Redefining Risk
Managing Healthcare Portfolios
Amid Unprecedented Uncertainty

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The healthcare industry is facing some of the most challenging times in recent memory. Changing regulations and new perspectives on financial assets will push many institutions to their limits, and the foundation of the industry is likely to shift under these newfound pressures. Successful healthcare institutions will have to find a way to navigate the changing environment. Institutions can help to protect their competitive standing, at least in part, by dedicating themselves to effectively managing their financial profile and investment portfolios. Healthcare organizations that protect their credit rating, safeguard their access to capital markets and maintain a clean audit report will have a competitive advantage over their peers as the industry charges ahead into an uncertain future.

The Keys to Financial Strength

Healthcare organizations face unique circumstances in both evaluating and maintaining their financial strength. Like all businesses, a strong financial position is critical to the long-term success of the institution. Unlike most other industries, the healthcare world faces a completely uncertain future due to the unknown long-term consequences of the Patient Protection and Affordable Care Act (PPACA). The changing regulations are likely to influence almost every aspect of the healthcare industry, including the payment institutions receive for providing essential care to their patients. PPACA might ultimately prove to be a financial windfall for certain institutions and a death knell for others. A select few healthcare organizations might have the political reach to influence how the new regulations are implemented, but most will be forced to wait and see what develops.

Proactive organizations are already working to strengthen their financial standing in areas that they can control. In most cases, the investment portfolios belonging to healthcare institutions have a direct effect on the institution’s financial characteristics. Discretionary portfolios, including board designated, funded depreciation, operating assets and others, are reflected directly on the organization’s balance sheet. Pension plans, while a distinct legal entity, are also reflected in financial statements and can appear as an unfunded liability (if the plan is underfunded). As a result, healthcare institutions must pay close attention to how their investment portfolios will be perceived by credit rating agencies, lenders and auditors. The liquidity and price transparency of the portfolio’s investments will shape that perception.
Liquidity

The liquidity of investment portfolios, and the underlying assets that make up the overall portfolio, is often the most important factor in how investments affect the organization’s financial profile. Highly liquid investments, including stocks, bonds and mutual funds that trade on a daily basis, count as part of the organization’s cash assets. This can be critical for specific accounting ratios, including days cash on hand. The liquidity of the portfolio can also affect the institution’s credit rating, with higher ratings (and lower borrowing costs) often bestowed on organizations that boast strong, highly liquid assets.

Price Transparency

Price transparency is highly related to liquidity, but it becomes more critical each year when the annual audit is completed. Auditors are responsible for categorizing investments as Level 1, 2 or 3. Level 1 assets have the greatest price transparency, as prices for these assets are widely quoted by publicly available sources like the Wall Street Journal or Bloomberg. Stocks, bonds and mutual funds are almost always classified as Level 1 assets. Level 2 assets are not publicly listed, and identifying accurate market prices is more difficult. Most commingled funds fall into this category. Level 3 assets are considered illiquid and difficult to price. Limited partnerships, including many hedge funds and private equity funds, are generally categorized as Level 3 assets. Healthcare auditors are often extremely strict on these classifications. All else equal, healthcare institutions generally prefer to have most (if not all) of their investments categorized as Level 1. Level 2 assets are less attractive to hold in portfolios, and many organizations will try to avoid investments classified as Level 3.

Investment portfolios often represent a significant portion of the assets for healthcare institutions. Organizations that demonstrate a preference for highly liquid assets with significant price transparency are likely to be rewarded with higher credit ratings, which lead to lower borrowing costs and more flexibility in the capital markets. A strong credit rating will also enable the organization to use balance sheet tools like interest rate swaps and forward contracts to help manage their outstanding debt. The preference for liquid, transparent assets will also increase the probability of maintaining a clean audit opinion. By following these guidelines, healthcare institutions will improve their competitive position and improve their ability to adapt to the changing industry dynamics that will follow the implementation of new regulations.
Classification of Financial Instruments

The International Accounting Standards Board (IASB) fair value measurements standards (International Financial Reporting Standards #7 Financial Instruments Disclosures) became effective on January 1, 2009. These disclosures required the classification of financial instruments at fair value within a hierarchy. These disclosures are the same as required under Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures of the Financial Accounting Standards Board Accounting Standards Codification.

IFRS #7 – Fair Value Hierarchy

IFRS #7 requires that the classification of financial instruments at fair value be determined by reference to the source of inputs used to derive the fair value. This classification uses the following three-level hierarchy:

• **Level 1** – quoted prices (unadjusted) in active markets for identical assets or liabilities

• **Level 2** – inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices)

• **Level 3** – inputs for the asset or liability that are not based on observable market data (unobservable inputs)

Use of Valuation Techniques

The fair value hierarchy focuses on the inputs used in valuation techniques rather than the techniques themselves. While the availability of inputs might affect the valuation technique selected to measure fair value, IFRS #7 does not prioritize the use of one technique over another. The determination of the valuation technique to be used requires significant judgment and is dependent on the specific characteristics of the asset or liability being measured and the market in which market participants would transact to sell, transfer or settle the asset or liability.

Conclusion

All Healthcare entities are impacted by IFRS #7 and ASC820 as they relate to the financial instruments held in the investment pools of the organization(s). A clear and full understanding is necessary to achieve full disclosure. These salient accounting pronouncements must be incorporated into the asset allocation.

Source: Classification of Financial Instruments within the IFRS #7 fair value hierarchy
The Keys to Building Successful Portfolios

Sophisticated healthcare institutions have long recognized that their investment portfolios must be considered within the broader context of the organization. The portfolios are not stand alone entities, as their importance to the overall balance sheet attests. Common investment practices, therefore, must be modified and shaped to correspond with the modern healthcare industry.

