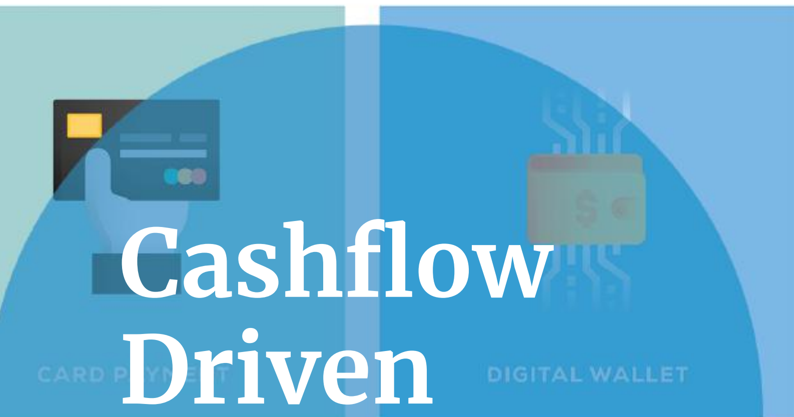

Cashflow Driven Investing Whitepaper

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Welcome to CAMRADATA's Cashflow Driven Investing Roundtable

Many defined benefit pension schemes have become cashflow negative in recent times – more money is being paid out than received.

According to Mercer's latest European asset allocation report, 66% of plans are now cashflow negative, while over half of those plans that are currently cashflow positive can expect to see the tides turn to negative within five years.

This imbalance is becoming an increasingly significant challenge for pension schemes to overcome, as trustees look to secure their financial future amidst unprecedented uncertainty.

Cashflow-driven investing (CDI) can potentially provide a remedy for the shortfall of income. The predominantly bond-focused approach can be used to try and generate cashflows in order to pay benefits, and increase the certainty of securing returns for pension schemes. CDI can also help reduce funding volatility, but the approach is not suitable for all types of schemes.

In an environment of low bond yields, the fixed income-focused strategy would not work for pension schemes that are still a long way off from reaching their funding objectives – it's better suited to those that have made decent headway in reducing their investment risks.

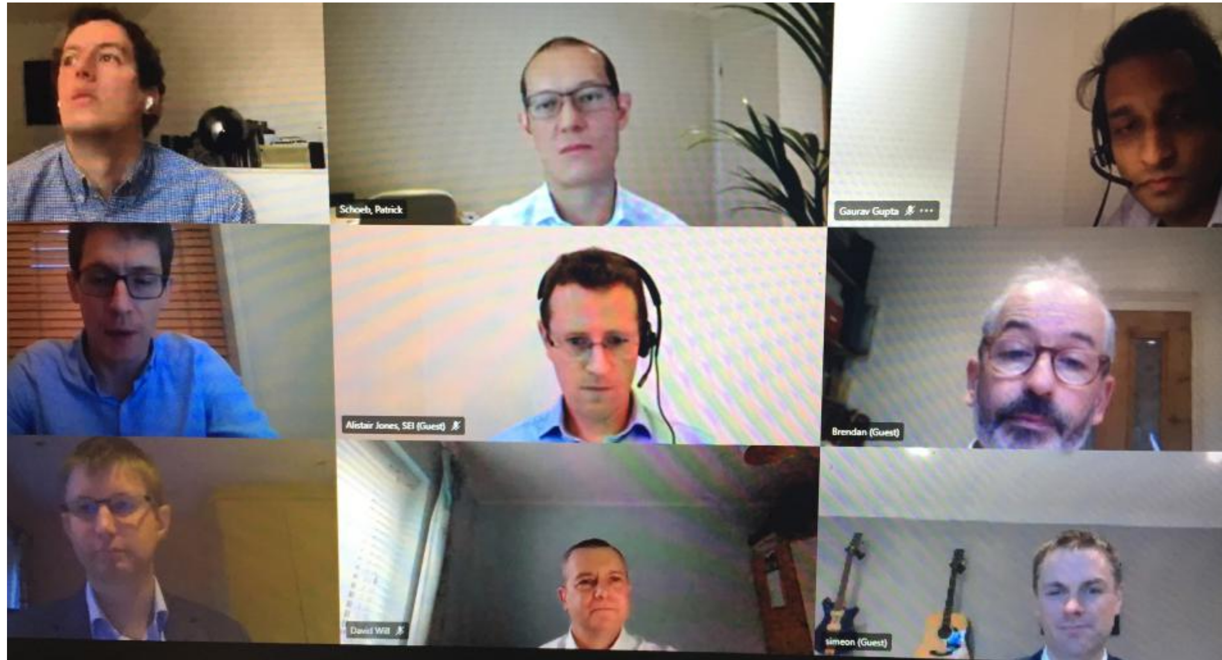
The CDI approach may be taken up with varying objectives for schemes. Some may see it as a tool to provide more certainty, having already de-risked their investments. Others might go down the CDI route with a view to entering into a buyout with an insurer, as the approach would mean investing in similar assets to insurers therefore making them more attractive to insurance companies.

