



Having enough cash to pay the bills is a common concern for many; pension schemes are no exception.

“Within 10-15 years, according to various pension consultants’ surveys, nearly 90 per cent of defined benefit (DB) pension funds are expected to be cashflow negative, meaning they do not have enough income to pay their outflows such as members’ benefits and expenses,” Janus Henderson Investors head of institutional client strategy, EMEA, Norbert Fullerton, says.

This is crucial, he explains, because having a deficit and a cashflow shortfall of 5 per cent of assets or more changes the dynamics of a DB pension fund’s risk profile and requires an adjustment to the investment strategy.

That is why for years now, attention has turned to cashflow-driven investment strategies (CDI).

Traditional CDI

There is no set definition of CDI, but broadly speaking, it is about receiving sufficient, predictable cashflow, through investments, to pay the scheme’s pension payment liabilities. This negates the need to sell assets, possibly at distressed prices, to generate the cashflow required.

These CDI portfolios typically rely heavily on assets such as high quality, government and investment-grade public debt.

Different views and beliefs have also dictated the nature and extent to which a scheme will use CDI, Aon consultant, Louis-Paul Hill, explains. “CDI has been most popular with well-funded and mature schemes where there is certainty over the liability profile and limited

Summary

- Traditional CDI strategies aim to ensure sufficient cashflow for a scheme’s payments, typically by investing in high-quality debt instruments.
- A criticism of traditional CDI is that its approach is too rigid to factor in changes in cashflow requirements, and restricts the type of investments available.
- CDI-lite is more flexible than traditional CDI with the type of investments available, and broader in its cashflow-matching aims.
- CDI-lite broadens the number of schemes that can implement a CDI strategy, and many schemes may already be adopting a similar investment approach.

A lite touch

▶ Laura Blows explores how cashflow-driven investment (CDI) strategies have spawned a more ‘CDI-lite’, flexible approach

deferred or active members who can use pensions freedoms to change the liability profile.”

It is also proving popular with those pension schemes looking towards an ‘endgame’, which is generally self-sufficiency or buy-in/buyout.

However, BMO Global Asset Management director, investment solutions, Simon Bentley, is sceptical of CDI portfolios being suited for those targeting buy-in/buyout. This is because, at the point of buy-in/buyout, the credit assets will need to be sold and transferred to the insurer. Long-dated credit is typically less liquid and more expensive to trade than shorter-dated credit, in addition to the greater mark to market volatility giving rise to greater market timing risk.

In contrast, Aberdeen Standard Investments, pensions senior solutions director, Keith McNally, states that a CDI approach can help provide a proxy hedge against the price of buyout, as CDI strategies are akin to how an insurer invests.

Once up and running, the limited changes required makes CDI a low-governance solution to schemes aiming for their endgame – whatever that may be. Trustees do not need to be so concerned about short-term market volatility, due to

most CDI strategies holding investment grade ‘buy-and-maintain’ corporate bonds, including ‘hybrid’ assets that have both return seeking and liability hedging characteristics.

It also provides a number of other benefits for DB schemes, including reducing cashflow re-investment risk, as once cash is received, it is immediately paid out. It can also reduce funding level volatility with its improved match to liability movements.

While the key benefit of CDI is the predictability of cashflow it can provide, it can also generate problems.

For instance, sourcing inflation-linked assets can be difficult, particularly for the long term, such as obtaining corporate bonds with maturities over 20 years.

Axa Investment Managers head of portfolio solutions, fixed income, Sebastien Proffit, says that due to the number of assumptions within liability analysis, there is no certainty of future cashflows. Also, spurious accuracy when it comes to a cashflow strategy could lead to portfolio inefficiencies, potential concentration risks and additional costs.

This limitation seems the most significant.

“One of the main limitations/criticisms of CDI strategies is that, although it provides liquidity for expected

future cashflows, it does not necessarily provide liquidity to meet unexpected cashflow requirements such as transfer values. This is particularly apparent for CDI strategies with significant allocations to illiquid assets such as private credit, eg if a scheme looks for liquidity to buy out benefits with an insurance company quicker than anticipated,” McNally says.

Insight Investment deputy head of solution design, Paul Richmond, notes that some say the fact that scheme cashflow requirements are subject to change is a limitation of CDI.

“This would be true if CDI is defined as investing in a portfolio that generates cashflows that precisely match of projected cashflow obligations of a scheme,” he explains. “However, if CDI is about maximising certainty of achieving funding outcomes in a cashflow-related fashion, then precise cashflow-matching in this fashion is not a requirement.

“CDI is about ensuring – regardless of changes in a scheme’s specific cashflow obligations – a high certainty of getting to its desired funding position. This can be achieved without precise cashflow matching, using credit assets placed alongside a well-constructed LDI programme.

“A key limitation of current approaches to CDI, therefore, is that they are not constructed and monitored relative to scheme-specific funding objectives and, in turn, their cashflow challenges.”

CDI-lite

This is where ‘CDI-lite’ comes in.

