised; and we believe only multi-asset managers with expertise in all underlying investments should be considered.

CASE STUDY C

Client C's first priority was to ensure that it would not recognize losses. Russell Investments recommended that Client C invest its return-seeking assets in a single multi-asset fund, so that any tactical adjustments or rebalancing back to strategy weights would occur within the fund and thus not trigger recognition of gains or losses. As Client C has only two funds to rebalance across (i.e., its multi-asset return-seeking fund and its core fixed income fund), rebalancing would trigger recognized losses only if both funds experience losses at the same time. This is because rebalancing naturally requires selling the asset class that has had the better performance and buying the asset class that has had the poorer performance. It is, therefore, only in market environments similar to that of 2008, when both return-seeking assets and core fixed income experienced losses, that rebalancing would trigger the recognition of losses.

Separate accounts might also be avoided so that concerns on realized losses do not impact a manager's ability to execute trades based on best thinking. 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. 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.

Pursuing consistent income

Hospitals and health systems looking to derive consistent income from investments are incentivized to implement their portfolios differently from those focused on avoiding realized losses. Income-paying vehicles become more attractive as they consistently generate income, and they are likely the only way to produce income when all investments are experiencing losses. However, constant recognition of dividends and coupons as income makes it less likely that gains will accrue to be realized at a later time. This makes income-paying vehicles less useful for enterprises that are aiming to accumulate realized gains from investments. An organization could aim to accumulate gains either to offset expected declines in margins, or to be available in case there are unforeseen losses in other parts of the enterprise.

Another strategy for pursuing consistent income is to use different investment vehicles for individual asset-class segments, rather than a single, broad multi-asset investment vehicle. The wider the array of investment vehicles, the more likely it is that there will be an accumulated gain in at least one vehicle that can be realized when income is needed. It is also important to understand that if gains are frequently realized, it is more likely that market declines will lead to a realized loss when an investment is sold. We recommend diversification to all investors as it helps reduce drawdowns; the argument is even more compelling for investors with the specific desire to consistently realize gains.

The wider the array of investment vehicles, the more likely it is that there will be an accumulated gain in at least one vehicle that can be realized when income is needed.

CASE STUDY D

Client D was looking to generate income that would equal approximately 4% to 6% of its asset base annually. Russell Investments assisted Client D in developing a diversified portfolio across commingled asset class funds. Although Client D has a strategic asset allocation, the rebalancing framework is not automatic; it is customized monthly, with the aim of realizing gains equal to 0.3% to 0.5% of assets each month. If it is impossible to rebalance to target weights without realizing losses, the client is contacted, and a temporary mismatch with the strategic asset allocation is permitted.

Conclusion

We encourage our non-profit hospital and health system clients to manage their investments based on a thorough understanding of the plans and anticipated financial needs of their enterprises. 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.

[1] There is greater ability for the enterprise to tailor the long-term pool to balance organizational objectives than for a DB fiduciary governed by ERISA, which has a required duty to focus on the interests of plan participants and to diversify investments rather than potential conflicts with organizational objectives.

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.

For more information

Call Russell Investments at **866-739-7979** or

visit **russellinvestments.com/healthcare**

Important information

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Case studies provided are 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.

Russell Investments' ownership is composed of a majority stake held by funds managed by TA Associates with minority stakes held by funds managed by Reverence Capital Partners and Russell Investments' management.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the "FTSE RUSSELL" brand.

First used: April 2015. Revised: January 2021

AI-28591-01-24