Executive summary: Managing investments is an increasingly critical component of a hospital’s financial health, made more complex by an uncertain economic environment and increased government regulation.

Hospitals must balance decreasing payment rates against the need to preserve capital and liquidity to deal with unexpected events. This puts a premium on effective management of investment asset pools.

Hospitals that take the time to thoroughly consider three questions will be better positioned to succeed:

1. Are your investment assets defined properly?
2. Are you setting the right allocations for your asset pools?
3. Are your investment assets managed in a way that is consistent with the financial health of your organization?

This commentary provides five steps to help position a hospital for success and ensure it is on the right track.
The increasing importance of investment assets

Executives at nonprofit hospitals are finding that managing investment assets has become an increasingly critical component to the overall financial health of their organizations. According to a recent survey of 90 nonprofit hospitals conducted by Commonfund, investment income as a percentage of net income rose to a median level of 50% in fiscal 2010.

While the strong market performance in 2009 and 2010 clearly contributed to the magnitude of this recent increase, investment income as a percentage of net income has been rising over time for many hospitals, including some of the most financially secure organizations. And we expect this trend to continue as hospitals face an increasingly uncertain market and regulatory environment that is likely to pressure operating margins further.

Managing investment assets has never been easy for nonprofit hospitals. In contrast to most other nonprofit organizations, hospitals have to answer to many stakeholders, including medical staff, administrators, patients, regulators, payers, and insurance companies. In addition, hospitals face an increasingly competitive environment to leverage new technologies and treatments and are also burdened by the expense of costly machinery and equipment that must be periodically upgraded and replaced.

This environment has led hospitals to create more elaborate investment structures and establish a greater number of investment asset pools to meet the technology needs and spending obligations of this diverse group of stakeholders.

While other nonprofits may have only an endowment or foundation portfolio to manage, it’s not unusual for hospitals to take on the additional responsibility of managing a defined benefit retirement plan, a funded depreciation account, several operating accounts, and self-insurance pools. All of these pools have distinct investment goals and time horizons and should be managed to meet specific objectives.
Economic and regulatory pressures

While hospitals have been under pricing pressure for some time as their share of Medicare and Medicaid payments has grown and government reimbursements have declined, the situation has become even more uncertain as economic events and increased government regulation have combined to tighten margins further.

The sluggish economy has depressed hospital revenues. And even after the Supreme Court’s decision in June which gives states leeway to opt out of the Medicaid expansion, early estimates indicate that the new health care law will still increase Medicaid enrollment (Figure 1) which will lead to reduced reimbursement rates as the share of payments from Medicaid and other low margin sources continues to expand.

Finally, new mandates, such as the requirement to computerize all hospital medical records, have driven up expenses.

Figure 1. Affordable Care Act’s (ACA) impact on employer-sponsored and Medicaid coverage

Estimated percentage change in enrollment compared with pre-ACA estimates

Source: Congressional Budget Office.

*Includes enrollment in the Children’s Health Insurance Program (CHIP).
In the past, some nonprofit hospitals may have responded to difficult financial circumstances by simply reducing discretionary spending. But stricter community-benefits standards required to maintain their tax-exempt status have made it more difficult for these organizations to cut back in this area.

Hospitals now face the challenge of balancing decreasing revenues with the need to preserve capital and liquidity to deal with unexpected events. This environment has put a premium on effective management of investment asset pools.

**An appropriate response**

As one of the largest investment providers to nonprofit hospitals and one of the largest purchasers of hospital debt, Vanguard has been actively involved in helping these organizations adapt. While each hospital’s situation is unique, we believe hospitals should consider three fundamental questions to help them manage their investment assets properly.

Answering the following questions thoroughly and honestly will help hospitals not only manage their investment assets more effectively, but also better integrate investment decisions into the hospital’s overall financial management—something that has taken on increased importance in recent years.

1. **Are your investment assets defined properly?**

The investment accounts a hospital typically holds often have been viewed as one fungible pool of assets with a common allocation, time horizon, and risk profile. But investment asset pools usually represent a diverse array of specific uses and time horizons and, in most cases, need to be managed independently.

For example, it may appear that two operating accounts—operating cash and funded depreciation—have many similarities and would require a similar asset allocation. But as the diagram below (Figure 2) illustrates, these two pools have very different purposes and time horizons. Operating cash is generally used for payroll, billing, and other short-term needs. While funded depreciation is still considered an operating account, it typically has a longer time horizon to fund expenditures for capital equipment replacement.

**Figure 2. Investment horizon spectrum**

<table>
<thead>
<tr>
<th>Shorter-term assets</th>
<th>Operating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day-to-day cash management, such as payroll and bills</td>
<td></td>
</tr>
<tr>
<td>Intermediate-term operating</td>
<td></td>
</tr>
<tr>
<td>Longer-term expenditures such as malpractice self-insurance pools</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Long-term operating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined contribution/Defined benefit assets</td>
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<tr>
<td>Retirement plans</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Longer-term assets</th>
<th>Retirement</th>
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<tbody>
<tr>
<td>Rainy-day fund for unexpected events such as a catastrophe</td>
<td></td>
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<thead>
<tr>
<th>Endowment-like assets</th>
</tr>
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<tbody>
<tr>
<td>Foundation/Endowment-like assets</td>
</tr>
<tr>
<td>Unknown major expenses; assets to exist in perpetuity</td>
</tr>
</tbody>
</table>

A critical step in managing investments for the maximum benefit of your organization is defining the intended use of each asset pool and how much risk it will shoulder. This can occur only after you have clearly identified, articulated, and documented the following criteria for each investment pool:

- Specific use.
- Time horizon.
- Return objectives.
- Acceptable risk parameters.

