

Turning to CDI

✓ **Jon Exley and Patrick O’Sullivan explore the benefits of a CDI approach and the role it can play within a LDI strategy**

Why should pension schemes consider a CDI approach?

All defined benefit pension schemes fundamentally need to meet their liabilities as they fall due. Ideally they would do this by investing in a ‘cashflow matching’ gilt portfolio so all future liability cashflows would be met with the income and redemption proceeds from government bonds.

However, few schemes are currently in a sufficiently well-funded position to implement such a strategy. Historically, most have instead by necessity constructed their investment portfolios using higher-risk assets such as equities to close their funding gap. In doing so they are effectively relying on a combination of dividend income and equity sales at unpredictable prices to deliver some of the cashflows needed to meet future liabilities.

A cashflow-driven investment (CDI) approach can however provide an alternative solution with more certainty of outcome than a traditional growth and matching approach. It does this allocating to assets that provide a greater certainty of delivering the required cashflows without any required future disinvestment in unknown future market conditions.

Take a pension scheme that is 90 per cent funded on a gilts valuation basis and is invested in only equities and gilts. To move to a CDI strategy, we would replace the equity allocation with a different (typically higher) allocation to non-gilt fixed income assets held on a ‘buy and maintain’ basis. This is illustrated below in Figure 1 with asset cashflows separated between gilts and these non-gilts.

Importantly, the non-gilt portfolio does not in isolation need to match the liability cashflows exactly – the gilt portfolio fills gaps and mops up excess cash inflows through reinvestment. Furthermore, the liabilities may be inflation linked which is not typically addressed by the non-gilt fixed income portfolio. Instead, the non-gilt portfolio is designed to meet the client preferences in terms of investment risk profile and deliver the overall quantity of cash (after an appropriate allowance for default risk) required without worrying about precise timing or inflation linkage.

Incorporating LDI into a CDI strategy

CDI therefore works best when the non-gilt portfolio is fully integrated with a gilt portfolio managed using an LDI approach:

- The gilts in the LDI portfolio will be used to match the longest-dated pension

liabilities, as the non-gilt fixed income assets will typically mature before these liabilities fall due

- Index-linked gilt exposures in the LDI portfolio can also be used to match the inflation exposures noted above

- The non-gilt portfolio will not deliver the exact cash required to pay pensions and lump sums every month. Instead, the LDI portfolio will act as a liquidity “reservoir” – or bank account – to absorb excess asset cashflows in some months and from which to drawdown in other months.

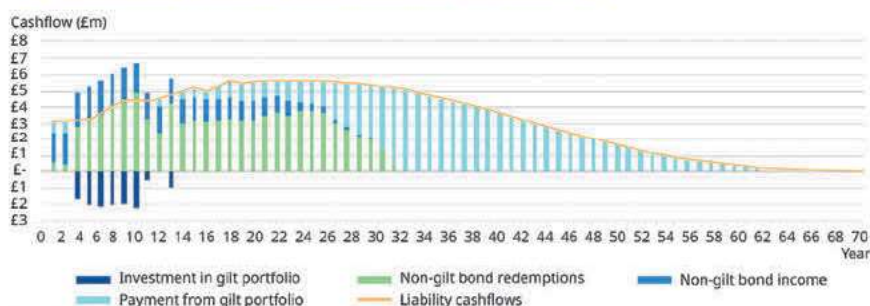
- The LDI portfolio may also provide sophisticated currency hedging if non-UK bonds are held as part of the overall strategy

The design of a CDI solution

To recap, CDI is about increasing the certainty of meeting liabilities. In practice, this means investing in fixed income assets that have predictable and well-defined returns. In order to have these predictable returns, CDI solutions invest in non-gilt fixed income assets managed on a ‘buy and maintain’ basis. Importantly though, the overall CDI solution must deliver enough credit return, or spread, above gilts from these assets to allow a scheme to close any funding deficit. Figure 2 illustrates this for a pension scheme that is 90 per cent funded on a gilts-flat basis. The navy bars of Figure 2 represent the cashflows we can fund through gilts while the green bars show the deficit cashflows that could not be delivered through investment in gilts alone but are met by the extra spread earned on the non-gilt allocation.

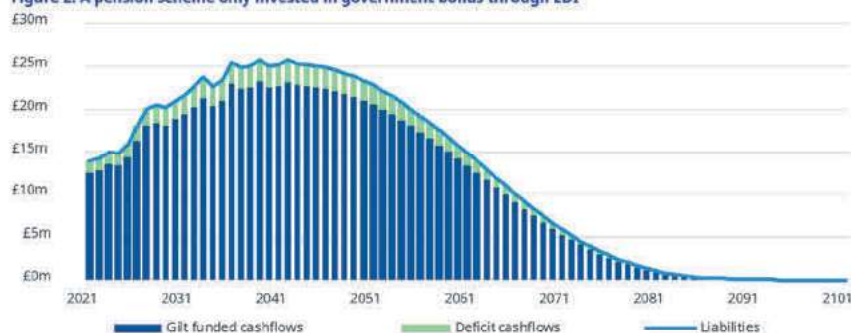
Thanks to this additional spread, investing in these non-gilt fixed income assets on a ‘buy and maintain’ basis therefore effectively means we can deliver future cashflows at a lower cost than through gilts in return for accepting the associated credit risk. The reduction in this cost of delivering cashflows depends on the spread generated by the asset

Figure 1: Asset and liability cashflows for scheme invested in corporate bonds and gilts



Source: Schroders. For illustrative purposes only.

Figure 2: A pension scheme only invested in government bonds through LDI



Source: Schroders. For illustrative purposes only.

Figure 3: Examples of assets available for building CDI solutions



Source: Schroders. For illustrative purposes only.

multiplied by the duration of the fixed income assets. We tend to see a separation between higher spread, shorter duration credit strategies with lower credit quality and lower spread versus longer duration credit strategies with higher credit quality in CDI solutions, as illustrated in Figure 3. A CDI investor's long-term objectives will shape the credit strategies included in the CDI solution. Long term self-sufficiency objectives may lead to a solution using higher quality, longer duration bonds with lower annual spread. On the other hand, if buyout is a near-term objective, the solution may favour lower quality, shorter duration bonds with

higher spread in order to close any deficit earlier.

Who should use CDI?

As discussed above, a scheme can fully implement a CDI solution if the scheme's deficits can be met entirely through hold-to-maturity credit investments. Schemes that are not sufficiently well funded to implement a full CDI solution can introduce a partial CDI solution by building an allocation to hold-to-term credit in their portfolio and integrating it with their LDI strategy. Schemes looking to adopt such an approach might, for example, aim to maximise the proportion

of future expected return being delivered with certainty from hold-to-term credit. In this wider context, the principles of CDI can be relevant to most pension schemes and will probably become increasingly so over time.

Whether and precisely how a scheme implements a CDI solution will depend on market conditions when the solution is evaluated. This will vary through time due to market spreads and asset availability.

Conclusion

A successful CDI strategy can offer pension schemes higher certainty of meeting the liabilities than a typical 'growth plus matching' strategy. This is achieved by constructing a portfolio of bonds that, if held to maturity, will secure sufficient funds to meet the liability cashflows without any reinvestment or disinvestment risk. CDI is usually most suitable for mature, well-funded pension schemes but it can also be applied either wholly or partly to other types of scheme depending on the circumstances.

CDI is not an alternative to LDI and, indeed, LDI should be integrated into CDI for a complete solution.



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