Looking at the big picture: Non-portfolio assets matter

Albert Einstein once famously said, "If I were given one hour to save the planet, I would spend 59 minutes defining the problem and one minute resolving it." Sage words.

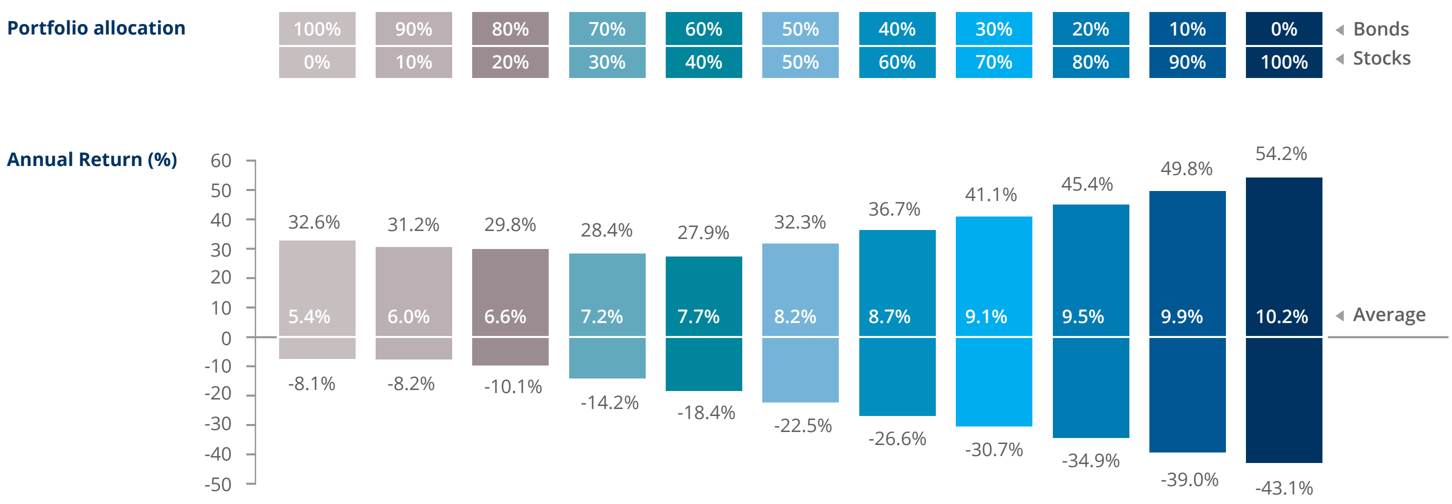
Indeed, it's really important to ensure that one is solving for the right problem. After all, arriving at any answer is not challenging, but arriving at the right one—one that will further your cause—is considerably more taxing. All investors can be guilty of a little tunnel vision at times—solving for a part of rather than the whole problem. When it comes to investing, to properly solve the problem, it's equally important to spend sufficient time defining your problem holistically. All too often, it's easy to focus on the most obvious thing: performance. But merely looking at performance in a vacuum won't necessarily get you toward your end goal—you need to look at the bigger picture in the proper context. Consider the purpose outlined in your Statement of Investment Policy. Is it primarily to maximize return? Or does your portfolio need to support the operation and mission of your organization?

Asset Allocation Is Paramount

While performance is a very important element, achievement of long-term organizational goals requires thoughtful portfolio construction and asset allocation (see Figure 1). In fact, asset allocation, or how you put the portfolio together, is widely viewed as the single most important element towards achieving your goals and avoiding scenarios that could detract from your progress as an organization. In our experience working with and advising the decision makers at senior living communities such as life plan communities ("LPC") or continuing care retirement communities ("CCRC") —whose investment portfolios need to help meet a diverse range of needs and goals—these insights certainly hold.

Figure 1: The Mixture of Assets Define the Spectrum of Returns

Best, worst,and average returns for various stock/bond allocations, 1926–2016



Source: Vanguard. Notes: Stocks are represented by the Standard & Poor's 90 Index from 1926 to March 3, 1957; the S&P 500 Index from March 4, 1957 through 1974; the Wilshire 5000 Index from 1975 through April 22, 2005; and the MSCI US Broad Market Index thereafter. Bonds are represented by the S&P High Grade Corporate Index from 1926 to 1968; the Citigroup High Grade Index from 1969 to 1972; the Bloomberg Barclays U.S. Long Credit AA Index from 1973 to 1975.; and the Bloomberg Barclays U.S. Aggregate Bond Index thereafter. Data are through December 31, 2016.

