Summary
• CDI strategies help funds to generate stable and predictable income streams to meet pension payments and increase the likelihood that the required return from assets is achieved.
• Many such strategies are being achieved using higher quality, liquid fixed-income assets, alongside hedging, to manage interest rate and inflation exposure, without the need to take as much investment or liquidity risk.
• As long as credit spreads remain high, some observers suggest it is likely the trend toward simpler, lower-risk CDI portfolios will continue in the future.

Building stable income streams

Abigail Williams explores how cashflow-driven investment strategies are used in pension portfolios and how this may be evolving

Cashflow-driven investment (CDI) strategies are a consistently attractive way for pension funds to build portfolios of assets that generate predictable cashflows and increase the likelihood that schemes can meet cashflow requirements and funding objectives. So, what are the key considerations for pension fund managers in devising CDI strategies? What have been the key recent developments in CDI at UK pension schemes? And how might such strategies evolve in the coming years?

Factors to consider

A CDI strategy invests in assets that generate regular income that broadly match the predicted benefit payments being paid out of a pension scheme. As Barnett Waddingham head of LDI research, Danielle Markham, explains, this is typically achieved by investing in high-quality fixed income-type assets that provide contractual income. Hedging the interest rate and inflation exposure also helps to "stabilise the funding position of the scheme".

"There are many factors to consider when devising CDI strategies. To begin, decision-makers will want to consider the yield available and ensure that this will be sufficient to fund the scheme's benefits over time. This needs to be accessed through the right fixed income assets, allowing for limitations around the assets available and what they are reasonably able to match," she says.

Elsewhere, Schroders Solutions head of CDI, Michael Burdett, says that a CDI strategy is an investment approach which tends to focus on investing in assets that deliver contractual cashflows – including gilts, investment grade corporate bonds, infrastructure debt and private lending. Through this approach, a pension scheme can "generate stable and predictable income streams to meet pension payments and increase the likelihood that the required return from the fund's assets is achieved".

"Depending on a pension fund's return requirements, CDI strategies can be combined with traditional growth assets to target higher investment returns, albeit with some potential increase in volatility," he says.

Burdett notes there are a range of factors for scheme managers to consider before devising a CDI strategy, including how well-funded the pension fund is, as well as trustees' and sponsors' funding objectives, including potential timeframe to a buyout, and the target return for the fund's assets. Other factors range from whether the return "can be achieved through CDI alone, or in combination with traditional growth assets", to the projected cashflow and liquidity requirements – as well as ESG objectives.

Management framework

With higher spreads available on high-quality liquid assets like buy-and-maintain credit, Markham notes that investors now have "less need to hunt for yield from less liquid assets or lower-quality credit, which carries more risk". As a result, she says that CDI strategies are being achieved using higher quality, liquid fixed-income assets, alongside hedging, to manage interest rate and inflation exposure, without the need to take as much investment or liquidity risk: "Whilst it's important to have robust tools to model CDI portfolios, it's advisable to avoid any spurious accuracy when implementing CDI. This is even more true in the current environment. It is important to get the right governance set-up, including appointing an investment

manager with experience in managing the liability-related risks for schemes.

"In the current environment of volatile yields and inflation, the need for flexibility in re-balancing and meeting collateral calls has proven to be essential and, where leverage is needed, CDI strategies should include a robust collateral management framework."

Recent developments

According to Hymans Robertson chief investment officer, David Walker, recent developments in CDI strategies include a shift in the relative value offered by higher quality and lower quality, often less liquid, assets: "With investment-grade bonds offering reasonable spreads over gilts, there are opportunities for CDI portfolios to rebalance into higher-quality credit and increase the predictability of the cashflows on their underlying assets."

Walker advises scheme managers to "consider how longer-term cashflows can be matched and how inflation risk can best be managed, given many traditional CDI asset classes are relatively short-term and do not provide inflation linkage".

"Whilst this could be addressed by holding long-term, real assets, this introduces long-term illiquidity and reduces flexibility. This is particularly important for schemes that intend to buyout in future. It is likely that asset reinvestment will be required at some point in a CDI strategy, and so appropriate thought should be given to manage this risk," he says.

Meanwhile, Burdett observes that CDI is becoming more widely adopted as pension funds get closer to achieving their funding objectives, a situation "hastened by rising government bond yields and improving funding positions". This has led to a broadening of the asset classes used within CDI strategies, in particular the use of a range of private assets alongside gilts and high-quality corporate bonds, often held to maturity.

"Volatility in gilt yields in late 2022 demonstrated the importance of sound liquidity and collateral management and there have been a number of innovations in this area, including methods to generate temporary liquidity, such as corporate bond 'repo' arrangements and a trend to integrate LDI and credit assets with a sole investment manager," he says.

Consolidating improvements

Looking ahead, Markham believes it is likely that CDI strategies will become ever more popular as schemes "mature and look to achieve a strategy that ensures member benefits can be paid through reliable income, whilst maintaining a stable funding position".

Since many schemes have found themselves much better funded as a result of rising yields, she also points out that moving to a relatively low-risk CDI strategy will help to consolidate this improvement. Whilst buyout with an insurer may remain the 'ultimate goal' for many, Markham observes that CDI can achieve many of a scheme's objectives in the meantime, especially in the environment of higher credit spreads.

"Schemes are becoming increasingly cashflow negative, so schemes will be constructing more refined CDI portfolios with more awareness of which cashflows they are matching. As long as credit spreads remain high, it's likely the trend toward simpler, lower-risk CDI portfolios will also continue," she says.

Just as cashflow-generating assets are becoming an integral part of portfolios, Markham notes that managing ESG risk is "now an integral part of investing in fixed income" and, in the absence of voting rights, engagement is the "most important tool for stewardship".

"Compared with equities, fixed income investors have more issues to consider, such as issuer types, capital structures and maturities. Despite the challenges, managers' approaches to ESG within CDI strategies have evolved over the last few years. This is a trend we see continuing and is an important factor to consider," she says.

Cost-effective outcomes

Moving forward, Walker predicts that the evolution of CDI strategies will reflect trends in endgame planning across UK pension funds – which comes with greater certainty and predictability over pension fund liabilities and cashflows as funds continue to mature. In his view, this might make CDI more attractive for some pension managers, and lead to more funds adopting this strategy, "particularly if the yield on investment-grade assets provides a better point to lock into attractive yields".

"For others, the improvements in insurer pricing may mean that buyout is now a closer target, and so a CDI portfolio should evolve into a strategy that is more appealing as a match to an insurers' pricing," he says.

"This means even for those that want to follow a CDI approach now, having greater flexibility and reducing allocations to more illiquid cashflow-focused investments may become more commonplace, in order to give them more options on their endgame. Consideration will therefore need to be given as to how inflation risk is managed, as this role tends to fall partly on more illiquid assets," he adds.

Ultimately, Burdett expects that demand for CDI strategies will continue to rise, driven by "improved funding positions, regulatory requirements and a greater awareness of the benefits of this type of approach". As demand increases, and as fund managers scale up their propositions, he also expects to see "a further broadening of the asset classes employed and more customisation being offered to pension funds".

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