Healthcare system

Russell Investments

Reduced complexity, reduced volatility, and improved pension funded status

Client case study

The organization

A non-profit healthcare system (the “system”) providing a wide array of services, including several hospitals, an ambulatory care center, and multiple community health and long-term care centers. Management oversaw multiple asset pools, including board-designated assets (also known as the long-term pool), a frozen pension plan, and a foundation. The system was financially strong and was considering acquisitions. Management and the investment committee realized the need to align their investment strategy with the overall financial goals of the system.

Challenge 1: Volatility

The healthcare system’s primary investment challenge in recent years has been market volatility. Volatility within the board-designated assets had negatively impacted the balance sheet. Market and interest rate volatility in the pension plan also created an unexpected level of unfunded liabilities. The uncertainty resulting from the volatile market environment created multiple challenges in managing the balance sheet and debt-coverage ratios. Prior to the global financial crisis, the healthcare system managed its board-designated, pension, and foundation assets to a total return target across all asset pools. This resulted in investment portfolios that were nearly identical across all three pools. Managed in this “one size fits all” manner, the investment portfolios produced attractive investment returns, but the board-designated assets experienced more volatility than the investment committee desired, and without a liability-driven investment program, the pension plan’s assets did not move in concert with plan liabilities.

Challenge 2: Complexity

The complexity of establishing multiple objectives for individual asset pools (and then managing to those objectives) was daunting, even as a means of reducing overall portfolio volatility. Delegating many of the operational tasks to a co-fiduciary (Russell Investments) allowed the healthcare system to simultaneously increase the sophistication of their investment program and ease management’s administrative burden. Delegated tasks included portfolio analysis, manager research and oversight, investment implementation, and performance reporting, to name a few.

Benefits of delegation

Delegating many of the operational and investment tasks to a co-fiduciary allowed the healthcare system to simultaneously increase the sophistication of their investment program and ease management’s administrative burden.

With the program's operational and administrative complexity reduced through delegation to Russell Investments, the healthcare system was able to focus on establishing the following objectives for the individual asset pools:

ASSET POOL	OBJECTIVES
Board-designated assets	• Manage volatility and maintain credit rating • Ensure ability to fund short-term and long-term projects • Achieve investment returns to meet or exceed cost of capital
Pension plan	• Improve funded status • Understand role of pension plan within context of plan sponsor financials • Manage volatility of funded status and contributions
Foundation	• Support non-profit mission and operating budget • Meet spending requirements and manage liquidity • Manage volatility and maintain purchasing power

Investment solutions: A new approach

Board designated assets

With new investment objectives now clearly defined for the board-designated assets, Russell Investments and the investment committee targeted minimizing the volatility of the assets to create a return stream that would be more in line with the net cost of capital for the healthcare system. Together, we explored several strategies for reducing the portfolio's investment risk, including:

DIVERSIFICATION

Increased diversification of asset classes through reduced home country bias and an increased allocation to hedge funds, high yield bonds, and real estate strategies

REDUCE RISK

Reduced exposure to "risky" assets through an increased allocation to fixed income and other less volatile assets

REDUCE VOLATILITY

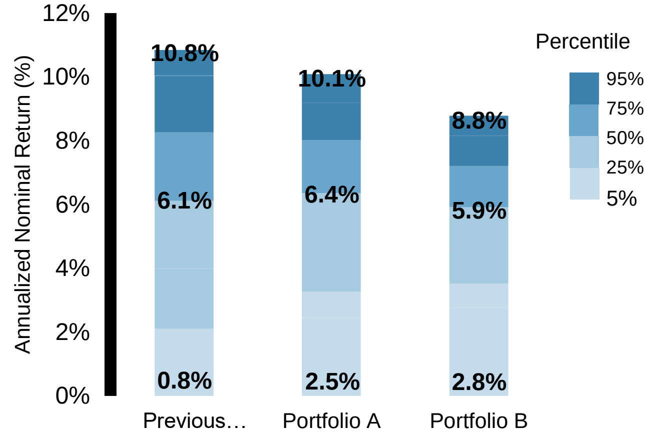
Reduced volatility of "risky" assets through the addition of investment strategies with better downside protection characteristics, such as defensive equity

DYNAMIC RISK-HEDGING

The addition of dynamic risk-hedging strategies that can more effectively adapt to rapidly shifting risk-on / risk-off market environments

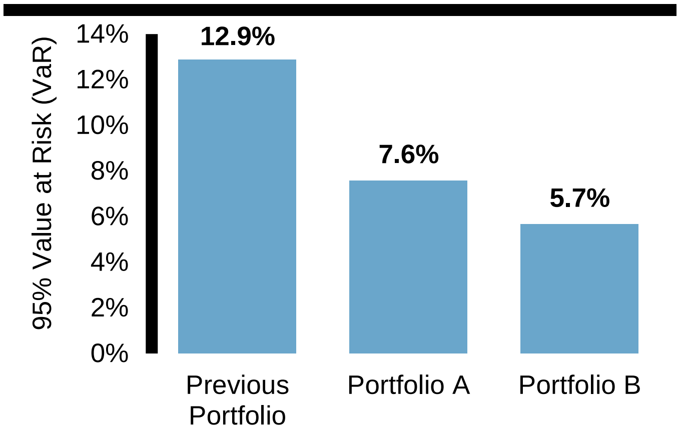
After extensive analysis, the committee settled on two primary options for consideration. The first portfolio (Portfolio A) was designed to reduce volatility without sacrificing return. Portfolio A reduced the volatility by 30%, from 9.9% to 7.4%, while matching the current expected return as can be seen in Exhibit 1. The second option (Portfolio B) that the committee considered reduced volatility even further at the expense of some growth but was still designed to achieve an investment return that would cover the net cost of capital, plus 50 basis points (0.5%) of cushion. Portfolio B had an expected return of 6%, but further reduced the expected volatility to 5.9%. In addition, both Portfolio A and Portfolio B reduced the one-year, one-in-twenty downside scenario (95% VaR) by 41% and 56% respectively (from nearly 13% to 7.6% and 5.7%) as can be seen in Exhibit 2.

