
Not-For-Profit Healthcare Institutions: Diversifying the Investment Portfolio

May 2006

Overview

Due to healthcare institutions' short-term investment time horizon, relative to other institutional investors, domestic fixed income investments and cash equivalents historically have comprised the largest holding of the board designated hospital funds (investment portfolio). Typically the fixed income investments utilized are U.S. government debt or high quality domestic corporate bonds with an intermediate to short duration. U.S. equities typically represent the second largest allocation of the investment portfolio. Together these two asset classes represent over 80% of the typical investment portfolio, according to the Commonfund's 2005 Healthcare Report.

This report will provide an overview of our current outlook for domestic fixed income and equities, including the unusually high returns these asset classes generated over the past 25 years. Furthermore, diversifying asset classes will be introduced as a way to reduce the dependency on "conventional" asset classes.

Background

Over the past 25 years attractive investment returns have been relatively easily obtained even with a conventional (primarily domestic stocks and bonds), investment portfolio. For instance, an investment portfolio with 50% in domestic stocks and 50% in domestic bonds earned an approximate annual return of 11% over the last 25 years. This is an extraordinary return considering that over much longer time periods investors allocating 100% of their portfolio to domestic stocks would be lucky to achieve it. If you believe we are in a new environment (things are different this time) and that these returns are achievable going forward a conventional investment portfolio may be appropriate. However, if you believe as we do that returns are mean reverting, diversifying your investment portfolio away from conventional investments will be key to achieving returns necessary to support the growth of your organization. According to the Commonfund's 2005 Healthcare Report, the average not-for-profit hospital has a budgeted return assumption of 5.5% per year for their operating funds. Over the next 10 years it may be difficult for an investment portfolio relying heavily on domestic equities and fixed income to achieve this modest objective.

*Domestic Fixed
Income Investments*

Bonds (particularly Treasuries) are an attractive investment to investors due to the capital preservation they provide and their predictable stream of income. To understand why bonds have done so well over the last 25 years it is important to understand the mechanics of how they work. Like stocks, bonds fluctuate in price. A bond's price is inversely related to the change in interest rates. Therefore a *decrease in interest rates, increases the price* of outstanding bonds. Prices of bonds with longer maturities are more sensitive (both positive and negative) to interest changes compared to similar bonds with shorter maturities.

Exhibit 1

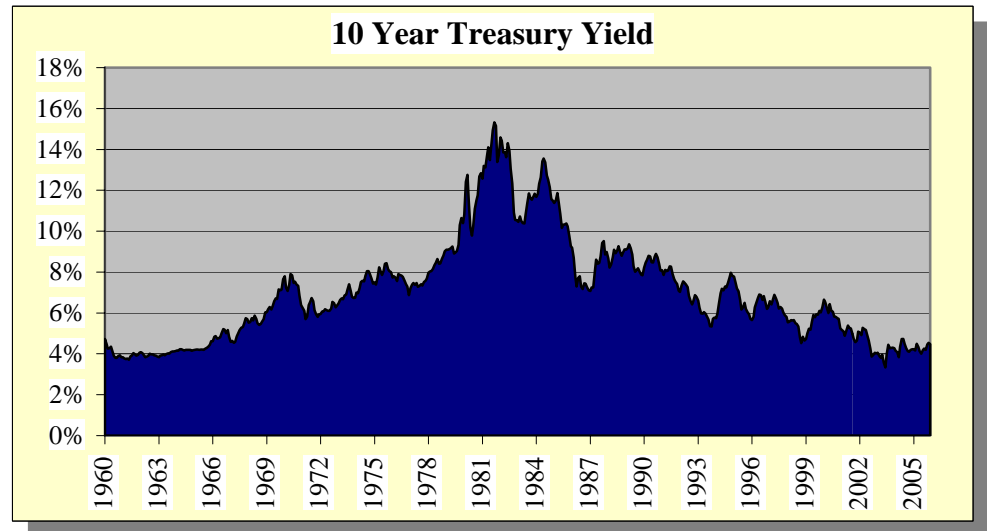
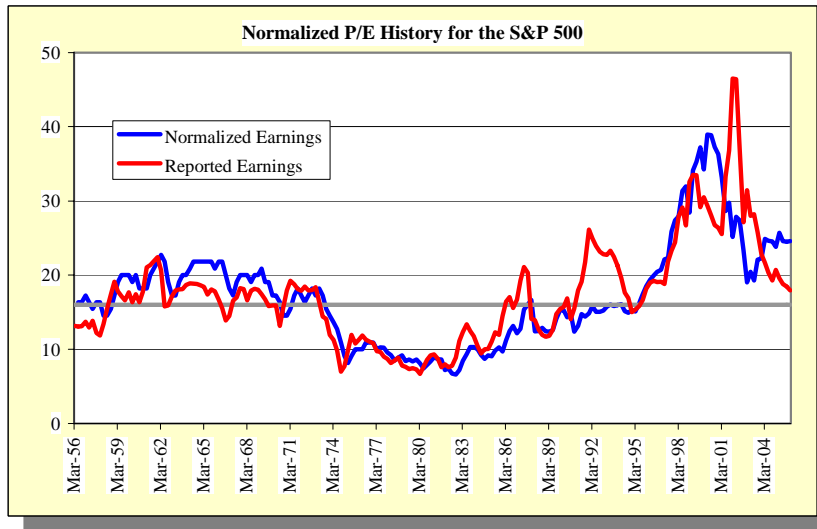


