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Cashflow focus:

A matter of balance

Graham Moles, head of portfolio solutions, LGIM

Summary

- Transfers should not be a problem in principle as a slice of assets should be held to back each member and trustees can reduce transfer values in some cases.
- Transfers out may offload scheme liabilities relatively cheaply, reducing risk.
- Transfers out require good liquidity management. This can involve monitoring the likelihood of their occurrence and taking pre-emptive steps, such as increasing the flexibility and efficiency of leverage.
- The unpredictability of transfers can be allowed for effectively in a well-constructed approach that includes cashflow matching.

Cashflow awareness: Transfers out

Graham Moles talks about managing transfers out of DB pension schemes

DB pension schemes are maturing. Over half of UK DB pension schemes will be soon be paying more out in benefits than they are receiving in contributions[1]. Effective cashflow management is therefore becoming increasingly important. Schemes may also face the need to meet unexpected cashflows such as transfers out. So what are the implications of transfers out of pension schemes and how can schemes best prepare?

An increase in transfers out

Since freedom and choice in 2014, which allows individuals the right to access their pension savings more flexibly, there has been a substantial uptick in transfers out of DB schemes. As gilt yields have fallen, transfer values have risen (Figure 1), offering large and attractive sums to members. There was 50 per cent growth in the volume of transfers out in 2016 alone. Around 2 per cent of scheme assets on average were transferred out with transfers out, exceeding pensions in payment for some schemes.

Much has been written in the press on the factors members should think about when deciding whether to transfer. But what about schemes themselves – how should they prepare?

Transfers out –not a problem?

In one sense, paying transfers shouldn't pose any problem. In principle a scheme has assets reserved for members to back this option, so the scheme can simply sell the slice of the assets backing those payments.

To calculate how much to pay, an actuary uses a set of assumptions (including the return on assets and how long people will live) called a Cash Equivalent Transfer Value ('CETV') basis. The CETV basis is normally a 'best-estimate' basis, meaning there is no prudence.

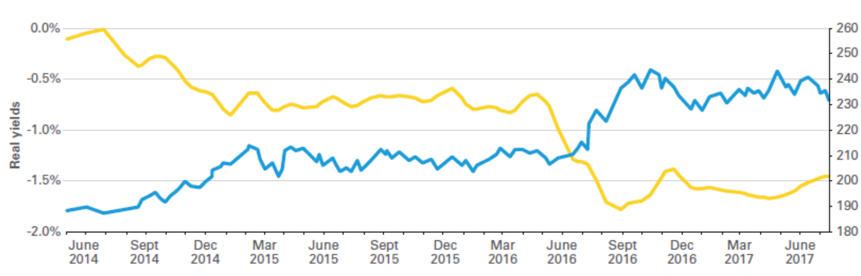
On a prudent basis, such as technical provisions (TP) or buyout, the deficit of a scheme improves following a transfer as the assets transferred are less than the liability removed. For example, the CETV for a member aged 64, entitled to a pension of £10,000 each year starting at age 65 (increasing each year with inflation), could be around £240,000. In contrast, buying the same benefit out with an insurance company could cost around £305,000.

From this perspective transfers out don't sound like a problem for DB schemes at all – quite the opposite!

However, caution is needed because a scheme that is underfunded on a CETV basis suffers a hit to its CETV funding level following each transfer out, even though the CETV deficit stays the same. This is because the assets and CETV liabilities reduce by the same amount on each transfer out but the deficit becomes larger as a proportion of the liabilities. The funding levels on other bases, such as TP, fall in line.

This can be concerning, particularly for schemes that are mostly reliant on investment returns, rather than contributions, to repair their deficit. However, where the trustees take the view that paying transfers at full value would prejudice the security of remaining members, the trustees may commission an 'insufficiency report'

Figure 1: Yields have fallen and transfer values have risen in recent years



Source: Xafinity, Bank of England, LGIM calculations

[1] **Source: Mercer European Asset Allocation Survey 2017**

from the scheme actuary that allows them to reduce transfer values to an extent. The upshot is that there should, at least in principle, be no threat to the long-term health of the scheme from members choosing to transfer.

Not so fast

However, there are some practical points that mean life isn't quite so simple. In particular, if markets are currently stressed this may not be an ideal time to sell assets. The funding level may have fallen following a market downturn but an insufficiency reduction may not have been applied to reflect this. It could also be inappropriate to apply a reduction given, for example, a strong employer covenant. Transaction costs may also be high, particularly for illiquid assets.

