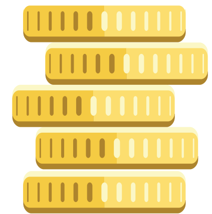
Summary
• The most desirable cashflow-driven investment strategy is one that is robust that can cover expected pension payments under a range of scenarios.
• There is a high margin of error in timing the start of a CDI plan.
• The hardest calculation of a CDI portfolio is choosing the target return above gilts.
• One recommended approach to CDI is the use of an LDI manager who applies an LDI plus credit approach.
• One of the most appealing aspects of CDI is that fees may be lower, because it can create a passive portfolio akin to credit instruments.

How robust is your CDI plan?



Key players in the cashflow-driven investment space have much advice for defined benefit schemes about to undertake this journey. All agree that such plans should be robust, but not all agree on the best path of travel. David Rowley finds out more

While you might have a 'smart, well-diversified' or perhaps a 'cautious' accumulation strategy, the most desirable cashflow-driven (CDI) strategy is one that is 'robust'. A word favoured by those who advise and implement these strategies, 'robust' refers to the likelihood of a schedule of cashflows from investments covering expected pension payments under a range of scenarios. These scenarios include asset price change, interest rate movements, mortality experience, cash transfer activity, sponsor risk and potential collateral calls on derivatives.

Robustness also refers to governance. All stakeholders should agree on what their beliefs and objectives are and the path the scheme should take.

Before the journey begins

While it may be a natural desire to seek a high level of precision in matching cashflows to pension payments, according to many in the industry, trustees should resist this, as no plan can ever be 100 per cent accurate. Hymans Robertson partner Emma Cameron says: "Trying to be unnecessarily precise in designing a CDI solution or spurious accuracy in a complex fully cashflow-driven solution (when the cashflows on which the solution is based are not certain), could be more costly and is likely to be at the expense of flexibility to capture the best market opportunities."

Cameron is also emphatic on the need to hedge the "vast majority" of interest rate positions. "That has been a very successful strategy for clients," she says. "The uncertainty [*of Brexit*] has increased so we continue to recommend very high hedges for clients."

Legal and General Investment Management head of portfolio solutions Graham Moles warns of the high margin of error in timing the start of a CDI plan. A key risk is the scheme's portfolio of credit assets incurring a high level of default without the growth assets to put such losses right. "Trustees can be lulled into thinking that cashflow matching is all, but some schemes can de-risk too soon, then you are guaranteeing failure," he says.

What assets to take on a CDI journey

Probably the hardest calculation to get right is in choosing the target return above gilts for a CDI portfolio. M&G head of fixed income John Atkin says this requires an analysis on the health of credit markets by trustees and then an agreement on the target return to be sought. "A key belief a scheme has to make is around its projections around the default risk of the assets it uses to pay pensions and the margin of safety that is there," he says.

One part of this risk-reward calculation will be the split of overseas fixed assets to domestic assets. Overseas assets can boost yield and spread risk, but will introduce currency hedging costs and increased complexity for those governing the plan.

There are differing opinions on this split.

Atkin says: "A swap on the currency is not cheap and it cuts what you can buy on a value basis. If you want to break that swap it is going to be expensive again."

He recommends a diverse portfolio of sterling assets with around 10 per cent in non-sterling assets. A counter view on UK credit is given by Aon Hewitt investment consultant Louis-Paul Hill, who thinks a greater emphasis should be given to overseas assets for diversification risk purposes. He points out that around only 5 per cent of global listed credit originates from the UK and that this segment of the global market is already in high demand. And he emphasises how concentrated the UK credit market is; a disproportionately large section is issued by financial services companies. There is also the issue of declining credit ratings. "What is worrying is the increasing amount of triple B available," says Hill. "In 2008 triple B made up 15 per cent

of the Merrill Lynch sterling investment grade index and now it is over 40 per cent of the index."

Three ways to travel

One recommended approach to CDI is the use of an LDI manager who employs an LDI plus credit.

Moles describes the role of a traditional LDI manager in running a CDI portfolio as one of a 'completion manager'. This is regardless of whether they are managing all the assets or only a portion. In this role their job is to look at the entire portfolio to ensure an even and optimal spread of risk and to best judge how much inflation and interest rate hedging is needed.

"Increasingly you are going to see more information shared with the completion manager to allow them to get to the overall goal," he says. This would mean the manager creating bespoke portfolios of assets to best complement existing mandates with other external managers to achieve good cashflow matching. It may also mean restricting external managers from buying certain types of assets or names to ensure the best spread of risk.

An alternate model is a team-based approach of investment consultants, actuaries, fund managers and trustees governing the process. In this model, a fixed income manager (or managers) is employed at the sharp end of the plan to create a portfolio that is solely designed to generate income to pay pensions. This is likely to entail a target rate of return over gilts.

There are a number of ways this could work. For funds that are not yet cashflow negative, the fixed income manager could help them transition their asset allocation to a cashflow-driven investment plan over a five-year horizon.

Or where a buyout is the chosen solution, the fixed income manager's job may be to create a liquid range of assets suitable for an insurer. On the flip side, the fixed income manager maybe helping a plan transition from an LDI approach run by an insurer.

Atkin describes how when his team has bought a target tranche of assets to match a cashflow payment profile, then the corresponding swaps positions are turned off. He adds that M&G have also been asked to strip the capital risk from a range of credit instruments and simply provide the known cashflows. For the future M&G is also working towards creating a pooled solution for smaller funds to access.

A third route is the use of an implemented consulting model. Here smaller schemes can benefit from access to pooled funds of assets shared with other smaller funds.

Hill says one of the advantages is gaining a better diversification of income producing assets across, investment grade, high yield and private credit. This has the potential to offer higher yields at a time of near historic lows in fixed income. The appeal of such a plan is that the governance aspect of it is shared too.

Fees

One of the most appealing aspects of CDI is that it can create something akin to a passive portfolio of credit instruments, so fund management fees should be lower.

M&G calculates that a buy and maintain portfolio can turn over 10-15 per cent per annum, whereas a fully active might have a security turnover of 40-50 per cent. Partly this is due to CDI portfolios not being measured to a benchmark, hence it does not need to rebalance as the benchmark changes.

Aon Hewitt is not convinced that such approach is optimal. Hill says: "Buy and hold is certainly cheaper than active grade, but you are missing out on potential performance."

Written by David Rowley, a freelance journalist