CLIENT CASE STUDY

PRIVATE INVESTMENTS STRATEGY

Russell Investments

Health university endowment implements sophisticated, streamlined global private investments strategy

The organization

Health sciences university client seeks updated investment strategy

A private health sciences university composed of multiple colleges, schools and a nationally ranked hospital. With more than 42,000 employees, including 1,900 faculty and 13,000 medical staff and 8,200 students, these constituent organizations work together to provide quality patient care as well as education to future healthcare professionals. The university's Investment Office is led by the chief investment officer (CIO), who oversees more than $6 billion of assets across five pools of capital. A portion of the assets, roughly $3 billion, are held in the long-term pool, which functions as an endowment supporting the financial needs of the overall organization.

The challenge

Following a round of merger and acquisition activities that took place over several years, the university's long-term pool's asset allocation strategy shifted significantly. Namely, the allocation to private capital investments, consisting of private equity, private natural resources and other real assets, decreased as the acquired entities held smaller allocations to privates. The hedge fund program was also wound down over time due to the client's changing needs and views on hedge funds and interest in capitalizing on private credit for its similar or better return and diversification potential.

Meanwhile, the Investment Office understood the important return and diversification functions that private capital investments held in its investment strategy. They knew that the streamlined global private investments allocation could continue to play a critical role in helping address key objectives the university had established for its long-term pool.

These objectives included:

- A target return for the pool that would support an annual 4% to 5% spend, net of inflation
- Increased allocations to asset classes with greater diversification and return potential than those in the current strategy
- Reduced portfolio drawdowns
- A high degree of transparency into underlying investments
- Improved oversight without increasing burdens on investment staff
- A more dynamic investment strategy to capitalize on potential fleeting market opportunities

> *They knew that the streamlined global private investments allocation could continue to play a critical role in helping address key objectives…*

The solution

The university approached Russell Investments, its long-term investment partner, for a solution to help manage the smaller private capital allocation while enhancing diversification and potential returns. The university's goal was to improve its ability to meet its investment return objectives given expectations for rising interest rates and a lower-return environment, as well as enhance portfolio construction and strategy selection.

Having served as the university's investment provider for many years, Russell Investments understood the complex needs and end goals of the university's investment program. We worked with the university's Investment Office developing a tailored solution to help the university achieve its desired outcomes for the long-term pool.

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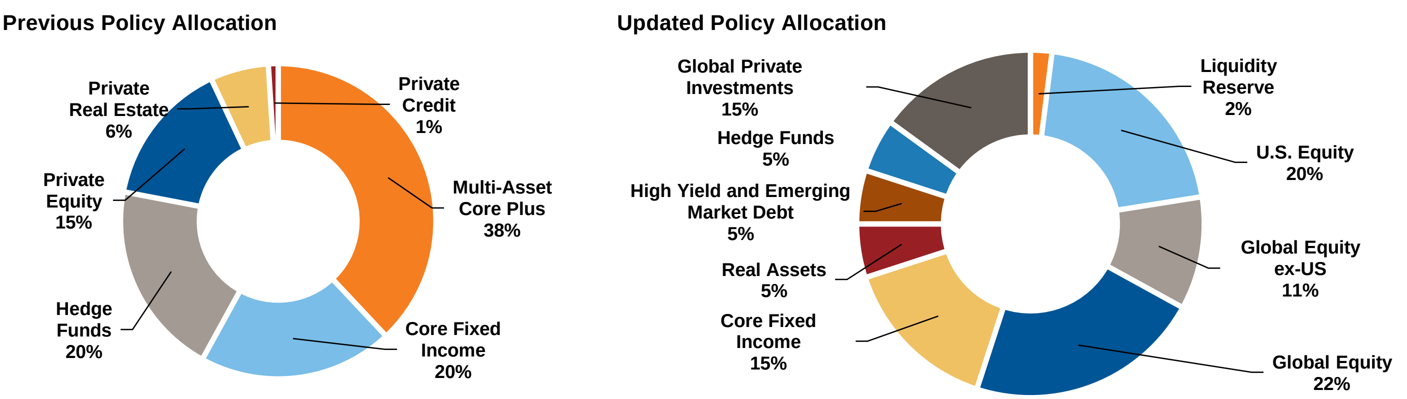
Portfolio strategy

