Summary
• The vast majority of DB schemes are expected to be cashflow negative by 2027.
• The current low interest rate and bond yield environment is making it a precarious time for schemes to enter into cashflow-negative territory.
• There are a number of options for cautious and diligent trustees that will still allow schemes to enter a smooth run-off while paying off their pensioners.

Running out of money

DB schemes maturing can often cause challenges, as they start to become cashflow negative. Thankfully, solutions are out there for trustees who are prepared to tackle the realities of their dwindling money pots

Jokes about midlife crises are ten a penny. But amid all the laughs about wearing tight leather trousers, finding a partner half your age, and buying a 1970s two-door Aston Martin convertible, there is a serious side to the condition.

Anxiety, depression and a loss of self-confidence are all afflictions that can cripple someone heading into middle age.

The UK's DB schemes are now at risk of suffering from similar debilitating states as they head through their own periods of midlife.

According to the PPF, around half of eligible schemes are now closed to new members, more than a further third are closed to accrual, and some 40 per cent of members are pensioners. With the proportion of members who take their benefits and transfer out increasing, swathes of DB plans are becoming cashflow negative, as a natural part of their lifecycle.

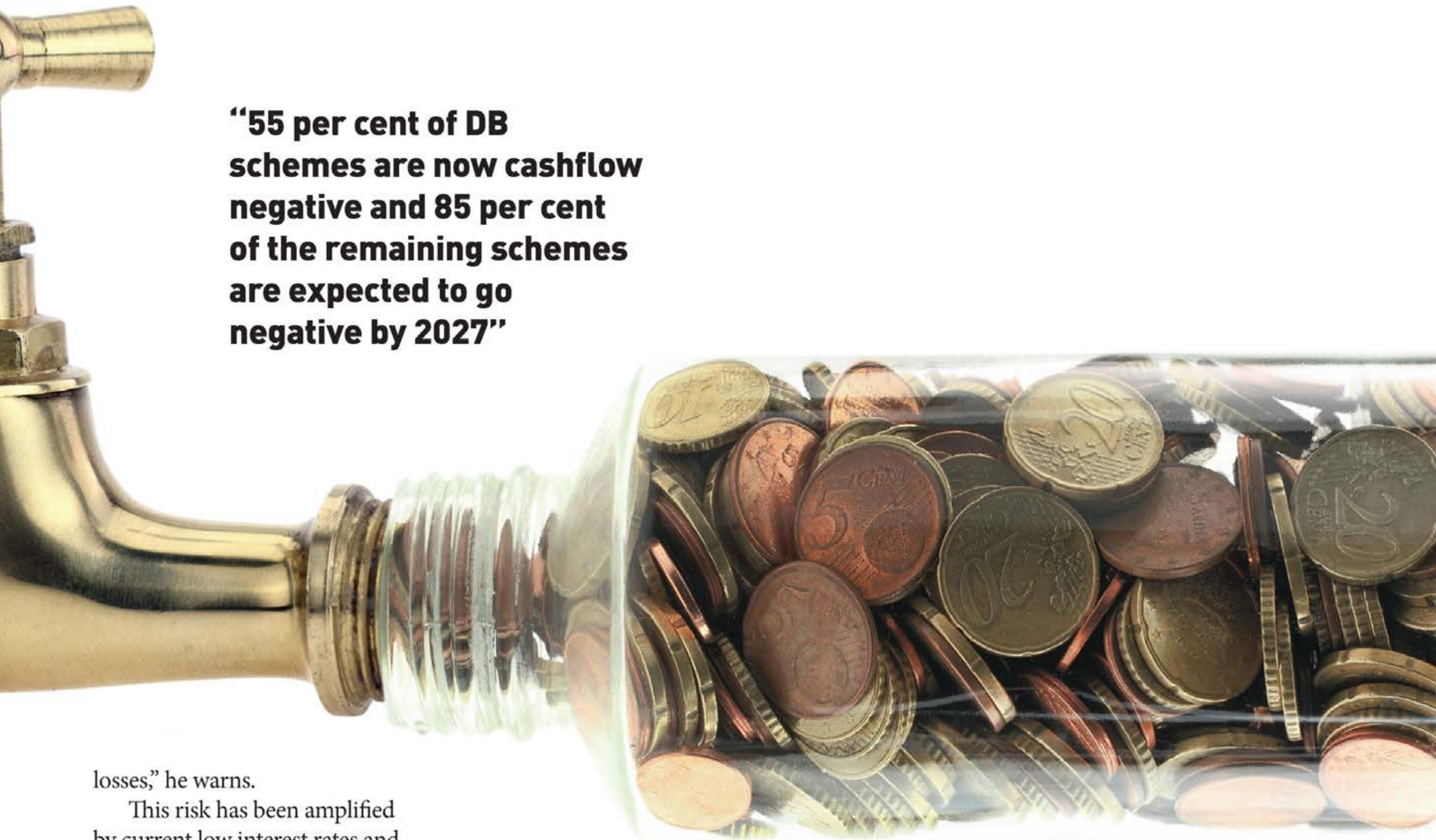
In its 15th *European Asset Allocation Survey* released this summer, Mercer estimated that 55 per cent of DB schemes are now cashflow negative. It also calculated that 85 per cent of the remaining schemes are expected to go negative by 2027.

