



# Assessing Investment Risk for Not-For-Profit Healthcare Institutions

### Overview

In recent years, non-operating revenue, which is mostly investment returns, has been a driving force in improved bottom-line profitability for many not-for-profit healthcare institutions. As non-operating revenue becomes an increasingly important contributor to operating results, investment strategies for healthcare board designated funds will be scrutinized for signs of excess investment risk. This report provides a framework to determine the best risk tolerance, or return volatility, for healthcare investment portfolios.

While healthy operating cash flow and strong investment returns have contributed to past growth in cash reserves, the outlook for continued gains is uncertain due to several challenges on the horizon, which include: 1) the likelihood of a low return environment for U.S. stocks and bonds; 2) compressed healthcare operating margins as expense increases outpace revenue growth; and, 3) growing capital spending needs for most providers. Responding to these challenges will require investment strategies designed to meet achievable return objectives without exposing the institution to excessive investment risk.

Integrating the investment process with an institution's comprehensive financial plan can help not-for-profit healthcare systems develop strategies that complement the institution's financial and community mission objectives. Carefully evaluating key financial trade-offs will improve the likelihood that investment returns will adequately support plans to maintain balance sheet strength, fund growing capital investment needs and support operating budgets.

An integrated approach to the investment process can accommodate customized investment strategies that address:

- Increased variable rate debt interest expense;
- Higher labor costs due to unanticipated inflation;
- Variances to capital spending budgets; and,
- Capital finance and debt rating objectives.

The first step in a not-for-profit healthcare institution's investment process should include an assessment of all areas that may be impacted by investment performance. This review sets the baseline for the portfolio risk tolerance, which is a fundamental building block of the investment policy.

There are a variety of approaches to incorporating the long-term financial plan into the investment process. These range from an informal assessment to detailed analytical models that interface with the long-range financial plan. An asset/liability study is one tool available for integrating the investment and financial planning processes. These studies consolidate forecasts for operating income, capital spending, debt service and other cash flow items into a single stream of cash flows, which can be helpful in determining the investment risk tolerance for board designated funds.

Healthcare spending has steadily grown from 6% of GDP in 1965 to 16% of GDP in 2004, and is projected to reach 19% of GDP by 2014. As baby boomers mature, significant capital investments will be required in healthcare delivery to meet increased demand. In planning for growing community needs, not-for-profit providers will pay particularly close attention to their investment portfolios, which often account for more than half of an institution's assets. Investment returns have become an important contributor to operating income for not-for-profit healthcare providers. Although investments provide an estimated 2% to 3% of revenues, this translates to as much as 50% to 60% of operating income. Investment returns also strengthen liquidity and enhance borrowing capacity to support capital spending needs and ensure the ability to cover unreimbursed healthcare for the underserved.

### **Background**

As healthcare accounts for a greater portion of the U.S. economy, not-for-profit providers will become increasingly prominent on the institutional investment landscape. The complex and unpredictable nature of the healthcare delivery marketplace will require innovative approaches to the not-for-profit healthcare investment process, which may differ significantly from the endowment and foundation model. The healthcare investment model should support the institution's overall long-term financial objectives, and have the flexibility to adjust to changing conditions.

Historically, healthcare investment portfolios have been more conservative than most college endowments for a variety of reasons. First, healthcare investments generally require greater liquidity, due to debt covenants and unpredictable spending requirements. Endowments have specific spending objectives that are tied to the portfolio value. Second, healthcare investment strategies require flexibility because spending needs can be unpredictable due to marketplace dynamics. Endowment strategies can be relatively static, because spending is fairly stable and predictable. Third, healthcare institutions bear higher economic risks due to a concentrated revenue base (primarily Medicare and Medicaid), limited control of expenses, and significant debt obligations. College endowments usually have a diversified donor revenue base, control over long-term spending and less debt relative to the size of the investment portfolio. These fundamental differences should be reflected in the investment process, and healthcare institutions will need investment strategies that reflect each provider's unique financial situation.

### **Multiple Investment Objectives**

Investment strategies for board designated hospital funds often support multiple objectives such as, enhancing revenues to cover unreimbursed healthcare costs, expanding debt capacity, and maintaining reserves for revenue shortfalls or unexpected costs. These mission objectives affect the investment process differently, and may present tradeoffs. For example, many healthcare providers, place a priority on Balance Sheet strength, and focus more on liquidity ratios, like days-cash-on-hand, than operating earnings. Other institutions must rely on long-term investments as a source of cash to fund capital spending or debt service requirements. While some not-for-profit healthcare systems are primarily focused on generating investment returns for a stable supplement to operating income. Each of these institutional objectives has a different impact on the investment process.

Investment Committees are responsible for balancing multiple objectives for board designated funds, and setting clear investment goals that strike a balance between all aspects of the long-term financial plan. To help develop a consensus on investment priorities, it is useful to assess the institution's financial statement objectives. This review considers the investment performance implications on the Operating Income Statement, Balance Sheet and Cash Flow Statement. The findings will provide insight



into priorities that will lead to the right investment risk tolerance.

The long-range (typically five-years) Operating Budget forecast will set a floor for non-operating revenue requirements, which are primarily driven by investment returns. The investment strategy should be engineered to meet this need with a very high level of confidence. Any returns above this budgeted amount will build long-term Balance Sheet liquidity.

### ***Operating Income Implications***

It is also useful to consider significant risks to the operating budget (revenues and expenses), because the investment strategy can be engineered to insulate the impact from some unexpected events. For example, salary and wage costs tend to be correlated with the overall inflation rate (CPI). The investment portfolio can be structured in a way that is expected to provide higher returns in an inflationary environment. If the actual CPI inflation is higher than the rate used in the planning process, salary and wage expenses will likely be unfavorable to the long-range budget, and these higher expenses would be partly offset by higher than expected investment returns.