Mercer partner, Wayne Fitzgibbon, puts it succinctly: “CDI-lite, or flexible CDI, simply aims to generate a level of cashflow that substantially covers pension payments in the broad sense.”

As Bentley notes, the market is waking up to the fact that pure CDI is no more than a technical theory and that the theory needs to be softened slightly to work in practice.

“It is impossible to match a scheme’s

cashflows precisely using credit as you are limited by bond availability and changing scheme cashflows. As a result, it is pointless striving for a spurious level of accuracy and a less rigid approach is typically adopted,” he explains.

“For example, cashflows might be matched in annual buckets rather than month by month and you probably wouldn’t try to match cashflows beyond 30 years. You can take this a step further and not seek to ‘match’ cashflows at all but ‘generate’ cashflows with a sufficient run-rate to meet outgoings. This is often described as CDI-lite.”

The main difference between ‘traditional CDI’ and ‘CDI-lite’ are in the types of assets held.

According to Bentley, a traditional CDI portfolio will hold long-dated credit on a buy and maintain basis. “This requires the portfolio to be very high quality and limits the scope for excess return. The credit will provide a meaningful amount of interest rate hedging and so the LDI component of this portfolio is modest,” he says.

In contrast, CDI-lite focuses on shorter-dated credit. “The shorter-dated maturity profile and modest turnover mean that the manager can move down the credit quality spectrum slightly to target a higher return. The short-dated credit will contribute very little in the way of liability hedging and so the LDI positions will be more meaningful in a CDI-lite portfolio,” Bentley adds.

The benefit of this is the greater flexibility and opportunity it provides, along with better overall diversification and portfolio efficiency, compared to the constraints of investing only in pure CDI investments, Hill states.

This flexibility also allows a scheme to respond to changes in market conditions – both positive and negative – as well as its own circumstances. It can also provide some scope for responding to changes in cashflow obligations,” Richmond adds.

However, given the imprecise nature of CDI-lite, there are risks that

income could be higher or lower than requirements, Fullerton warns. “In such cases, assets will either need to be sold to cover shortfalls or reinvested at future unknown interest rates. These cases will be exacerbated during times of market stress or if a pension fund sponsor covenant is weakened.”

Take up

Despite this, CDI, in all its forms, is growing in popularity.

The wider range of assets with CDI-lite increases the number of schemes that can use a cashflow-driven approach that otherwise would not be able to due to current funding positions, Hill states.

Sometimes, schemes do not realise they are even implementing CDI-lite. Fitzgibbon says that as schemes have de-risked and reduced equity holdings, they have bought a range of assets where the return comes predominantly from contractual cashflows, such as traditional corporate debt, private debt, infrastructure debt and equity, and even insurance-linked securities.

Bentley agrees that CDI-lite “is a natural evolution of the way many schemes manage their excess LDI collateral, as the credit held within a short duration collateral pool is largely the same as that held in a CDI-lite portfolio”.

“However, traditional CDI is an easy to understand concept and one that is more familiar to most trustees. Therefore, some additional work is required by some trustee groups to fully understand how CDI-lite could fit within their investment strategy,” he warns.

The degree to which a scheme may seek precision in their cashflow payments will vary. Therefore, as M&G Investments director of fixed income, John Atkin, says: “Cashflow-aware investing should be viewed as a spectrum, along which most schemes will sit, rather than a binary choice between ‘full CDI’ and ‘CDI-lite.’”

 Written by Laura Blows

As financial analysts and pension scheme trustees have watched the coronavirus pandemic take a wrecking ball to the value of their investments, the common comparison has been with the financial crash of 2008. We've seen the 'worst quarter since the financial crash', the 'biggest one-day falls on markets since the crash' and many other similar headlines.

But beyond returns, the current situation is very different from 2008. It is not just affecting markets but decimating entire industry sectors (at least in the short term), as well as potentially remodelling day-to-day education, work and social culture. And, it has put public-sector workers under pressure like never before.

That, in turn, has affected the Local Government Pension Schemes (LGPS) in many different ways, from the inevitable impact on the value of schemes' assets, through to how it handles the effect of frontline staff, such as social workers, coming back out of retirement.

Investment

The investment headline remains the same, that recent falls in stock markets have seen LGPS schemes' equity holdings plummet in value, just as they have for other types of pension funds. But as open, cashflow-positive schemes, the LGPS has the benefit of being able to take a long-term view.

"The LGPS schemes' timespans are 40 to 50 years, so they are in a good position to ride out a market fall of this type," says Hymans Robertson head of LGPS, Catherine McFadyen. She adds that the investment approach of individual schemes will have made a difference, "and it will be interesting when we have analysed fund returns at end of March to see how much difference diversification strategies and hedging will have made to schemes."

"The extent to which each scheme is



Summary

- LGPS schemes' investment values have been hit by coronavirus, but diversification has lessened the blow.
- In the short to medium term, LGPS cashflows should hold up, but employers' ability to make contributions may be an issue.
- LGPS processes can easily handle the return to work of retired staff such as social workers.


