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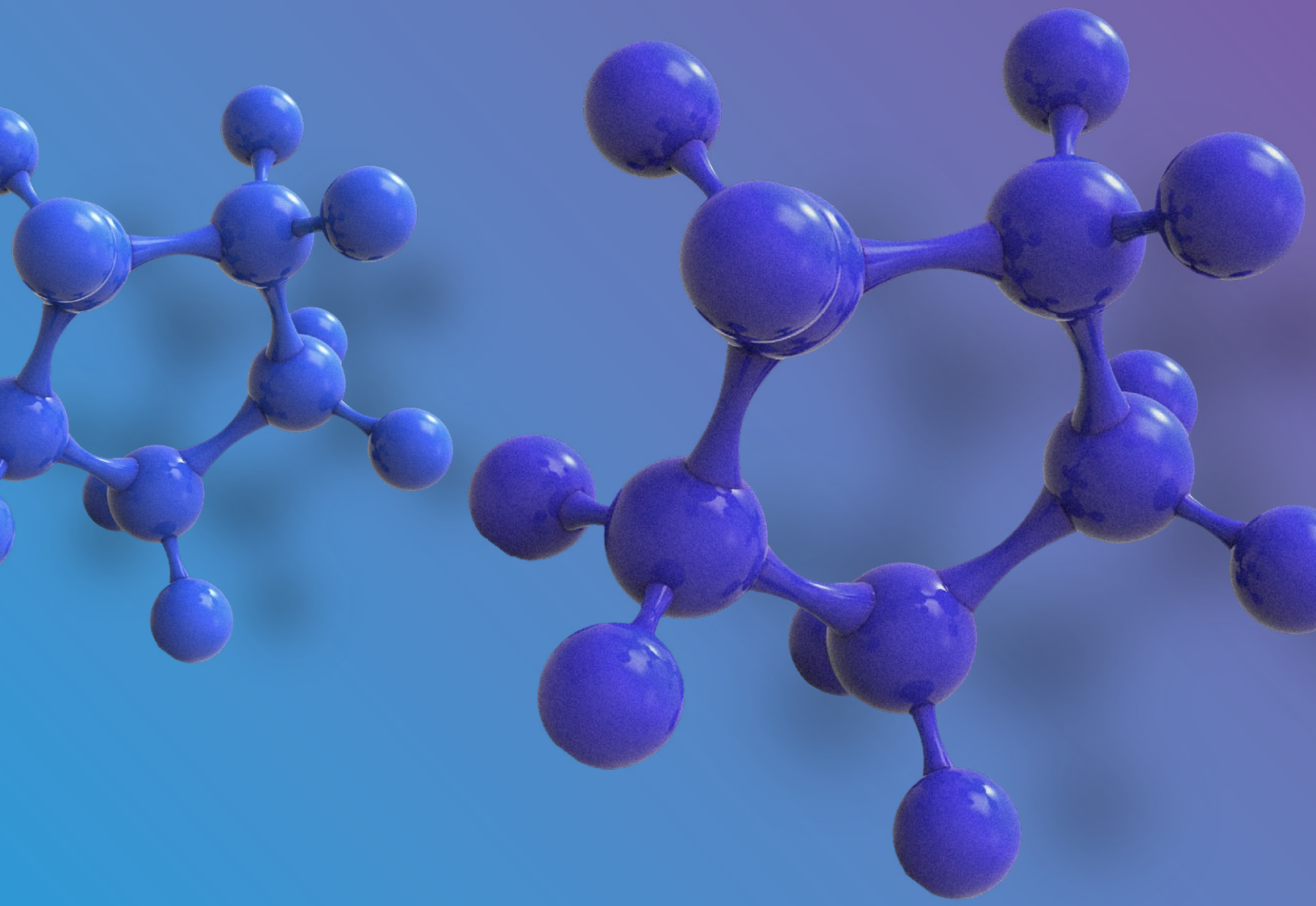
Top considerations for not-for-profit healthcare in 2022



As 2022 approaches, healthcare investors can be thankful for the robust returns recently delivered by markets, but find themselves facing an environment characterized by rich equity valuations, low yields on fixed income investments and recently awakened inflation. Health systems continue to be challenged, particularly through wage pressures. In this paper, we have prioritized what we believe to be top considerations for health systems in this area over the next 12 months.

Ensuring balance sheet strength and sufficient liquidity requires a thoughtful approach, all while maintaining an investment return that will help achieve longer-term capital spending goals and pension obligations amid rising inflation and the past decade of robust US market returns. This, coupled with growing pressure to incorporate environmental, social and governance (ESG) concerns and impact investing, not to mention simultaneously monitoring progress as it relates to diversity, equity and inclusion (DEI), leaves health systems with plenty to focus on in 2022.

Are you ready for the next drawdown?

Revisit your risk budget and capital market assumptions with an eye toward inflation

High valuations, low interest rates and low expected returns suggest meeting return targets in the years ahead will be challenging. One would be forgiven for a feeling of déjà vu that takes them back to the years following the global financial crisis (GFC). However, a big difference this time around is the return of inflation. Though price levels should eventually cool off, near-term risks are to the upside.

Though inflation is in focus at a broad economic level, it's familiar territory for health systems that have had to cope with years of elevated operating expense growth, including times when it has outpaced revenue growth. Given an ongoing personnel shortage, this issue is unlikely to go away anytime soon since labor costs account for roughly half of a typical health system's expense structure.

We believe it's vital currently to remain resilient against future market drawdowns while staying positioned to capture much-needed returns. So, how can health systems prepare for any future downturn?

1. Stress-test portfolios

Traditional portfolios dominated by stocks and bonds have performed very well in the disinflationary environment over the past decade. Although inflation expectations remaining anchored is our base case, given an environment of persistently higher and more volatile inflation, they could be negatively affected.