For CDI to be effective in turning around cashflows, schemes need to evaluate their goals and how CDI can be suitable for achieving them. But what are the risks and challenges entailed with CDI, and how can DB pension schemes best use the approach to lower risk and become cashflow positive once more?

Ongoing evaluation of the strategy is key. CDI is not a quick fix to make cashflows positive once more – but adopting the method can prove a step in the right direction for reducing liability long-term.

Cashflow Driven Investing Roundtable

The latest CAMRADATA Cashflow Driven Investing roundtable took place virtually in London on 21 October 2020.



The 2020 CAMRADATA roundtable on Cashflow Driven Investing began with a simple question: for a well-funded, closed DB scheme, would you like to see the reference benchmark for investments as gilts-plus or a CDI portfolio or some other?

Anthony Curl, co-head of Long Income at Alpha Real Capital (ARC), said "it's more logical to use the yield of the actual portfolio as a starting point for the liability discount rate - as insurers do. This is also why insurers have been investing in private market assets for some time and earning the illiquidity premium. There is no reason why pension funds shouldn't exploit CDI in the same way."

Patrick Schoeb, a director of fixed income at M&G, noted that by using the yield on the portfolio, adjusted for prudence, the value of assets and liabilities could move more in sync, so reducing volatility. He warned, however, that the industry is not there yet and although "it's slightly arbitrary to use gilts-plus", that would continue for the time being.

> *" If you structure the asset portfolio to deliver cashflow that matches the liability profile, an investor will never be a forced seller of assets "*

David Will, senior consultant at Cartwright Benefit Solutions, mostly agreed. "The ultimate benchmark is the liability cashflows but you can use the expected yield from CDI less a margin for prudence and possible default," he said.

Keith McInally, senior solutions director – pensions at Aberdeen Standard Investments (ASI) said that gilts-plus is most commonly used. But he noted the flexibility CDI offers in allowing for changes in yield.

Some of the other panellists were less polarised in their view of CDI as a reference benchmark, including Gaurav Gupta, manager researcher at Barnett Waddingham. and Simeon Willis, head of investment consulting at XPS Group.

Willis said that CDI sounds great and can work really well but also presents some challenges, so there is room for both approaches. The wider world of corporate finance successfully works on gilts-plus for evaluating all kinds of fixed income assets.

Crevan Begley, investment consulting director at Broadstone, said the fact many defined benefit pension schemes are now cashflow-negative has meant CDI has become much more important. "And what are these schemes trying to achieve? To maximise the money-weighted return on scheme assets. If you structure the asset portfolio to deliver cashflow that matches the liability profile, an investor will never be a forced seller of assets. This removes the risk of having to sell assets when market sentiment (and prices) are low.

That's what CDI is: it allows an investor to remove market sentiment risk from its funding plan."

Begley said it was useful to focus on the short term. For an investor who is cashflow negative, the return over the next year, will always matter most. Protecting against a bear market is key. "That means not needing to sell anything when prices are low. You can knuckle down and take the coupons and redemptions," he said.

Willis added that the primary benefit of CDI is increased certainty of outcome. He emphasised that for most XPS clients, managing short term cashflows was not a challenge. The big uncertainties instead lie five years out and beyond.

Following Willis, Alistair Jones, UK client strategy director at SEI, warned that CDI often quantified liability and asset cashflows with spurious accuracy. "Be careful of overselling the promise," he said. He believed in disinvestment risk and building blocks to secure income but argued that variability of cashflows was not something trustees should overly worry about.

