



THE SONG REMAINS THE SAME

- ▲ Inflation is currently the topic de jour for investors. The easing of COVID-19 lockdowns has pushed inflation (as measured by CPI) to levels not seen since 2008.
- ▲ While transitory effects such as supply bottlenecks and lockdown-induced year-over-year comparisons explain much of the recent increase in inflation, we believe the seeds have been planted for sustained longer-term inflationary pressures.
- ▲ As discussed in our [2016 Insight](#), inflation is particularly detrimental for not-for-profit (NFP) healthcare organizations, as they must contend with the impact of inflation on both operations and the investment portfolio. Post COVID-19, healthcare inflation and operational pressures are unlikely to recede and could possibly accelerate.
- ▲ Despite healthcare’s powerful inflationary forces, many NFP healthcare investors remain under-allocated to inflation-sensitive assets.

Today’s Environment

If there’s a topic currently dominating financial markets and news media, it’s inflation. It’s easy to see why, considering that inflation has been mostly contained for the past 40 years. However, recent signs point to much higher levels of inflation, particularly here in the United States. As the world emerges from COVID-19 lockdowns, bottlenecks in the global supply chain along with labor shortages are pushing prices higher. In June, the consumer price index (CPI) report showed inflation rising to 5.4% on an annual basis, its highest reading since 2008. Additionally, core CPI rose to 4.5% (annualized), a level not seen since 1991.



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HIGHLAND ASSOCIATES
 2545 HIGHLAND AVENUE SOUTH
 SUITE 200
 BIRMINGHAM, ALABAMA 35205
 P. 1-800-405-7729 / (205) 933-8664
 F. (205) 933-7688

- ▲ BIRMINGHAM
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While it’s likely that these transitory forces pass by next year, cooling off levels of near-term inflation, we believe investors should be mindful of sustained inflationary pressures over the longer term. As we discussed in a recent Asset Allocation note titled “[Heat Waves](#)”, there are a number of reasons for this:

- ▲ Looser monetary policy could contribute to inflation. The Fed’s embrace of average inflation targeting, for instance, has shifted monetary policy in a more dovish direction.
- ▲ Relaxed fiscal policy could prove inflationary. Congress has passed a record >\$5T in fiscal stimulus since the end of 2019, with more proposals currently being debated in Washington.
- ▲ Evolving consumer expectations could compound these fiscal and monetary pressures. While economists and market participants expect inflation will return to more normal <2.5% levels by 2022, American households are less sanguine. The May University of Michigan Survey of Consumers showed Americans’ intermediate-term inflation expectations are climbing. That could become a self-fulfilling prophecy if inflationary psychology makes it easier for businesses to pass along price hikes.

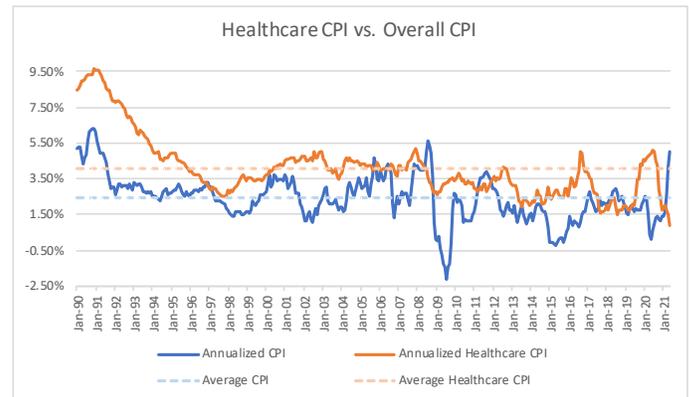
Already one of the most overlooked and unmonitored risks for investors, higher levels of inflation can erode an institution’s purchasing power more quickly. For example, with a 5% inflation rate, an investor’s purchase power is cut in half every 14 years. Dovish monetary policy, expansive fiscal policy, and climbing inflation expectations greatly increase the risk of higher longer-term inflation.

