HIRTLE CALLAGHAN & CO
Chief Investment Officers

Non-Profit Healthcare

Investing with an Enterprise Risk Mindset

In today's environment, healthcare systems and stand-alone hospitals face considerable financial, operational and governance challenges. Confronted with a dynamic operating and regulatory landscape, leadership teams are paying increased attention to the impact that investment portfolios have on their organization's ability to achieve enterprise-wide goals.

In this paper, we will explore some of the current challenges faced by non-profit healthcare providers, the complexities associated with managing multiple investment pools and the importance of adopting an enterprise risk mindset to position non-profit hospitals and health systems for continued success.

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Non-Profit Hospitals are Facing Significant Financial Pressures

Healthcare providers are currently confronted with multiple headwinds that impact their ability to operate at a profit and continue as a going concern. Key challenges facing the industry include:

- **Regulatory Uncertainty:** The U.S. healthcare industry is plagued with an ever evolving political, legal and regulatory environment. There is no clear consensus among healthcare providers, payors, physicians and other industry groups for a cogent, national healthcare policy.
- **Evolving Payer Mix:** As the U.S. population ages, Medicare enrollees are projected to grow from 47 million in 2010 to 80 million by 2030. This shift is negatively impacting revenues, as providers receive less reimbursement per procedure from Medicare versus private insurers.
- **Decreasing Utilization:** The advent of higher deductible private insurance plans has caused more patients to use independent outpatient facilities or forgo treatment altogether.
- **Growing Capital Expenditure Requirements:** Capital spending has increased as hospitals expand their geographic footprint and raise spending on technology initiatives such as electronic medical records, IT infrastructure and artificial intelligence. Hospitals have also been investing in programmatic changes to prepare for the move towards value-based care.
- **Vendor Consolidations:** As the insurance, pharmaceutical and benefit management industries consolidate, health systems are losing pricing leverage resulting in less favorable cost structures.
- **New Entrants:** Non-traditional healthcare providers and new business models have emerged which present fresh, competitive threats to healthcare systems.

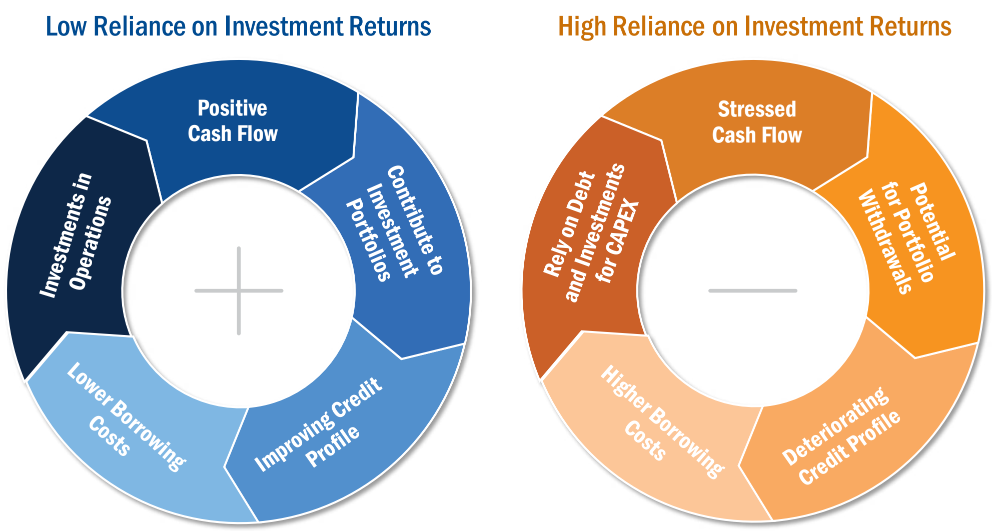
Although operating profits appear to be stabilizing after consecutive years of decline, the above trends have forced organizations to reexamine the role that investment programs have on their ability to achieve financial success. We believe that many health systems will be forced to rely on their investment portfolios to meet working capital needs, finance capital expenditures and to access the capital markets. Given the growing importance of investment results in relation to the overall success of the institution, it is critical that leadership teams develop an understanding of the intricate relationships that exist between their investment program and total risk to the enterprise.

