

Hospital system



Increased return and managed volatility with custom overlay program

Client case study



The organization

The organization is a large non-profit academic medical system with more than 6,500 affiliated physicians and 20,000 employees. The system's investment program is made up of nearly \$8 billion in assets spread across the pension plan and long-term operating pool.

The challenges

Both of the system's investment pools consisted of well-diversified multi-asset strategies (including equities, fixed income, real estate, and other alternative strategies) and nearly identical manager line-ups, with the primary difference being that the operating pool held more cash. However, excess cash, inefficient cash flow management, and a mismatch between the target asset allocation and actual asset allocation chipped away at the system's assets, leading to the loss of valuable basis points—which was estimated at 15-20 bps per year over time.¹

In our experience working with non-profit healthcare systems, we have observed that holding excessive operational cash can cause a drag on total portfolio performance, and unintended exposures increase risk but not expected return. Moreover, in this client's case, the cash equitization process was managed in-house, placing a significant operational burden on investment staff. This created an undesirable and untenable situation for the healthcare system's investment team, who sought an efficient solution that would help them capture the market risk premium over cash while reducing risk and providing a robust platform for managing large cash flows.

The solution

To address the client's unique needs and objectives, we crafted a custom overlay program combining implementation, liquidity and investment management, and administrative coordination services. The toolkit consisted of futures initially, but capabilities were recently expanded to include OTC solutions, such as swaps and options exposures.

Overlay program

The overlay program aimed to reduce risk, improve total portfolio returns, and lessen the client's administrative burden associated with periodic cash flows.

¹ Impact from 12/31/87 to 10/31/17 of 1.5% US equity, 2.0% International equity and 1.5% fund cash (total cash ~2.5%) vs. a pro-rated target of 35.0% Russell 3000 / 25.0% MSCI ACWI ex-US / 40.0% Barclays US Aggregate. Fund size assumed to be \$10.0 billion. For illustrative purposes only. Does not represent any actual investment. Indexes are unmanaged and cannot be invested in directly. Data is historical and not a guarantee of future results.

The overlay program aimed to reduce risk, improve total portfolio returns, and lessen the client's administrative burden associated with periodic cash flows. The futures overlay served to equitize cash in both investment pools' cash accounts as well as frictional cash held by equity managers in separate accounts, while rebalancing across liquid asset classes to keep portfolio exposures in line with policy targets.

Additionally, the overlay proxied alternatives strategies using available equity and fixed income futures, which helped manage costs. Thanks to its flexibility, the overlay was able to customize various proxying methods. For example, the private equity strategy used a custom split to proxy with U.S., international, and emerging market equities, while the hedge fund strategy was proxied with a custom split across equities and fixed income.

Results

The overlay was introduced to the client's portfolio in spring 2019. Since implementation, the client benefited from reduced costs, gained valuable incremental basis points, and recovered from implementation slippage overall. By executing more efficiently using derivatives, which are less costly than physical securities, the overlay program added 70+ basis points annualized since inception to the total portfolio.²

More broadly, the overlay provided our client with a holistic view beyond equitizing cash only in the master cash account, by looking across the total portfolio, across all accounts. Moreover—where there was liquid, available, and unused cash—the overlay was able to equitize it and provide the desired market exposure.

Flexibility in a crisis

In early 2020, when market volatility increased dramatically due to the COVID-19 pandemic, the overlay's flexibility and ability to manage risk and market exposures proved critical. Although liquidity was significantly compromised in many physical asset classes, the overlay moderated this impact by nimbly rebalancing and managing risk exposures. This allowed the client flexibility in raising needed liquidity and rebalancing the total portfolio to mitigate risk. Thanks to timely rebalancing at the end of March, both investment pools saw lower transaction costs and successfully captured the market rebound. By sticking to a predetermined strategy during a difficult time and utilizing the overlay to adjust portfolio positioning synthetically rather than relying on physical securities alone, results were meaningfully improved.



By executing more efficiently using derivatives, which are less costly than physical securities, the overlay program has added 70+ basis points annualized since inception to the total portfolio.

Benefits

By partnering with Russell Investments, the client was able to benefit from specialist advice, efficient execution, and a nimbler implementation of investment decisions. This customized solution helped our client realign their asset allocation with their investment policy's stated targets and manage excessive, unintended cash exposures, lessening their operational burden. Moreover, the solution enabled the client to enhance returns and manage their investment program holistically, aligning it with their broader organizational objectives.

² As of August 31, 2020

About Russell Investments

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For more information

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