To start, Russell Investments conducted a strategic review of the existing investment policy and evaluated various allocation scenarios and trade-offs with the Investment Office. To continue supporting an annual 4% to 5% spend net of inflation with a focus on reducing portfolio drawdowns, Russell Investments recommended the following adjustments to the strategic asset allocation, as illustrated in **Exhibit 1**:

- Increased exposure to public equity, away from U.S. and non-U.S. towards global equities, thanks to greater confidence in the potential alpha to be reaped from the latter
- Expansion of the fixed-income allocation to include return-seeking fixed-income strategies, such as global high yield and emerging market debt
- Diversified sources of return and risk mitigation through establishing a meaningful position in private credit alongside private equity, private natural resources and other real assets, and private real estate within the global private investments strategy

Exhibit 1: Previous and updated asset allocations



Source: Russell Investments, as of May 2021.

Global private investments strategy

The **global private investments strategy**, a critical component of the long-term pool, seeks to generate returns greater than those of its public market counterparts and to diversify the pool's overall risks through investment in businesses and/or strategies that are unavailable in the public markets.

By adopting this strategy, the university benefited from Russell Investments' **breadth of expertise in, and access, to leading managers**. In the private capital space, expertise is essential in navigating the wide spectrum of available opportunities and investment options (e.g., buyout, venture, private natural resources, infrastructure, etc.).

Additionally, the private investments strategy allows for **dynamic portfolio management and the timely allocation of capital**. Many private investment strategies only have narrow windows for commitment. With implementation discretion delegated to Russell Investments (within clearly defined boundaries), the university was able to quickly invest in time-sensitive investments without waiting for the next Investment Office meeting.

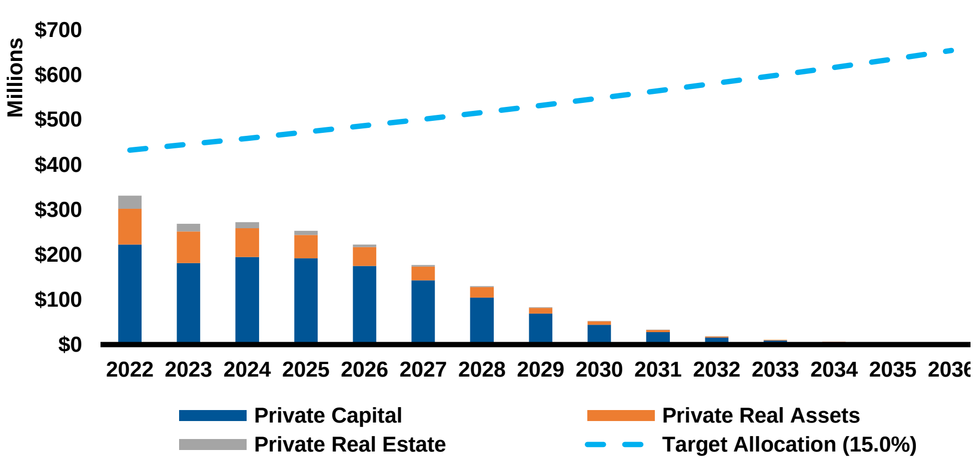
As seen in **Exhibit 2**, the strategy addressed several important issues:

- Managed growth of private capital exposures with new commitments and cash flow expectations
- Diversification of the portfolio within private equity and across private capital strategies based on market dynamics
- Reduction of risks associated with managing frequent cash flows thanks to the delegation of portions of the university's portfolio

The private investments strategy allows for dynamic portfolio management and the timely allocation of capital.