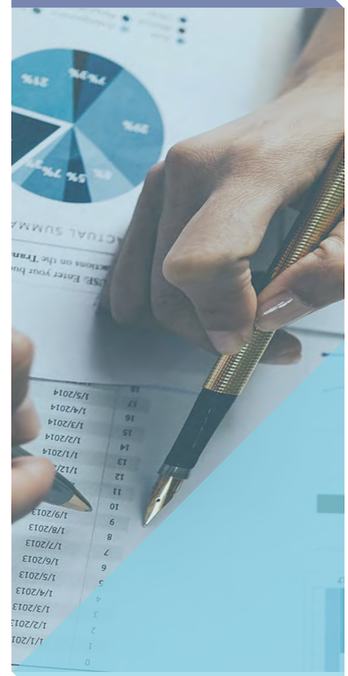
Health Systems Have Unique Financial Characteristics

Health systems have a number of attributes that make them unique in comparison to other institutional investors. While certainly not an all-encompassing list, each of the below characteristics are common to non-profit healthcare institutions and should be accounted for when building an investment program with broader enterprise risk considerations in mind.

- The financial profile of a typical non-profit health system is heavily exposed to, and influenced by, movements in the capital markets. For example, it is not uncommon for unrestricted investment portfolios to account for more than 50% of total organizational assets. On the liability side of the balance sheet, long-term debt and underfunded defined benefit pension plans can represent a significant share of organizational liabilities.
- Hospitals are responsible for managing multiple investment pools with varying intended uses, liquidity needs, time horizons and risk tolerances.
- Unlike their for-profit counterparts, non-profit health systems are unable to sell equity stakes in their business to raise capital. As a result, maintaining ongoing access to the credit markets at attractive lending rates is a perpetual business concern.
- A positive correlation exists between the market forces that drive investment returns and the financial performance of hospitals. For example, during economic recessions hospital utilization tends to decline which negatively impacts operating margins and cash flow. Under this environment, investment pools positioned for long-term growth are more likely to lose value, which erodes the balance sheet and decreases non-operating income.

The visual below highlights the relationships that exist between hospital operations, investment returns and total enterprise stability.



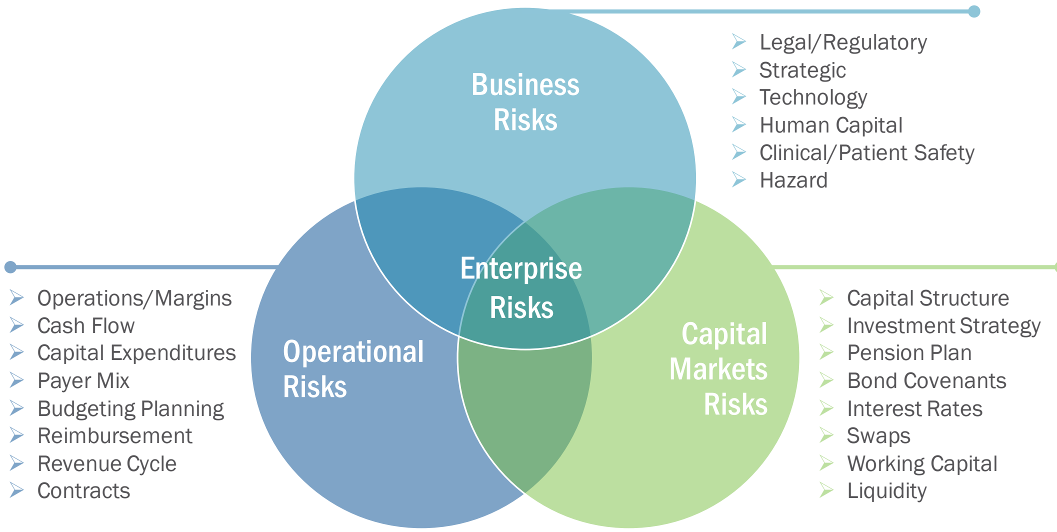


During periods of strong operational performance for health systems, positive operating margins and strong cash flow generation lead to flexible capital spending budgets, improving credit metrics and a low level of reliance on investment returns. When the operating environment weakens, profits and cash flow tighten, which in turn increases the potential need for outside financing or withdrawals from the investment portfolios to meet spending requirements (often at an inopportune part of the market cycle). It is critically important that providers understand the intricacies of their overall risk profile, including the relationships that exist between hospital operations and the investment program.