The Implications for Healthcare

For NFP healthcare organizations, inflation presents its own set of challenges. We discussed this in greater detail in a 2016 Insight

titled “[A Hospital’s Balancing Act: Operations, Investments, and Inflation.](#)” In summary, while other institutional investors are generally focused solely on the investment portfolio and maintaining its purchasing power, healthcare organizations must contend with the impact of inflation on both its operations and investment portfolio. Additionally, as healthcare organizations are capital-intensive institutions, they must contend with inflation’s impact on capital expenditures. Healthcare entities also have a much higher hurdle, as medical inflation has historically outpaced the general overall level of inflation. As shown in Figure 1, since 1990, overall CPI has averaged 2.4%, while medical CPI has averaged 4.1%.

Figure 1:



Source: St. Louis Federal Reserve

NFP healthcare systems have always operated with razor-thin margins for a couple of reasons: (1) the revenue structure is one where hospitals are not typically fully reimbursed for the cost of care and (2) they have an unfavorable cost structure that is very labor- and capital-intensive. In fact, over the past five years, operating margins have averaged only 1.8% for all NFP hospital systems rated by Moody’s. Since 2017, it has become increasingly difficult for NFP healthcare systems to earn operating margins above 2% (Figure 2).

Post 2010, healthcare organizations benefited greatly from the passage of the Affordable Care Act (ACA) and Medicaid expansion in many states. This is evident as median operating margins jumped to nearly 3.5%. This proved unsustainable, as margins began to erode in 2017 as hospitals began to grapple with much higher expenses, particularly on the labor front. This was

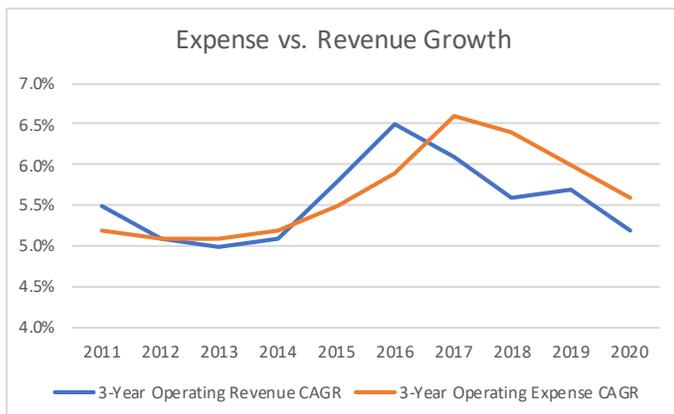
on top of a slowdown in revenue growth as more and more baby boomers switched to Medicare, which typically reimburses less than commercial insurance. As Figure 3 illustrates, expense growth has outpaced revenue growth substantially since 2017. Alongside this difficult operating environment, merger and acquisition (M&A) activity has increased tremendously, and surprisingly has done little to curtail the trend in lower operating margins. Acquisitions and capital spending would likely not be possible without inviting capital markets, which have buoyed investment portfolios and increased debt issuance across the NFP healthcare space. According to SIFMA, since 2011, municipal bond issuance has increased 64%, given the favorable interest rate environment for public debt issuers. COVID-19 has only exacerbated the trend of higher expenses, as hospitals were forced to ramp up critical supplies and inventory of COVID-19–related personal protective equipment (PPE). Increased staffing needs, particularly the use of contract nurses to treat COVID-19 patients, also contributed to higher costs.

Figure 2:



Source: Moody's Investor Services

Figure 3:



Source: Moody's Investor Services

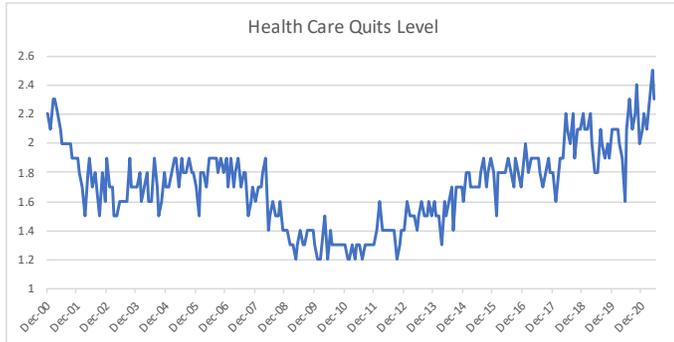
In 2021 there has been a meaningful divergence between overall inflation and healthcare-related CPI. While headline inflation is being driven by base effects and supply/demand imbalances, healthcare inflation has largely been immune to these effects. Aside from labor costs, healthcare organizations are not facing the same supply constraints that other segments of the economy are forced to cope with. Therefore, it could be some time before we see healthcare inflation ascend ahead of overall CPI. While immune from most of the short-term transitory effects, we do believe healthcare investors would be ill- advised to wager on lower healthcare inflation in the future.

In our prior Insight, we discussed how, for most healthcare organizations, labor is the single largest component of hospital expenses. According to the Centers for Medicare and Medicaid Services (CMS), labor and associated expenses accounted for 43% of hospital's overall costs in 2018. CMS data likely underestimate true labor costs, as employee benefits are included as overhead costs. Some studies put the true number closer to 60%. Labor costs for healthcare organizations have seen tremendous growth over the past 15 years. This trend is not letting up. The increase in wages for healthcare workers is well above those in other industries. According to a 2021 study by LocumTenens.com, physician salaries have increased by 16% since 2016, while nurse practitioner salaries have grown by 7%. Additionally, according to the U.S. Bureau of Labor Statistics, salaries for registered nurses have grown by 9.6% since 2013.

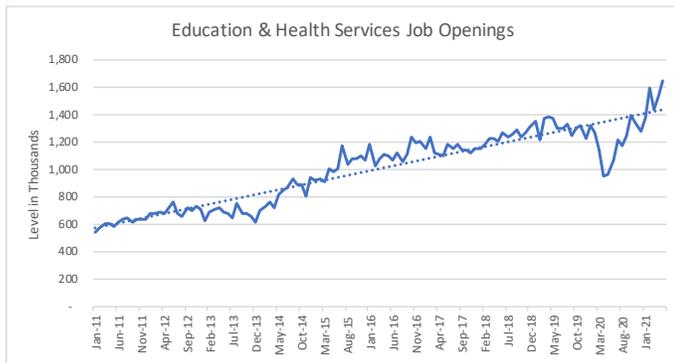
It's hard to foresee this trend changing anytime soon given the repercussions of the COVID-19 pandemic and its future impact on NFP healthcare systems' bottom line. For instance, healthcare organizations are likely to face higher levels of turnover associated with burnout from treating COVID-19 patients. According to a Washington Post–Kaiser Family Foundation poll, roughly one-third of healthcare workers want to leave the profession, and 6 out of 10 say stress from the pandemic has harmed their mental health. When examining quit rates for the healthcare industry, you can see this has been trending higher for many years and is at all-time highs since COVID (Figure 4).

Meanwhile, there are 1.6 million job openings for healthcare workers, according to the Bureau of Labor Statistics. These numbers are going to remain elevated as baby boomers continue to age, exacerbating the need for healthcare workers.

Figure 4:



Source: Bureau of Labor Statistics; quit rate reflects the % of workers who quit their jobs



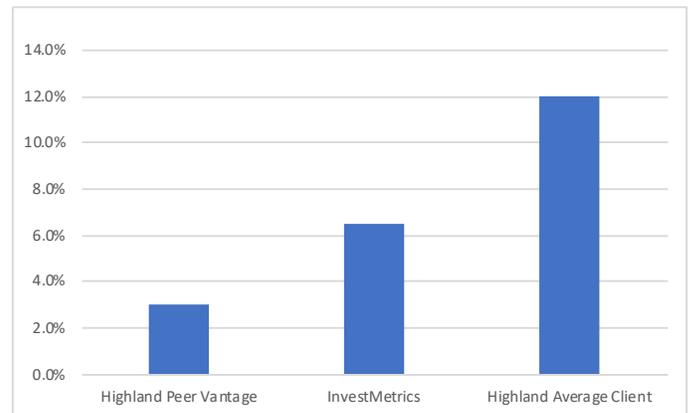
Source: Bureau of Labor Statistics; job openings for education and health services

