Summary
• Liquidity is an important part of a pension fund's strategy for multiple reasons, from paying out pensioners to matching liabilities and covering the funding of some long-term investment.
• Cash, equities and bonds can provide reliable but generally low returns through interest, dividends and coupons. Careful management is required to ensure cash pays the best interest possible.
• Some argue that settling for liquid assets is detrimental to a pension fund and could worsen funding gap issues, and that pensions place too much focus on the ability to access their assets.
• Investing in long-term assets, where funds are blocked for some time, usually provides an 'illiquidity premium' that rewards investors for keeping assets locked up.
• A balance is essential – liquidity requirements can't be ignored, but then neither can the need to pursue better returns.

Going with the flow

Sandra Haurant explores how pension funds are adapting their ratio of liquid asset holdings to meet their changing needs

Liquidity has long been a focus for pension funds. Pensions may have fared relatively well during the liquidity crunch of 2007-08, but ensuring an adequate cashflow is nonetheless an essential part of any pension fund's strategy. This was an area that was thrown into sharp relief when the financial world was thrown into crisis, and those investors without sufficient liquidity found themselves high and dry.

Liquid assets are those that can be converted into cash quickly, and of course, in the case of cash itself, accessed readily. Illiquid assets, on the other hand, are those that are far harder to sell or to liquidate, like infrastructure, for example. Liquid assests form a major part of pension funds' portfolios. According to the latest Willis Towers Watson Global *Pensions Assets Study*, published in February 2018, asset allocation in global pensions is split so that 46% is invested in equities, 27% in bonds, 2% in cash and 25% in 'other' investments. In the UK, 47% of total assets is held in equities 35% in bonds, 2% in cash and the remaining 16% is in assets.

Know your needs

"It is very important that pension funds should be aware of their liquidity requirements," says Cambridge Associates' head of European pensions, Alex Koriath. "Different liabilities pose different risks. First, we have funding level risks because of interest rate and inflation changes. Then there is the fact that most pension funds in the UK are cashflow negative, so they are paying out more that they receive in. Trustee and pension fund administrators need to be aware of the coming outflows over the near and medium term, and how they will source these. You need to be aware what your immediate liquidity needs are."

Payden & Rygel (London)'s managing principal Robin Creswell adds: "In the defined benefits (DB) sector, the majority of pension funds have adopted liability matching plans or strategies. They match those liabilities in a number of ways, and some of these result in having very significant cash being generated to hold as collateral against their liability matching contracts."

In the defined contributions (DC) sector, too, there has been an increased focus on liquidity and specifically cash. "DC is interesting, because historically all the focus has been on building up growth for members," says Payden & Rygel's director, institutions, Mark Stanley. "The big change is the freedom of choice to continue to roll on that investment, which means drawing down against the value of investments rather than buying an annuity. I think that changes decisions for trustees, in terms of how they make investment options available to retired members. There is a need to manage the day-to-day liquidity part of that portfolio more carefully."

While a proportion of the portfolio can be invested in growth-style assets, Stanley suggests that there are increased shorter-term liquidity needs within the portfolio to meet pension payments in the near future.

Cardano's head of client solutions, Andrew Stewart, adds: "Pension freedoms have led to increases in transfers out of DB schemes into DC arrangements. Schemes need to ensure that sufficient liquidity is retained to pay out higher transfers and that the remaining portfolio is not overly dominated by illiquid assets. However, as these freedoms have been available for a few years now, schemes should have good understanding of additional liquidity needs."

Liquidity, then, has an important part to pay, and finding the right ways to provide it is a necessary strategy. Where there is cash, it's important for pension funds to put it to good use. "When we went into 2007, a custodian for a pension fund would sweep cash at the end of a day to as many as 50 counterparty banks and today that is down to about five or six. Not because there are not other credit-worthy banks, but there are only a small number paying meaningful interest." Of course, on sums of this size, small differences can make a tremendous difference, and expert managers seek out the best rates.

And while equities and bonds pension funds offer a degree of liquidity and cashflow, in the form of dividends and coupons, they are not without risks. "Here is the irony: you could have assets that seem liquid, but still require a long holding horizon. Take for example equities. No one would buy shares if you knew you were going to buy a house in a year's time. You don't know where the equity market is going to be by then. You could lose your deposit if you were forced to sell at the wrong time," says Koriath. It's similar, he argues, for pension funds. "The worst case is that you find you have to pay out a significant amount in pension payments, and you don't have liquidity coming in, and so you have to sell risky assets at the wrong point in time, when they have fallen. You have to think about how you manage liquidity and avoid forced selling."

Missing out?

What's more, argues Koriath, a preoccupation with assets at the liquid end of the scale could be working against pension funds' interests and making it harder for pension schemes to close their funding gaps. "If you only invest in bonds and equities, you can still cover your immediate outflows and equity for longer-term returns, but in our view you are missing out. You might be better investing part of that in less liquid assets to harvest an illiquidity premium."

An illiquidity premium is essentially a higher return that is paid out because illiquid assets oblige investors to put their money away for the longer term. As a reward for making the funds inaccessible for a period of time, investors are offered higher rates. And in a sustained low interest rate environment, where bond yields continue to lie low, and where cash pays very little, some argue that it is time to shift towards more illiquid assets in search of these better returns.

"Liquidity rightly becomes a key consideration for schemes that are likely to be in a position to buy out in the short term. For schemes that are either some way off buyout, or planning to run off the pension scheme over time, investment time horizons are a lot longer," says Stewart. "This means that the theoretical additional return available on illiquid assets represents low hanging fruit for these pension funds – particularly illiquid assets that pay a stream of income which can be used to pay benefits."

Structural issues

There is a flipside to this, though. Certain illiquid assets actually create the need for higher liquidity within a pension fund. "It is fairly common for pension funds to have a commitment of three to five years to invest in, for example, private equity or infrastructure, or other illiquid assets, or indeed a combination of all three," explains Creswell. "With infrastructure, for example, there could be a three-year funding programme where the pension fund knows it will have to meet quarterly payments for construction deadlines, for example. The approach some of the pension funds take is to sell down equities or bonds because they can't risk the capital value of those portfolios fluctuating."

The need for liquidity, then, can be provoked in the process of accessing illiquid assets that should pay a premium. "You need to take into account all your commitments. Your most effective line of defence is the absolute limit you put on the illiquid assets you invest in," says Koriath. "If you only have 15% in illiquid assets, by definition you have 85% in liquid assets. I think there are very rare circumstances where you would need 85% of your assets, and that situation doesn't occur over night."

Is it possible to find the right combination of liquid assets offering sufficient cashflow, and illiquid assets allowing pension funds to access the higher returns they need? "A balance can be struck between the risks and (potential) returns," says Stewart. "However, this balance needs to be evaluated against other available investment opportunities in a portfolio context, before deciding whether to invest in a less-liquid asset."

Written by Sandra Haurant, a freelance journalist