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Making Investment Decisions That Match Strategy

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Non-profit hospitals and health systems face some of the most difficult investment challenges among large institutions.

Many are responsible for oversight of retirement funds, operating funds, foundation assets and other investments, all of which have their own specific goals and return targets. At the same time, in creating a financial plan for the overall enterprise, all of these pools must be made to work towards one goal.

Practically, this means that health systems – more so than other organizations – need to do two things at once: ensure that individual asset pools meet their goals and manage the impact each has on the long-term financial strategy of the overall organization. To succeed at this balancing act, organizations have to carefully factor business and income needs into their strategic asset allocation process.

Building portfolios that support concrete business needs

The unique situation of the organization - including its goals - must help determine how assets should be invested and how much risk can be taken. For example, the investment time horizon and risk tolerance is lower when a healthcare system expects its investment pool to finance capital projects, repay debt or compensate for cash shortfalls. By looking at its overall financial strength, the enterprise may explicitly evaluate the role it expects the investment pool to play in supporting business objectives.

In terms of asset allocation, capital projects and other shorter term demands may spark a desire to maximize returns; however, increasing risk in the investment portfolio may lower the organization's credit rating and make financing more expensive. To maintain a credit rating, the investment portfolio may need to keep allocations to liquid investments above certain levels and also ensure that a stressed market environment is unlikely to increase the proportion of illiquid investments beyond an acceptable threshold.

In general, many hospitals and health systems rely on the ability to issue debt for financing needs. This makes it crucial to consider the impact of asset losses on the metrics used by credit rating agencies, such as measures of days cash on hand and debt coverage. The good news is that investment portfolios may be analyzed to determine likely outcomes for various asset allocations.

One recent example is a healthcare system that realized the ratio of unrestricted reserves to long-term debt was just above the median recommended to maintain its credit rating. It analyzed the probability that the ratio would drop below that floor, along with the probability that its investment portfolio would meet growth targets. The organization decided to reduce the risk in its investment portfolio because maintaining their credit rating was their primary concern.

The results of scenario analysis can be surprising. For example, hospitals with strong financials might find that they can take on more risk. On the other hand, testing investment losses may show an impact that radiates out beyond the investment portfolio to other capital pools. By looking at an investment portfolio's effect on the entire enterprise, an organization may spot potential sources of difficulty and manage its assets to avoid them.

Addressing difficult markets

An investment portfolio needs to be prepared for market downturns. At a healthcare system, that means being mindful of when the portfolio's strength and liquidity will likely be most beneficial to the rest of the enterprise.

Private real estate is a good example. Non-profit hospitals and health systems often own and operate buildings which are exposed to fluctuations in real estate value. The investment portfolio may have similar risks which should be minimized, which could potentially mean

divesting private real estate holdings in the investment portfolio and seeking to replace them with vehicles that have different exposures.

Rising interest rates are another risk that may potentially cut across an organization, especially when it has significant floating rate debt that will require higher cash outflows to service. One way the investment portfolio can prepare for rising interest rates is to decrease exposure to longer-duration fixed income and introduce exposure to absolute return or floating-rate fixed income.

Declining interest rates, on the other hand, carry their own risks and health systems with defined benefit plans may potentially face higher contributions when rates drop. An investment portfolio may be able to account for this risk by reducing its allocation to equities and increasing longer-duration fixed income exposure.

Recently, one hospital looked at three critical components of its net worth to operating budget ratio: the asset allocation in its investment pool, its office building and its pension plan. What it found was significant overexposure. The allocation in its investment portfolio to core private real estate overlapped with the ownership of its office building, and the equity allocation was partially correlated with its pension plan. The organization responded by reducing its investment allocation to private real estate, which turned out to be sufficient. As a result, the investment portfolio was able to maintain the equity allocation designed to meet its long-term growth target even though it was correlated with some investments in the pension plan.

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When a healthcare system considers the asset allocation in its investment portfolio relative to its balance sheet and cash flow needs, it may better meet the cash flow needs of the larger enterprise and reduce the likelihood of coincident losses on the balance sheet and income statement due to correlated risk.

Addressing income goals

A final, important consideration is how the investment pool impacts income statements. Healthcare organizations may seek either to avoid stating losses for their investment pools or to generate income from them. In either case, it is important for the enterprise to set guidelines in advance because there is always a trade-off between managing realized gains and losses versus rebalancing the asset allocation to meet strategic objectives.

Multi-asset vehicles may be attractive to enterprises that wish to avoid realized losses and accumulate income for future use, as opposed to current use. These portfolios can buy and sell investments dynamically in a comingled fund structure. Only when assets are moved between the multi-asset vehicle and another vehicle are gains and losses realized.

One reason to accumulate realized gains from investments is to offset expected declines in margins or other unforeseen losses in the other parts of the enterprise. If these gains are particularly important, using different vehicles for individual asset classes is one solution. If the mix of asset classes is diverse, it is more likely at least one vehicle will show a gain when needed. This has the added benefit of encouraging a diversified investment portfolio, which is a proven strategy for achieving long-term goals.

There are different considerations for hospitals and health systems that want to derive consistent income from their investments. As an example, a hospital system may be looking to generate income of approximately 3% of its asset base annually. Sources of income include rebalancing, dividends and coupon payments.

Rebalancing can trigger gains and losses, so an organization focused on targeting a specific level of i ncome from investments might consider avoiding automatic rebalancing, particularly if scheduled on a monthly basis. Instead, the rebalancing could be customized for a monthly evaluation with the aim of realizing a portion of available unrealized gains each month. If it is impossible to fully rebalance without realizing losses a temporary mismatch between the strategic and actual asset allocation may be allowed.

Income can often be re-invested in a fund to give the enterprise flexibility in when it recognizes the accounting gain. Alternatively, organizations can take a stream of payouts but it is also important to remember that frequently realizing gains reduces the likelihood that gains will accrue to be realized later. It also raises the likelihood that market declines could produce realized losses.

There is no "one-size-fits-all" solution, but a proactive strategy that incorporates a view of the entire enterprise can be essential in helping CFOs actually meet their organizations' investment goals. ■

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