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A Mercer practice

Annual Benchmark Study — Healthcare Operating Assets

August 2020

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Introduction

With its sizable client base within healthcare, Pavilion, a Mercer practice ("Pavilion"),[1] is in a unique situation to analyze a broad range of client portfolios. The study aggregated information from across Pavilion's healthcare client base to provide details on our clients' operating asset pools, which includes 67 observations of varying sizes across the debt rating spectrum as of December 31, 2019.

[1] Services to be provided by Mercer Investments LLC using the business name of Pavilion, a Mercer Practice. Mercer Investments LLC is one of several associated legal entities that provide investments services to clients as part of a global investment advisory and investment management business (collectively referred to as "Mercer"). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, New Jersey, North Carolina, Oklahoma, Pennsylvania, Texas and West Virginia; as "Mercer Investments LLC (Delaware)" in Georgia; as "Mercer Investments LLC of Delaware" in Louisiana; and "Mercer Investments LLC, a limited liability company of Delaware" in Oregon.

1. Constituent breakdown by debt rating and size

Debt ratings[2] of our healthcare institutions remain strong, with the majority rated either AA or A. The institutions with larger operating pools tend to have higher credit ratings — of the top 25 organizations by size, 15 are rated AA- or better.

Debt rating	Number of observations
Aa/AA	19
A/A	30
Baa/BBB	9
Ba1/BB+ and below	1
Not rated[3]	8
Total	**67**

Market value	Number of observations
<$500M	28
$500M–$1B	18
$1B–$3B	16
$3B+	5
Total	**67**

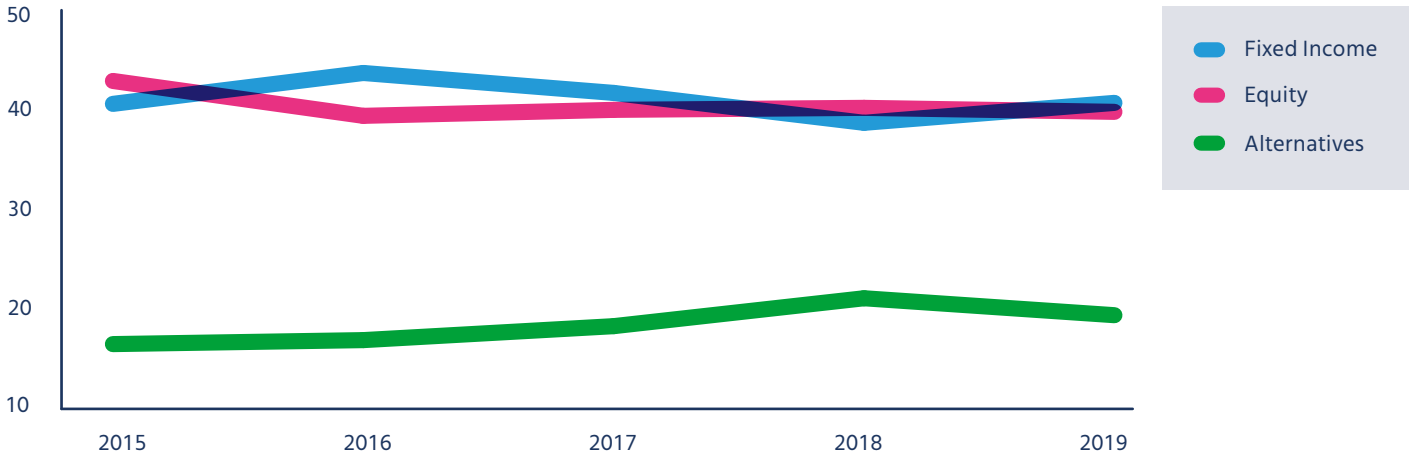
[2] Debt ratings are those assigned by Moody's, S&P, and/or Fitch and are opinions of the relative creditworthiness of issuers and financial obligations for the institutions within a particular country. They address the possibility that a financial obligation will not be honored as promised.

[3] Not rated entities consist primarily of organizations that have not issued debt and tend to be on the smaller side, with all eight observations under $300 million in size.

2. Average allocation over time

Asset allocations across broad asset classes have been relatively consistent over time. The allocation to alternative investments saw a steady increase until 2019, though the underlying composition has changed, which we touch on later in this document. Clients will often use alternative investments to diversify away from traditional equity and fixed income investments and obtain idiosyncratic returns not typically available in traditional markets.

Asset class breakdown over time (%)



Asset class (%)	2015	2016	2017	2018	2019
Equity	42.9	39.4	40.0	40.2	39.8
Fixed Income*	40.6	43.7	41.7	38.7	40.7
Alternatives**	16.5	16.9	18.3	21.1	19.4
# of observations	29	38	42	66	67

*Includes cash and cash equivalents.

**Includes hedge funds, private capital, real assets and other non-traditional investments.

3. Alternatives breakdown by debt rating and size (excluding real assets)

As the operating asset pools increase in size and credit ratings strengthen, institutions tend to allocate a higher percentage of their assets to alternative investments. This is likely due to a number of factors, including the ability to take on more illiquidity risk, better access to alternatives investment managers, and larger staffs to monitor and evaluate these investments.