> “Traditional risk management is no longer sufficient to sustain organizational success in an environment of transforming healthcare delivery and payment.”
>
> – *American Society for Healthcare Risk Management*

Health Systems Should Adopt an Enterprise Risk Mindset

Board members and leaders within healthcare organizations are tasked with managing risk across the total enterprise. As a result, investment programs should not be constructed in a “silo,” rather they should be developed, implemented and monitored within the context of a broader enterprise risk management framework. According to the American Society for Healthcare Risk Management, “enterprise risk management in healthcare promotes a comprehensive framework for making risk management decisions that maximize value protection and creation, by managing risk and uncertainty and their connections to total value.” By incorporating this philosophy when building a system-wide investment program, the hospital can be assured that the overall investment strategy and accompanying risk profile is well aligned with the unique financial characteristics and aspirations of the organization.



There are five key steps to incorporating enterprise-risk management principles into the investment decision-making process:

1. Clarify and prioritize organizational goals and objectives
2. Understand your financial profile and drivers of risk
3. Define the investment strategy for each asset pool
4. Create a comprehensive enterprise risk model
5. Monitor on an ongoing basis

1. Clarify and Prioritize Organizational Goals and Objectives

Hospital systems should have a clear understanding of their financial goals. Examples of common short-term financial goals include strengthening the system’s financial metrics (such as the days cash on hand and debt-to-capitalization ratios) or improving the funded status of the defined benefit pension plan. Longer-term financial goals may be harder to achieve and typically require significant planning. Examples of longer-term goals include improving the credit rating of the system, expanding the geographic footprint of the organization through strategic partnerships or merger activity and long-term capital-intensive projects (such as the construction of a new patient tower). As leadership teams work to clarify and prioritize their organizational goals, they are laying the foundation for the objectives of their investment program.

2. Understand Your Financial Profile and Drivers of Risk

It is critical that leadership teams develop a clear understanding of the risks to the overall financial health and stability of the organization, along with the role that their investment pools can have on mitigating (or amplifying) these risks. Examples of common concerns include:

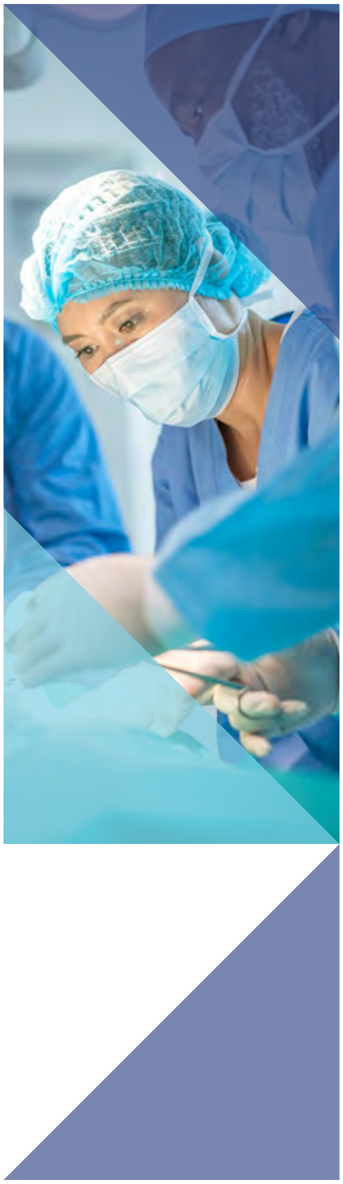
- **Current Credit Profile:** As noted previously, non-profit health systems are unable to sell equity stakes in their business to raise capital. As a result, maintaining ongoing access to the credit markets is of critical importance. Since investment portfolios typically constitute a notable percentage of total balance sheet assets, the performance and volatility of these pools can play a large role in determining the key financial ratios that stakeholders use to measure the overall credit strength of an organization.
- **Free Cash Flow After Capital Expenditures:** If the system is not generating enough cash through operations to cover expenses and other obligations, forced withdrawals from the long-term investment pool may be unavoidable. This scenario could expose the system to a number of unattractive situations, including selling investments at inopportune moments. If a hospital is expecting to generate insufficient cash flow and will need to finance their capital budget internally, a well-coordinated approach to managing cash needs is imperative.
- **Cash Conversion Cycle and Liquidity Needs:** Holding too much cash (or not enough) can impede the ability of the organization to maximize the return potential of their unrestricted cash and investments. Specifically, holding more cash or short-term reserves than is needed can represent a significant drag on the return potential of the investment program, which in time can impede improvement of the organization's financial profile.

