Healthcare CIO Corner

J.P. Morgan Asset Management Endowments, Foundations & Healthcare

Summer 2019

J.P. Morgan Asset Management hosted its second annual National Healthcare Investment Forum in June, featuring a CIO panel discussion, "CIO Perspectives: Healthcare investment approaches and enterprise-level considerations," with **Janice K. Murphy** of Kaiser Permanente, **Rob Roy** of AdventHealth and **Anthony S. Waskiewicz** of Mercy Health. Jean Walshe, J.P. Morgan Asset Management Client Advisor for Endowments, Foundations and Healthcare, moderated. The following are a few highlights:

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Q: Let's start with enterprise risk management. How does your system's financial health impact your asset allocation, and has this changed over time?

ROY: We're around 2-to-1 cash-to-debt now. But in 1991 it was $.04 cash for every dollar of debt. The firm's capacity to take risk in the investment portfolio was zero. Any disruptive market event would have put the company out of business. During 1999, we started coming to this core idea: making sure the operating business was supported by the level of risk we were capable of taking in the investment portfolio. We ended up going to a 3% equity allocation at the end of '99, which was enormously fortuitous. In the dot-com crisis, the idea worked very well.

Relative to peers with more capacity to take risk, our portfolio performance doesn't look good over intervening time periods, but big picture, the purpose of integrating finance and operations was to support the organization's mission, and we did that. Other entities came to us and said, "We're down on capital. You're still strong. Can we be a part of you?" Now the ratios look good, we're AA, and we've got nice EBITDA margins—all the outcome of a disciplined approach through time.

MURPHY: We also learned that important lesson in the late '90s—to balance the risk profiles of the operating and financial sides. Long story short, we had a (surprise) negative 5% operating margin in 1997, followed by a still very tough two years and a gradual improvement back to targets. Back then, though, we thought we were conservative in our operating financial practices, our balance sheet assets were 60% equity—but quality equity—and our pension plan was aggressively positioned at 70% equity, mainly growth-oriented. We combined our operating and financial results, so there was not a clear focus, other than in treasury. Lessons learned. Now we say our focus is on the operating margin—and it is, on both the predictability and stability. Our balance sheet is orders of magnitude stronger, and our debt service remains extremely low as a percentage of our operating cost, so, our enterprise risk assessment modeling would say—even taking into account our long-tailed liabilities—that we can afford that higher level of investment risk-taking.

The risk stat we start with in asset allocation is the maximum drawdown. We relate that to identified risk tolerances for other possible events, such as the impacts of pension funded status changes on net income/balance sheet, or an insured/uninsured catastrophic event. What can management be comfortable with—we call that, risk appetite—and also tolerate? Because our financial assets are over half of our total assets, a change in return can actually overwhelm the small operating margin. So we have begun to put more thought to the expected volatility target. Recently we shaved it from 10%-plus to 9.5%. That has led us to a few simple

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but clearly diversifying assets for the balance sheet. However, the story of risk management for me is always about managing expectations—the eye of management may not always be focused on the investment portfolio, but I can guarantee that in a downturn management will be quick to react and request actions unless they are prepared and forearmed.

WASKIEWICZ: We build the portfolio closely integrated with Mercy's financial status. The balance sheet reserves are about one-third of Mercy's assets. Volatility in the reserve portfolio is volatility on the balance sheet. We want to be long-term investors, but there are short-term sensitivities around drawdown. If we had a tough year, we have to appreciate how the rating agencies and bondholders might view our audited financials. It might be a catalyst for a downgrade and increase our cost of capital. We build the portfolios and set objectives around risk tolerance first.

Mercy's investment policy is written around a volatility target, not a return target. We have to be risk-aware first, return-seeking second. We want to maximize the rate of return available to us within a certain volatility target. We're AA minus, but if you look at us relative to other AA minus peers, we actually have a low 160 days cash on hand DCOH. Off of that base, how far could Mercy stay solvent, not breach its bond covenants, satisfy its other obligations? I think the median for AA minus is 240 days. So why are we AA minus? We don't have a lot of debt. We restructured our debt so we'll gradually be increasing our risk tolerance to 12% from 10% target volatility.

Q: How did you get to knowing that 12% volatility is the right target for you?