Furthermore, the Association of American Medical Colleges estimates a shortage of up to 124,000 physicians by the year 2034. Demographic forces (more than 40% of physicians are 65 or older) on top of burnout are driving this labor gap. On the nursing front, the Bureau of Labor Statistics has projected the need for 1.1 million new registered nurses to avoid a shortage. This will likely increase the need to utilize more expensive contract labor alongside higher salaries or sign-on bonuses. We are already witnessing this across a number of hospital systems. Signing bonuses and incentives are currently anywhere from \$10,000–\$20,000 for new nurses. These headwinds are unlikely to diminish in the near future and will only continue to pressure labor costs and operating margins for NFP healthcare organizations.

Are Healthcare Portfolios Protected?

The investment portfolio is the most efficient way for healthcare investors to hedge these unique inflationary risks. Unfortunately, many healthcare systems remain under allocated to real assets, which offer the best way to protect the portfolio during periods of higher inflation. Our 2016 analysis of healthcare portfolios indicated an allocation of roughly 5% to real/inflation-sensitive assets. When examining data today, we see a similar story. Figure 5, which includes data from our Peer Vantage system, indicates only a 3% average allocation to inflation-sensitive assets at the end of 2018 (note that this includes total unrestricted cash and investments for each hospital system). Data on healthcare operating portfolios from InvestMetrics (which includes our healthcare clients' portfolios) shows a slightly higher allocation of 6.5%. While inflationary risks remain paramount for healthcare investors, many have not allocated accordingly to protect themselves from higher levels of inflation.

Figure 5:



Source: Highland Associates (as of 12/31/18), InvestMetrics (as of 3/31/21). Highland client average as of 5/31/21.

Highland has long favored a greater allocation to inflation-sensitive assets where appropriate. This includes private real estate, treasury inflation-protected securities (TIPS), commodities, commodity producer equities, and

infrastructure. The benefits of allocating 15% of an investor's portfolio to real assets are considerable. This includes higher risk-adjusted returns over time while protecting investors from inflation shocks and preserving purchasing power during periods of above-average inflation. When looking across our NFP healthcare client base today, the median allocation to real assets currently stands at 12% (with many at 15%), well above most healthcare peers, as also shown in Figure 5.

Today we continue to favor a higher than average allocation to inflation-sensitive assets. We are finding opportunities within listed real estate (REITs), which should offer more upside in sustained inflationary environments. With higher infrastructure spending on the horizon, both commodities and listed infrastructure securities are likely to benefit from these tailwinds, and we believe investors will be rewarded for dedicated allocations. We are also evaluating our positioning in private real estate and taking advantage of opportunities post-COVID-19. This includes allocations to properties within the life science and industrial sectors.

Conclusions:

We are likely in the midst of a regime change when it comes to inflation. While much of today's inflation can be explained by transitory forces post-COVID-19 lockdowns, the likelihood of sustained higher inflation over the longer term has increased. Preserving purchasing power for investors during periods of sustained inflation is of utmost importance. It is especially important for healthcare allocators because inflation impacts both the investment portfolio and operating costs, which have historically outpaced the overall level of inflation. Unfortunately, the trend of higher healthcare inflation and expenses is unlikely to let up. Healthcare investors would be best served to review their allocation to real assets to protect their portfolio and organization from the threat of higher inflation. For healthcare investors and inflation, the song remains the same.

Author:

J. MICHAEL THOMAS, CFA
 DIRECTOR OF
 HOSPITAL ANALYTICS



HIGHLAND ASSOCIATES
 2545 HIGHLAND AVENUE SOUTH
 SUITE 200
 BIRMINGHAM, ALABAMA 35205
 P. 1-800-405-7729 / (205) 933-8664
 F. (205) 933-7688

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- ▲ BIRMINGHAM
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