These healthcare institutions understand that their overarching investment philosophy should encompass four key elements: establishing risk limits, asset allocation, investment selection and portfolio governance.

Establishing Risk Limits

Investors of all sorts strive to balance risk and return, but healthcare institutions need to expand their perception of risk when considering their investments. The risk to an institution, as presented in the earlier section, goes far beyond investment losses. An overly aggressive portfolio could drop 20% during a difficult market environment. That type of investment loss might cost the portfolio millions of dollars, but the balance sheet impact could be even greater. Losses in the investment portfolio could compromise key financial ratios, including days cash on hand and the debt to equity ratio. Less favorable ratios could trigger a drop in the organization's credit rating, which in turn could lead to elevated borrowing costs and reduced access to capital markets.

Given the potential consequences, healthcare organizations should focus on the potential drawdowns of their investment portfolios. Drawdowns measure the investment loss from a portfolio’s high point to the bottom of a bear market. Healthcare institutions should review their balance sheets, understand how investment losses could affect their key financial ratios, and establish a maximum expected drawdown for their portfolios. The maximum drawdown should, of course, be set at a level that will not affect the organization’s financial strength. This establishes a risk limit for the portfolio, and it should ensure that the organization effectively protects itself from the consequences of the next market downturn.
Redefining Risk

Asset Allocation

The risk limits set for the portfolio should have a direct tie to the asset allocation process. Many healthcare portfolios will be relatively conservative due to the consequences of sustaining losses. The mix of stocks, bonds and diversifying assets should be determined in a way that maximizes the expected return while minimizing the expected drawdown. Investors are accustomed to the efficient frontier, which plots risk and return for investment portfolios. With a slight tweak, the efficient frontier can be used to visually compare expected returns and drawdowns (the common efficient frontier plots return versus volatility). Healthcare institutions should seek out portfolios that land on or above the traditional investment curve. Portfolios that plot on or above the curve are likely to achieve greater returns while effectively controlling risk.

Investment Selection

The selection of investment strategies and instruments goes hand-in-hand with asset allocation decisions. Traditional stocks and bonds are appropriate, in potentially different proportions, for almost any portfolio. These assets are classified as Level 1 assets, so there is little concern about using them in portfolios. Healthcare institutions should be somewhat more cautious in selecting assets likely to be classified as Level 2. Commingled funds, which are similar to mutual funds but not traded or priced daily, can be an effective way to access specific investment strategies.

Healthcare institutions should weigh the advantages of a commingled fund against the possible impact a Level 2 asset could have on the institution’s audit and financial ratios. It is better to explore the treatment of such a fund with the organization’s auditor before investing.
One of the biggest choices facing healthcare investors is the potential use of alternative investment strategies. Alternatives can help the portfolio shift up and to the left on an efficient frontier graph, signifying greater return with less risk. Alternatives also usually lack liquidity, have little price transparency and are characterized as Level 3 assets. The choice to include alternatives in a healthcare portfolio goes well beyond the traditional views of investment risk and return. The Investment Committee responsible for the portfolio should consider the likely impact of these investments on the organization as a whole before proceeding.

**Portfolio Governance**

Managing healthcare investments requires strategic risk planning, robust asset allocation decisions and the appropriate selection of investments. None of those elements can be accomplished without an effective governance structure. Healthcare institutions should follow several best practices in setting up the governance structure for their portfolio.

1. Populate the Investment Committee (or Board of Directors) with qualified professionals that demonstrate relevant experience, sound judgment and an understanding of how the portfolio fits into the overall institution. Selecting the right people for the Committee will pay long-term dividends for the portfolio and the organization.

2. Draft a robust Investment Policy Statement to govern the portfolio and outline the responsibilities of the Committee. Revise the Policy when necessary, but review it at least annually. The Policy will help to impose discipline and fight against the urge to make emotional portfolio decisions.

3. Meet on a regular basis to review the portfolio and the key developments within the organization. Markets can change quickly, and it is often necessary to adjust the portfolio to maintain the expected returns without violating the risk limit.

4. Recognize the limitations of the Committee and utilize outside experts when appropriate. Individuals that serve on an investment committee assume fiduciary responsibility for the portfolio; it might be beneficial to share that responsibility with experts in the field of investment management.

**Conclusion**

Healthcare institutions face an uncertain future, where long-term success is likely to be determined by the institution’s ability to thrive amid a rapidly changing environment. Successful organizations will find ways to manage their investment portfolios for the benefit of the entire organization. This requires critical thought far beyond traditional investment philosophies. Institutions that establish risk limits, construct a responsible asset allocation, select appropriate investments and abide by proper governance will be well ahead of the curve in managing their portfolios. Stronger portfolios contribute to a stronger balance sheet, higher credit rating and more flexibility for managing the organization. At a time of historical uncertainty, it is important to have the best possible strategy to guide the organization into the future.
About the Team

Joseph Karpinski, Area Executive Vice President, and Ryan Lennie, Area Senior Vice President and Area Director, are part of the Institutional Investment & Fiduciary Services team of Arthur J. Gallagher & Co., focused on improving the investment program of your benefit plan and other investment pools. Gallagher’s Institutional Investment & Fiduciary Services team are a group of established, proven investment professionals who provide objective insights, analysis and oversight on asset allocation, investment managers, and investment risks, along with fiduciary responsibility for investment decisions as an independent fiduciary or outsourced CIO.

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