WASKIEWICZ: Starting with the drawdown tolerance we can accept, we modelled what that means from a 1-, 2-, 3-standard deviations perspective and layered on third-party capital market assumptions, and return, risk and correlation forecasts. We try to optimize a portfolio at what became a 12% volatility target, but it does, at some point, become more of an art than a science. Keeping your outcomes within a volatility target is almost impossible.

We have two primary constraints around the portfolio: As a Catholic health system, we have a socially responsible investment (SRI) mandate and we have a liquidity constraint. We're rated by S&P and Moody's, which use slightly different frameworks for liquidity measurement, so we created one halfway between. The policy says that we need X of DCOH available within one to three days, three to 45, 45 to 90, 90 to 360, and then beyond. Any excess could be in the illiquid bucket. Ninety days is the real sensitivity: How much capital can we get in a 90-day period? Mercy set a threshold for that as well.

Q: To execute on these strategies, you need a great team. How did you build your teams, and how do you motivate them?

WASKIEWICZ: Mercy does something interesting: We count all the fees—staff fees, consulting fees, legal fees, custodian fees—against investment performance. So our reported numbers are net of those fees, and my team's incentive comp is based on returns above the benchmark after that netting process. That keeps everyone motivated and focused on the same objectives. We also use consultants, and my job is to recognize what we can't do in-house and to integrate internal and external resources.

ROY: We've built four teams: research, portfolio management and trading, administration and technology. As CIO, investing may seem like the most interesting part, but really, at the very highest level, is having the right people—understanding what your purpose is and figuring out how your teams are going to work toward it. That has lasting value well beyond trying to find alpha in asset classes.

MURPHY: Two and a half years ago, I had the honor of being selected to again run the investments at Kaiser Permanente, after a 10-year stint managing another function. Previously, there were three of us, and my job encompassed much more as treasurer. Now I am fortunate to return to a team of 10 and continue not only the growth of the alternatives platform but also the establishment of a strong and foundational governance platform. We now have a focus on investment operations, risk management, performance management and financial reporting to a variety of stakeholders. In addition, of course, to our attempt to rationalize each beta and search for alpha. We do this with highly experienced staff who oversee, direct and leverage external experts, including a carefully and newly designed way of working with a consultant. Each expert has ready and willing, deep staffs of their own to ensure expert responsiveness as we need it. The portfolio managers oversee and have primary responsibility for an asset class, but that belies the fact that actually they wear many hats and are expected to be curious, take the initiative and manage several other projects or initiatives. For example, the person who manages the real estate portfolio has also made significant inroads working on impact investing with our Community Health folks. What seems to be fairly motivating is that our portfolio managers are afforded the opportunity to understand—and discuss as a team—the span of investment issues presented to us, exactly because we are small enough. And they have the opportunity, if they're willing and interested, to be part of the execution in resolving an issue.

Q: What are your thoughts around governance? Is there anything you have done recently?

MURPHY: There is a research paper on the governance alpha by Clark and Urwin[1]. In essence, it has to do with decision-making structure and the importance of flexibility and adaptability of decision-making and how being thoughtful yet quick can drive value and alpha to net returns. We spent a lot of time thinking about the appropriate governance structures, especially as they related to our investment committee (IC) and various subcommittees. Based on a governance evaluation of our practices, we focused on clarifying our mission and goals, discussing and formulating our guiding beliefs—both as an IC and as an investment team—and invigorating and integrating a risk management framework-both, process and system, into a regular investment review process and into various investment decisions.

ROY: To the point that you're making on the value of governance—you have to make sure you've got clarity on what the purpose of that governing body is. And that it's well documented. That you have the right people with the right experience and the right seniority in an organization to make significant decisions. And that you run that process in a way where they're engaged. They show up having read the material, having thought about it, having interesting questions to ask.

Something that I'm going through at this point in my career is learning the great difference between management and governance. They are different roles. For me, sitting on both sides of that now, I have a great appreciation for the role that governance plays in asking questions and leading a process, helping to set a vision and things like that, as opposed to management, which is really day-to-day driving the implementation.

