Professional liability insurance company

Enhanced strategic asset allocation and reduced administrative complexity

Client case study

The organization

A professional liability insurance company (the “organization”) composed of five member hospitals and healthcare entities that have combined their self-insured assets. The organization is designed to provide professional liability coverage for member organizations, to segregate members’ assets and liabilities, and to spread risk across its members in a risk retention group structure.

The challenges

The organization had concerns about its investment portfolio’s asset allocation, which consisted of 30% equity investments and 70% fixed income investments. The investment committee feared that its allocation to core bonds may have been too high. The portfolio not only exhibited low diversification but was also perilously exposed to the downside valuation risks of a rising interest rate environment. The committee expressed concern that this portfolio positioning could put downward pressure on overall returns and on the real value of the organization’s assets, and chip away at the cash flows that the organization needed to pay insurance claims for its underlying member organizations.

The organization also had complex reporting obligations. Each individual member organization needed to view detailed reports on its particular investment sub-account, and the management of the broader organization required consolidated reports for the entire asset pool. This created an administrative burden on the organization’s financial and accounting teams to manually prepare detailed, as well as consolidated, reports on a quarterly basis. The complexity of the organization’s reporting needs was a daunting challenge that took away from the staff’s time to focus on broader organizational priorities. Moreover, the committee had its hands tied by the complex paperwork required to follow the unique insurance regulations of the state in which the organization was domiciled. This detracted from the committee’s time to set high-level, impactful strategy for the organization’s investment program.

The committee and staff were keen to work with an investment provider who could help them better manage their investment program across the multiple sub-accounts and reduce their administrative burden, allowing them to focus on broader organizational goals.

Ultimately, we created a holistic solution that was designed to address our client’s investment and administrative goals.

The objectives

PORTFOLIO DIVERSIFICATION

Explore a wider range of asset classes and alternative strategies for additional sources of return while adhering to appropriate liquidity levels and retaining a conservative risk profile

RISK MANAGEMENT

Manage volatility by maintaining upside potential and limiting downside risk during major market events

RETURN ENHANCEMENT

Generate returns that would allow the organization to pay claims as they arise and maintain the real value of the portfolio's assets

ADMINISTRATIVE DELEGATION

Delegate onerous administrative tasks associated with completing separate accounting for each member and with meeting state regulatory requirements, to allow increased focus on high-level governance and portfolio strategy

The solution

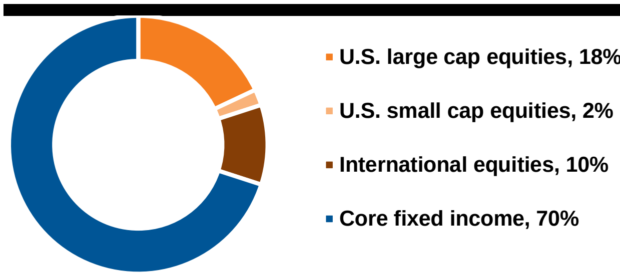
The organization, a longtime Russell Investments client, approached us with the multiple objectives listed above. With intimate knowledge of the organization, we conducted in-depth investment and risk analysis and weighed their options carefully. Ultimately, we created a holistic solution that was designed to address both their investment and administrative goals, which sought the following characteristics:

- Minimizing risk by emphasizing high-quality instruments and diversification, including a customized direct hedge fund program
- Maximizing income yield subject to risk and liquidity restraints
- Maintaining appropriate levels of liquidity to pay claims
- Minimizing fees and other expenses consistent with risk, liquidity, and return objectives
- Taking on the administrative burden of consolidating accounting statements and meeting state regulatory guidelines

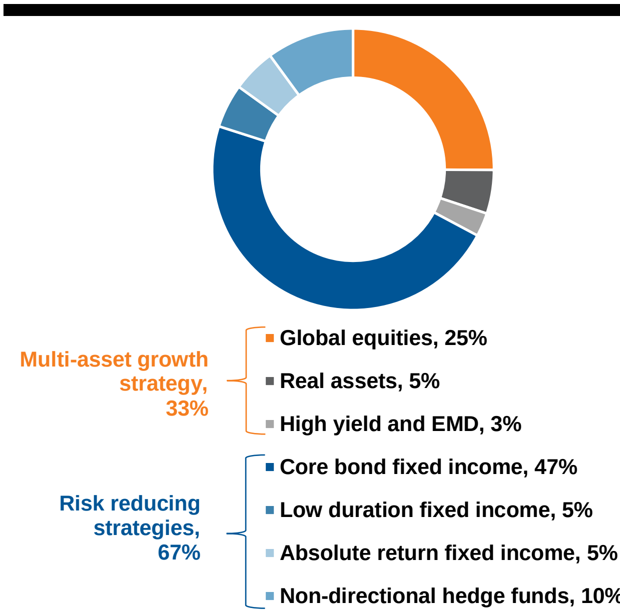
Together, we designed a new strategic asset allocation (SAA) that consisted of a combination of multi-asset pooled strategies along with a managed account to provide direct access to single-strategy hedge funds. This new SAA provided access to a range of Russell Investments' researched "best-in-class" asset managers with complementary investment styles and processes, while simplifying the investment program through the use of a commingled fund structure. Rather than designing the SAA by asset class, we revised it using a roles-based framework, dividing the portfolio into growth seeking assets and risk-reducing assets. To help provide stability, the new SAA kept the original overall structure but included diversified investment return sources and a host of new strategies, which greatly expanded the organization's opportunity set. Additionally, shifting from a single asset-class based framework to a dynamic, multi-asset, roles-based framework better positioned the portfolio to achieve the organization's desired outcomes. The legacy and new strategic asset allocations are illustrated in Exhibit 1.