3. Define the Investment Strategy for Each Asset Pool

Health systems should identify and memorialize the purpose, size, desired investment return, time horizon, risk tolerance and liquidity requirements for each asset pool. The below table provides an overview of common investment portfolios maintained by a typical health system.

	Operating Cash/ Short-Term	Board Designated	Foundation	Self Insurance	Defined Benefit Pension Plan
Purpose	▪ Working capital needs ▪ Warehouse for near-term planned expenditures ▪ Debt service ▪ Backstop for re-marketable debt	▪ Credit rating support ▪ Funding source for capital projects ▪ Financial stability ▪ Debt covenant support ▪ Supplement operating income	▪ Provide operational support to hospital/system ▪ Support charitable initiatives ▪ House hospital "restricted use" donations	▪ Fund medical claims filed by covered persons ▪ Reserves to pay property and liability claims	▪ Fund obligatory benefit payments to pensioners
Asset Allocation Consideration	▪ Need for liquidity vs. long-term return ▪ Determining appropriate level of reserves	▪ Ability vs. willingness to take investment risk (current credit profile) ▪ Future expectations (business outlook) ▪ Liquidity needs	▪ Spending policy ▪ Fundraising expectations	▪ Variety of program structures ▪ Permissible investments often statutorily driven	▪ Size of plan relative to total balance sheet ▪ Contribution policy ▪ Asset/liability relationship
Time Horizon	Short	Long	Long	Varies	Long
Risk Tolerance	Low	Varies	High	Generally Low	Varies
Liquidity Needs	High	Generally Low	Low	High	Varies

While portfolios with a specific purpose (such as a self-insurance pool) may carry stipulations regarding the types of investments it can hold, organizations have many options for how to invest funds that are considered "unrestricted" in nature. For example, a large health system with a strong operating profile and healthy balance sheet metrics may hold a large percentage of their unrestricted investments in the Board Designated portfolio, which is generally designed to be long term in nature with a growth-oriented asset allocation. In addition to having more assets allocated to longer-term investment strategies, financially strong systems are also better positioned to invest in illiquid asset classes such as private equity which would increase the expected return of the portfolio. In contrast, a hospital or health system facing operational or financial challenges may choose to take a more defensive posture with regard to the investment of their unrestricted cash and investments. A defensive-minded investment strategy will typically result in a greater percentage of unrestricted funds being held in the short-term operating portfolio as opposed to the Board Designated pool. The result is a more conservative global asset allocation with lower return volatility and less potential for large drawdowns that may negatively impact the financial profile of the overall system.