MURPHY: Based upon all that kind of thinking, I restructured how our committees were formed. We went from three hours to six hours four times a year so we could include some education and thoughtful dialogue for direction. For example, we started with a beliefs workshop. We asked, "What do we really believe in?" There was a lot of foundational work, on the way we're going to make decisions, the interaction, the direction we needed from you all who were on the committee. That brought folks together.

[1] Gordon L. Clark and Roger, Urwin,"Best-practice pension fund governance," Oxford University (December 2007).

Q: Would any of you like to describe a framework you've developed for a market dislocation?

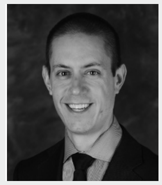
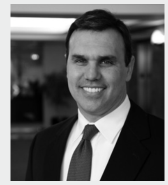
ROY: We've designed something we think is a very good, high probability, solid plan A, but we also acknowledge that we're at times going to get that wrong, and we want to have a preconceived plan B—an enhancement to our risk management process that takes down risk once we violate our thresholds and gives us the ability to stay invested through a crisis. Not many asset managers think in this vein, mainly because you don't get that for free—the implicit cost would cause you to underperform the index or peer group. But from an asset owner's perspective, it increases your Sharpe ratio and improves the probability of hitting your targets.

Q: To close, a quick question for a quick response: When it comes to your organization and your philosophy, what's your edge?

WASKIEWICZ: Governance.

MURPHY: We are Goldilocks: not too large and not too small, which affords us the luxury of T-shaped professionals—depth in one field and breadth in several others— with competency to connect the two.

ROY: I think we know the difference between ourselves and our asset managers.

	 **Janice K. Murphy** *VP-Pensions & Investments, Kaiser Permanente*	 **Rob Roy** *Vice President, Chief Investment Officer, AdventHealth*	 **Anthony S. Waskiewicz** *Chief Investment Officer, Mercy Health (St. Louis)*
Organization overview	Healthcare program including 42 hospitals, 695 medical office buildings and 10 data centers serving 12.2 million members, with 310 million virtual encounters last year. Geographically-focused on California, Colorado, Georgia, Hawaii, the mid-Atlantic, Oregon and Washington. Of 219,000 employees, 59,100 are nurses, 160,000 are union-represented, and we have 22,900 physicians associated with various Permanente Medical Groups. There are about 350,000 retirement plan participants and beneficiaries.	Faith-based health system unifying 48 hospital campuses under the AdventHealth brand. Altamonte Springs, Florida-headquartered and geographically focused on Colorado, Florida, Georgia, Illinois, Kansas, Kentucky, North Carolina, Texas and Wisconsin. More than 1,200 care sites employ more than 80,000 and serve more than 5 million patients annually.	Health system of 50 acute, managed and specialty hospitals, and 900 physician practices/outpatient facilities serving a variety of special needs, particularly for low-income patients in Arkansas, Louisiana, Mississippi and Texas. Geographic focus also includes Kansas, Missouri and Oklahoma. The staff of 45,000 includes 2,400 physicians.
Investment assets (USD $)	Of total assets of $116 billion, Kaiser Financial Investments' balance sheet totals $45 billion; the Kaiser Permanente pension assets total $44 billion, plus $27 billion of Kaiser Defined Contribution assets and $6 billion of Kaiser Permanente Voluntary Employees' Beneficiary Association (VEBA) assets.	Investment assets of $14.5 billion total: $6.5 billion of operating capital, $6.5 billion of defined contribution assets, $1.0 billion of defined benefit assets, $0.5 billion of medical malpractice assets.	Total: $2.9 billion.
Asset allocation	Kaiser Financial Investments (long-term portion): fixed income 31%, equities 29% and alternatives 40%. Kaiser Permanente Pension: equities 45%, fixed income 30% and alternatives 25%.	Govt Bonds: 20%. MBS: 12%. Inflation Linked: 16%. Investment Grade: 9%. High Yield: 6%. EM Bonds: 3%. Equity: 19%. Commodity: 6%. Alpha: 9%.	Alternatives: 30%. Cash and short-term investments: 22%. Fixed income: 14%. U.S. equities: 13%. International equities: 12%. Other: 3%.
Investment team members	10	10 (one open tech position): 2 quantitative researchers, 2 portfolio manager/traders, 2 settlement and accounting administrators, 2 in IT.	6 (3 dedicated to investment, 1 risk manager, 1 operations manager)

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