Exhibit 1 illustrates that bonds have benefited from the secular decline of interest rates over the last 25 years. In 1981, 10 year Treasury yields topped out at over 15%, by the end of 2005 they had fallen to around 4.5%. The Lehman Brothers Aggregate index returned 9.6% per annum over this time period. With yields currently around 5% on 10 year Treasuries it is unlikely returns will be anywhere close to this over the next 25 years (from 1960 to 1980 the Lehman Brothers Aggregate index returned 4.5%).

Domestic Equity Investments

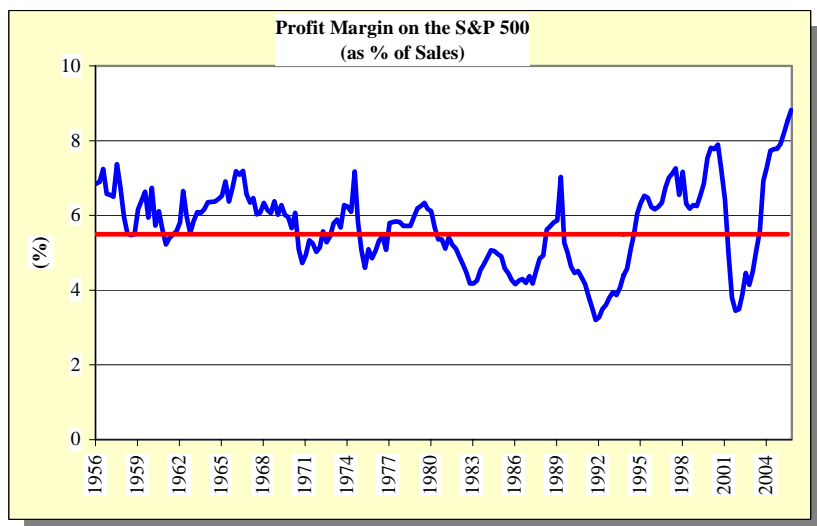
Domestic equities are also a common large holding in most investment portfolios due to their superior return potential (compared to bonds and cash) and liquidity. Despite a sharp sell off to start this decade, domestic equities have provided a very attractive return for investors over the last 25 years (12.5% per annum as measured by the S&P 500 index). Unfortunately, like domestic fixed income they appear to be richly valued. The P/E ratio of the S&P 500 index is 18. A P/E ratio of 18, while above the historical average of 16 is reasonable (see exhibit 2).

Exhibit 2



Our concern is that the reported P/E ratio of 18 is based on record profit margins (see exhibit 3).

Exhibit 3



The profit margin on the S&P 500 is currently 9% of sales, which is 60% above the long-term average. Historically, profit margins have been highly cyclical and mean reverting. Based on our normalized earnings measure, which assumes profit margins decline (although not all the way back to the historical average), the P/E ratio on the index is 24.