Keep in mind that the purpose of scenario analysis is to stress-test portfolios rather than predict the future. We recommend being humble regarding scenario analysis — in a world where the range of possible outcomes is wide, a broad indication of the direction and magnitude of returns from each scenario is sufficient. Any attempt at "accuracy" is likely to be spurious.

2. Differentiate between inflation at the system level versus the broad economy

As mentioned, health system operating expenses have been rising at a faster pace than broader price levels for years. Though systems can take various approaches to combat rising costs, from an investment standpoint they should determine whether it's feasible to pursue higher investment returns as an offset to operating pressures, assuming risk tolerance permits. Given the outlook for traditional stocks and bonds, this could mean leaning into private markets, for those with capacity for illiquidity, or diversifying with hedge funds.

Meanwhile, to address pricing pressures at the broad economic level, we believe a diversified approach is the best course of action given the heterogeneous nature of inflation. The investment toolkit includes real estate, infrastructure and natural resources (both in public and private forms), along with inflation-linked bonds.

To the extent inflation places upward pressure on rates, floating rate notes and various forms of private debt could play a role. From an enterprise perspective, it may be worth discussing with debt advisors the potential merits of additional borrowing while rates are presumably still low. This could reduce the need for investment returns to fund operating or capital needs. Finally, keep in mind that higher rates would lower pension liabilities. Assuming an improvement in funded status, this could create opportunities to de-risk or lower pension costs.

3. Re-examine liquidity

With various forms of COVID-19 funding relief set to commence repayment or already underway, now is a good time to ensure there are adequate levels of liquidity to provide any short-term cash-flow support in the absence of those funds. Take into account other potential sources of liquidity in the form of debt issuance or lines of credit.

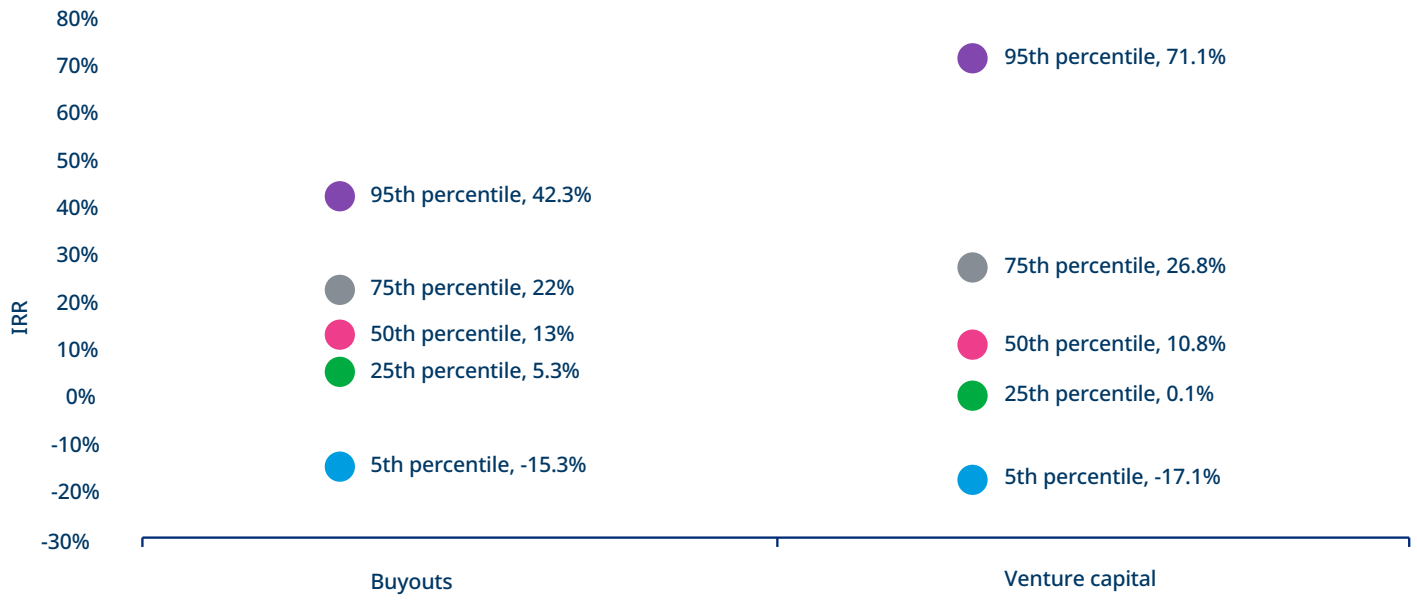
Is now the time to build out or increase your private markets program?

Considerations for building/managing an effective private markets program

After the COVID-induced liquidity crisis in 2020, days cash on hand and total liquidity (unrestricted cash plus investments) recovered to reached new highs at the end of last year, with unrestricted cash plus investments up almost 30% and days cash on hand increasing 49 days, to 253 days.[1] Improved liquidity metrics, coupled with forward-looking return expectations for traditional asset classes being more muted than the prior decade, have led healthcare systems to either increase their target allocation to private markets or consider building an allocation.

Although new/increasing allocations have seen more capital flow into private markets, all managers are not created equal, and the dispersion of returns remains quite high, which we believe makes manager selection and access critical.[2]

Figure 1. The dispersion of private market returns



Source: Burgiss Private i as at March 31, 2021

[1] Moody's Healthcare Medians, 2020.
[2] Mercer — The private equity value-add premium available at: https://www.mercer.com/our-thinking/wealth/the-private-equity-value-add-premium.html

Building a private markets program is not an exercise in selecting managers and removing them due to poor performance. Much of the legwork should be done upfront between your consultant and their private markets team, management and the committee. Curating and maintaining a forward calendar, identifying target managers and holding the necessary due-diligence conversations with the committee or relevant stakeholders prior to the committee meeting allows for a streamlined meeting and focus on the future, as opposed to running the risk of having a meeting wasted on manager selection instead of planning for the future.