Will disagreed with the idea of CDI as a policy to meet different scenarios. "LDI is about balance-sheet risk management," he said. "whereas CDI is an extension of LDI, providing cashflows as and when needed, in addition to matching interest rate and inflation sensitivities."

> *" Be careful of overselling the promise "*

McInally then chipped in that a lot of people mistakenly think that CDI is about precise matching. "CDI is not precise. It's important to have flexibility and liquidity in case of unexpected cashflows." He said that if clients want more certainty, they could get it from a series of contractual incomes in a hold-to-maturity portfolio.

On unexpected cashflows, Will pointed out that some small schemes' liabilities are concentrated in benefits for a handful of senior executives. If one of them requests a transfer value, then the consequences for the whole scheme can be serious.

Jones followed this by arguing that because of the nuances of pension scheme provision in the UK, including discretionary pension increases, CDI is scenario-planning.

The conversation then turned to size. McInally said that smaller schemes need greater planning because larger schemes have access to the repo market, a means of lending out debt securities in return for quick cash to cover shortfalls. Gupta agreed with this point.

Will felt more product was needed in this space. He said it was quite difficult to find good Buy and Maintain Credit strategies in a pooled fund form. "The big issue for smaller schemes is whether they can access these funds and other CDI building blocks at a reasonable cost," he said.

Curl was insistent that smaller schemes can find value: "There are governance budget constraints for small schemes but niche areas can be found which they can access."

He gave the examples of long-income property, commercial ground rents, social real estate and renewable energy infrastructure, notably wind farms. Alpha Real Capital has the UK's largest commercial ground rents only pooled fund, with over £1.7bn in assets. Curl explained that this strategy offers long-duration, inflation-matching, contractual income with a very low risk profile given the significant rental and valuation over-collateralisation. Available spreads exceed 400 basis points over long-dated index-linked gilts and the emphasis is on providing secure long-term income rather than traditional property investment targeting return through income and capital growth. ARC already has many blue-chip UK pension schemes as clients in the fund, but with low minimum investments ARC's funds are also accessible for much smaller schemes.

Curl said that ARC conducts its own pro-active sourcing of commercial ground rent opportunities rather than rely on brokers to bring them. He explained that property owners and acquirers, including private equity sponsors, use commercial ground rents as a financing tool.

The CAMRADATA panel then discussed whether a series of specialists such as Alpha Real Capital or one-stop shops like ASI or M&G worked better in CDI. "The answer depends on the journey of the scheme," said Gupta. "If it is going to buy out, then we will see more fixed income come into the portfolio. That suits Buy and Maintain and LDI with one manager; illiquids with a specialist manager." His caveat was that it all depends on the governance budget of the scheme.

Gupta stressed the importance of breadth of research from managers because it brings diversification into the portfolio. "The more issuers you have, potential for defaults will be lower," he said. "The asset class and experience matter more."

This means that for Barnett Waddingham selecting managers with a diversified portfolio and a focus on quality issuers, rather than the "highest returning" is important. Willis agreed that it is breadth of portfolios and the consequent diversification that matters more in CDI than high-conviction stockpicking.

On diversification, Begley said this can be a distinguishing feature between pooled and segregated mandates: "Pooled CDI funds will typically have a strong sterling bias because sterling assets do not generate hedging requirements for the investment manager. Non-sterling assets will generate hedging requirements and the investment manager will have to set cash aside to meet margining. This means sterling assets are more efficient and it is not surprising that they dominate pooled fund CDI offerings.

"For a segregated investor the marginal cost of hedging foreign bonds can be lower, if the investor is able to use gilts elsewhere within the investment strategy to meet margining requirements," continued Begley. "This could allow a segregated investor to write a CDI mandate with a higher proportion to foreign assets versus a pooled fund equivalent, given the differences in hedging efficiencies."