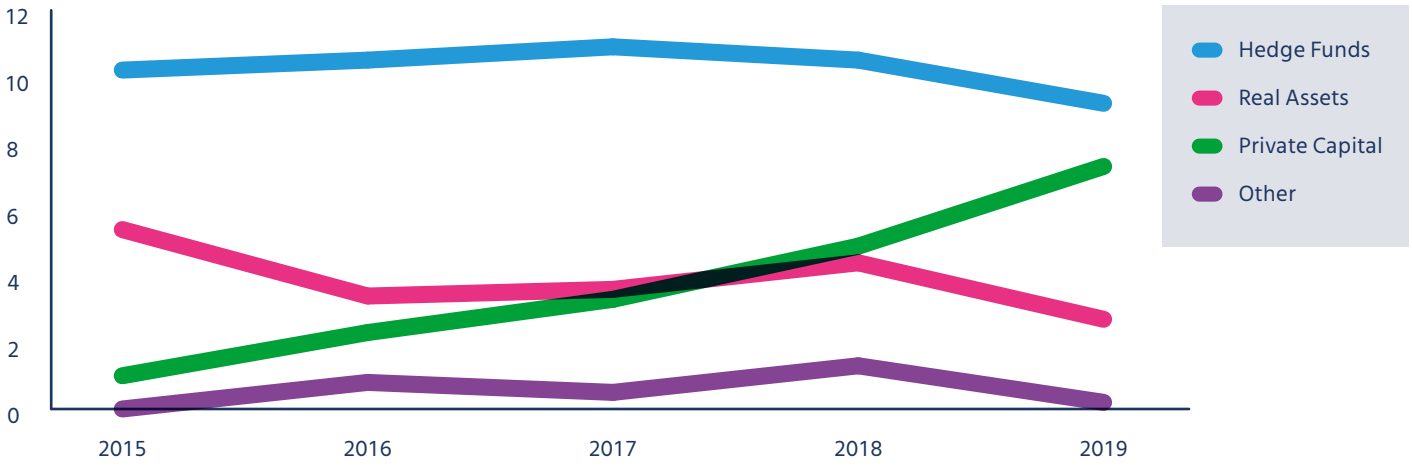
Debt rating	Aa/AA	A	Baa/ BBB	Below Baa/ BBB	Not rated
Allocation to Alts (%)	26.7	12.9	12.3	10.0	11.2

Size	>$3B	$1B–$3B	$500M–$1B	<$500M
Allocation to Alts (%)	34.1	21.7	18.4	9.2

4. Breakdown of alternatives allocation

Within alternative investments allocations, private capital saw the largest increase over the past four years. Exposure to this segment of the market has been more prevalent among larger healthcare organizations, as their size has created the ability to sacrifice some liquidity in order to gain access to an asset class that has provided strong historical returns. On the other hand, both hedge funds and real assets saw a recent fall in their allocations in 2019, with a portion of that allocation transitioning to private capital investments. Performance of hedge funds and real assets has struggled to keep pace with traditional assets amidst the decade-long, bull market rally in equity markets.

Allocation to alternatives over time (%)

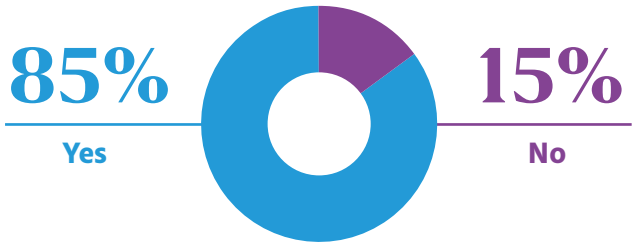


Asset class (%)	2015	2016	2017	2018	2019
Hedge Funds	10.2	10.5	10.9	10.5	9.2
Private Capital	1.0	2.3	3.3	4.9	7.3
Real Assets	5.4	3.4	3.6	4.4	2.7
Other	0.0	0.8	0.5	1.3	0.2
Total Alternatives	**16.5**	**16.9**	**18.3**	**21.1**	**19.4**
# of observations	29	38	42	66	67

5. Allocation to passive investments

The majority of our clients use passively managed strategies within their portfolio, with the most common area being US large cap equity. Given the efficiency of information flow within this asset class, historically it has proven difficult for active managers to outperform the index. On the other hand, passive strategies tend to be less relevant in fixed income and alternatives due to these markets being less efficient, meaning active managers have had an easier time outperforming the benchmark.

Clients using passively managed strategies



Asset class (%)	Total	Equity	Fixed	Alts
Average	22.1	18.9	2.9	0.4
Min	5.5	5.1	0.0	0.0
Max	61.0	39.7	45.0	8.0
# of observations	57	57	14	5

Conclusion

While at the surface asset allocation has remained relatively stable over the past several years, a deeper examination reveals a shift toward private capital strategies, as organizations look to supplement long-term returns by giving up some of their portfolio liquidity. This trend is more prevalent in larger organizations as well as those with higher credit ratings, which is not surprising given they are often better positioned to allocate to less liquid strategies. We expect this trend to potentially boost performance results longer term, as investors capture the illiquidity premium associated with investing in private assets.

If you'd like to discuss these findings or other topics related to healthcare operating assets, we would love to hear from you.

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