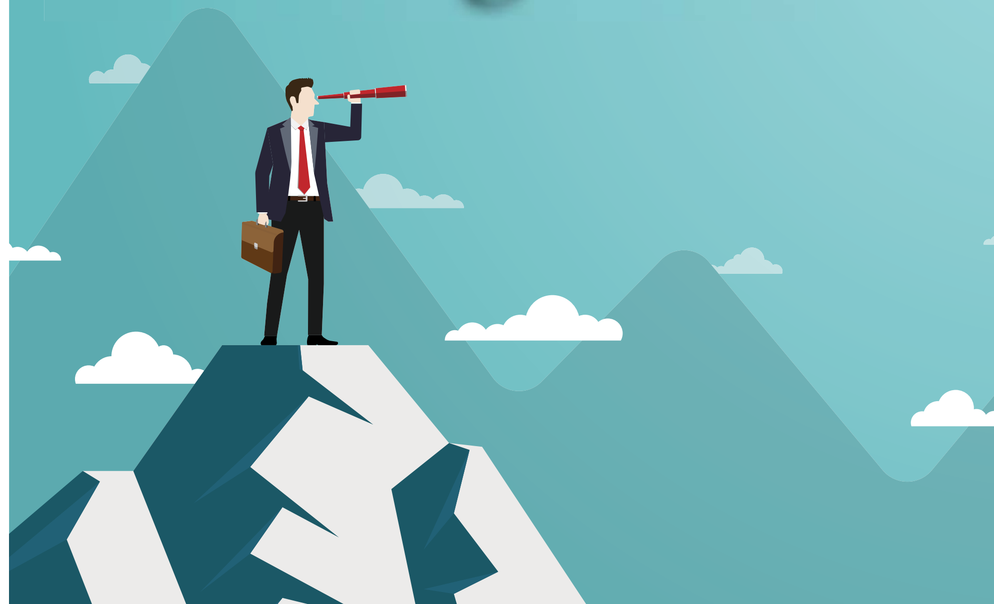
Summary
- Low interest rates and negative cashflows continue to make long-income products popular propositions.
- Their popularity has meant that some markets such as real estate can be constrained and a global reach is needed.
- The illiquidity can pose a problem for any potential buyout so investors need to do careful analysis and understand their options.

The long view



Lynn Strongin Dodds considers how low interest rates and negative cashflows make long-income products appealing to pension funds

Although the UK has entered into a new decade, its defined benefit (DB) pension fund community is still grappling with the same old issues of depressed interest rates, spluttering growth and geopolitical tensions. Their cashflow-negative positions are only set to worsen over the next 10 years, which is why long-income products, such as real assets and credit, are expected to remain key features in their asset allocation.

A study last year by Mercer highlighted the direction of travel. It found that 72 per cent of UK DB schemes were in the cashflow red, up from 66 per cent in 2018. In other words, three out of four DB schemes were distributing benefits annually that were higher than the amount of new contributions received. This is mainly due to the maturing of these schemes, which are now being closed both to new members and accruals, according to the report.

It also showed that for 91 per cent of respondents, divesting assets remained the most common method to meet cashflow requirements, although 2019 saw an uptick in alternative ways to meet liabilities. For example, nearly 50 per cent turned to fund managers to dispense income from investments, compared to 43 per cent who employed this tactic the previous year.

In the past, index-linked gilts would have been the preferred hunting ground but not only are they too expensive, but the returns are meagre and the yields have been significantly compressed over the past seven years. One of the problems, according to Columbia Threadneedle global head of asset allocation, Toby Nangle, is that there is no longer enough duration in the gilt market to satisfy pension funds' requirements. Aggregate UK DB plan liabilities, valued on a section 179 basis, top £1.8 trillion and have an effective duration of 19 years, he says.

"The entire conventional gilt and sterling non-gilt market put together offer less than three-quarters of the duration needed to match these liabilities, and that's before we exclude the £445 billion of duration-bearing assets that the Bank of England has taken out of the system in its programme of quantitative easing," Nangle adds.

The confluence of factors has meant that UK pension funds need "cashflow to pay the benefits, especially in a low interest rate environment", says J.P. Morgan Asset Management head of pensions solutions and advisory, EMEA, Sorca Kelly-Scholte. "This is why we are seeing an increased demand in real assets such as real estate. For example, high-quality, core properties with 10-year leases have high-quality cashflows that have been stabilised for decades."