Schoeb thought that there would be new developments in CDI pooled products and noted that M&G itself was working on new pooled CDI products for smaller schemes that would be well diversified by combining public and private debt, next year. He accepted that an allocation to illiquid private assets might not suit schemes that are very close (say two years) to the endgame of buyout, but for many other smaller schemes that are further from such an endgame, private assets could be very helpful.
On foreign-denominated issues,

" Gupta stressed the importance of breadth of research from managers because it brings diversification into the portfolio "

Schoeb was a believer in the benefits of bringing in non-sterling debt, both public and private. He noted that M&G were currently looking to source non-sterling private assets from the Asia Pacific region via their Singapore office. He also noted, however, that non-sterling investments had to be done carefully with a consideration of the cost of fx hedging. "You may get additional spread but there will be a trade-off, with performance drag from posting collateral on the hedge."

In response to Begley, McInally said that ASI's pooled fund had seven buckets of Investment Grade credit from one year to 30 years, which made it more akin to segregated because it gave clients choice within those buckets. He said there was sufficient diversification of exposure by industrial sector. "COVID has shown just how important diversification was," he added.

Aberdeen Standard Investments went sterling when Buy and Maintain was designed because

"we took the view that there was more certainty of cashflows in the short-term," said McInally. "There is sufficient issuance to 15 years of sterling-denominated credit for diversification."

For the furthest-dated bucket, over 15 years, the ASI fund goes further afield. About 15% of these longer-dated issues are from North America, hedged back to sterling. "We have the flexibility to increase that allocation over time," said McInally.

For SEI, Jones said it could piece together specialist managers, e.g. Long Lease with Buy & Maintain credit to bring large-scheme solutions to the smaller ones. He emphasized, however, that the core of CDI has to be Investment Grade credit: a deep and liquid market.

Jones added that IG could be supported by specialist managers in High Yield, Emerging Markets, Long leases, infrastructure or even private assets. "But trustees need to be cognisant of liquidity," he warned, highlighting collateral needs in LDI but also possible conflicts between high exposure to illiquids and unexpected cash calls.

On illiquidity, Curl made the case that many pension funds are overliquid. He noted that pooled vehicles such as Alpha Real Capital's commercial ground rents fund (ILIF) has shorter terms of redemption than the process of buy-out. He urged asset owners to flip the usual argument on its head: "What is the opportunity cost of not going into illiquids?" he asked. "What do you miss out on if you have 20% of a pension fund in sovereign debt versus private markets? The answer is a huge premium."

Curl also noted that while ARC's diversified social long income fund isn't an impact fund per se, by investing across a range of social sectors, clients enjoyed stable investment returns as well as societal benefits. ARC uses an external agency – Social Profit Calculator – that found for every pound invested in ARC's Social Long Income Fund, the benefits to society were in excess of £3.

Begley said that the level of complexity will change as putting together CDI can include more illiquid private assets.

Willis did not share the concerns of other consultants regarding lack of current offerings in this space. "In the last fifteen years, there has been incredible growth in choice," Willis said, noting that many are available on platforms, which increases accessibility. He said that schemes could achieve considerable breadth even via a small number of managers, adding that just because a scheme was big did not mean it had to have lots of managers.

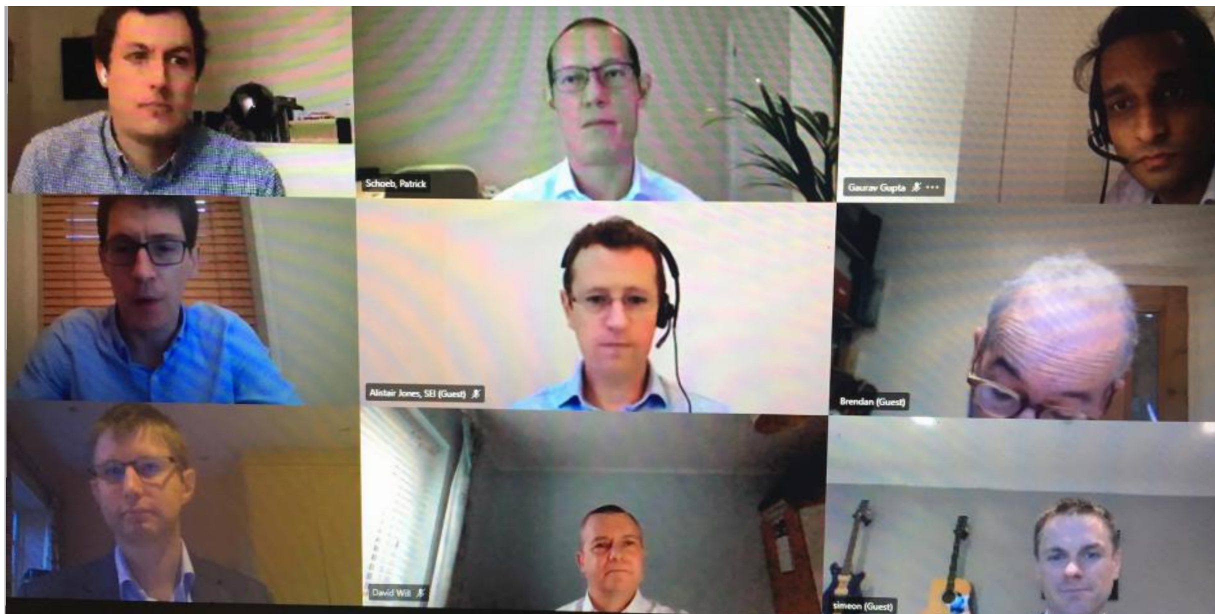
Schoeb then made the case for M&G as a big house with deep expertise in multiple areas spread between 250 investment professionals in public and private fixed income. "We are renowned in public fixed income, with good performance, and have deep specialisms in private markets, from private placements to infrastructure, social housing and ground rents." He noted this experience stretches back to the 1980s and makes M&G Investments one of the largest private debt investors in Europe, with £39bn assets under management.