Exhibit 1: Distribution of 10-year expected nominal returns



EXPECTED RETURN	6.5%	6.5%	6.0%
STANDARD DEVIATION	9.9%	7.4%	5.9%

Exhibit 2: Downside risk analysis



See note within Important Information about Exhibits 1-3.

Pension assets

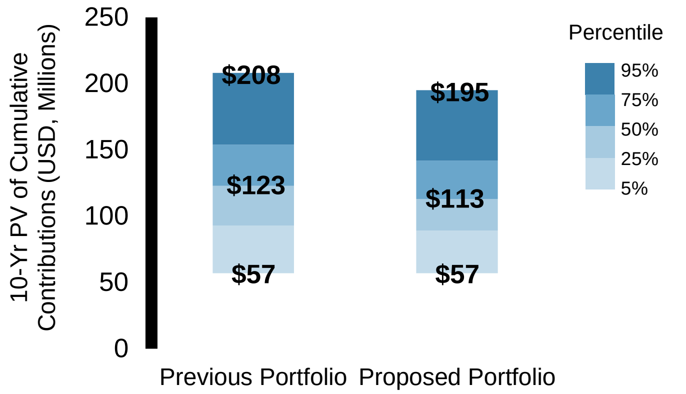
With the investment objectives of the pension plan now clearly identified, the committee and Russell Investments worked to implement portfolio changes with the intent of improving funded status and minimizing the duration mismatch between pension plan assets and liabilities. We identified key steps of a pension de-risking strategy designed to reduce both market risk and interest rate risk as funded status improves.

Our eventual strategy consisted of three primary steps which were integrated into a single seamless solution:

1. **Extend the duration** of the fixed income portfolio to minimize the impact of interest rate changes on the plan's funded status
2. **Adopt a Liability Responsive Asset Allocation (LRAA) strategy** to dynamically shift the portfolio from equities to fixed income strategies as the pension plan's funded status improves
3. **Optimize the portfolio's growth assets** to target long-term growth and manage short-term volatility

By combining these steps and adopting a de-risking strategy, the system was able to reduce cumulative expected pension contributions by more than 8%, or roughly $10 million as shown in Exhibit 3 on the following page. In addition, the plan's expected surplus volatility going forward was reduced by 17%. In just two years since implementation of the new pension strategy, funded status had improved by 3% over the system's original legacy portfolio.

Exhibit 3: Distribution of 10-year cumulative pension contributions



See note within Important Information about Exhibits 1-3.

Foundation

The key objective for the system's foundation was to maintain the purchasing power of the assets into perpetuity to support the foundation's mission: improving the health and education of the community. Given the foundation's required spending rate and need to generate real returns above inflation, the system's original total return-based investment strategy was actually well suited to the new goals identified for the foundation. While no significant portfolio changes were deemed necessary for this pool, the periodic review of goals and strategies was a valuable exercise for the investment committee (and co-fiduciary Russell Investments) in demonstrating their due diligence and prudent fiduciary care.

More on delegation and outsourcing

By delegating selected tasks and discretion to Russell Investments, the healthcare system gained an experienced co-fiduciary with extensive resources and clear accountability for the investment management process. This approach allowed the investment committee and board to leverage our capabilities and resources, which acted like an extension of their own staff.

With the Russell Investments team handling many of the day-to-day implementation details, the committee was able to shift its focus to top-level issues:

- strategic oversight
- governance matters
- objective setting
- performance monitoring

Hiring a proven provider with a broad range of capabilities under one roof was a key step in advancing the healthcare system's investment programs.

Results

Working together, the system's investment committee and co-fiduciary Russell Investments were able to develop an appropriate investment program for each asset pool. This gave them confidence that they were implementing state-of-the-art investment programs across all their portfolios, positioning each investment pool appropriately for its unique investment objectives:

- The board-designated assets achieved a much lower level of expected volatility, while still being positioned to produce the returns needed to meet their cost of capital.
- The duration of assets within the pension plan was brought more in line with liabilities, resulting in a reduction of surplus volatility and expected contributions.
- The goals and strategies of the foundation were subjected to a much-needed review, and the existing return-based investment strategy was confirmed as appropriate to meet expected spending needs.

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 **800-426-8506** or visit **russellinvestments.com/healthcare**

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The analyses shown in Exhibits 1 - 3 are based on Russell Investments' most recent capital market assumptions available at the time, with a 10-year forecast horizon. (12/31/12) Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. There is no guarantee that the stated results will occur.

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