Hospitals that fail to define the intended uses and risk parameters of each asset pool may not only fail to meet the specific needs that these pools were established to address, but also jeopardize the overall financial health of their organization in the eyes of bondholders—which can have severe implications for hospitals.

How much risk your organization decides to take within each pool should be based on the goals of your hospital and not those of comparable organizations. But no matter what strategies you select, you cannot manage these investments for the maximum benefit of your organization without defining their intended use and how much risk you are willing to take.

It may be instructive to look at how this process helped a hospital client of ours better define one of its short-term operating accounts to address its liquidity needs and improve the overall financial position of the organization.

In this particular account, the organization had nearly 75 days of cash equivalents. A more thorough analysis of cash flows showed that maintaining closer to 15 to 20 days of cash equivalents would adequately address liquidity needs without jeopardizing key financial ratios.

So, the organization was overhedging liquidity risk while ignoring the opportunity cost of potentially higher-yielding longer-term investment strategies. By investing approximately $50 million in investments with returns close to zero, the hospital had foregone millions in annual investment income that it could have received by investing part of these assets in higher-returning long-term investments.

To illustrate how much income this hospital was potentially losing because of its conservative investment strategy, this particular investment pool would have generated $19 million in additional income had it invested these assets in a balanced 60%–40% stock-bond portfolio from 2009–2011. While no one could have predicted the strength of the stock market during this three-year period, this detailed level of analysis helped produce an investment strategy that more appropriately aligned the liquidity needs and time horizon of this organization.

We have seen other hospitals do the opposite and invest short-term operating accounts too aggressively regardless of the potential liquidity needs of their organizations. But in either case, hospitals that properly define their asset pools improve their chances of addressing short-term liquidity needs and maximizing potential investment returns.

2. Are you setting the right allocation for your asset pools?

After you’ve defined your asset pools, the next step is to assign an appropriate asset allocation for each of these investments. Vanguard believes that the goals and uses for each pool should be considered independently and should be assigned asset allocations that are appropriate to meet their specific purposes. Hospitals should not try to match the average allocation of the other pools with similar time horizons or try to match an industry average that has no relevance to the hospital’s unique situation or risk profile.

This means first gauging the likelihood of meeting specific return objectives given different allocation choices, the probability of losses of a specific magnitude, the likelihood of preserving real portfolio value over a planning horizon, and a variety of other risk metrics.
Occasionally, hospitals may be able to manage some of these pools using the same asset allocation if the risk tolerances are similar and resources for the organization are limited. But in most cases, hospitals should assign a different allocation for each investment asset based on the investment’s goals and time horizon as well as the amount of risk the hospital can withstand and still fulfill its long-term capital obligations.

A closer look at two asset pools—an endowment and a defined benefit pension plan in the text box below—illustrates why it makes sense to manage these pools differently.

### Asset pools with similar time horizons but different investment strategies

Both endowments and pension plans are considered long-term investments. However, they are distinct asset pools that need to be viewed separately. A hospital may determine that a 70%–30% stock-bond allocation may be appropriate to support and preserve inflation-adjusted principal for an endowment with a perpetual time horizon and a 5% annual spending rate. For the pension plan, that much risk may not be suitable if it is fully funded, closed, and composed of beneficiaries who tend to be older. Indeed, a more conservative allocation with a greater exposure to long-term bonds may be more prudent.

So while the endowment and pension plan are usually considered long-term accounts, the asset allocation that a hospital assigns to the pension plan may differ dramatically depending on the characteristics of the plan and demographics of its participant population.

#### 3. Are your investment assets managed in a way that’s consistent with the financial health of your organization?

In addition to ensuring that each asset pool is managed appropriately, hospitals also must make sure that their investment pools are contributing to the overall health and risk posture of the entire organization.

Hospitals should keep in mind that their overall financial health is important for investors considering whether to hold the hospital’s debt in their portfolios, and they should manage investment assets in ways that do not compromise this important responsibility.

Increasingly, investment decision-making needs to be integrated with the financial management of the hospital, because the investment characteristics and performance of each pool will affect the overall risk posture and financial position of the entire organization. While each asset pool needs to be viewed uniquely, they are all integrated parts of the hospital’s financial structure.

For example, the size of a hospital’s contribution to its pension plan may depend on the effect that it has on the organization’s cash flow, debt covenants, and other parts of its financial statements. A hospital with a large pension plan may decide to make a sizable cash contribution that will increase the plan’s funding level as part of a long-term investment strategy. But it may have to do so gradually over several years to minimize any adverse effect that the contribution might have on the hospital’s financial standing and key financial metrics, such as day’s cash on hand.
Five steps for measuring success

Because of growing financial pressures, hospital CEOs and finance committees may have to focus more of their time and attention on managing their investment assets and income. Hospitals that thoroughly consider the three questions addressed in this commentary will be better positioned to succeed in the new world of increased economic and regulatory uncertainty that has pressured hospital margins in recent years.

To make sure you are on the right track, Vanguard recommends that hospital executives and their investment committees take the following steps:

• Understand the portfolio’s investment objectives in terms of organizational goals and spending objectives.

• Have a clear understanding of why your hospital’s portfolio holds each investment and review each one annually to determine whether they’re being managed properly in light of their respective time horizons and your organization’s tolerance for risk.

• Manage your time wisely in overseeing both your organization’s operational and investment assets. Investment committees should consider dedicating time and resources to the management of their investment assets that is proportional to the percentage of net income that these assets represent.

• Meet with your investment providers and consultants annually to review investment strategies.

• Monitor the costs associated with managing your investment pools. Associated costs can include internal staff, consultants, investment managers, and banks.

By following these best practices, you can more efficiently manage each asset pool to meet its specific objectives, make your organization a more attractive portfolio holding for investors, and ultimately improve the chances of fulfilling your organization’s mission.
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