" In the last fifteen years, there has been incredible growth in choice "

The shadowed economy

The CAMRADATA panel then turned to the spectre of COVID overshadowing the economy. McInally began by noting ASI's heritage managing insurance clients' money for 25 years. "We have been able to avoid a large proportion of downgrades and defaults in the market. With the impact of COVID we are starting to see significant levels of downgrades."

Schoeb mentioned Ford, Rolls Royce and Marks & Spencer as just three household names to have seen their credit rating fall - more were expected. "The probability of default has gone up," he said. "This is relevant to CDI and brings us back to credit research and having the expertise to properly stock pick. Credit researchers these days are gold dust: as a portfolio manager you need real-time updates.



Anything that could change your cashflow matters, not only defaults."

Schoeb added that as an actively engaged manager, M&G could work with borrowers, for example, in providing waivers on covenant breaches and accepting deferral of coupon payments where appropriate. He also said that M&G has a dedicated debt restructuring team for those companies that really fall down.

Curl said that he used to be a mezzanine lender and so had had painful first-hand experience of the challenges of restructuring. But the Alpha Real Capital Commercial Ground Rents fund had suffered no valuation haircut on assets through the COVID crisis. Curl said that vast majority of rents had been collected on time; only 5% was outstanding but had been deferred and would be received in full with appropriate interest.

Consultants were sceptical about disclosures on downgrades and defaults by managers generally (not specifically those at this roundtable). Gupta warned that managers gamed this information. Jones agreed, recommending that consultants and fiduciary managers bring in the credit analysts to better understand positions held.

" Managers have to demonstrate where they are adding value. In sub-Investment Grade, for example, how many assets have managers had to sell at distressed levels? "

"It is not just about success in avoiding downgrades and defaults," said Will. "Managers have to demonstrate where they are adding value. In sub-Investment Grade, for example, how many assets have managers had to sell at distressed levels?"

"There has to be a range of metrics," said Willis. "If there is just one factor, managers can play towards that factor."

On a concluding note, Will said CDI was a different mindset for trustees, but also for managers. "We are less concerned about mark-to-market losses if there are no impairments and cashflows continue. The metrics for risk ought to change and reporting has to reflect that."

On collaborations, McInally pointed out that ASI has been working with a range of pension fund consultancies, to provide more than just fund management to help clients with their derisking journey towards the endgame."

CDI is one path to that ultimate destination.

Roundtable Sponsor

Keith McInally, Senior Solutions Director - Pensions

Personal Profile

Keith joined the Pension Solutions team as an Investment Director in January 2019 with an initial focus on LDI and CDI opportunities. Keith is a qualified actuary and previously worked as a senior investment consultant within the Financial Strategy Group at Mercer, where he provided complex investment advice to a wide range of DB clients with £20m to £4bn of assets. Keith's main focus at Mercer was on LDI, investment strategy and journey planning.

