Summary
• Pension funds are hurtling into cash-negative territory and looking at different options to generate income and cashflows.
• Cash-driven investing has become a popular framework but it is best suited for the well-funded, mature schemes that do not need growth assets such as equities to plug any significant gaps.
• While the CDI framework has taken off, some fund managers believe pension schemes do not have to go farther afield but make the assets work in their existing portfolios.
• Others see CDI as more of a marketing fad and emphasise that asset allocation is and always will be the main driver of outcomes.

The rise of CDI

Lynn Strongin Dodds looks at the pros and cons of the CDI framework

In the not too distant past, liability-driven investing (LDI) was all the rage in the UK pension fund universe but as schemes have increasingly headed into negative territory, income or cash-driven investing (CDI) is gaining traction. However, as with many strategies, it is not a silver bullet and finding attractive opportunities, particularly in private credit, are becoming more challenging.

The direction of travel though is unlikely to be reversed. Mercer's latest *European Asset Allocation* survey shows that more than half, or 55 per cent, of UK DB pension funds are now paying out more in pension payments than they are bringing in through investments and contributions. Moreover, of the schemes that generated a cash surplus in 2017, 85 per cent will be in the red by 2027.

There are several confluences converging such as the closures of DB schemes, shifting demographics and a maturing liability profile pushing funds to take a closer look at their cashflows and income streams. Perhaps the most unforeseen trend has been the fast pace of transfers, which as recent figures from The Pensions Regulator show hit the 100,000 mark in the financial year 2017-18. "The high transfer rate was not anticipated but it has had an immediate impact on short-term liquidity," says Russell Investments managing director, head of strategic client solutions, David Rae. And the pace is not expected to abate. "This has focused the minds of many pension funds and is one of the main reasons why they are becoming cashflow negative so rapidly."

The CDI or income framework has been one solution because it can provide greater certainty of the future cashflows and prevents funds from being a forced seller of assets. However, fund managers are keen to point out that it is not suitable for every scheme. The most likely candidates are the more mature, well-funded ones that do not need the same level of growth assets to close any meaningful funding gaps.

"If you are a pension scheme and have an investment strategy that needs to generate gilts plus 2 per cent to 3 per cent plus, there is limited scope to invest in CDI," says Aviva Investors investment strategist, global investment solutions Boris Mikhailov. "Pension schemes have no choice, but to invest in the more traditional barbell strategy that has growth assets such as equities and hedge funds as well as liability-matching assets to get these levels of returns. Full CDI is more appropriate for those with a 1.5 per cent target or below, while a partial CDI approach, which includes some growth assets, could work for schemes that are in between the two."

Many CDI flavours

There are unsurprisingly different iterations of the CDI or income based investment themes being marketed but they all share a smattering of the tried and trusted buy and maintain credit funds. Some have ventured further afield and have included infrastructure or real estate debt while others have added ground rents, insurance linked gilts and asset backed securities to the mix.

One of the biggest challenges is that despite the long and growing list of CDI-friendly assets, the prospects are narrowing as institutional investors continue to pile into many of these areas. The issues were highlighted in a recently published paper by Willis Tower Watson, which found that assets allocated to credit strategies more than tripled between 2007 and 2017. Direct lending to mid-sized corporates was particularly singled out but the study notes that overall there is "a tendency for managers to focus on ideas that can be

quickly raised, are scalable and profitable to run—which ultimately results in them flocking toward very similar opportunities."

M&G director, global institutional distribution, Annabel Gillard agrees that "credit markets are expensive and there is a lot of money chasing the same opportunity set. The supply is limitless and it is very important to maintain discipline and buy at the right price. This is why investors have to make sure that their managers have experience and know how to negotiate the legal agreements in the direct lending contracts. We are coming to the end of the credit cycle and investors need protection."

One response by fund managers is to look at the shorter end of the credit curve as well as the more niche sectors such as the liquid US residential mortgage backed and inflation-linked securities markets. "We have money-market funds and also short-dated bonds such as liquid ABS, Libor Plus and global ABS, which have slight longer lives on average; 1-2 yr, 3-5 yr and 5-7 years respectively," says Insight Investment head of fixed income product management April LaRusse. "We also have medium-dated fixed income strategies investing in loans and bonds – secured finance strategies – which are designed to generate income for the next 10 years. Focusing on the next 10 years is difficult to do with too much precision because of the changing demographics and liabilities of a scheme."

UK pension funds are also being advised to take a much broader world view. "They need to be well diversified across assets as well as geographies which is why we are seeing an uptick in global strategies," says J.P. Morgan Asset Management head of EMEA pension solutions and advisory group Sorca Kelly-Scholte. "The focus should be on the quality and durability of the underlying cashflows. For example shorter leases where lease renewals carry little risk remain appropriate, these could be in prime office locations such as downtown New York."

In some cases pension funds may find the answers in their own investment backyard. Janus Henderson Investors head of secured credit Colin Fleury notes that the decisions schemes take will depend on their funding levels, journey plan and the strength of the covenant but believes a good starting point is to look at the assets already in their portfolio and ask if they can be managed differently. "To us it is more about being cash aware and less about which new asset class can we buy that will generate extra income and cashflow. It is more about looking at what you own, the cashflows already being generated and how that could help solve some of the issues," he adds.

This could mean for example, according to Fleury, supplementing the portfolio with other but similar investment-grade bonds that the scheme does not own or adding say high yield or asset-backed securities for extra return. "It is more of a modest evolution of management style rather than significant portfolio allocation shift," he says.

Schroders fiduciary manager in its solution business, Rosalind Mann, also advises clients to look at the total return and overall risk management of the portfolio, and to ensure that they have enough liquidity to meet all their needs. "There is a danger if income is the only focus because you may find that the portfolio is too risky, or locked up in too many assets that are illiquid," she says.

Other fund managers have expressed scepticism about CDI simply being the latest fad. They argue that portfolio managers should buy assets that are reasonably priced and offer the best risk-adjusted return instead of selecting ones based on maturity dates. This is because it is not always easy to find assets that will perfectly fall due when cash flow pain points arise.

"Asset allocation will always be the primary driver of outcomes," says Legal & General Investment Management head of multi-asset funds John Roe. "One of the problems is that focusing on just income is too narrow and pension schemes could lose out on assets that make sense. As an alternative, take a sensible diversified growth fund or DIY diversified portfolio. It will reduce market volatility and extreme drawdowns but also still have assets such as high yield, European corporate credit and emerging-market debt with shorter-term maturity profiles and cashflows that can be accessed and help manage the path dependency when they need to."

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