

**THE RATING AGENCIES ARE LISTENING:**

*What's your story?*

Mark Twain once wrote that a story “shall accomplish something and arrive somewhere.” While most people think of their favorite book when they think of “stories,” Mark Twain’s quote also connects to the world of investing. Every investor has a story. For not-for-profit (NFP) healthcare organizations, each story is unique. In past *Insights*, we have examined how the multifaceted nature of healthcare presents unique challenges as healthcare organizations attempt to support their mission. A NFP healthcare investor’s investment portfolio serves a variety of needs, as shown in *Figure 1*.

FIGURE 1



SOURCES: HIGHLAND ASSOCIATES

Some of these may carry more weight than others. Many organizations may require their investment portfolios to support operations more than others. For others, there may be significant capital improvements that need to be made, which the portfolio could be required to support, or pension funding that stresses overall cash flow. Whatever the needs may be, when it comes to investing, an institution’s portfolio should always match its story so that it can ultimately fulfill its mission.

**ITS ALL ABOUT THE NARRATIVE**

Highland believes in a comprehensive approach to investment advice. As NFP hospitals are large issuers of debt, credit rating agencies play a significant role in the overall strategy of these organizations and how the investment portfolio complements that strategy. As part of Highland’s ongoing dialogue with the rating agencies, this fall we visited with Moody’s and Fitch in New York. It was apparent from our discussions that both rating agencies are very interested in each organization’s story and how the investment portfolio fits within the overall strategy and financial profile – bringing



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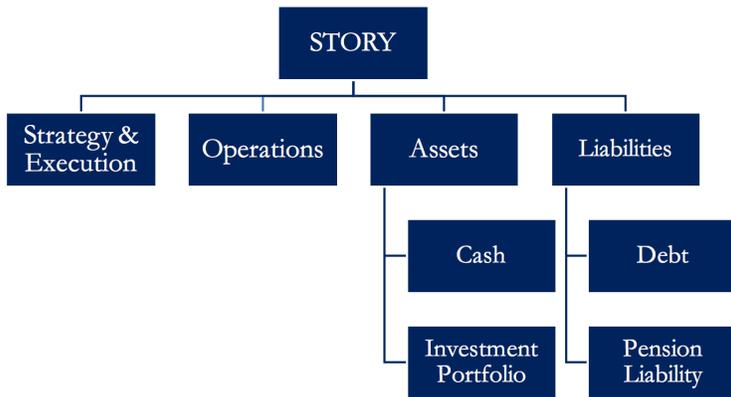
**ABOUT OUR FIRM**

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and insurance portfolios. As of September 30, 2017, we serve as investment consultant on approximately \$22.5 billion in assets. Please visit the website at [www.highlandassoc.com](http://www.highlandassoc.com) to learn more.

their evaluation into line with the advisory approach we have used since our founding.

As **Figure 2** illustrates, rating agencies focus primarily on four key areas: management’s strategy and history of execution, past operating results and future projections, and balance sheet (asset and liabilities).

FIGURE 2



SOURCE: HIGHLAND ASSOCIATES

## RELATIVE LIQUIDITY

The 2008 financial crisis stressed the liquidity of organizations across both sides of the balance sheet. In contrast, today’s environment is characterized by higher levels of cash and calmer debt markets – the tax reform debate notwithstanding. As a result, past thresholds for portfolio liquidity, such as the 75% monthly target by Moody’s, are now being de-emphasized. The context is the key evaluation point now. Factors such as anticipated operating performance, sizing of the capital expenditure budget and funding sources, and defined benefit funding requirements set the stage for what level of portfolio liquidity is appropriate. Demonstrating the ability to forecast future deposits or draws from the portfolio based on these factors plays well in ratings reviews.

This softened stance has opened the door for NFP healthcare organizations to utilize all available asset classes as long as the portfolio strategy complements the organizational strategy. We discussed the challenges facing NFP healthcare investors when balancing liquidity and required returns extensively in 2016 in a paper titled "*Catch 22: Balancing Portfolio Liquidity in a Low Returning World.*" Consequently, we view this updated position not only as a material change in the rating agencies’ approach but also a welcome change given the low return environment.

## LIQUIDITY DOES NOT EQUAL RISK

With a diminished focus on liquidity as the primary risk, asset allocation and portfolio volatility must also complement the organization’s story. For example, a portfolio that is 100% liquid but has a large weight in equities might put capital expenditures at risk if cash draws correspond with a large equity market drawdown. Simply put, rating agencies are more willing to grant that high liquidity does not equate to low risk. As with liquidity, modeling the impact of various market environments on the portfolio and the resulting impact on strategic plans would be well received in ratings reviews. In fact, Fitch’s utilizes a forward-looking approach to credit analysis, which includes scenario analysis to assess the likely impact of a change in investment portfolio value on the issuer’s balance sheet.

## HIGHLAND'S VIEW

Highland’s comprehensive approach to investment advice and collaborative efforts with the rating agencies help to put our clients in a position of strength during their ratings reviews. Our understanding of their latest views on portfolio liquidity and risk help to inform our advice to our clients.

Highland’s Comprehensive Portfolio Review (CPR) process integrates historical financial performance and forward-looking projections to measure the impact that changes could have on the organization’s financial ratios and balance sheet. The CPR seeks to determine the impacts on key ratios and metrics such as days cash on hand on an absolute basis and compared to the client’s rating peer group.

Linking the assets to operations and to pension requirements helps to complete the circle for our clients. This way we ensure that investment portfolios are aligned with the organization’s needs and financial profile and, as Mark Twain once said, “accomplish something and **arrive** somewhere.”

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