Keith started his career in the Retirement team at Mercer supporting scheme actuaries with DB pension valuations. Keith is a qualified actuary and has 8 years' experience in the industry and 1 years' experience at Aberdeen Standard Investments. Keith is a fellow of the Institute and Faculty of Actuaries, Chartered Enterprise Risk Actuary (CERA). He also graduated with a BA (Hons) in Actuarial Science from Heriot Watt University.

Aberdeen Standard Investments

Company Profile

Aberdeen Standard Investments is dedicated to helping investors around the world reach their desired investment goals and broaden their financial horizons.
We seek to provide world-class investment expertise across a breadth of markets and asset classes. Our full range of solutions span equities, multi-asset, fixed income, liquidity, sovereign wealth funds, real estate and private markets. Coupled with a wide range of investment approaches, we transform new investment ideas into practical investment products designed to deliver real value for money to investors.
With employees in more than 40 locations worldwide, our operations extend across global financial capitals and important regional centres. This brings us closer to our clients and customers around the world, and provides invaluable knowledge and insight to share with our people.
Today, we manage a total of £455.6bn (€501.2bn/$562.9bn) of assets on behalf of governments, pension funds, insurers, companies, charities, foundations and individuals across 80 countries (as at 30 June 2020).
As a responsible global investor, we leverage our scale and market position to raise standards in both the companies and industries in which we invest, and help drive best practice across the asset management industry.

Roundtable Sponsors

Anthony Curl, Co-Head of Long Income

Personal Profile

Anthony joined Alpha Real Capital at the start of 2019 and is Co-Head of the Long Income team. Anthony has over 15 years' financial services and investment management experience, including across private asset classes and particularly in the context of liability-aware investing.

Prior to joining Alpha, Anthony set and implemented investment strategies at life insurance companies, including as Portfolio Manager for Friends Life's annuity portfolios. He was also a Director at BlackRock, where he worked directly with UK pension fund clients. Anthony started his career in banking and as a leveraged loans credit analyst.

Alpha Real Capital

Alpha Real Capital

Company Profile

Alpha Real Capital LLP ('Alpha') is a specialist real assets investment manager focused on secure income strategies. We invest in UK and European assets with predictable secure long term cash flows.
We provide market leading and innovative real asset solutions across a range of investments such as commercial ground rents, UK renewable infrastructure, social real estate and secured lending, combining operational real estate expertise and fixed income skills.
Alpha has a 130 plus strong team of professionals, with approximately £4 billion of assets under management, including capital commitments, as at 30 June 2020. Established in 2005, Alpha is jointly owned by Phillip Rose, members of the Alpha management team and companies ultimately owned by the PS Gower Personal Settlement. We look for long term relationships with our investment partners, tenants, lenders and other stakeholders.
Alpha operates across diversified investment markets: listed and unlisted property vehicles, open and closed-ended property vehicles, UK and international funds, working with large institutional investors as well as private investors, family offices and wealth managers.

Patrick Schoeb, Fund Manager - Fixed Income

Personal Profile

Patrick is an experienced fixed income credit investor with expertise in the management of the investment portfolios of insurance companies. Since joining M&G as a Fund Manager in 2010, his primary responsibility has been the management of the annuity funds of Prudential UK, which invest in a diverse range of public and private assets. He has also worked with a number of M&G's UK pension fund clients as they seek to become more 'annuity fund like' and is engaged in M&G's wider cashflow driven investment propositions.

Prior to joining M&G he worked as a portfolio manager at both Paternoster (now part of Rothesay Life) and Canada Life. At M&G (for Prudential UK) and Paternoster, he was involved in numerous pensions buy-in/buy-out bulk annuity transactions. Patrick has a Master's degree in Engineering and Management from the University of Manchester and began his career at Barclays. He is a CFA charterholder and a Fellow of the CISI.