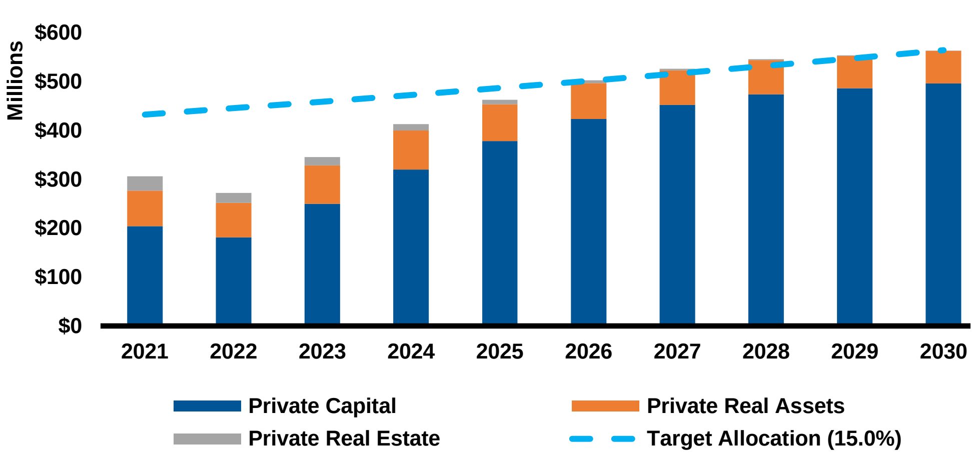
Exhibit 2: Strategic portfolio construction across private capital strategies

Forecasted Exposures of Existing Portfolio



Source: Russell Investments. Current exposures based on June 30, 2021 NAV.

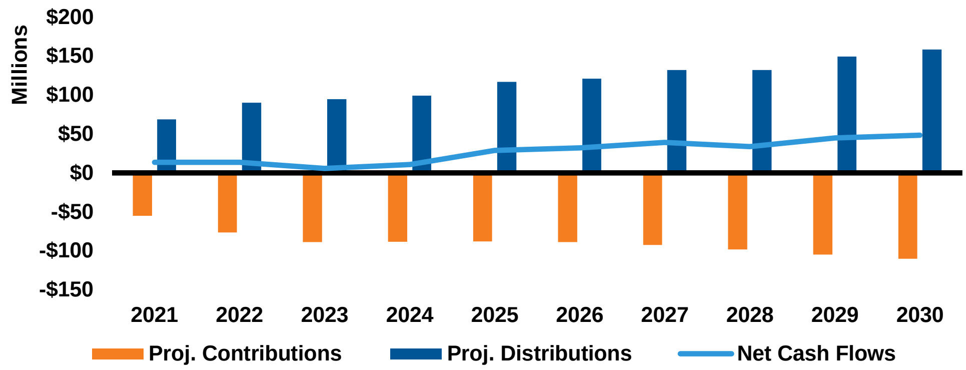
Forecasted Exposures with Expected New Commitments



Source: Russell Investments.

Projected cash flows for the private capital strategies are illustrated in **Exhibit 3**. These projections highlight one of the primary benefits of a mature private capital allocation, which is that it becomes self-funding over time. As shown in Exhibit 3, projected distributions are expected to outweigh projected contributions over time, allowing the university to maintain its allocation without making additional out-of-pocket contributions to fund capital calls.

Exhibit 3: Projected cash flows across private capital strategies



Source: Russell Investments.

Private credit strategy

A notable addition to the global private investments allocation has been the incorporation of a **private credit strategy**, as the university wished to capitalize on the superior performance potential of private credit relative to public fixed income such as bank loans and high yield. The university also wanted to take advantage of diversification benefits, such as reduced volatility and greater downside protection—private credit loans are typically higher in the capital structure and have strong covenants that include lender protections requiring companies to meet certain financial conditions, such as debt/EBITDA or interest coverage ratios.

Another key attribute of private credit investments is that the interest rates paid on loans are floating rate and increase in conjunction with interest rates, providing protection against the risk of rising interest rates—one of the university's concerns. Lastly, the shorter average lifespan of private credit relative to private equity results in a quicker investment period and return of capital, benefiting investors that are subject to liquidity constraints.

The private credit strategy targets investments across a spectrum of private credit and related opportunities and a wide geographic expanse, as illustrated in **Exhibit 4**. The strategy takes a flexible implementation approach that leverages closed- and open-end structures to accelerate exposure and dynamically adjust over time. The strategy emphasizes senior secured, sponsored and asset-backed opportunities for enhanced downside protection relative to alternatives.