As investment programs have grown in size, so too have commitment sizes, resulting in increased difficulty in gaining targeted capacity/access to top-tier managers. For capacity-constrained managers, we believe the time to "fundraise (aka, start traction for an allocation) is when they aren't fundraising," from the allocator's perspective. This would involve the following best practices from our end:

- Identify target managers early and build relationships well before fundraising.
- Tell your organization's story and communicate long-term commitment to asset class.
- If needed, consider streamlining investment-decision process.
- Stay in close touch and be prepared when they start fundraising.
- Make quick, firm decisions.
- Offer to participate in first close and potentially offer to add to commitment if other limited partners drop out.

Although the US still garners much of private market dollars, building a robust private markets program requires a view of the total opportunity set. For example, China's private equity and venture capital market is the second-largest private equity/venture capital market in the world but many portfolios have not explored this area within the context of their broader portfolio. Bringing these conversations to the forefront can help identify areas of opportunity to high-growth companies not accessible via other asset classes.

The COVID crisis has also shone a spotlight on liquidity management. Did your organization need to sell public equities at the bottom of the market in order to meet capital calls, thereby locking in losses? When reviewing pacing models, we recommend stressing the public market portion of the portfolio to help ensure ample capital is available for calls to avoid forced selling. As we work with clients to build out private markets portfolios, it's imperative to regularly review the pacing model so that portfolios do not run the risk of never reaching their intended target or overshooting the expected target due to stale growth assumptions. These pacing reviews should also include a full discussion with management and the committee on inflows/outflows needed from the portfolio to account for any elevated capital expenditures in the forecast or a potential debt issuance to take advantage of low rates that would affect the size of the portfolio.

Are hedge funds a good substitute for fixed income within operating portfolios?

Revisit the role of hedge funds within the context of current market conditions

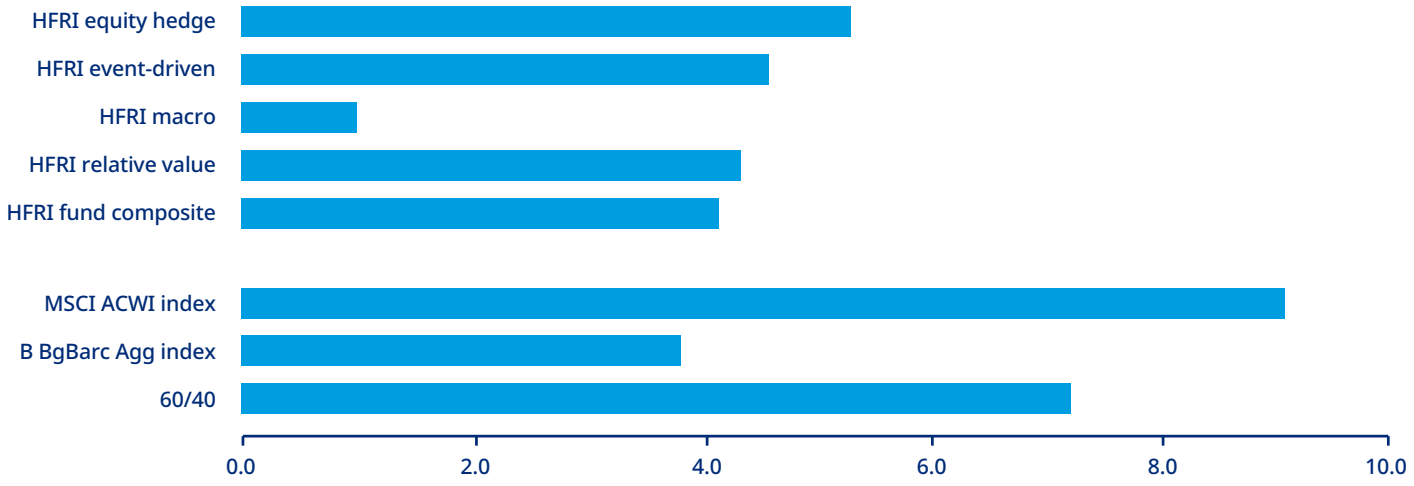
Fixed income investors have largely been aligned with global central banks' easy monetary policies in the post-GFC period characterized by disinflation. Healthcare operating pools have been the beneficiary of this environment with core fixed income's annualized 10-year return of 3.4% for the period ending June 30, 2021, as measured by the Bloomberg Aggregate Index. As central bank policies are now expected to normalize, interest rates may well trend higher. We are likely entering a period when the world becomes less globally interconnected, in part because the pandemic has highlighted vulnerabilities in supply chains. Less globalization, increasing inflationary pressure and tighter monetary policy will likely lead to fixed income investors finding a more challenging environment over the next 10 years.

Mercer projects traditional core fixed income will annualize 1.5% and cash will return 1.6% over the next 10 years, resulting in negative real returns over this period with elevated volatility versus historical results.[3] Importantly, fixed income is less likely to provide the defensive and uncorrelated characteristics broadly delivered over the last four decades in large part due to declining interest rates. We may very well be entering a period when stocks and bonds become correlated and more so during any drawdown.

Though this environment may be difficult for fixed income, it likely creates opportunities for strategies that fall within absolute return strategies or hedge funds. At Mercer, when we think of hedge funds, we think of risk-controlled exposure to a diversified collection of non-traditional return streams that help diversify traditional portfolios and seek attractive risk-adjusted returns. The role of hedge funds is to provide risk-reducing exposure that differs from traditional fixed income while also being uncorrelated with growth assets and reducing the overall portfolio beta to equities and credit.

We acknowledge the period post-GFC produced positive but pedestrian relative performance for hedge funds as shown in Figure 2. In addition, hedge fund management fees were difficult to justify during this period when performance modestly outperformed core fixed income and significantly trailed global equities.