### ***Balance Sheet Implications***

Maintaining a strong Balance Sheet will play a critical role in the capital finance plans as bond insurance and other credit enhancements become increasingly expensive. Many not-for-profit organizations are more focused on balance sheet liquidity than earnings, because a strong cash position bolsters credit strength and the ability to cushion unexpected shocks from the healthcare marketplace.

Balance Sheet considerations for the investment strategy include: restricted vs. unrestricted investments; the accounting treatment for various financial investments (usually a function of liquidity); variable vs. fixed rate debt; and liquidity ratio requirements for debt covenants (e.g., days-cash-on-hand or cushion ratios).

Balance Sheet objectives influence the investment strategy by posing a trade-off between low (and stable) investment returns for non-operating revenue needs, and higher expected (but more volatile) returns to grow long-term investments over time.

### ***Cash Flow Statement Implications***

Cash Flow Statement forecasts also provide a key input for assessing the investment risk tolerance. Investment related considerations include: operating cash flow forecasts, debt service requirements (include swaps and other structured finance arrangements); capital spending forecasts (mandatory vs. discretionary); the merger & acquisition environment; charitable donation objectives; and, underfunded defined benefit pension obligations. The Cash Flow Statement forecast helps to determine whether the institution will be a net user or generator of excess cash, which is a key factor in setting the right investment risk tolerance.

### ***Determining Investment Risk Tolerance***

A comprehensive review of financial objectives determines the cash flow characteristics over the planning horizon. Net cash generators have a higher

investment risk tolerance and cash users have a lower risk tolerance. The assessment process can range from a simple summary of financial objectives, to a detailed model that interfaces with the formal financial planning process.

### ***Asset/Liability Studies***

The formal approach to integrating the planning and investment processes can include an asset/liability study, which combines the expected cash flows from operations, capital spending plans, debt service requirements and other obligations into a single net-cash flow stream. These studies can complement the formal financial planning process to forecast the size and variability of cash flows. The models can be updated with financial forecast revisions, which may signal the need for investment strategy adjustments which complement changes to long-range financial plans.

The asset/liability model will determine the “duration”, of net cash flows over the forecast period, and the expected volatility of net cash flows based on the degree of risk imbedded in the budgeting process. Duration is the present value of a stream of future cash flows, and the investment strategy can be designed so that the duration of assets matches the duration of liabilities. This measure helps set the investment time horizon and is also useful in evaluating the portfolio’s desired interest rate sensitivity.

### ***Investment Time Horizon***

Investment risk tolerance is usually measured by the expected swings in annual portfolio returns (standard deviation). The investment time horizon helps determine the acceptable portfolio standard deviation. Investments with a short time horizon have a lower risk tolerance due to the limited opportunity to recover from a down year. A long holding period can withstand a higher standard deviation because the investment strategy can remain intact over multiple investment cycles to allow recovery from periods of weak returns.

Not-for-profit healthcare investments have near-term and long-term investment goals, which suggest a “bi-focal” investment time horizon. Since investment returns contribute to multiple financial objectives, the investment strategy should incorporate intermediate-term and long-term return and risk expectations. For example, a short time horizon is required to increase the degree of confidence that investment returns will meet non-operating revenue budget targets. On the other hand, balance sheet objectives might include growth in long-term investment assets, which lengthens the time horizon and risk tolerance. With these dual time horizons, asset allocation policies tend to be more dynamic for healthcare institutions to accommodate revisions to operating and capital spending forecasts.

### ***Investment Risk Tolerance***

In addition to time horizon, other factors help determine the appropriate investment risk tolerance for healthcare institutions. These include the strength and predictability of Operating Cash Flows (OCF), the flexibility of capital spending plans, and the level of Operating Income support to be provided by investment returns. The matrix below illustrates how these factors come together to influence investment risk tolerance.



Balancing these factors can pose a “Catch-22” situation for institutions. As investment return requirements rise, the need to take risk increases, while the ability to take risk declines. Institutions with a strong and stable operating cash flow are in the best position to take greater risk, but may not have a compelling reason to do so. Institutions with low or unpredictable operating cash flows may feel the pressure to take on additional investment risk to support operations or fund capital spending requirements. However, they are often in the worst position to take risk, especially if they have significant mandatory capital spending needs. If market returns meet expectations, everything works out, but a brutal bear stock market can over-stress the unrestricted investment portfolio. Certain hedge fund strategies can be beneficial in these situations to reduce expected portfolio volatility without sacrificing the potential investment return.

We have outlined a framework for determining investment risk tolerance for not-for-profit healthcare providers. An integrated assessment of the institution’s financial objectives improves the Investment Committee’s ability to set the best investment risk tolerance, which is a fundamental element of a solid investment policy. Institutions with a strong financial position might consider increasing the investment portfolio expected return/risk profile with higher allocations to illiquid alternative assets like private equities and real assets. Institutions with narrow operating margins and significant capital spending or debt service requirements would be prudent to have less volatile portfolios. This leads to a conundrum for such institutions — investment risk provides the chance for overcoming difficult operating conditions to meet budget goals, yet downside volatility would intensify financial stresses.

## **Conclusion**

With a clear view of the appropriate portfolio risk tolerance, the Investment Committee can apply a variety of techniques for developing effective investment strategies. Broadly diversified asset allocation policies that include alternative assets like hedge funds can help not-for-profit healthcare institutions improve the likelihood of achieving long-term return targets with an acceptable level of portfolio volatility. While the increased complexity of these portfolios requires additional investment expertise, the long-term benefits to the institution’s financial strength can be substantial.

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