NAVIGATING THE HEALTHCARE LANDSCAPE IN 2017

For most not-for-profit (NFP) healthcare systems, 2016 was another steady year, as evidenced by growing patient volumes, stable operating cash flows, and solid investment returns from most traditional asset classes. Nevertheless, 2017 proves to be a challenging year for the world of NFP healthcare. Just as margins have begun to stabilize, changes in the Affordable Care Act (ACA) and a much more volatile investment environment could derail gains from the previous years. We have outlined what we believe to be ten critical areas that NFP investors should reevaluate as they attempt to steer through a complex and ever-changing world.

Not-for-profit (NFP) healthcare providers comprise a distinct class of institutional investors. Nowhere is that more apparent than within their operating portfolios. For NFP healthcare investors, operating assets have multiple investment objectives and are charged with the distinctive goal of delivering quality healthcare within their communities. These portfolios serve 3 fundamental purposes:

- Primary funding source for future capital expenditures
- Access to capital through public finance debt markets
- Complement operating strategy

1. ALIGN THE INVESTMENT PORTFOLIO TO THE NEEDS OF THE ORGANIZATION.

Healthcare is different from the typical endowment model, and there is no one-size-fits-all solution for NFP investment strategies. NFP healthcare investors should take an organizational-wide view to understand the impacts that portfolio decisions may have on the financial health of the overall organization. This is imperative given the higher levels of scrutiny from credit ratings agencies. For instance, how much risk can an organization take in an operating portfolio if the Days Cash On Hand target is 250 days? An integrated approach to portfolio construction helps understand and quantify the impact of allocation decisions.

2. BALANCING PORTFOLIO LIQUIDITY IN A LOW-RETURNING WORLD.

With traditional assets expected to deliver lower than average returns going forward, many investors have moved into less liquid alternative investments in search of higher future returns. However, NFP healthcare organizations face unique liquidity demands ranging from operating and capital needs to rating agency demands. In "***Catch 22: Balancing Portfolio Liquidity in A Low Returning World***" we discussed the challenges NFP investors face and how they have a catch-22 dilemma whereby they must balance portfolio liquidity in a low-returning world.

3. ASSESS OPERATING ENVIRONMENT IN LIGHT OF ACA CHANGES.

NFP healthcare organizations have always been challenged from an operational standpoint due to a concentrated, government-influenced or private insurance revenue base that does not fully reimburse the full cost to provide healthcare. Uncertainty will only increase as the new administration looks to “repeal and replace” the Affordable Care Act. Per Moody’s, the House Republicans’ proposed ACA repeal is credit negative for NFP hospitals. If changes are made, investors will likely need to revisit their portfolio strategy and risk tolerance given the potential implications for healthcare operations. In a more difficult operating environment, investment portfolios could be called upon to supplement operations.

4. REVIEW DEFINED BENEFIT PLAN RISKS.

Healthcare defined benefits plans have endured extreme fluctuations in funding status, which have presented a risk to balance sheets. To manage funded status volatility, investors should consider developing a “glidepath” strategy to de-risk a plan and work toward achieving a fully funded status. Also, PBGC premiums are set to rise significantly in 2017, leading plan sponsors to examine ways to lower plan liabilities and reduce premiums. Many healthcare organizations have utilized vested terminated buyouts as a way to reduce pension liabilities and costs.

5. MAXIMIZE RETURNS FOR SHORT-TERM CASH POOLS.

While NFP healthcare cash balances have grown significantly since 2009, traditional investments such as demand deposit accounts and money market funds offer minimal yields. Regulations have also transformed both of these industries, putting healthcare investors at a disadvantage. In *"**Is Cash King? Optimizing Liquidity in a Lower-Returning Environment**"* we discussed solutions, which involve tiering healthcare cash programs based on time horizon, which can significantly increase potential returns without sacrificing liquidity.

6. REVISIT INFLATION-SENSITIVE ASSETS.

Inflationary pressures have been building, and several measures are at their highest levels since 2012. In "***A Hospital's Balancing Act: Operations, Investments, and Inflation***" we discussed how healthcare organizations must contend with healthcare inflation, which has historically exceeded overall inflation. Inflation impacts not only NFP healthcare portfolios but also operations, which can negatively impact a hospital’s ability to access debt markets and impair its ability to fund future capital expenditures. Unfortunately, many hospitals remain under-allocated to inflation-sensitive assets, making them ill-prepared to handle increases in inflation.

7. PROACTIVE REVIEW OF RETIREMENT PLANS IN LIGHT OF HEIGHTENED SCRUTINY AND EVOLVING LAWSUITS FOR 403(B) PLANS.

The year 2016 witnessed a notable evolution within the litigation of retirement plans, as the first lawsuits were filed against 403(b) plans. Furthermore, for the first time a healthcare provider was targeted for excessive administrative fees within its plan. In light of recent litigation, new laws, and changing participant needs, it is vital that plan sponsors adapt and evolve their retirement plan playbook. In "***Playbook - The importance of Adapting and Evolving***" we discussed ways for plan sponsors to review and make adjustments to their retirement plans in order to adapt to the current environment.

8. STAY THE COURSE WITH HEDGE FUNDS.

Many investors are questioning the benefit of allocating money to hedge funds after recent bouts of underperformance along with well-publicized outflows. In our view, the industry has suffered in two ways: (1) it became crowded with too many managers following similar strategies and (2) funds have sacrificed too much of the upside in order to protect on the downside that never materialized post 2009. With that said, we believe hedge funds remain an important strategy, particularly for healthcare clients who need to meet return requirements but cannot be exposed to large amounts of equity market volatility. Highland’s approach to hedged equity is to deliver sustainable alpha through multiple sources. First, we pursue “structural alpha” through portfolio construction. Secondly, we target “manager alpha” by finding skilled managers that can generate returns in all kinds of market environments. We discussed Highland’s approach to hedged equity in "***Conformists, Rebels, and Realists: Are Hedge Funds Still Viable?***"

9. ACTIVE AND PASSIVE STRATEGIES CAN CO-EXIST IN A PORTFOLIO.

The active vs. passive debate continues to rage on as 2016 was another difficult year for active stock pickers. While Highland prefers active management, we do understand that some areas of the market are more efficient than others and may call for passive implementation. We believe emotional capital is better spent investing in areas of the market that are more inefficient and lend themselves to active management. Highland believes that it does not have to be an "either/or" approach when considering active or passive strategies.

10. VIEW THE WORLD IN 3-D.

Capital markets are increasingly driven by geopolitical fears. Brexit and the rise of populist movements across the globe are just some of the recent events that are shaping capital markets. In this environment, simply investing in broad geographic markets will not work. Investors searching for returns must look at the world's opportunity set in 3-D: Decode and Deconstruct to Deliver value. In "***4Q16: The World in 3-D***" we discussed how investors can take a more micro view, allowing them to avoid the areas with higher downside risk and commit capital to the ones that should benefit from this new era of nationalism and populism.