



## RESEARCH NOTE: NOT-FOR-PROFIT HEALTHCARE A Primer on Alternative Investments

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### Executive Summary

- Alternative investments have become an increasingly popular investment for not-for-profit healthcare institutions the last several years. This Research Note covers the basic elements of alternative investments for not-for-profit healthcare institutions; including how effectively designed programs can enhance portfolio risk/return characteristics, and mitigate some risks associated with these investments.
- Alternative investments cover a broad range of investment strategies with historical returns that have low correlations to stocks and/or bonds. With improved diversification, adding alternative investments can reduce portfolio return volatility (risk), increase long-term expected returns, or both. This is particularly compelling for not-for-profit healthcare institutions that want to enhance profitability margins, increase long-term growth of investable assets and/or broaden funding sources for capital projects. However, commitments to alternative investments generally reduce portfolio flexibility, which highlights the importance of thoroughly vetting all aspects of the programs prior to incorporating these strategies into an institution's strategic asset allocation policy.
- Alternative investments include hedge funds, private equity, real estate and natural resources. Each plays a different role in an investment portfolio, and should address specific needs in supporting the integrated long-term financial plans for not-for-profit healthcare providers.
- These investments are largely unregulated, and the transparency of underlying holdings will often be limited. Therefore, validating the existence and valuation of these investments may complicate or delay the annual audit process, and rating agencies are taking a higher level of interest in not-for-profit healthcare institutions' allocation to alternative investments.
- Alternative investments achieve intended return characteristics through complexity and non-quantitative risks relative to the traditional stock or bond markets. Therefore, appropriate due diligence in manager selection and ongoing monitoring is paramount for successful programs. Without robust due diligence processes, it would be prudent for institutions to forego these investments. Key considerations include liquidity, an asymmetrical distribution of manager returns, and idiosyncratic manager risk (e.g., excessive fees, fraud or fund mismanagement).
- It is a sellers market for talented alternative investment managers, which command the highest fee structures in the industry. Therefore, fee structures are an important consideration when building alternative programs, because high fees without the desired return characteristics can erode returns, and cause disappointing program results.

In this Research Note we provide an introduction to a topic that has become increasingly popular, and likely an inevitable consideration for many not-for-profit healthcare institutions – alternative investments. After notable financial news headlines, the mere mention of “alternative investments” can drive shivers down the spines of some fiduciaries. Nonetheless, alternative investments have entered the Investment Committee lexicon, rather than becoming a passing fad. Not-for-profit healthcare institutions have recently dipped their toes into the alternative investments pool; which is reminiscent of endowments and foundations getting their feet wet 10-15 years ago, and defined benefit pension plans taking the dip 5-10 years ago. Since alternative investment returns generally do not move in tandem (i.e., are not highly correlated) with equity and fixed income markets, they provide diversification benefits. This allows investors to build much more efficient portfolios – higher expected

returns with lower expected risk (as measured by standard deviation). However, alternative investments have special, often non-quantifiable, risks that can be overlooked until years after investment commitments have been made without a proper due diligence process. Furthermore, the investment challenges faced by not-for-profit healthcare institutions are vastly different from endowments, foundations and defined-benefit pension plans. Therefore, it is imperative that Investment Committees consult objective advisors with deep alternative investment experience and an appreciation for the dynamics of the not-for-profit healthcare operating environment prior to investing in alternative programs. Overzealous or impertinent commitments to alternatives have the potential of violating an institution's debt covenants or triggering a negative outlook from debt rating agencies.

### What are alternative investments?

Alternatives typically refer to investments outside the purview of traditional, “long-only” marketable stock and bond portfolios. This broad definition encompasses a variety of investment strategies with specific objectives and a variety of potential implications for investment portfolios. The broad range of strategies and structures for alternative investments include exposure to hedge funds, private equity, real estate and natural resources.

**Hedge funds** have received significant press coverage in recent years (a good portion of which focuses on rare, yet spectacular failures). On its own, the term hedge fund can create a sense of mystery, as the universe of these largely unregulated funds has grown to more than 10,000 products covering an array of techniques and strategies that do not fall into any single well-defined asset class.

The attraction to hedge funds is that a well designed program can offer stock-like returns with bond-like volatility. Returns are largely driven by manager skill (typically a hand full of people are responsible for key investment decisions) rather than the direction of the capital markets. However, most managers jealously guard their trade secrets, and transparency of underlying investments is limited. Manager skill can be diluted as assets under management increase, so fund size becomes an important consideration for many strategies. Unlike traditional asset classes where manager risk (tracking error) can be eliminated by indexing, there is no investable index for hedge funds. Therefore a successful hedge fund experience is contingent upon selecting the right strategy mix and access to good managers.

**Private equity** investments are added to portfolios to increase expected long-term returns. These funds provide financing to businesses that are unable, or unwilling, to access funding through public markets. Since private equity funds acquire stakes in private companies, investments are illiquid (typically for periods of 10 years or more). Illiquidity premiums provide a key return driver for private equity programs, Hammond Associates typically targets expected returns of 500 basis points over the S&P 500 index. Lack of liquidity is an important consideration for not-for-profit healthcare institutions, because some auditors have concluded that illiquid assets should not be included in days-cash-on hand or other key liquidity ratio calculations.