The attraction for long-income properties was reflected in a recent survey by Alpha Real Capital. It found 84 per cent of professional investors canvassed believe pension funds will increase their investment, with 20 per cent expecting a dramatic hike to

combat low bond yields and an uncertain macroeconomic backdrop. Moreover, eight in 10 investors gave income security and inflation protection top marks while 68 per cent cited its attractive risk-adjusted returns.

Feeling the squeeze

However, the growing popularity of these products has also created concerns over capacity, which is why selectivity has become increasingly important. "Where there is a lot of demand in the market, returns can be competed away," says M&G Investment director of institutional distribution, Annabel Gillard. "We do not look at sectors as such but the specifics of a deal from a credit quality and bottom-up focus. We have tended to go for less frequent and lumpier deals such as the American Anglo deal (to redevelop its London headquarters), which will complete this year, and the hotel development with Whitbread."

A global reach has also become significant in the long income space. "Instead of moving down the size scale and increasing allocations, we think a more robust response is to diversify globally," says Kelly Scholte. "We like high-quality, core assets that have a greater degree of resilience, such as downtown office buildings that have stable tenets and low vacancy rates. We are also looking at OECD-grade infrastructure, as well as global transportation, such as shipping and airplanes."

Renewables are also of particular interest on the infrastructure front. "Increasingly we are looking abroad because the UK PFI (private finance initiative) model has been exported to other countries, as has the stable income-generating business model for renewables," says Newton Investment Management fund manager, Paul Flood. "We like operational wind and solar farms, for example, because generally speaking they have government subsidies, power purchasing agreements with a utility and stable revenue streams. They are well suited for pension funds who need long, steady income and there is a wide global opportunity set."

As for credit, given the relatively minnow size of the sterling market, Insight Investment head of investment specialists, April LaRusse, believes that pension funds have no choice but to cast their nets wider to look at the more opportune euro and dollar markets. "For example, the long end of the US market has considerably more bonds available than the UK, as well as better liquidity and spreads, so if you need to sell a bond you can," she adds. "There is an added layer of complexity with the currency hedging but it is not a problem and easily doable."

Some fund managers are also exploring the world of private debt, particularly as the banks continue to withdraw due to the more stringent regulatory capital requirements. The income and returns may be appealing but these investments can also be more resource intensive. "When dealing with private asset markets there is a huge opportunity but obviously these deals are harder to access as you need the scale and relationships with companies," says Invesco head of EMEA client solutions, Mark Humphreys. "Although you need to be selective, it is worth the work because senior-secured loans, for example, offer much higher yields than investment-grade credit. The size of the private debt market has also grown dramatically to around $800 billion in 2019, four times what it was in 2008."

The illiquidity barrier to buyout?

Despite the breadth and depth, pension funds are advised to understand the role these illiquid assets play, especially in regard to the impact they could have on buyout outcomes. As AXA Investment Managers head of client group UK, John Stainsby, puts it, maturing pension schemes should have some form of balancing act between designing a portfolio to generate long-term cashflows, while remaining attractive to potential buyout partners. "In truth, it makes sense for schemes to keep their options open," he says.

Stainsby notes that there are typically a number of interim steps that most schemes can consider today on the journey to achieving an attractive buyout deal. "Coupled with the fact that the amount of capital available for buyout across the market is relatively limited, we would urge schemes not to ultimately just bet on a buyout in the endgame and design a portfolio with this goal in mind," he adds. "They should also ensure that they can consider other options such as self-sufficiency, at least for the next five to 10 years."

Mercer principal, Matt Scott, also believes that illiquid assets are not an insurmountable obstacle to buyout in and of themselves. For example, he notes that a trustee may agree with an insurer to transact 95 per cent of the premium on one date, and a 5 per cent portion corresponding to illiquid assets within say the next year. In addition, a long-income asset may be something that an insurer would be happy to have passed over, as it is the type of investment some insurers already have.

As with any investment decision though, careful analysis should be part of the equation. "For schemes with illiquid assets who are considering buyout, they should consider their plans for their illiquid assets in advance of going to market, and engage early with insurers to understand options for accommodating the illiquid assets in a transaction," he says. "The advice on illiquid assets has always been to make sure you are in it for the long term and the current focus on endgame has brought this into sharp relief."

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