Health system

Improved portfolio returns and reduced costs through custom cash overlay program

Client case study

The organization

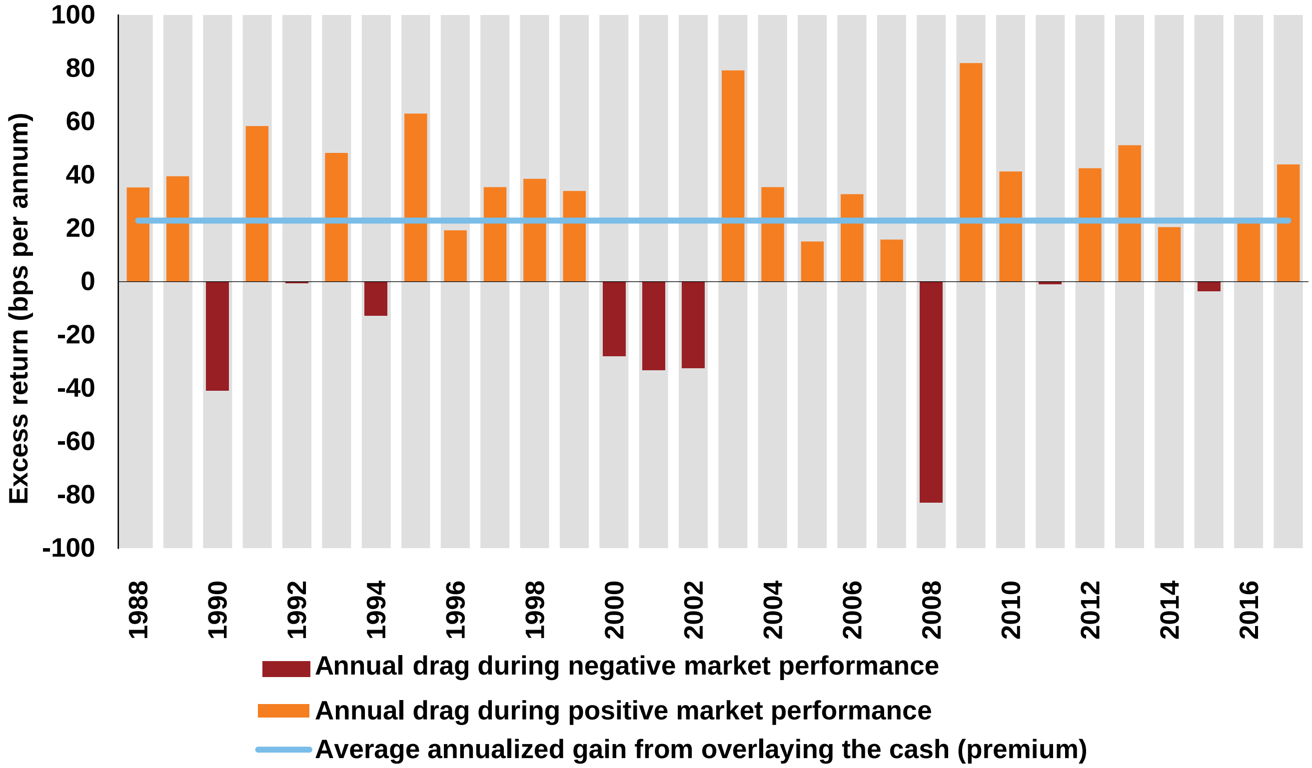
A large non-profit health system (the “organization”) composed of multiple hospitals and medical groups, which has been serving its community for over 60 years. The management team oversees multiple asset pools, including a pension plan, foundation assets, and short- and long-term investments in excess of $10 billion.

The challenge

Due to growing sponsor contributions and distributions from illiquid managers that have not yet been invested, the organization found significant unintended cash exposure, or frictional cash, in its portfolios. While portfolio liquidity is required to meet benefit payments and to ensure that capital calls can be met, unwanted cash exposure deviating far from levels specified in the strategic asset allocation (SAA) presented the organization’s staff with significant operational and investing challenges. Large cash flows frequently circulated between the organization’s numerous asset pools, which required coordinating with investment managers, conducting currency transactions, and monitoring projected cash balances. These administrative tasks proved to be difficult and time consuming, taking away from the staff’s time dedicated to other organizational priorities.

Worse, higher liquidity reserves created a drag on portfolio performance. The uninvested cash was chipping away at overall returns when it could have been invested in other asset classes, which were projected to yield higher returns over the long term. This resulted in considerable lost performance for the organization. For example, if a typical multi-asset portfolio held 3.5% of the portfolio in frictional cash, it would have been relinquishing the potential premium of 20 basis points per year. In a $1 billion portfolio, this would translate to $2.1 million in foregone returns. Exhibit 1 (on the following page) illustrates the impact of frictional cash on the portfolio by calendar year over a 30-year period from 1988-2017.

Exhibit 1: Annual performance drag from cash



For illustrative purposes only. Past performance is no guarantee of future results.