Diversification Trend

The move from conventional asset classes into diversifying asset classes has already started to slowly take place in many healthcare institutions. The 2005 Commonfund Healthcare Report indicates that healthcare organizations anticipate following the trend set by large endowments and foundations over the past several years, including allocating more assets to international equities and alternative strategies while reducing their exposure to domestic equities and fixed income. The shift towards non-conventional asset classes stems from their return potential and diversifying power. The following are several diversifying asset classes Hammond Associates utilizes to build our clients healthcare investment portfolios.

Treasury Inflation Protected Securities

Treasury Inflation Protected Securities (TIPS) are a very intriguing investment option for healthcare investment portfolios. TIPS while considered by many to be a fixed income investment, since the United States Treasury issues them, actually behave quite differently than traditional fixed income investments. Since traditional bond interest payments are fixed, their value can be eroded by inflation. TIPS on the other hand offer protection against unanticipated increases in inflation. TIPS are particularly compelling to healthcare investment portfolios to offset the increased expenses these institutions would experience during inflationary periods (i.e., employees salaries would increase which represent a large portion of healthcare organizations expenses.)

International Fixed Income

International bonds offer another method of reducing the exposure to conventional investments particularly domestic bonds. International bonds offer diversification benefits that arise from a broader investment opportunity set. Global diversification can provide investors with some defense against rising U.S. rates, potentially enhancing the returns on a core bond portfolio. U.S. bond returns are expected to be modest for the foreseeable future therefore international bonds may provide a source of higher returns. If exposure to foreign currencies is not hedged back into U.S. dollars international bond investors would benefit from a declining dollar. Given the macroeconomic imbalances resulting from the large U.S. current account and federal budget deficits, we expect a secular dollar devaluation relative to other currencies.

Hedge Funds

Hedge funds have become increasingly popular to institutional investors over the past several years. Hedge funds are specialized investment vehicles managed by investment professionals who have at their disposal a wide variety of trading techniques across virtually all types of securities. Most hedge fund investments are through funds of hedge funds, which invest in a mix of individual funds. By investing in funds of hedge funds the inherent risks of these investments are reduced compared to investing in a single hedge fund manager. Hedge funds are particularly interesting to healthcare investment portfolios since funds of hedge funds return expectations typically exceed the target return sought in these portfolios. Successful funds of hedge funds are able to achieve these returns with volatility (as measured by standard deviation) modestly higher than fixed income investments. Hedge

funds also offer significant diversification opportunities due to their low correlation to domestic equity and fixed income investments as well as many other assets.

International Equities

Broadening the equity universe by including international stocks provides the potential for enhanced returns with the diversification benefits that may reduce a portfolio's overall risk. According to the World Bank foreign markets account for nearly 70% of world output and 56% of the world's equity market capitalization and many of these markets are growing faster than the United States. International markets are just too large to ignore, especially as China and India continue to gain global prominence. Similar to international bonds, international equities' returns (to US based investors) would be enhanced if the dollar were to decline relative to other currencies.

Real Assets

An allocation to real assets includes a broad spectrum of investments including real estate, commodities and natural resources. These investments are expected to protect the investment portfolio from unexpected inflation and provide diversification benefits due to their low correlations with other investments. Real assets have generated very attractive returns over the last few years, thus they are not considered cheap on a historical basis. Even at lofty levels real assets warrant a small place in the investment portfolio.

Conclusion

With valuations of domestic equities well above the historic norm and domestic fixed income providing yields around 5%, it appears that investment returns will be hard to generate for the foreseeable future. Healthcare investment portfolios, which typically have a majority of their investment assets invested in domestic equities and fixed income, stand to be particularly vulnerable in this challenging investment environment. The risk for not-for-profit healthcare systems that generate insufficient returns with their investable assets is that they may not be able to maintain their balance sheet strength, fund capital investment needs and/or support operating budgets. To reduce this risk diversifying the investment portfolio beyond "conventional" investments will be necessary.

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