Regional Hospital makes Strategic Decision to fund Pension Plan using Long-Term Assets

THE ORGANIZATION
A regional hospital providing a wide array of services, employing over 200 physicians and 1,600 clinical and administrative personnel. Management oversees multiple asset pools, including a long-term investment account, a frozen pension plan, and a foundation—just under $200 million in all. The pension plan represents about half of the total investible assets.

The challenge
An underfunded pension plan was creating multiple problems for the hospital. While asset returns for the plan had been very good since the global financial crisis, interest rates had dropped significantly, causing plan liabilities to grow rapidly. The resulting drop in funded status led to unexpected required contributions to the plan, causing management concern about possible impact to the hospital’s credit rating.

Managing the underfunded plan had also become quite expensive, with PBGC\(^1\) premiums set to increase over the next few years. While the investment committee was hopeful that interest rates would rise in the future, causing some of the balance sheet liability to disappear, they decided to evaluate making a large contribution as a way to a) shore up the funding of the plan, and b) allow them to begin a pension de-risking strategy.

A strategic solution
The finance committee sought Russell’s recommendations on how to best make this large contribution. In particular they wanted advice on:

1. How large should the contribution be?
2. What assets should the committee sell to transfer into the pension plan?
3. How should the committee allocate the contribution once it is in the plan?
4. When should the committee make this contribution?

This hospital and longtime Russell client was able to quickly rebound from the global financial crisis of 2008. Operating revenue had steadily increased over the past few years and the hospital enjoyed more days of cash on hand than many others in their peer group. While the hospital was an early adopter of a liability driven investing (LDI) approach, the plan still maintained about 60% of their pension portfolio

\(^1\) Pension Benefit Guarantee Corporation
Russell helped the committee realize that making a lump sum contribution created a good opportunity to revisit the hospital’s entire investment strategy—an exercise that would provide clear answers to the committee’s questions and position their total investment program for the future. After conducting an asset/liability study, Russell recommended the implementation of a dynamic de-risking strategy for the pension plan called Liability Responsive Asset Allocation (LRAA).

Under the LRAA schedule Russell developed, the plan’s liability hedge ratio target and allocation to fixed income increases as funded status improves, given that the plan has less incentive to take interest rate risk. However, since the liabilities are only partially hedged, any unexpected rise in interest rates would still benefit the plan and improve funded status. The schedule below shows the fixed income allocation for the pension assets (with the remainder allocated to return seeking strategies) and an interest rate hedge ratio target at each funded status.

### EXHIBIT 1: LIABILITY RESPONSIVE ASSET ALLOCATION (LRAA) SCHEDULE

<table>
<thead>
<tr>
<th>FUNDED STATUS</th>
<th>FIXED INCOME ALLOCATION (% OF TOTAL ASSETS)</th>
<th>HEDGE RATIO TARGET</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;70%</td>
<td>40%</td>
<td>28%</td>
</tr>
<tr>
<td>75%</td>
<td>45%</td>
<td>34%</td>
</tr>
<tr>
<td>80%</td>
<td>50%</td>
<td>40%</td>
</tr>
<tr>
<td>85%</td>
<td>55%</td>
<td>47%</td>
</tr>
<tr>
<td>90%</td>
<td>60%</td>
<td>54%</td>
</tr>
<tr>
<td>95%</td>
<td>65%</td>
<td>62%</td>
</tr>
<tr>
<td>100%</td>
<td>70%</td>
<td>70%</td>
</tr>
<tr>
<td>105%</td>
<td>75%</td>
<td>79%</td>
</tr>
<tr>
<td>&gt;110%</td>
<td>80%</td>
<td>88%</td>
</tr>
</tbody>
</table>

Using this approach lowered the expected pension contributions in adverse market scenarios, helping address the committee’s concerns regarding their ability to make pension contributions in a market downturn that would also negatively impact long-term assets and the overall financial health of the hospital.

The large allocation to fixed income also had the benefit of positioning the plan for a risk transfer strategy if the sponsor decided to transfer the pension liabilities to an insurance company in the future. The hospital decided to adopt this revised asset allocation strategy and incorporated it into their investment policy statement.

**Specific Answers to the Committee’s Funding Questions**

In our role as co-fiduciary, Russell worked closely with the hospital’s investment committee, finance committee, and the plan’s actuary to answer each of the following questions:

**1. HOW LARGE SHOULD THE CONTRIBUTION BE?**

Russell advised the client to put enough assets into the plan to reach the next funded status trigger on their LRAA schedule. This would reduce the hospital’s days of cash on hand to a level more in line with their peer group and still provide for ongoing financial flexibility. To materially impact the amount of PBGC premiums payable, the contribution had to be of significant size. The finance committee approved a contribution that increased the plan’s funded status from 64% to nearly 76%, and reduced the assets of the long-term pool by 11%.