Figure 2. Annualized returns (%) — 10 years ending 2020



Source: MercerInsight as at December 31, 2020

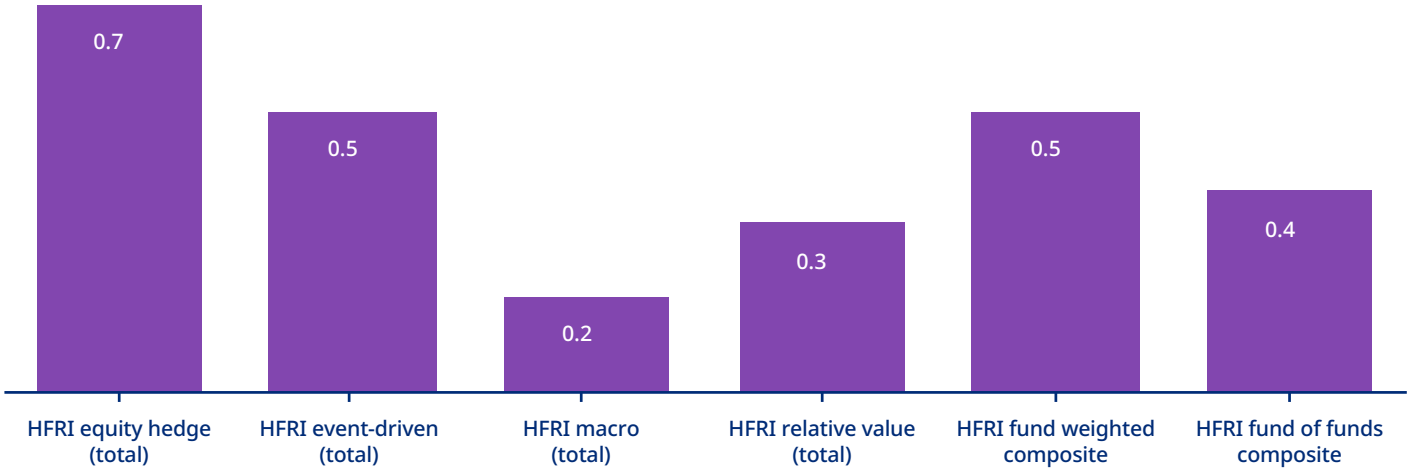
[3] Expected returns are hypothetical average returns of economic asset classes derived using Mercer's Capital Markets Assumptions. There can be no assurance that these returns can be achieved. Actual returns are likely to vary. Please see Important Notices for further information on Return Expectations.

However, this period coincides with unprecedented global monetary easing and stimulus, the impact of which has had extreme effects on risk assets. We note hedge fund industry impacts below.

- **Limited dislocations:** Hedge fund alpha is often delivered during market dislocations. The lack of sustained drawdowns has provided a false sense of market risk and alpha benefits.
- **Limited dispersion:** Extreme monetary stimulus has reduced the degree of dispersion at a security level, thereby reducing the opportunity set for relative-value and bi-directional investors.
- **Herd mentality:** Quantitative easing has been effective in forcing investors into risk-on mode and has so far resulted in increased passive investing. The environment has favored traditional assets. Beta and correlations have increased across most traditional asset classes, thereby reducing diversification benefits.
- **Volatility environment:** Volatility in markets creates opportunities that can be exploited by hedge funds. The effects of global stimulus efforts have provided extraordinarily long periods of low volatility.

As we exit this period of disinflation, we believe a diversified basket of hedge fund exposures are well positioned to capture returns from opportunities that fall between public and private markets. The unconstrained nature of hedge funds allows skilled managers to use tools and strategies not available to traditional managers, allowing for greater control of risk expression and management. At Mercer, we work to combine those strategies, instruments and risk exposures, seeking portfolios that we believe have the potential to generate a cash plus 4% return. This has a standard deviation in the 5%–7% range, and betas to equities, credit and interest rates less than 0.3. The net effect seeks to deliver defensive characteristics similar to fixed income, yet through alternative risk exposures including merger arbitrage, capital structure arbitrage and corporate balance sheet restructurings, relative value trades such as long/short credit and long/short equity, or trend following and global macro strategies. Figure 3, illustrates the betas between a 60/40 portfolio and a range of hedge fund indices.