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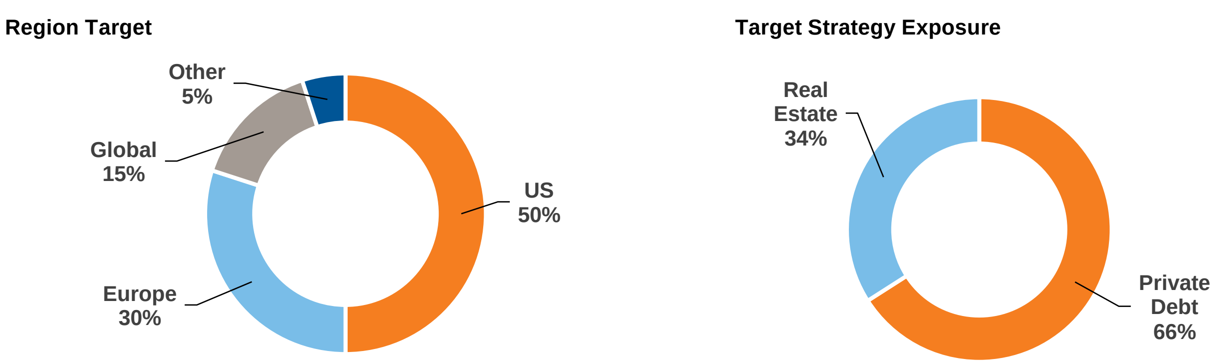
Exhibit 4: Private credit target exposures

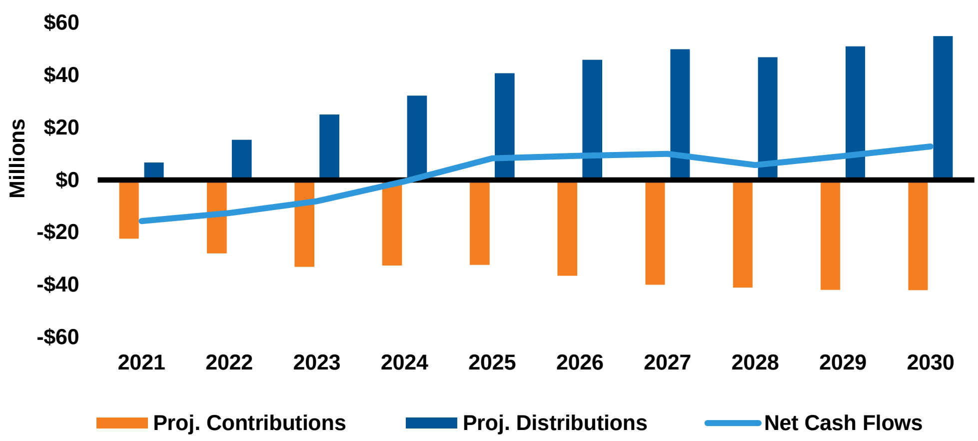


Source: Russell Investments.

The addition of the private credit strategy to the university's long-term pool resulted in an increase in the portfolio's long-term expected return while also reducing expected risk, compared to the original portfolio with no private credit exposure.

Projected cash flows are illustrated in **Exhibit 5**. Much like the cash flows shown in Exhibit 3, the private credit strategy is expected to become self-funding as it matures over time. Further, an allocation to private credit is expected to produce meaningful levels of current income, often in year one of its implementation, helping to support the university's annual spending needs.

Exhibit 5: Projected cash flows across private credit



Source: Russell Investments.

Results of the solution

University improves its investment program

Overall, by working with Russell Investments, the university benefited from:

- A customized, sophisticated, and streamlined private investments program with an increased likelihood of reducing portfolio drawdowns and meeting the portfolio's stated aim of funding an annual 4% to 5% spend net of inflation
- A strategic asset allocation designed with slightly lower expected volatility and an expected return higher than the university's previous strategy
- A dynamic portfolio management structure positioned to take advantage of fleeting market opportunities between investment committee meetings
- Reduced risks associated with managing frequent cash flows

Our unique integration of strategic advice, private market insights, research and implementation capabilities, and operational and administrative support enabled the university to more effectively evaluate private investment opportunities and implement them in a timely fashion.

Overall, since inception, the private investments strategy has generated an internal rate of return (IRR) of 15.7% on a public-market basis, outperforming public markets, with private equity generating an IRR of 23.7%, nearly 650 basis points (bps) over the public market equivalent, and private natural resources generating an IRR of 6.25%, nearly 30 bps over public market equivalents.[1]

[1] Based on estimated valuations as of June 30, 2021, which reflect net asset values as of June 30, 2021, adjusted for subsequent cash flows. Public market equivalent calculations reflective as of June 30, 2021, to match the valuation period of the private markets portfolio.

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