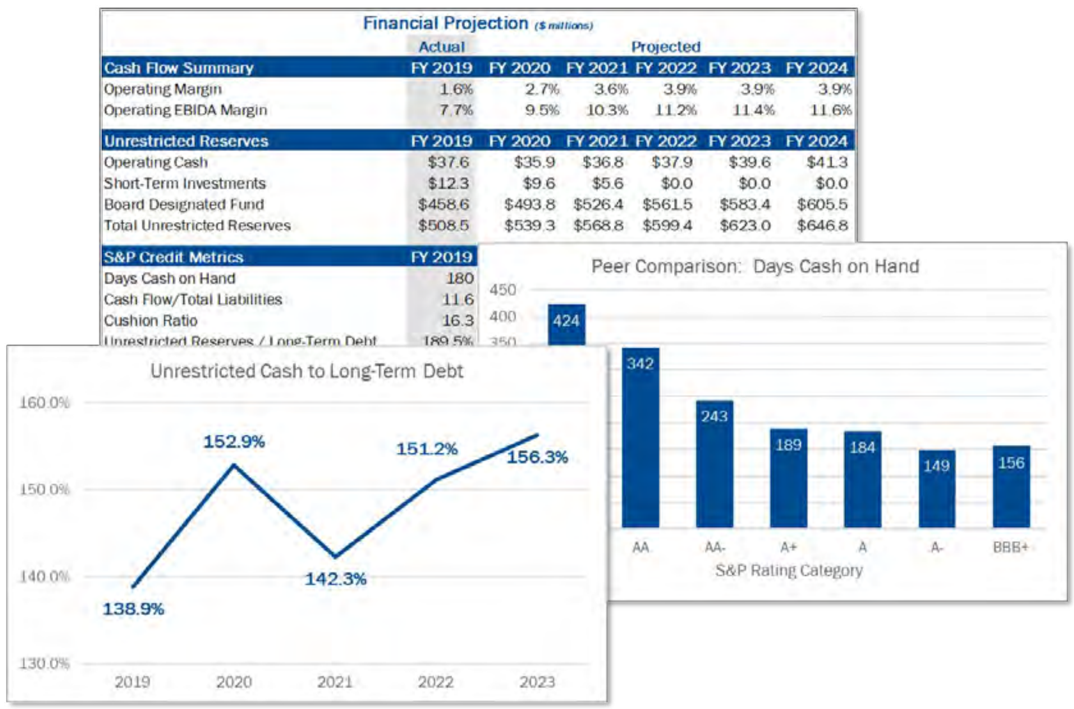


4. Create a Comprehensive Enterprise Risk Model

Health systems should utilize a comprehensive financial model that overlays the performance of disparate pools onto the financial condition and credit profile of the organization. This enterprise risk model should, at minimum, incorporate expectations around future operating results, capital expenditure budgets, debt issuance, cash management policies and capital market movements.

It is important to stress test the assumptions in the financial model and to allow the investment portfolio(s) to pre-experience risk. Stress testing enables stakeholders to quantify the potential organizational impact of varying investment and asset allocation policies. Typical questions that a well-constructed modeling exercise can help answer include:

- "Is the risk profile of our investment program properly aligned with the unique goals, objectives and financial characteristics of our health system?"
- "Are our investment portfolios structured properly when considering our credit profile and future operating expectations (projected future operating margins, planned capital expenditures, debt issuance, etc.)?"
- "How would a prolonged downturn in the economy (i.e. a poor environment for hospital revenues and investment returns) impact my financial and credit profile?"



Financial Projection ($ millions)

	Actual	Projected				
Cash Flow Summary	**FY 2019**	**FY 2020**	**FY 2021**	**FY 2022**	**FY 2023**	**FY 2024**
Operating Margin	1.6%	2.7%	3.6%	3.9%	3.9%	3.9%
Operating EBIDA Margin	7.7%	9.5%	10.3%	11.2%	11.4%	11.6%
Unrestricted Reserves	**FY 2019**	**FY 2020**	**FY 2021**	**FY 2022**	**FY 2023**	**FY 2024**
Operating Cash	$37.6	$35.9	$36.8	$37.9	$39.6	$41.3
Short-Term Investments	$12.3	$9.6	$5.6	$0.0	$0.0	$0.0
Board Designated Fund	$458.6	$493.8	$526.4	$561.5	$583.4	$605.5
Total Unrestricted Reserves	$508.5	$539.3	$568.8	$599.4	$623.0	$646.8
S&P Credit Metrics	**FY 2019**					
Days Cash on Hand	180					
Cash Flow/Total Liabilities	11.6					
Cushion Ratio	16.3					
Unrestricted Reserves / Long-Term Debt	189.5%					

At Hirtle Callaghan, we run our investment portfolios and client financial projections through multiple scenarios to understand how they would perform during varying economic environments. It is critical to plan in ordinary times to guide decision-making in times of market distress.

5. Monitor on an Ongoing Basis

Implementing an enterprise risk management program is a continuous project. Interest rates move up and down, industry dynamics change and strategic and operational priorities shift. Each change impacts your balance sheet, operating model and risk profile. Financial models should be ever changing and fluid. Investment programs must be continually monitored and stress tested to understand the impact changes have on financial covenants, liquidity ratios and the risk profile of the organization as a whole.

Establishing an investment program that effectively accounts for risks to the enterprise is a critical step that leadership teams can take to help ensure that their organization is well positioned for future financial success. Strategic planning is at the foundation of Hirtle Callaghan's investment process. Through careful planning we are able to construct an investment program that incorporates your institution's distinct financial condition, risk tolerance and goals. Our process establishes a shared vision for your investment strategy that aligns with your strategic objectives while accounting for the impact the investment program has on the overall enterprise.