Figure 3. Beta to 60/40 — 20 years ending 2020

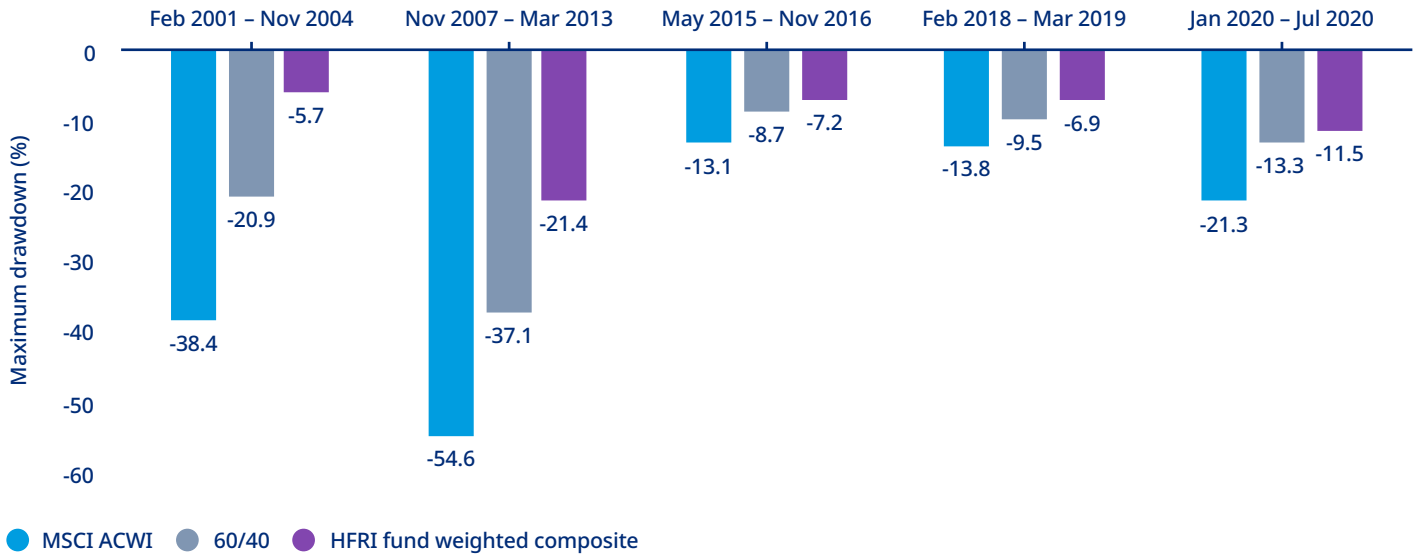


Source: MercerInsight as at December 31, 2020

The unique asymmetry of returns for hedge funds can be a powerful tool for health systems with a return target on operating assets as hedge funds can help mitigate shortfall risk while also balancing downside risks. When we model healthcare systems' assets in our enterprise risk analysis and we stress-test portfolios for various negative scenarios, we see that hedge funds hold up well during negative market environments, such as the periods shown below.

Though fully diversified fund of hedge fund portfolios have historically demonstrated value during difficult environments, the trade-off versus traditional core fixed income is less short-term liquidity, making it important to pair hedge funds with other traditional liquidity sources as part of a holistic risk-reduction allocation. It is also important to evaluate the entire illiquidity budget of a healthcare system's overall portfolio as rating agencies may not distinguish between the illiquidity profile of hedge funds versus less-liquid private market exposure.

Figure 4. Major equity drawdown periods — 20 years ending 2020



Source: Thomson Reuters Datastream, Bloomberg and Mercer calculations as of December 31, 2020.

The 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

How do you align your mission with your investment program?

Creating a thoughtful approach to ESG and impact

Over the past year, conversations regarding the implementation and action of ESG and impact investing increased by a meaningful margin. Although both of these topics are not new for the healthcare industry, the attention brought by committee volunteers and the general community has increased substantially. As noted in our 2020 Annual Healthcare survey, 18% of survey respondents incorporate ESG into their investment programs, whereas 12% had dedicated impact-investing programs.[4]

With more than 105 healthcare clients, we have not only observed these conversations but have helped facilitate discussions for clients who are searching for their own ESG and impact-investing identity. We acknowledge that creating and implementing an ESG and impact-investing ethos is not easy. There are many different views, and often very few resources, to develop a well-thought-out blueprint off the ground. Despite these issues, we have observed a few characteristics that often help guide the process:

- **Alignment with the Mission:** Historically, many organizations have felt their impact story was delivering low-cost, easy-to-access healthcare to their community. As times have evolved and the industry has grown, more organizations are finding the need from both internal and external stakeholders to take a more active approach in leveraging relationships and the balance sheet. From this perspective, one of the most crucial steps is to identify and relate all ESG and impact-investing initiatives with the primary goal and mission of the organization. Frequently, the focus of impact investing tends to be on the social determinants of health — through affordable housing or food security, or both. Identifying these objectives is a great starting point for any ESG and/or impact-investing methodology.

- **Implementation of ESG initiatives:** The increased interest in ESG has prompted investment committees to examine how underlying investments integrate into the goals and mission of the organization. We have been able to leverage multiple areas within our organization to assist organizations in structuring portfolios that pursue our clients' ESG objectives. We have often approached this process by looking at underlying managers through one lens. The first lens is Mercer's manager-review process of assigning an ESG grade to approved strategies. Across equities, fixed income and alternative strategies, all approved managers are reviewed and graded by our Responsible Investment team.[5] Using these grades, we are able to look at what percentage of the managers meet or exceed any ESG investment-management criteria. Another lens examines what the managers are reporting back to our traditional research teams. As part of the process, our researchers are asking managers to provide information related to the integration of ESG into the investment process, firm ownership information, diversity statistics, hiring practices, etc. Lastly, we look at other various third-party measurements and services for any insight. We believe the combination of these three lenses allows our clients to get a real understanding of what they are investing in, with whom they are invested and how it aligns with their mission.

- **Implementation of impact initiatives:** For larger organizations, the concept of impact investing in local communities or mission-aligned projects is nothing new. However, with margins compressing, balance sheets increasing and interest growing across all client sizes, it is becoming more and more difficult for clients to implement activity without jeopardizing existing priorities. Across our healthcare client base, approximately 12% have a dedicated impact-investing initiative; however, interest is growing, and we would expect this number to increase significantly over the next few years.[6] As demand has increased across our client base, we have worked with our Responsible Investment team to identify and present compelling investment ideas that can either supplement existing programs or allow our smaller organizations to establish a foothold with impact-investing initiatives. Whether this is helping them find managers that invest actively within their stated footprint, identifying broadly diversified impact strategies or making introductions to third-party organizations, this area continues to grow in complexity.

[4] Mercer. [Annual healthcare survey], 2020.
[5] See Mercer's Guide to ESG Ratings: www.mercer.com/our-thinking/mercer-esg-ratings.html
[6] See Mercer's 2020 Healthcare Investment Study as of end of December 2020.

- **Measuring and messaging the results:** To manage the expectations of a wide audience, we have leveraged our proprietary tools and reporting to create custom or ad hoc reporting to help present results more clearly. Whether this is helping a client add to existing investment policies or create stand-alone guidelines, creating information that can guide compliance or report to a board is key in measuring success.