As such, it is important to ensure there is sufficient liquidity in the scheme. As we explain in *Raising cashflow awareness* there are pre-emptive steps schemes can take to prepare for unexpected cashflows. These include:

- **Increasing the flexibility and efficiency of leverage and collateral** – leverage (via either LDI or synthetic equities / credit) can be used to gain more efficient exposure to markets than physical allocations
- **Tailoring assets to generate more natural cashflow** – eg. taking dividends as a source of cashflow
- **Using uncorrelated funds as a collateral safety net** – eg. absolute return funds

Transfers – like any human choices – are hard to predict. However factors that increase the chance of a large number of transfers include:

- Lower interest rates, which make transfer values appear more attractive
- A smaller scheme will have a greater level of uncertainty around the amount of transfers
- More members approaching retirement
- A weaker sponsor causing members to worry about the security of their pension

Monitoring these factors may help identify a need for additional pre-emptive action.

Implications for cashflow matching

It's tempting to believe that cashflow matching is a red herring in the context of hugely uncertain cashflows such as transfers out of the scheme. But, whilst cashflow matching is not a silver bullet, we believe that transfers do not materially damage its advantages (as part of a cashflow aware solution) for several reasons:

(1) A slice of asset cashflows should already be held to back any particular member. If that slice is cashflow matched, there is less mismatch between the value of that slice and the transfer value when market conditions change

(2) If a transfer occurs this is actually likely to be beneficial in terms of reducing the long-term risk of insolvency of the scheme. As such trustees should arguably be more worried about what occurs if transfers out don't happen and focus on reducing reinvestment risks and transaction costs in that instance. We believe it makes sense to focus on the journey plan and make it flexible enough to cope with transfers, rather than construct an approach based around transfers necessarily occurring

(3) Transfers are only possible for as long as there are deferred members. As schemes mature, these deferred members retire and cannot transfer. Given that there is no harm in structuring bonds to match benefits, trustees along with their Investment Consultant should consider whether it is appropriate to do so now rather than restructuring later at a cost – it is good to be pro-active.

Like all cashflows, transfers may form an opportunity for the portfolio to be rebalanced towards its target position, allowing for any active views currently held and transaction costs.

Written by Graham Moles, head of portfolio solutions, LGIM

In association with Legal & General Investment Management

A new king in town

Lynn Strongin Dodds reveals how cashflow-driven investing is fast becoming the dominant investment style for defined benefit schemes

Summary
• Cashflow-driven investing is not new but has gained traction as pension funds age.
• Opportunities have become tighter due to overcrowding and stretched valuations.
• Choosing the right investment strategy at the right time can significantly improve returns.

Cashflow driven investing (CDI) may seem like another pension fund buzzword but it is fast becoming one of the most important themes in the UK defined benefit world. There are different flavours but all agree that a more dynamic and thoughtful approach is required today to meet future obligations.

CDI is not a new trend, but an ageing population and structural changes, such as the move to defined contribution, has taken its toll on the cash coffers of many pension funds. Mercer's latest *European Asset Allocation* survey shows that more than half of UK DB pension funds, are now paying out more in pension payments than they are bringing in through investments and contributions. Moreover, 55 per cent were in cashflow-negative territory, based on a sample of around 600 UK schemes.

A separate study by Spence Johnson reinforces the issue, as it shows that aggregate net contributions to UK private sector DB schemes turned negative in 2012-13, and this is expected to climb to around £23 billion a year by 2025. The result is that "CDI has become an important topic but it really is no surprise because, put simply, as UK DB schemes mature, there is less money coming in from contributions and an increasing number of people taking benefits," says Janus Henderson head of secured credit Colin Fleury. "Historically, the focus was more on asset liability management but pension funds are increasingly turning cashflow negative and this will continue to grow for a number of years."

Russell Investment head of strategic client solutions EMEA, David Rae, echoes these sentiments. "CDI has become front and centre over the past 18 months, which is reasonably sensible as demographics and circumstances change," he says. "However, despite being universally talked about it makes more sense for some pension funds than others. The main objective is to optimise the portfolio to generate cashflows with a greater degree of certainty."

Although negative cashflows has been a main driver, Legal & General Investment Management head of portfolio solutions Graham Moles believes the move to CDI also reflects a change in investment mindset that is more akin to the insurance industry. This means adopting a more holistic approach that is less reliant on traditional growth assets to generate excess returns, and places a higher emphasis on liquid and illiquid income generating strategies.