THE GOVERNANCE CHALLENGE AND THE CASE FOR OUTSOURCING

Serving as a fiduciary for a non-profit health system in today's complex operating environment is a complicated and important job. Health and hospital system fiduciaries are not only tasked with overseeing investment pools, but also liability portfolios, capital markets issuance, derivatives, treasury, budgeting and strategic planning. As the amount of available investment strategies continues to grow in number and complexity, it is increasingly difficult for healthcare investment teams to maintain a dynamic investment program.

The landscape in healthcare is forcing fiduciaries to concentrate their time on the most pressing issues such as mergers and acquisitions, strategic partnerships and evaluation of physician-owned business models (among others). As all healthcare systems focus on efficiencies to gain competitive advantage through better strategic decisions, it makes sense to consider the idea of outsourcing the investment management function to an Outsourced Chief Investment Officer (OCIO). Key benefits to this approach include:

Strategic Focus: The complexity of decision-making for governing fiduciaries are numerous and continue to grow. Outsourcing gives both the treasury and governing fiduciaries operational leverage to focus on key strategic issues.

Point Accountability: Non-discretionary investment consulting models leave gaps between a decision taken and the ultimate party responsible for the decision. This gap does not exist in an OCIO model.

Cost Considerations: The implicit and explicit costs of an investment program are sometimes difficult to quantify. Beyond investment management and custodial fees are the implicit costs of time and attention to portfolio matters. An OCIO can help alleviate the burden in managing complex and labor-intensive investment decisions.

Institutional Knowledge: Governing fiduciaries of not-for-profit healthcare systems are dedicated volunteers whose tenure varies from organization to organization. An outsourced model creates institutional knowledge and greater consistency as board members rotate on and off of committees.

Implementation Shortfall: The growth of investment products and asset classes continues to outpace the knowledge base of healthcare treasury and board of trustees. The OCIO model takes advantage of diverse asset classes to enhance the overall investment program and provides the flexibility to make efficient tactical investment decisions.

Holistic Understanding of Risk: Through a comprehensive dialogue to assess operational, financial and market risks, an OCIO can assess and implement an investment program to account for the holistic, enterprise risk exposures.

Founded in 1988, Hirtle Callaghan is America's first Outsourced Chief Investment Officer, servicing institutions and families. In our role as Chief Investment Officer, we build global investment programs that are customized to each of our client's unique needs. The firm uses its collective purchasing power and aggregate expertise to access best-in-class specialist managers in diverse asset classes and strategies.

The Healthcare Practice Group at Hirtle Callaghan is comprised of professionals with expansive and diverse experience working with non-profit healthcare providers in various capacities. Our team has extensive experience in-house at a large healthcare system and advising hospitals on portfolio construction, enterprise risk and fiduciary / governance issues. We welcome the opportunity to discuss how Hirtle Callaghan can help you adopt an enterprise risk-based approach to building and managing your investment program.

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As a member of the Portfolio Management Group, Chris is responsible for working with and advising the firm's non-profit healthcare clients. Prior to joining Hirtle Callaghan & Co, Chris spent 10 years at SEI Investments where he was responsible for advising non-profit healthcare OCIO clients on topics such as asset allocation and enterprise risk. Prior to his work at SEI, Chris worked at TD Bank where he underwrote fixed income offerings on behalf of non-profit hospitals and health systems. Chris earned his B.S. in Finance & International Business from The Pennsylvania State University, is a CFA charterholder and a member of the CFA Society of Philadelphia.

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Paul is a Portfolio Manager and is responsible for servicing and implementing the firm's Investment Strategy decisions within healthcare and hospital accounts. Prior to joining Hirtle Callaghan, Paul was a Manager of Investments at Catholic Health Initiatives and part of a team managing multi-asset class portfolios for an operating fund, foundations, defined benefit pension plans, and an insurance company. Paul focused on monitoring current managers in the portfolios and conducting due diligence on prospective managers. Additional duties included oversight of asset allocation and risk management. Prior to Catholic Health Initiatives, Paul was with Fund Evaluation Group, an institutional investment consultant based in Cincinnati. Paul earned his BA in International Business from Rhodes College. Paul is a CFA charterholder and a member of the CFA Society of Colorado.

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