According to J.P. Morgan EMEA head of pensions solutions and advisory Sorca Kelly-Scholte: "While this has been predictable from a long way off, what was less predictable is that pension funds would still be substantially in deficit once they reached this tipping point. This gives pension funds the challenge of trying to repair deficit while also decumulating."

Yet on paper, reaching this milestone should not be anything to fear, says LCP partner John Clements: "You are on the home straight. The whole point of a pension scheme is that you spend a long time building up a reserve of money to pay people when they retire, and now you are just using that pot of money to do what it is there for."

However, he says, trustees can fall into a trap. Many assume that the solution to their cashflow negative position is to have ultra-liquid assets. But the real issue is the much shorter time horizon that schemes are now working with, given that the average member age is over 60 for many pension funds.

"The big risk that creates is not that you can't find the cash when you need it, it's that you are forced to sell assets whenever they are in depressed conditions. So you are forced to lock in



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losses," he warns.

This risk has been amplified by current low interest rates and low yields on gilts, as Hymans Robertson's head of corporate consulting, Jon Hatchett, highlights. If a DB plan is holding gilts today then the short-term yield might be 0.5 or 1 per cent. On a £100 million portfolio of gilts, that equates to somewhere between the £1-£2 million mark in income.

"If you roll back a decade you would have been getting £5 million of income. That could have paid for a lot more pensions," he says.

Redington's head of DB pensions, Dan Mikulskis, has identified a point at which matters can become very serious for a scheme. He says that when negative cashflows reach more than 5 per cent of a scheme's assets per year, then this changes the whole way it experiences risk. It can mean that short-term market volatility can have a large impact on the final outcome through "path of returns risk".

"Our analysis suggests that in extreme cases the effect of negative cashflows can reduce a scheme's probability of paying pensions by as much as 20 per cent compared to a scheme with equivalent investment risk but lower cashflow demands," says Mikulskis.

Avoiding a crisis

With figures such as these making the rounds, the transition to cashflow negative status is one that requires maturity, and a cool head.

"It is different managing a portfolio of assets for members who are 70, rather than members who are 30," says Clements.

"So recognising that you are not a young scheme anymore and that you need to act appropriately *[is vital]*.

"Understand how much cash you might need. Quite often it is useful to do different scenarios – what if transfer values happen to be high, what if there are collateral calls on our LDI portfolios, how much cash could I need? As a rule of thumb, if more than 3 per cent of your assets every year is going out, then there is quite a pressing need to do something."

In reality, DB trustees have three options, says Barnett Waddingham consultant Barnaby Low. Ask the sponsor for higher contributions, raise income from your assets, or sell them down.

The first option may be difficult as contributions have already risen in recent years, but it may be the best option to avoid a deficit becoming so large that recovery is impossible, argues Low.

PTL managing director Richard Butcher suggests asking the employer to pay contributions early, which could help address a spike in transfer requests draining a scheme's cashflow, for example.

Barnett Waddingham also advises its DB clients to have a plan in place for meeting cashflow needs, such as switching into income-focused asset classes, or nominating particular existing assets for income and disinvestments.