"Schemes want to align their asset allocation better with the role of the trustees in terms of paying pensions in full and on time," he says. "They are becoming more like insurance companies in their thinking and doing something likely to be safer and secure, which will be more acceptable at the time of buyout."

There is of course no silver bullet or one-size-fits-all solution although finding the right opportunities in this current environment can be difficult. In many cases opportunities are thin on the ground as valuations are stretched and there are predictions that the end of the 30-year bull market is nigh. "One of the biggest challenges today is getting those certainty of returns," says Mercer head of strategic solutions Adam Lane. "The most important thing for a pension fund is not be a forced seller. In the past they would access cash by simply turning on all the taps because all assets generate a stream of income, whether it be coupons on bonds or dividends from equities."

However, in the current low-yield environment, generating for example 4 per cent from an asset is not that straightforward and investing has to be devised in a more structured way.

He adds that weaker-funded schemes have less flexibility because they need to generate returns and take on greater risk, while a well-funded scheme with a strong sponsor can chose more conservative assets that are more cash matching.

Typically CDI includes gilts, even though they are low yielding, asset-backed securities, long-lease property such as ground leases, investment-grade credit, infrastructure and private debt. Some schemes are also looking at casting their net wider to emerging-market debt as well as sub-investment-grade credit. The asset allocation mix will depend on the funding levels, maturity, strength of the sponsor and buyout objectives.

BlackRock director in client solution Vivek Paul believes that considering risk, cashflow and return needs together is essential to building cashflow-aware portfolios. "For cashflow-negative schemes, ignoring cashflow needs can lead to materially worse scheme outcomes in adverse market scenarios, such as equity market drawdowns," he adds. "Equally, for underfunded schemes, prioritising cashflow needs over risk and return considerations by concentrating on 'locking in' investment-grade credit can lead to worse outcomes, particularly at today's valuations."

Paul adds that a portfolio that balances risk and return objectives and generates excess near-term income to meet cashflow needs is a sensible middle ground, allows a more equitable split of near-term and longer-term objectives. "The comparatively attractive returns that shorter-dated private debt generates can be combined with sizeable LDI and growth asset allocations to create a portfolio with flexibility to de-risk through further allocations to cashflow assets on an opportunistic basis," he says.

Views are mixed as to where the LDI component should sit in the portfolio. Schroders solutions manager Jon Exley does not believe the two should be separate. "CDI is not an alternative to LDI but should be an integral part of the solution," he adds. "We see CDI including an LDI overlay to manage the risks of inflation and interest rates, as well as currency hedging of non-UK bonds."

J.P. Morgan Asset Management head of UK institutional Paul Farrell also believes that CDI and LDI should sit side by side but that more attention should be paid to pension cashflow needs. "LDI got people to think about the risks but didn't solve the cashflow problem," he says. "CDI is a framework and a process that requires granular analysis of cashflow projections and how they can be met from different income generating assets. Some pension funds are at the advanced stages while others are at the foothills but it is an evolutionary process and could take years to change the asset allocation."

In general, Fleury says he is "seeing schemes interested in looking at different areas of the securities market such as high yield, emerging-market debt, asset-backed securities and secured loans. This may reduce the precision of the expected cashflow profile but still be good enough to help the scheme address its cashflow needs, whilst enhancing the opportunity to generate returns. However, others may adopt the approach of focusing initially on a buy and maintain style investment-grade bond strategy, where on day one you build a portfolio of bonds with a maturity profile that matches the cashflows needed, whilst retaining the flexibility to supplement this with investments from higher-yielding parts of fixed income market as attractive opportunities to do so arise."

Moles notes that high yield and emerging-market debt may be better suited to well-funded pension funds that ar 'cash aware' and not those that needs cash matching. "This is because there is no guarantee that they will be here in five years' time," he adds. "For cashflow-matching we advocate investment-grade bonds on a global basis and have around 35 per cent in the US and we hedge the currency risk. Other asset classes are less liquid and they come with their own challenges. Also, if you go to sub-investment grade, they will not be accepted by insurance companies when it comes time to a buyout."

Choosing the right strategy at the right time can significantly improve the chance of a DB scheme paying full benefits to members, according to a recent report co-authored by Redington's Dan Mikulskis and Alex White, and University of Kent professor of actuarial science Paul Sweeting. For example, it can jump from a 60 per cent probability to a 75 per cent probability for the same initial funding level and contributions.

Written by Lynn Strongin Dodds, a freelance journalist