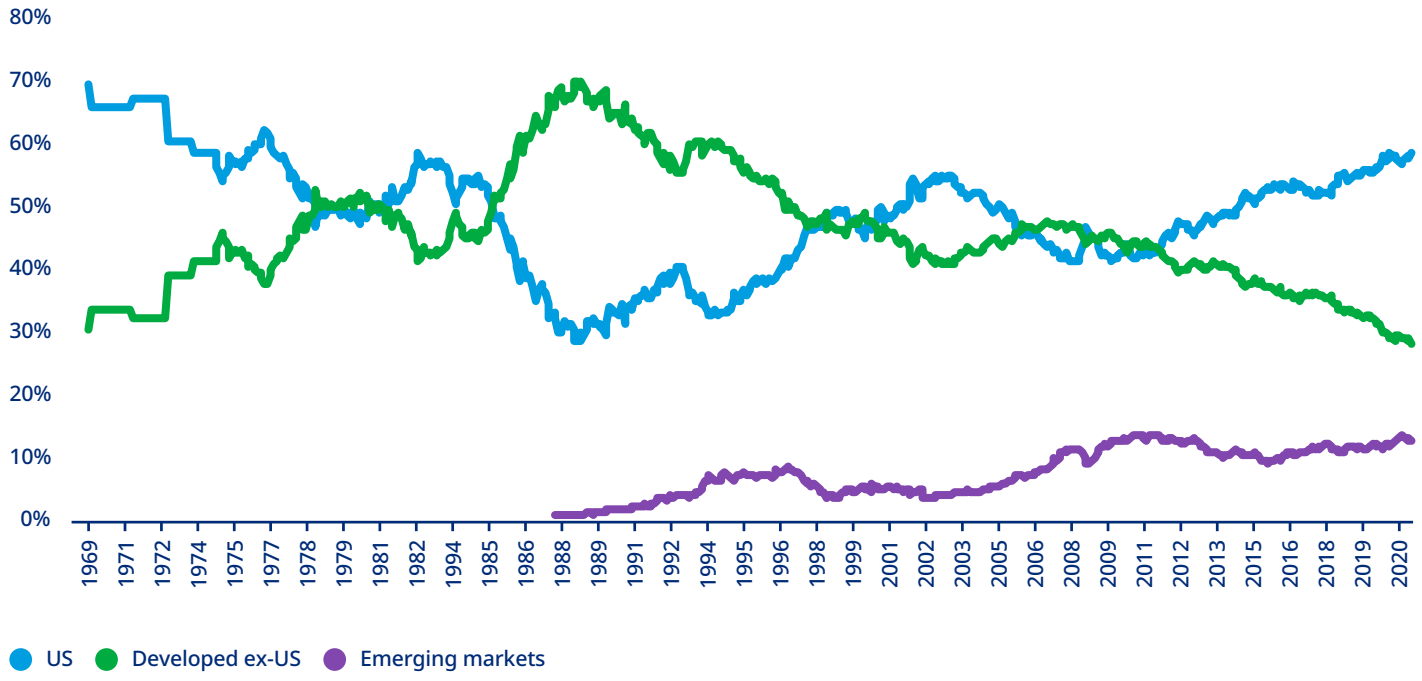
We continue to see high levels of activity and interest in ESG and impact investing. Though we continue to believe that no two organizations are the same, there is efficiency in numbers in the way initiatives are aligned, implemented and messaged across our client base.

Will there be continued US equity market exposure bias over the next decade?

Looking through index weights to consider diversification and long-term investment objectives

US equities have dominated performance in the decade following the GFC. Over the 10-year period ended September 30, 2021, US stocks returned 16.1%, significantly outperforming developed international and emerging markets stocks, which returned 8.1% and 6.1%, respectively.[7] As a result, the US now accounts for nearly 60% of the MSCI AC World Index (ACWI) — its highest weight in four decades.

Figure 5. MSCI ACWI weights

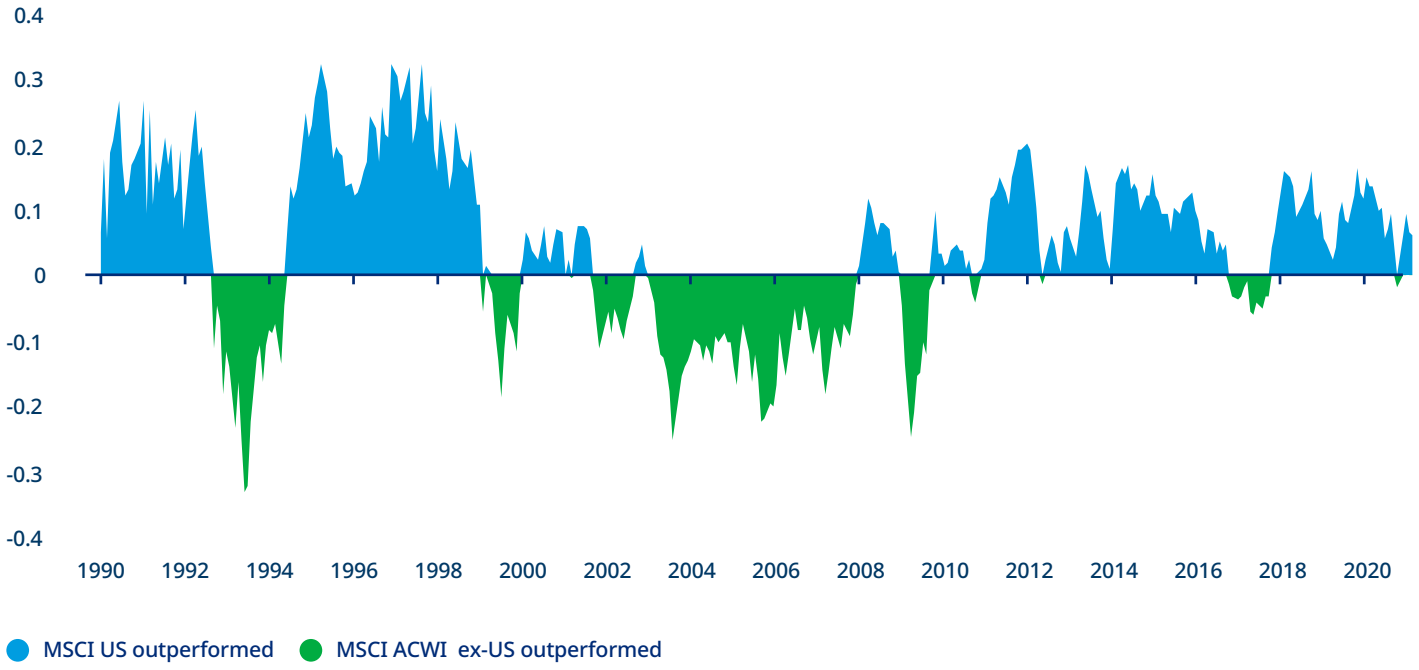


Source: Datastream as of June 30, 2021.