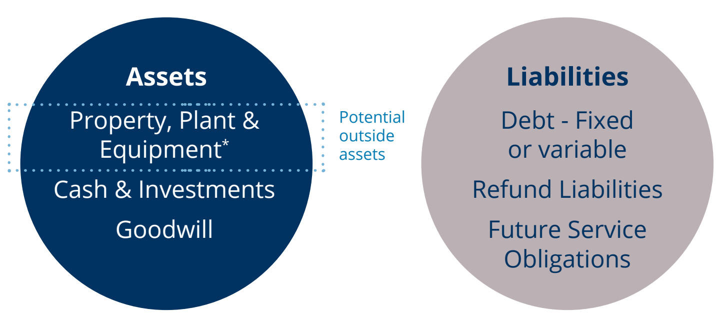
The Financial Footprint of an LPC is an Ideal Starting Point

We mentioned earlier that proper definition of the problem is really half—or likely far more—of the battle. What we have found is that in many instances institutions approach the solution with an incomplete definition of the problem and therefore possess an incomplete set of variables when they start. One of these variables is non-portfolio assets (see Figure 2). But it's important to factor these assets into the mix and look at portfolio construction holistically. Why is this the case? Even if portfolios have identical risk profiles and liabilities, the nature of their non-portfolio assets can lead to a different perspective on overall risk and return.

LPCs and CCRCs have a financial footprint that is unique to those of other organizations. Therefore it is essential to consider their organization's "outside assets"—the ones that reside outside of their investment portfolio—as well as the ones inside their portfolio in order to get a clear line of sight into portfolio construction and overall portfolio strategy.

The assets of a LPC/CCRC typically include portfolio, property, plant and equipment as well as goodwill. On the other side of the equation, liabilities will include debt (including debt to fund future growth) and entrance fee refunds and/or future service obligations.

Figure 2: Anatomy of an LPC Balance Sheet: Account for Outside Assets



Taking a closer look at assets, LPCs need to consider that they have a lot of inherent exposure to the real estate asset class. That is due to their property, plant and equipment that these communities own. What are the implications of outside assets that are comprised of real estate? This is effectively a form of equity risk—because real estate tends to behave like the real estate asset class – so this risk should be factored into asset allocation decisions.

Key questions to consider on the liabilities side of the equation are whether debt liabilities are fixed or variable rate. If they're variable rate, then your portfolio will be more sensitive to policy rate movements and you will need to mitigate that risk, perhaps by offsetting some of the debt with short term fixed income. If your debt is fixed for a long term, you might consider owning longer-duration bonds to match your liabilities. For example, if you have fixed rate debt and interest rates plummet (sound familiar?) very short-term bond portfolio will struggle to help pay the long-term debt, whereas a longer-term portfolio with call protection should be able to help pay call-protected debt. This could be more important now that the advance refunding option has been eliminated by the *2017 Tax Cuts and Jobs Act*. In addition, the long bond portfolio will tend to appreciate in market value with lower interest rates.

Entrance Fee Refunds An Important Cash Flow Consideration

Finally, the possibility of portfolio drawdowns due to the timing of entrance fee refunds can affect cash flow and cash to debt for LPCs and CCRCs (see Figure 3). This type of liability is clearly correlated to the local real estate market, and can have a strong positive correlation to equities. You can see that in properly defining your problem, there is an entire network of complex and interrelated decisions that need to be considered when making asset allocation calls that will help a LPC/CCRC attain its goals. A community's risk-reward profile should be built to match the risk of the enterprise to ensure its goals are aligned with residents' needs and to help fulfill the community's fiduciary duty to its residents and constituents.

Figure 3: Entrance Fee Refunds Closely Correlated with Local Real Estate Market

A Case Study: Portfolio Segmentation at Work

In a thoughtful asset allocation process, non-portfolio assets should have an impact. But how can we go about isolating them and getting clarity on our problem? A strategy that we have found successful in tackling this challenge is an approach called portfolio segmentation. Quite simply, we look at the different liabilities in a portfolio and create portfolio segments to address each liability. Then we aggregate those segments to produce an overall asset allocation.