Weathering the storm

➤ **The LGPS, being open, cashflow positive and with a long-term investment horizon, should be in a better position than many schemes to overcome the Covid-19 difficulties, Maggie Williams finds**

affected will depend on their exposure to global equity markets, as well as the level of diversification and the liability risk management they have employed," says Redington senior vice president global assets, Tara Gillespie. "Assuming an allocation of 50 per cent equities, diversified with bonds, liquid alternatives and private assets, the assets could have suffered a 15 to 20 per cent fall since the start of the year, versus the equity market which is down 20 to 25 per cent."

"Investment diversification will definitely have helped," adds Aon partner, Colin Cartwright. "Equity exposure in LGPS funds has come down from around 80 per cent to 40 or 50 per cent in some cases. And while other assets may not have gone up in value, they may not have fallen as much as equities. However, as a global investor, LGPS schemes will be affected by the worldwide nature of the crisis."

"I don't think the current situation



will change the journey towards diversification,” he adds, “but it will remind everyone why we are on it.”

Pensions and Lifetime Savings Association (PLSA), policy lead for DB and LGPS, Tiffany Tsang, says that the robustness of the investment approach is in part testament to the hard work the LGPS has put into its structures and sharing risk through pooling. “When that was set up, no-one dreamed of something this awful, but it has shown the strategy is effective.”

Cartwright adds that the crisis will inevitably also create some buying opportunities that, given their long-term investment horizons, LGPS schemes will

be able to take advantage of. “All assets were expensive prior to the crisis, and some will now become cheaper,” he says. “Although schemes will be looking at rebalancing funds in the short term, there will also be a focus on buying opportunities.”

Cashflow

Tsang says that in general LGPS members are not concerned about cashflow at present. “There is sufficient cash reserve to pay what has been promised to pension members for at least the next six months to a year, although it varies from fund to fund.”

However, she cautions that beyond that time point, when the full impact of coronavirus should be clearer, “we may start to hear more from employers about whether they are in a position to meet their contribution rates. They may either be asking for an extension or saying they can’t make the payments.”

“There will be some employers in the schemes, such as charities and leisure centres, who will have been hit hard by the current situation and may struggle to make contribution payments as usual,” agrees McFadyen. “Although they are a

relatively small proportion of the LGPS funds, the schemes may need to work out how to support them and their members.”

“The LGPS has been set up to mitigate worst-case scenarios and risk is evenly spread,” adds Tsang. “If the worst happens and an employer can’t make contributions, the first step would be to liaise with the employer and decide whether they want to exit the scheme or delay contributions. Members have nothing to worry about as benefits are guaranteed in legislation, so if in, say, 18 months cashflows are buckling, there is a government underpin.” She adds: “Hopefully we are a long way from that scenario but there may need to be questions asked about how to deal with a situation where a lot of employers are doubting whether they can make the contribution rates.”

The wider picture

But, the long-term effect of coronavirus on LGPS schemes could be subject to far greater forces. The UK will shoulder a huge amount of government debt to meet the cost of the current job retention scheme (covering 80 per cent of the salary of some UK employees), as well as commitments to pay self-employed workers, for example. And, while there will be some industry sectors that will benefit from the pandemic, it is still too early to understand longer-term shifts in consumer behaviour and whether it will drive permanent changes in economic outlook.

Other difficult topics may inevitably have to be addressed. “It is probably too early to say if there will be an effect on life expectancy within the funds,” says McFadyen. “We still haven’t seen the full effect of fatalities and whether coronavirus will have a longer-term impact on mortality analysis.”

Another issue for local authorities to consider has been how to manage the pensions of employees such as social workers who are returning

from retirement to work through the pandemic.

Under usual circumstances, employees returning from retirement would be required to abate their LGPS pension. However, with services struggling to cope and a pressing need to encourage experienced staff back into front line roles wherever possible, LGPS Scheme Advisory Board chair, Roger Phillips, wrote to administering authorities on 19 March calling on them not to apply abatement rules in the current circumstances. “Each authority will have its own approach to abatement, but this letter asks that if there is an abatement policy, it should be suspended,” says Tsang. “If we need more workers in some roles to ease the current situation, then anything that can be done to incentivise that is a good thing.”

McFadyen adds that removing the abatement process could, in fact, simplify administration for schemes. “Schemes will simply be paying out the pensions they expected to anyway – so if anything, it’s less administration work.” She also believes that as there are no changes to future assumptions as a result of removing abatement, there should be no major cost impact to the scheme either.

As the pandemic crisis continues to unfold and the full economic effects become known, the wider implications for the LGPS will become clearer. Heavy government borrowing, a potentially changed economic landscape and an uncertain outlook for markets will all inevitably have an impact. Gillespie concludes that “as open schemes, LGPS have a long time over which to recover losses and manage the funding level back up”. However, she adds, “it is in triennial valuations that funding impacts can result in higher contributions from the underlying employers. With the next valuation date in March 2022, we would hope to see a recovery before then”.

 **Written by Maggie Williams, a freelance journalist**