Raising cashflow awareness

Graham Moles explores methods of effective cashflow management for DB pension schemes

As defined benefit (DB) pension schemes mature and become cashflow negative, schemes may be better off focusing on being cashflow aware than being cashflow matched.

What is causing the cashflow issue?
DB pension schemes are maturing. According to Mercer[1], over half of UK DB pension schemes are cashflow negative or soon will be, with 85 per cent of cashflow positive schemes expected to turn cashflow negative within 10 years.

At the same time, there are other pressures that mean precisely matching all benefits is not necessarily possible or ideal. These include underfunding, longevity risk and sponsor/covenant risk.

What can schemes do to manage their cashflows better?
The most important aspect of managing cashflows is getting the broad asset allocation right – trustees should not lose sight of the big picture. We recommend examining the long-term distribution of outcomes the scheme might face using a model that takes into account the scheme's circumstances, including how cashflow negative the scheme is. Success is either paying all pensions as they fall due or paying as high a percentage of those pensions as possible.

Trustees can choose the investment strategy with the most attractive profile of future outcomes and decide how much to allocate across broad asset classes. However this is not the whole story – assets should also be structured in a cashflow aware way, subject to this broad split.

We suggest the following additional steps:

1) Prepare for expected cashflows
a) Target cashflows in the short to medium term
We recommend structuring assets so that a high proportion of cashflows are met by natural cashflow generation from assets for approximately the first 10 years.

b) Turn on the taps – use all natural cashflows
Bonds and some real assets generate contractual cashflows. These can help reduce scheme risk even if the cashflow match is imperfect. Although they are not contractual, dividends from equities can also be aligned with pension payments.

c) Use an appropriate growth strategy to meet long-term cashflows
There is a variety of different approaches available to trustees targeting a more cashflow aware growth strategy. These include income-generating multi-asset funds and equity strategies that focus on selecting companies with sustainable dividends that grow with inflation.

2) Prepare for unexpected cashflows
a) Pre-emptively increase liquidity
There are various potential ways of increasing liquidity in a pension scheme without compromising its risk-return profile:

- Increase flexibility and efficiency of leverage: LDI offers leveraged exposure to rates/inflation and therefore frees up cash
- Consider tailoring growth asset exposure: adopt a cashflow aware strategy and avoid excessive allocations to illiquid assets
- Consider using uncorrelated funds or market neutral funds with a low expected maximum drawdown as a safety net

b) If asset sales are needed, allow for costs and any active views
Most schemes currently use up cash and then increase leverage in their LDI portfolio to meet unexpected cashflows. If this is not sufficient or leverage levels are already high, they may also make use of cashflows available from growth strategies.

Once these avenues are exhausted, it is likely that the scheme may need to sell assets, possibly in stressed conditions. Schemes should sell assets that move the scheme towards the most attractive asset allocation today (allowing for any carefully researched active views) but bearing in mind transaction costs.

3) Be proportionate
A simple plan or priority order may sometimes be appropriate, especially if schemes have a limited governance budget. For example, some trustees might consider selling relatively liquid growth assets first, followed by LDI and leaving the sale of illiquid assets as a last resort. Others might prefer to reduce their hedge ratio before selling growth assets.

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[1] Mercer European Asset Allocation Survey 2017

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