Exhibit 1: Legacy and new strategic asset allocations

Legacy portfolio: Asset class based



New portfolio: Asset role based



While the previous allocation comprised just equity and fixed income investments, the new allocation consists of a multi-asset growth strategy and risk-reducing assets, including diversified fixed income and a customized hedge fund exposure.

The new multi-asset growth strategy positions the portfolio to capture fleeting return opportunities through a dynamically managed mix of global equity, global fixed income, and real assets strategies. For this component of the portfolio, the organization gave Russell Investments discretion to manage real-time implementation decisions and to capitalize on rapidly moving market opportunities on its behalf. This new approach improved the portfolio's implementation efficiency and opened the organization to a broader opportunity set.

The risk-reducing portfolio consists of more diversified fixed income assets (e.g., absolute return and low duration bonds), as well as a directly invested custom hedge fund strategy that was structured to complement the risk exposures across the entire portfolio. The hedge fund strategies provide quarterly liquidity to meet regulatory vehicle requirements. The addition of a separate, dynamically managed hedge fund program not only seeks to protect the organization's portfolio from the event of an equity market drawdown—it also mitigates the risk of rising interest rates, as the hedge funds have low correlation with equity beta. For example, in one year, while the portfolio's custom benchmark was down 1%, the total portfolio itself was only down by 0.35%. This can be attributed to diversification provided by the hedge fund program, and to downside protection provided by the multi-asset strategy.[1]

In addition to mitigating interest-rate risk, the new asset allocation strategy increased the expected 10-year return by 66 basis points relative to the legacy allocation, while only increasing the expected 10-year standard deviation by 27 basis points.[2] This resulted in a more efficient and effective portfolio. And, with our portfolio management team able to implement strategic decisions in real time, the investment committee could then review the asset allocation strategy periodically and adjust as appropriate based on changing market values and shifting organizational needs.

Lastly, our solution reduced the investment staff's operational and administrative burden. We provided customized reporting that showed values at the total portfolio level, and we created customized sub-account reporting for each of the member organizations. Russell Investments offered an automated solution by giving the organization access to a customized website that:

- Allows the organization to track, manage, allocate, and report on the investment details at the sub-account level, and affords round-the-clock access to account statements
- Provides consolidated reporting that integrates all of the organization's investment assets and reflects the results of the total portfolio

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The benefits

Russell Investments served as a strategic partner for the organization's investment committee and staff, enabling the organization to benefit from greater diversification and breadth of investment strategies, and a reduced administrative workload. We took on the operational burden of fulfilling state insurance regulatory requirements and providing separate accounting statements for each member organization, which greatly helped the staff. On the investment side, our open-architecture solution provided access to Russell Investments' "best-in-breed" managers of various disciplines and better positioned the portfolio to mitigate risk, achieve better returns, and improve expected outcomes. By implementing these changes, the organization was able to introduce more sophisticated strategies into its fixed income heavy portfolio. We also took on the daily dynamic management of the portfolio. This approach enabled the investment committee to focus their valuable time on long-term strategic decisions and to monitor the investment decisions that we make on their behalf—while resting assured that the organization would have sufficient cash flows to cover its member organizations' claims.

For more information

Call Russell Investments at **866-739-7979** or

visit **russellinvestments.com/healthcare**

About Russell Investments

Russell Investments has helped hospitals and healthcare system clients navigate challenges and meet goals since 1983. We work with each of our clients to fully understand their asset pools and unique investment needs. The comprehensive fiduciary solutions we design for our clients are tailored to meet each organization's specific goals and incorporate Russell Investments' award-winning advice, investment strategy, and implementation.

Important information

[1] Performance gross of fees. For illustrative purposes only. Past performance is no guarantee of future results.

[2] Based on Russell Investments Capital Market Assumptions as of 12/31/2014. Additional information available upon request.

Case study provided for discussion purposes only. Individual client results will vary based on individual circumstances and market events. There is no guarantee that all clients will experience the same positive results.

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. Although steps can be taken to help reduce risk, it cannot be completely removed. Investments typically do not grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

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