Exhibit 1 showcases that, while holding cash could be beneficial to the portfolio in down markets (such as 2000-2002), on average historically, cash can detract from performance. This unintended drag adversely impacted the pension plan's ability to meet its funding targets over time, and, combined with the rising cost of debt issuance, threatened the long-term pool's ability to fund short- and long-term capital projects.

Moreover, holding unintended cash exposure resulted in unnecessary risk relative to the organization's SAA. Since the SAA did not have a target allocation to cash, the actual portfolios were naturally overweight cash exposure and underweight return-seeking assets (e.g., equities). In addition, the portfolios experienced drift around the organization's target allocations as markets fluctuated, which increased the risk of a performance deviation relative to the SAA benchmark.

In short, the organization's investment program suffered from what we call "implementation leakage," or the loss of return and added risk that results from inefficiently converting investment decisions into investment actions. Consequently, the organization sought an efficient, effective, and comprehensive solution that would help capture the market risk premium, while reducing risk relative to the SAA and providing a platform for managing large amounts of cash flows. By addressing this issue, the staff would be better able to meet its broader organizational goals, including acquiring another organization, building a new hospital, and issuing additional debt.

Cash drag

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The solution

To help our client's unique needs and objectives, we crafted a custom cash overlay program that combined liquidity and investment management as well as implementation advisory and administrative coordination services. The program is designed to reduce the leakage created by frictional cash, inefficient cash flow management, and implementation delays. Our solution focused on overlaying the organization's frictional cash with highly liquid, low-cost, index-based futures contracts and, where appropriate, with currency forwards and total return swaps. An equity index futures contract (plus the return from the invested cash) essentially provides a similar return to the underlying market index it represents.

In this way, we created equity exposure for the organization synthetically, without having to purchase higher-cost physical securities. By implementing an exposure management platform that utilizes less expensive derivative instruments, our client saved a total of 64 basis points in transaction costs over an eight-year period (or eight basis points per annum), and reduced portfolio tracking error by approximately 70% relative to the SAA. By helping to capture the market risk premium over cash, and executing decisions more quickly and efficiently, the program added 19 basis points per annum to the total portfolio.[1] The organization was now better positioned to improve its portfolio performance over the long term.

From the investment side, the program helped our client capture valuable lost opportunities and reduce risks and costs. We also eased our client's administrative burden by serving as an extension of their investment staff, and performing the necessary maintenance, monitoring, and reporting of their total portfolio exposures, provided each day. This removed the organization's need to constantly raise cash from managers and to monitor portfolio liquidity. By allocating increased levels of administrative discretion to Russell Investments, the organization's staff now has additional time to focus on the larger, more strategic issues that health systems face in these increasingly uncertain times—while we implement their strategic decisions efficiently and effectively on their behalf.

And, thanks to the flexibility of the platform we built for them, our client can easily leverage other strategies when required, such as:

- Transition management services to restructure the portfolios
- A passive currency hedge designed to manage volatility—caused by the fluctuation of foreign currencies—in the portfolio's international assets
- Foreign exchange (FX) transaction assistance, which allows the organization's international private equity and global equity managers to deliver FX orders to a central currency desk; which nets the orders and efficiently trades them to reduce transaction costs, minimize liquidity requirements, and enhance reporting

Through their dedicated portfolio management team, the organization now has access to the full breadth of our implementation services through a single contact point—covering everything from portfolio structural changes and execution, to strategic exposure, tactical risk management, and liability-driven investing. The investment staff is also able to continuously monitor market, hedging, and risk exposures across the entire investment program, while having access to pricing and best-execution expertise within arm's reach.

Implementation slippage

By helping our client reduce implementation slippage, our cash overlay program added 19 basis points per annum to their total portfolio. This allowed our client to save a total of 64 basis points in transaction costs over an eight-year period and reduce portfolio tracking error by 70% relative to the strategic asset allocation.

[1] Gross of fees; if fees were applied performance would be lower.

The results

By partnering with Russell Investments, the organization has benefitted from specialist advice, efficient execution, and nimbler implementation of investment decisions. Our solution not only helped our client realign their portfolios with their investment policy's stated parameters and manage unwanted cash exposures, but also enabled them to enhance returns and venture into more sophisticated investment strategies at a lower cost.

Overall, our solution provided the organization a better platform than what they had before, which allowed them to implement strategic changes to their investment program—including paying for the construction of a hospital building, incorporating the assets from an acquisition, and investing the proceeds from a sizable bond issuance in a timely and risk-controlled manner.

Having a true investment partner helped the organization strengthen its governance structure and extend its implementation reach. Rather than being tied up in burdensome daily operational tasks, the investment staff were now free to focus on strategic investment decision-making—the area where their efforts can truly bear fruit and push their organizational goals forward.

About Russell Investments

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For more information

Call Russell Investments at **800-426-8506** or visit **russellinvestments.com/healthcare**

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