If the sponsor's coffers are running low, then, as Mercer's UK DB risk leader, Alan Baker, stresses, schemes need to follow this advice, while also exercising more caution with their investment strategy.

"They need to monitor things like hedging more frequently because the changing nature of the scheme means you need to keep a closer eye on what level of hedging you have got and how closely it matches your liabilities," he says.

Solutions

This is where cashflow-driven investing comes in.

This can translate into more of a focus on credit and corporate bonds, says Baker, where trustee boards can try to match the payments that come out from credit investments with what they are actually paying out to pensioners.

However, cashflow-driven investing can be more than simply relying on a defensive strategy of core bonds, "which would sacrifice returns – a luxury that underfunded pension schemes can ill afford," Kelly-Scholte says. "Rather, cashflow-driven investing seeks to understand and forecast pensions cash flow needs, secure the liquidity to deliver current and future payouts and keep the door open to generating returns."

Depending on whether a scheme is targeting buyout or buy-in – or a more long-term run off strategy – then it can also look at assets such as property that will deliver cashflow in the longer term.

Kames Capital's head of institutional, Peter Ball, believes that property can deliver the steady income required.

"With IPD core UK property yielding around 5 per cent, but with secondary UK property typically yielding around 7 per cent, this can provide an attractive income stream for pension fund investors, in addition to some potential capital appreciation," he says. "With property yields typically averaging 400 bps above long-term gilts, it can provide an attractive alternative source for pension funds looking for income."

Diversified growth funds (DGFs) are also an option. Ball says that not all DGFs provide the income that's needed, but some can provide decent income.

"The beauty of these funds is that they provide immediate yield without having to sell units and incur trading costs, thereby keeping clients fully invested in growth assets."

If a scheme finds itself in cashflow-negative territory then it should also take time to reflect on its LDI and de-risking plans, adds Ball. Instead of locking themselves into such a run-off approach, they can use simpler cashflow approaches and delay the costs of a buyout, for example.

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"Ultimately, as the plan gets much older and smaller, it can finalise the security of the members' benefits. And interest rates may finally have moved up by then to help make that more attractive. In the meantime, using higher-yielding growth assets alongside bond portfolios can be the way forward."

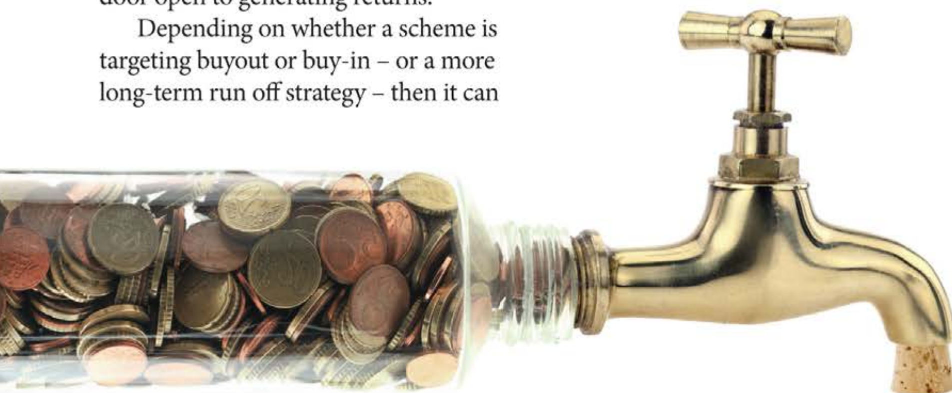
Aside from getting the right asset classes or strategies, Clements says that schemes need to focus on monitoring profits within their portfolios – and on looking to bank profits as part of your cashflow policy.

"If you are selling down month on month when you are banking profits, then that makes a massive difference compared to whether you are selling *[assets]* down and locking in losses," he says.

Clements likens it to paying a mortgage. If you slightly overpay you find you get it paid off much more quickly; and if you slightly underpay, you can get into a debt spiral and never get it paid off.

"Having the discipline to take a little bit of profit here and there really does add up over time," he adds.

Middle age may not be much of a laughing matter for DB funds, but with the right governance, trustees can make sure that it doesn't turn into an unedifying and harmful experience.



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