[7] Net returns for MSCI USA Index, MSCI EAFE Index and MSCI EM Index, respectively.

Given the run in US stocks, investors should review the geographic composition of their equity portfolios to consider whether the current exposures align with their risk and return objectives and contemplate if they are appropriately positioned for the next decade. This exercise can help investors better understand the global opportunity set and what they own. Investors seeking alpha can consider whether the growing dominance of the US has created opportunities going forward. In fact, historically the relationship between US and non-US stocks tends to be cyclical, rotating back and forth over sustained periods of time.

Figure 6. Rolling one-year performance of MSCI USA versus MSCI ACWI ex USA



Source: Investment Metrics, October 1,1990 through September 30, 2021, monthly periodicity.

Despite having nearly 3,000 constituents, the MSCI AC World Index may be less diversified than investors realize. As of September 30, 2021, the top eight stocks are all US-based, growth-biased (tech, consumer discretionary, communication services), and account for over 14% of the index.[8] Investors seeking diversification may want to increase their exposure abroad. The MSCI AC World ex US index (ACWI ex US) has more than 2,300 constituents from 22 developed markets and 27 emerging markets. As a result, the non-US market is more diversified by country and market cap, while less top heavy than the US market. It should also be noted that this diversification may present opportunities for active management, as Mercer believes this market offers greater alpha potential compared to US large cap.

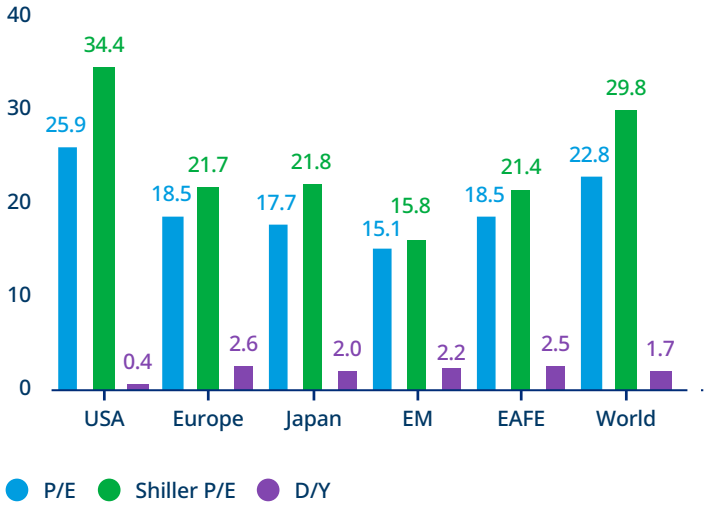
The ACWI ex US is more exposed to cyclical sectors such as financials, industrials and materials. As a result, we believe the non-US equity market is well positioned to benefit from a post-COVID reopening and potential global economic rebound, while also serving as a potential hedge against inflation or a weakening US dollar. Meanwhile, the US is more exposed to growth sectors that are at risk of multiple compression in the event of rising interest rates.

Finally, on a valuation basis, non-US stocks appear to be more appealing on both a trailing and forward basis, as P/E ratios (price-to-earnings) across the developed and emerging markets are closer to historical averages.

Although a US bias has greatly rewarded investors in recent years, investors should take the time to reevaluate their exposures given the structural shifts that have occurred across the global equity market.

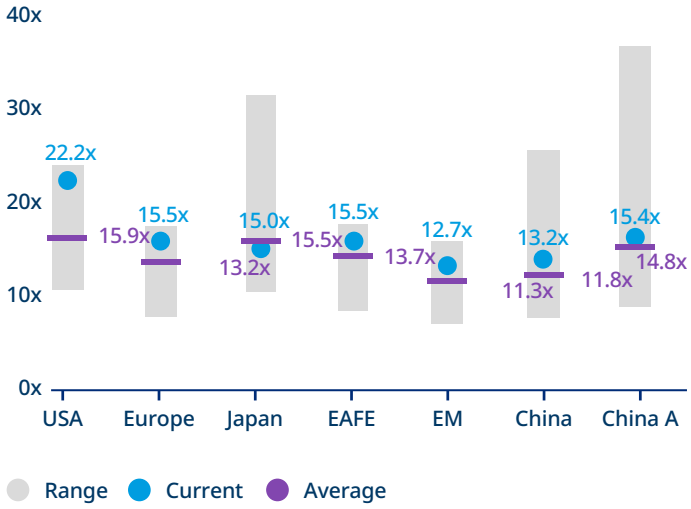
Figure 7. Global valuations

Global valuations (trailing)
as of September 30, 2021



Source: Datastream, Mercer calculations, as of September 30, 2021.

Global forward valuations
Current and 18-year next 12 month P/E ratios



Source: Datastream, Mercer calculations, as of September 30, 2021.

[8] Source: MSCI.

Do you have a defined benefit de-risking strategy that is optimized for broader organizational considerations?