Not only are LPCs and CCRCs unique in themselves relative to other organizations, each community's needs are also unique. That's why you need a financial partner that understands the mandate of LPCs/CCRCs and their specific liabilities. A consultant that understands LPC/CCRC structures and portfolio segmentation will help you understand the right mix of assets whether you are a non-rated credit or an investment-grade credit. Non-rated credits need to be especially smart about portfolio risk management, as their leverage may limit the extent to which they can target long horizon liabilities. On the other hand, investment-grade credits will probably want to start thinking about segmenting the portfolio into buckets around specific liabilities and long-term goals.

Example of Portfolio Segmentation

Let's look at an example of portfolio segmentation. Consider a relatively strong entity, with an A rating, 3x debt service coverage and a cash to debt ratio of 1:1. One might argue that this LPC/CCRC is financially sound enough to adopt an investment profile and long-term investment horizon similar to a large endowment or foundation. The untrained eye might conclude that we're talking about 60% in stocks, 20% in hedge funds/private equity and 20% in fixed income.

OR is there a different way of looking at and solving for this problem? Why? Because here we have an investment portfolio that is tied to an operating business. And that operating business has a large real estate component! As we mentioned earlier in this paper, property plant and equipment plus cash and investments comprise the lion's share of assets in a LPC/CCRC. In addition, there are liabilities that are unique to the LPC/CCRC world; namely entrance fee refunds and/or future service obligations. How might we account for these liabilities in portfolio construction? Portfolio segmentation might be worth a close look.

HOSPITAL AA

While LPCs/CCRCs are truly unique from an accounting standpoint, you can draw parallels to other industries, such as hospitals. Hospitals have investment portfolios tied to operating businesses and have liabilities such as reimbursement that contain useful parallels. Therefore it's instructive to look at how some larger hospitals approach asset allocation and portfolio segmentation.

Hospitals and hospital systems are generally much stronger financially than senior living organizations. It would be fairly easy to find a large number of examples of AA rated hospitals for example, whereas there are virtually no AA senior living credits. The scale of hospital systems is also more substantial—with many systems boasting investable assets in the billions. By the logic applied above, you would think that their asset allocations would be very aggressive. And in that assumption, you would be wrong. According to a study done by the Commonfund, hospitals allocated 41% to equities, 34% to fixed income and cash and 25% to alternative strategies. How did they arrive at that allocation?

Micro segmentation

Increasingly, complex organizations are looking to approximately match assets and liabilities and the way they do this is to identify their liabilities in discrete "buckets" or micro segments, each with their own goals.

- One such segment might be concerned with operating cash, short-term capital expenditures and debt service payments.
- Another segment might look at self-insurance and renewal and replacement as a risk management tool.
- Those organizations that have defined benefit plans will create a third segment for that.
- Finally, the fourth segment will be for initiatives that support future growth.

Each segment can be thought to have its own asset allocation —effectively its own ecosystem—reflecting the specific liabilities in the segment. So the operating cash segment will be the most conservative and other segments can be expected to be more aggressive. When you combine all of these allocations, you end up with an overall allocation that resembles the 41% equities/34% fixed income/25% cash allocation used by the hospital. As you can see from Figure 1, "The Mixture of Assets Define the Spectrum of Returns", the difference between 41% equity exposure and 60% equity exposure can have a meaningful impact upon downside probabilities.

Most LPCs/CCRCs will be considerably smaller in scale than hospitals but are similarly challenged by unique liabilities. There are of course differences: there may not be a defined benefit segment and the renewal and replacement segment will be smaller. But the operating segment, which might include some dry powder for refunds, can definitely be defined and isolated to 'solve for' the challenges that the community needs to meet. And finally, the long-term growth segment will satisfy many investment committees that feel compelled to be in the endowment/foundation investing challenge.

In the end, a more nuanced and thoughtful portfolio segmentation process represents an opportunity to define the problem in a more fulsome manner—and increase your organization's likelihood of success—to more clearly identify and manage your liabilities, and ultimately meet your true purpose or end goal.

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Jim Jeffery, Managing Director of Procyon Partners LLC, is a leading financial advisor to senior living organizations and high net worth families with more than 35 years' experience navigating financial and capital markets. Jim has a particular interest in the senior living industry, which dates from his experience as Executive VP & Head of Underwriting at Herbert J. Sims & Co, a leader in senior living finance. Specifically, for almost 20 years, Jim has been helping Life Plan Communities (Continuing Care Retirement Communities) develop Investment Policies that balance the assets and liabilities of these organizations. In addition, Jim's direct experience underwriting, structuring and re-structuring CCRC bond issues is invaluable in his role as financial advisor and consultant to senior living organizations.

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