Private equity investments are usually structured as private limited partnerships, with a general partner acting as the manager and limited partners as passive investors. General partners are responsible for selecting investments, managing the partnership and handling day-to-day operations. Limited partnerships, on the other hand, simply invest in the partnership, with little or no influence on the management of funds once commitments are made. Therefore, private equity funds are often dependent on the

general partners and a relatively small staff for all key investment decisions.

Implementation is often made through funds of funds due to the number of partnerships required for a diversified program. Fund of funds also significantly reduce the administrative burden of tracking these investments. Because private equity returns tend to be cyclical, and the duration for cash returns can be lumpy, time diversification is an important aspect for private equity programs. Partnership commitments need to be spread over several years for proper implementation of a private equity program, and these commitments take several years to become funded. The most common oversight in recommending allocations to private equity is that the long-term expected returns will not be realized for several years. In fact, reported returns for private equity are typically negative in early years because fees are charged on committed, not invested assets, and investments are often carried at cost until liquidating events occur. This is referred to as the “J-curve” effect, where private equity returns present a drag on the portfolio until partnerships mature.

**Real estate** is probably the most familiar alternative investment, since it has long been included in portfolios; not only for the diversification benefits, but also for inflation protection through commercial rent increases on office buildings, industrial facilities, retail centers and apartments. Additionally, the underlying value of income generating properties, tends to keep up with inflationary pressures.

Investors can access real estate exposure through publicly-traded REITs (real estate investment trusts), and less liquid private real estate partnerships. Both develop, own and operate properties, generate returns from net operating cash flow and long-term appreciation. Most are generally leveraged based on the underlying property borrowing capacity. Marketable REITs are listed on stock exchanges, and offer quick implementation of target allocations and straightforward audit valuations. Private real estate partnerships generally yield an illiquidity return premium. However, this approach can take several years to implement policy allocation targets, and creates added audit support requirements because market valuations are not readily available.

Private real estate partnerships can be structured as “closed end” or “open end”, which refers to liquidity rights for investors. Closed end partnerships usually have a lifecycle of about 10 years. After the commitment period, funds are closed to new investors. Capital is called as properties are purchased. Investors receive the operating income as the properties are developed, and return of invested assets with gains in the later years as properties are sold. Open end partnerships are managed into perpetuity and offer liquidity windows that allow investors control over entry and exit from the funds. These funds have the advantage of accelerated funding of asset

allocation targets and the liquidity return premiums over marketable REITs.

**Natural resource** investments have become increasingly popular with the recent bull market in global commodity prices. Like real estate, natural resources offer diversification benefits and inflation protection. Most natural resource funds invest in energy (exploration and/or production) and timber. There are very few liquid options for investing in natural resources. A close proxy would be a basket of natural resources industry stocks, which have higher volatility correlation to stock markets than private partnerships. Private partnerships are typically closed end funds that draw down investor funds to purchase resource production rights (e.g., in-the-ground oil reserves or tracks of timberland). The general manager generates returns through exploration, extraction and the resale of properties. These funds target mid- to high- single digit returns with an upside from unexpected inflation due to rising prices for the underlying commodities. These partnerships are illiquid and would be treated as “difficult to value” for the annual audit process.

### Important Risk Considerations

The same characteristics that make alternative investments attractive investment opportunities also carry special aspects of risk that must be considered. Many of these risk factors are not quantified in asset allocation models, so it is important that investors make careful qualitative risk assessments prior to adding alternative investments to the strategic asset allocation policy. Some of the most pertinent qualitative risks for not-for-profit healthcare institutions include:

**Liquidity** is a key driver of return premia for most alternative investments. Unlike endowments and foundations, which have an investment time horizon into perpetuity, hospital operating assets fund a liability stream with a duration that is impacted by a dynamic operating environment. Therefore, most healthcare providers design flexibility into the investment process, to respond to changes in the institution’s integrated financial planning process. Liquidity is an important factor in designing flexibility into an investment process.

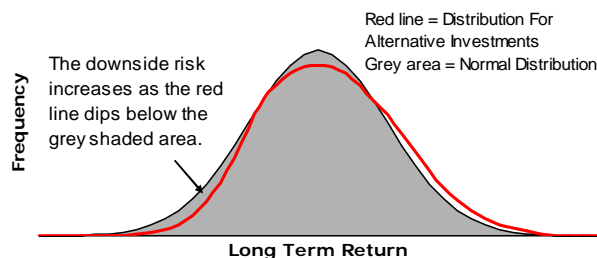
Some auditors will exclude material allocations to illiquid investments from calculations for days-cash-on-hand and other liquidity ratios. Recent changes in accounting standards have increased the focus on “difficult to value investments”, which include alternatives that do not have readily determinable market values. Therefore, an institution’s due diligence process should take account of the auditor’s views prior to making illiquid investment commitments.