Revisit your overall defined benefit strategy beyond funded-status volatility

Throughout the market turmoil of the past two years, holistic enterprise risk management has emerged as increasingly important, as the impact of distressed market conditions stressed operating and investing activities across all pools of assets. If there is a silver lining, perhaps it is bringing these issues to light, which highlight the interplay and interdependence of risk-taking not just within asset pools but, more importantly, among them.

In particular, the severe, simultaneous decline of equity markets and interest rates had a disproportionate impact on organizations that sponsor defined benefit (DB) plans. For healthcare organizations, the economic impact was even more exaggerated when considered in the context of the total enterprise. As a result, we have seen renewed focus on managing DB plans within healthcare organizations, as they look for ways to more effectively reduce risk.

Though it is true that the "rules" of pension investing are the same regardless of the type of organization that sponsors the plan, healthcare sponsors face unique challenges relative to their corporate sponsor "peers." Earlier this year, Mercer published a series of articles in conjunction with CFO Research discussing the findings of a survey of more than 200 plan sponsor executives.[9] Here, we narrow that list to focus exclusively on healthcare plan sponsor executive respondents and look at some of the key findings, and more importantly, differences between healthcare pension plan management and corporate peers.

To understand the findings, it is first necessary to acknowledge that for most healthcare sponsors, the role of the pension plan within the organization is different than corporates. More specifically, pension plans sponsored by healthcare organizations are more likely to be open, as they are still regarded and used as a workforce-management tool to attract and retain quality employees. At the same time, these plans are less healthy (no pun intended) than corporates, with a higher percentage reporting funded status below 90%. As such, the pension obligation can be significant, and the strategy with which to manage its unique risks is critical.

Overall, we find that healthcare plan sponsors are more aware of this dynamic than their corporate colleagues. A significantly higher percentage of respondents indicated their approach to DB plan management is intentional, that they follow a deliberate roadmap that takes the DB plan into consideration for overall enterprise risk management. They take into account future costs, like rising Pension Benefit Guaranty Corporation (PBGC) premiums, to help guide their decisions. Most healthcare sponsors take on the problem themselves, relying heavily on internal staff for DB-related activities, including investing. But at the same time, respondents overwhelmingly admit they do not have the expertise, bandwidth or confidence to make effective and timely decisions.

Internal investment teams at healthcare organizations are seasoned investors in the traditional sense. In fact, one could argue that the intellectual investment capital at a healthcare organization is, on average, superior to that of a corporation. Unfortunately, pension investing plays by different rules than investing for long-term operating pools. Because of this, the investment problem is harder to solve, and more importantly, investments are only one part of an overall DB plan strategy. Other aspects, such as governance, plan design, funding policy and risk-transfer activities, are equally important to get right. Just as investments across multiple pools within the organization need to be managed in concert, so do these various aspects of DB plan management in order to effectively reduce risk in a meaningful way across the system at large.

[9] https://www.mercer.us/content/dam/mercer/attachments/north-america/us/us-2021-cfo-survey-ebook.pdf

Summarized below are key findings and considerations for healthcare DB plan sponsors. These themes will be discussed in more detail in a forthcoming publication in 2022.

- **Plan design and pension risk transfer**

  Plans are more likely to be open. There appears to be some appetite to close plans, but very little to freeze benefits.

  Similar to corporate sponsors, healthcare systems have taken advantage of opportunities to reduce pieces of their pension liability through risk-transfer activities such as lump-sum offers. Retiree buyouts are also used, but less extensively and for a smaller, more targeted group than corporates.

- **Funding strategy**

  Healthcare sponsors are more willing to contribute above the minimum annual requirement for a specific purpose, in an effort to reduce either administrative burden or future costs (for example, contribute to avoid benefit restrictions and PBGC variable rate premiums).

  They are also more willing to adapt their contribution strategy to take into account current market conditions, in particular the level of interest rates.

- **Investment strategy and governance**

  Healthcare sponsors are more dynamic than corporates in that they are more likely to change investment policy in reaction to significant market events as they did in 2020; however, they are less dynamic in that they do not have the bandwidth to make real-time de-risking decisions when it matters most.

  Private assets and interest rate derivative strategies are more common in DB plans sponsored by healthcare organizations. They also take ESG factors and DEI into consideration much more than corporate sponsors.

  There is significantly less consolidation of DB services (admin, actuarial, investments), which may result in misaligned objectives across the categories above and exacerbate the pension problem.

Conclusion

Up until October, 2021 was shaping up to be a strong year from an investment perspective. Throughout the year, health systems generally saw significant improvements in liquidity, although both operating and cash-flow margins remained compressed. As health systems start thinking about positioning themselves for 2022 and beyond, a balancing act to meet the continued growth of capital spending needs, the pressures within the entire healthcare industry and an investment environment where nothing looks inexpensive. Responding to stakeholder requirements to build effective mission-aligned strategies adds another consideration to healthcare allocators' demands.

Mercer Healthcare Investments

We assist our clients — from single-site hospitals to larger, leading super-regional healthcare systems — in developing effective, customized investments strategies to meet organizational goals and objectives. Our team of more than 20 experienced consultants assist in around $350 billion in healthcare investment advisory mandates across more than 105 clients.[10]

Contact us

We welcome feedback and dialog with you and your organization as you plan for the upcoming year.
Please contact your consultant or to any of our colleagues below.

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[10] As of June 2021

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Portfolio expectations are forward looking and reflective of Mercer's Capital Market Assumptions, as defined by asset class and incorporating return, standard deviation, and correlations.

Our process for setting asset class expected returns begins with developing an estimate of the long term normal level of economic growth and inflation. From these two key assumptions, we develop an estimate for corporate earnings growth and the natural level of interest rates. From these values, we can then determine the expected long term return of the core asset classes, equity and government bonds. We combine current valuations with our expectations for long term normal valuations and incorporate a reversion to normal valuations over a period of up to five years. Volatility and correlation assumptions are based more directly on historical experience except in cases in which the market environment has clearly changed. Manager impact on performance is not incorporated into expectations. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future returns.

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