**2. WHAT ASSETS SHOULD THE COMMITTEE SELL TO TRANSFER INTO THE PENSION PLAN?**

The finance committee was particularly concerned about realizing losses in their long-term assets since any realized losses would flow through to the hospital’s financials, with potentially negative impacts on their credit rating and debt covenants. Russell conducted a thorough analysis and concluded that a pro-rata liquidation of assets in the long-term asset pool would lead to a realized gain and would not impact the hospitals’ credit rating or debt covenants. This pro-rata withdrawal approach had the added benefit of maintaining the overall risk and return profile of the long-term pool.
3. **HOW SHOULD THE COMMITTEE ALLOCATE THE CONTRIBUTION ONCE IT IS IN THE PLAN?**

With a large enough contribution to impact funded status and reach a different threshold on the LRAA schedule, an increased hedge ratio and allocation to fixed income was called for. Russell recommended that the committee invest almost all of the contribution in Russell Target Duration Fixed Income funds.

Using the Target Duration LDI funds enabled Russell to effectively match the duration, convexity and curve coverage of the liabilities while achieving the desired target hedge ratio, enabling the client to “lock-in” the funded status gain from the contribution. Ultimately, the contribution lowered the plan’s overall interest rate risk without increasing the overall portfolio’s market/equity risk.

Investing directly in the Target Duration LDI funds also helped reduce transaction costs, avoiding a two-step process of first investing pro-rata and then moving to the new allocation outlined by the LRAA schedule.

4. **WHEN SHOULD THE COMMITTEE MAKE THIS CONTRIBUTION?**

The committee considered two strategies regarding the timing of the contribution: dollar cost averaging over several months vs. making the entire contribution at once. After a careful evaluation of the advantages and disadvantages of both approaches, Russell recommended that the investment committee make the contribution all at once in order to reduce the interest rate risk as quickly as possible.

---

**Results**

By implementing three key changes, the hospital was able to reduce the likelihood and frequency of future unexpected pension contributions, along with their potential negative impact on the overall financial health of the hospital.

› Making a one-time contribution from long-term assets took significant risk off the table and reduced future PBGC premiums.

› Adopting an LRAA schedule helped further reduce expected contributions by approximately 3%.

› Incorporating the Russell LDI Target Duration Fixed Income funds enabled a better match between the pension assets and liabilities.

---

**FOR MORE INFORMATION:**

Call Russell at **866-739-7979** or visit [www.russell.com/healthcare](http://www.russell.com/healthcare)
ABOUT RUSSELL INVESTMENTS

Russell has helped hospitals and healthcare system clients navigate challenges and meet goals since 1983. We work with each of our clients to fully understand their asset pools and unique investment needs. The comprehensive fiduciary solutions we design for our clients are tailored to meet each organization’s specific goals and incorporate Russell’s award winning advice, investment strategy and implementation.

Important information

This case study is for that of an individual Russell Health Care client, and is provided to illustrate Russell’s capability and experience with this service. Individual actions and results will vary.

The Russell Target Duration LDI Funds are funds of the Russell Trust Company Commingled Employee Benefit Funds Trust Russell Liability Driven Investment Solutions; they are not mutual funds.

These collective trust funds are bank-maintained collective investment funds managed by Russell Trust Company, a Washington State non-depository trust company, and are not registered mutual funds. The funds are only available to certain qualified employee benefit plans and government plans and are not offered to the general public.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

Liability Driven Investment (LDI) strategies contain certain risks that prospective investors should evaluate and understand prior to making a decision to invest. These risks may include, but are not limited to; interest rate risk, counter party risk, liquidity risk and leverage risk. Interest rate risk is the possibility of a reduction in the value of a security, especially a bond or swap, resulting from a rise in interest rates. Counter party risk is the risk that either the principal or an unrecognized gain is not paid by the counter party of a security or swap. Liquidity risk is the risk that a security or swap cannot be purchased or sold at the time and amount desired. Leverage is deliberately used by the fund to create a highly interest rate sensitive portfolio. Leverage risk means that the portfolio will lose more in the event of rising interest rates than it would otherwise with a portfolio of physical bonds with similar characteristics.

Bond investors should carefully consider risks such as interest rate, credit, repurchase and reverse repurchase transaction risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield (“junk”) bonds or mortgage backed securities, especially mortgage backed securities with exposure to sub-prime mortgages.

Russell Investment Group, a Washington USA corporation, operates through subsidiaries worldwide, including Russell Investments, and is a subsidiary of The Northwestern Mutual Life Insurance Company.

The Russell logo is a trademark and service mark of Russell Investments.

Copyright © Russell Investments 2013. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an “as is” basis without warranty.

First used: May 2013
USI6872-05-14