Rating agencies have also heightening the focus on investment strategies, since liquidity can impact an institution’s credit quality and the ability to repay debt.

Many alternative investments have lock-up periods that preclude redemption for extended periods. After lock-up periods have expired, alternative investments typically have limited liquidity windows (monthly, quarterly or sometimes a year or more) and gates where access to funds can be constrained under unusual circumstances. Rating agency reviews will often include discussions on liquidity constraints, which are an important consideration in the design of effective alternative programs. Since strategic planning and operational needs can change significantly over time, healthcare providers need to be especially thoughtful in setting liquidity budgets for investable assets. Liquidity analysis and management is warranted when alternative investments comprise a material portion of the strategic asset allocation.

**Manager Selection** is particularly important for alternative investments due to the asymmetric distribution of returns among managers. For most traditional asset classes, the distribution of manager returns resembles a *normal* bell-shaped curve (grey area in graph below). For many alternative investments, manager returns *skew* to the right because a few exceptional managers pull up the average for the overall universe. For investors, this accentuates the importance of identifying, and having access to, the most talented managers. Therefore, mitigating manager selection risk is an important aspect of well-designed alternative investment programs.

Volatility May Not Accurately Portray Risk



**Idiosyncratic risk**, or manager-specific risk, is a particular concern for hedge fund programs. Like individual companies in a traditional stock portfolio, hedge fund managers carry systematic, or diversifiable, risks that must be mitigated for hedge fund portfolios. There are more than 10,000 hedge funds available to investors, and up to 20% close each year for reasons specific to the organization (similar to company failures in the stock market). Because hedge funds are largely unregulated, managers can open up shop by simply “hanging their shingle” with seed money from a few investors. Many of these managers are not suitable for well-designed hedge fund programs, and ultimately exit the business due to poor process control, disappointing returns, and in rare instances, fraud.

To mitigate idiosyncratic risk, strategy diversification and manager selection due diligence are critical for designing effective alternative investment programs.

### Other Factors to Consider

**Fees** are an important consideration for alternative investments, which are the most expensive asset classes in institutional investment portfolios. Our research team will often forego an otherwise attractive fund, simply because the fee structure diminishes the probability of achieving targeted return goals. Take, for example, hedge funds, where our asset allocation model assumes an expected return of 8% annually. While funds of hedge funds offer advantages of streamlined manager selection and reduced administrative burdens, these funds typically carry additional management fees of about 1.5% annually. For larger institutions, direct programs provide fee savings that can significantly increase the probability of meeting the 8% long-term return targets.

**Accounting implications** are especially important for not-for-profit healthcare providers. Because the outside audit process hinges on the individual judgment of auditors, we encourage discussions with a client's audit team prior to recommending specific alternative investments. Since material investments in illiquid funds can reduce the asset base on which cash-on-hand and other liquidity ratios are calculated, reviewing these funds with auditors can help define the corridors for a portfolio "illiquidity budget".

The American Institute of Certified Public Accountants (AICPA) recently revised its audit guidelines for "difficult to value investments" which include most alternative funds (and commingled funds for traditional asset classes). The new guidelines heighten the auditor's burden to test the existence and valuation of investments to ensure there is no material misstatement of an institution's financial statements. Alternative investments can increase management's responsibility in the examination and testing process.

**Rating agencies** are taking a keen interest in the role alternative investments play in not-for-profit healthcare institutions' investment strategies. Before recommending alternatives, the healthcare provider's investment consultant must have a clear understanding of potential constraints presented by outstanding debt covenants.

Rating agencies have become particularly interested in healthcare management's understanding of how alternative investment strategies fit with the institution's overall financial objectives. Strong operating cash flow, balance sheet flexibility and visible funding sources for planned capital spending will support significant allocations to

alternative investments. The ability to communicate integrated financial plans (including the rationale for adding alternatives to the investment portfolio) to rating agency analysts will help ensure that alternative investment allocations do not lead to a negative ratings outlook.

### Conclusion

Robust due diligence processes will become increasingly important as not-for-profit healthcare providers continue to increase alternative investment allocations (i.e., hedge funds, private equity, real estate and natural resources). The trend toward alternative investments is likely to continue because these investments can support an institution's mission by improving portfolio performance through higher returns and/or reduced the volatility. Investment returns will likely play a continued role in sustaining non-operating revenues and managing overall profit margins. For many healthcare providers, moving toward alternative investments will support consistent sustainable investment returns. Facilitating the alternative investment process requires sophisticated analysis, oversight and monitoring, as well as increased disclosure. To effectively support this process, investment consultants need to appreciate the unique needs of healthcare providers, and communicate the role of alternatives to investment committees, auditors, rating agencies and other constituents.

Strong investment research has always been important in designing effective alternative strategies, securing access to the best managers, and monitoring program performance. However, this will become increasingly important for not-for-profit healthcare institutions because these institutions face a dynamic operating environment that demands a clear understanding of all aspects of investment risk. Documenting investment practices and monitoring procedures will be increasingly important, and alternative programs will need to be designed with the flexibility to respond to the changing needs of healthcare providers.

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