M&G Investments

Company Profile

M&G Investments is part of M&G plc, a leading savings and investments business with distribution offices in more than 20 locations across the UK, Europe, North America and Asia. Our goal is to become your trusted long-term partner by putting your needs at the heart of our business.
We manage more than £272bn* on behalf of individual and institutional investors globally including pension funds, insurers, endowments and foundations, sovereign wealth funds, banks and family offices.
We offer solutions across a broad range of capabilities that span both public and private markets including fixed income, equities, multi asset, real estate, infrastructure and private equity, supported by over 400 investment professionals, including one of the largest and most experienced credit research teams in Europe. Our strength in fixed income provides access to a broad range of public and private debt assets including government bonds, corporate debt, asset-backed securities, multi-asset credit, illiquid credit, real estate debt, leveraged finance and project and infrastructure finance.
Our active management approach aims to deliver outperformance regardless of market conditions. We believe that this is underpinned by detailed credit analysis and our fund managers' ability to act with conviction.
The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested.

*M&G Investments as at 30 June 2020

Roundtable Participants

Gaurav Gupta, CFA

Senior Manager Research Analyst

Gaurav is a Chartered Financial Analyst and has extensive knowledge of investment products in the industry. He joined the investment consultancy industry in 2017 and provides strategy and investment manager research services.
He currently works at Barnett Waddingham, having previously been head of multi-asset research at XPS Investments. Prior to joining investment consultancy, he worked at Thesis Asset Management where he won multiple industry awards and co-managed the Thesis multi-asset model portfolio service which he helped grow to approximately £250m under management.

Crevan Begley

Investment Consulting Director

Crevan joined Broadstone in 2019 and has over 13 years' industry experience. He advises clients on a full range of investment areas, such as setting strategic objectives, asset allocation, liability hedging, manager selection, implementation and monitoring.
He started his career with Willis Towers Watson (formerly Willis) in Dublin. He also worked as a fixed income portfolio manager for the Central Bank of Ireland, fiduciary manager for Russell Investments and as an investment strategist for a large UK pension fund.
Crevan has a Master's degree in Electrical Engineering from University College Dublin and is a qualified actuary.

David Will

Senior Investment Consultant

David is senior member of the Investment Consulting team at Cartwright, having joined in January 2020. He has over 29 years' experience in the pensions industry and is responsible for advising clients on investment strategy, manager selection, implementation and governance. In addition to his role at Cartwright, David is a member of the Society of Pension Professionals' Investment Committee and a regular speaker at industry events.
Prior to joining Cartwright, David held a senior position in the investment solutions business of another consultancy where he was Head of Manager Research, as well as being a member of the both Tactical Asset Allocation Group and the LDI Group. He has extensive manager research experience across a variety of asset classes, including fixed income, LDI, multi asset and alternatives.

Alistair Jones

Client Strategy Director

Alistair provides strategic asset allocation advice to institutional investors and manages a number of day-to-day relationships. His specialisms include designing multi-asset, LDI, CDI, and defined contribution investment strategies.
Alistair has over 20 years industry experience. Prior to joining SEI in 2018 he spent several years as a Strategist in Schroders' Portfolio Solutions Team where he advised on strategic asset allocation. Before this Alistair spent over a decade in consultancy, latterly as an Investment Consultant at Aon focussing on investment strategy and derivatives. Alistair started his career on the liability side of the balance sheet at Watson Wyatt (now Willis Towers Watson) where he worked in their actuarial team. He has worked with a wide range of asset owners including Defined Benefit and Defined Contribution pension funds as well as charities, private investors, overseas clients and other institutions. Alistair has spoken at a number of industry conferences, in the press and is a member of CFA UK's Pensions Expert Panel.

Roundtable Participant

Simeon Willis, CFA

Partner, Chief Investment Officer

Simeon leads our thinking on journey planning and asset allocation, along with being responsible for research across the investment team. Simeon is an experienced investment specialist with 19 years' experience, advising trustee and corporate clients on a full range of investment related matters, with a particular emphasis towards strategy and risk management. Simeon is frequently quoted in the press on matters relating to investment opportunities and topical debate.

XPS Pensions Group

Moderator

Brendan Maton

Freelance Jounalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.
Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.
Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

Cashflow driven investment – a compelling option

When planning for the defined benefit (DB) endgame, a cashflow driven investment (CDI) approach can be a compelling option, especially for well-funded, mature pension schemes. Here we explore what it entails and the benefits that adopting such a strategy could bring.

The basics

Cashflow driven investing, or CDI, is where a pension scheme invests in assets that provide contractual income to match as far as possible the expected future cashflow requirements of the pension scheme.
As an example, a corporate bond offers a series of coupon payments along with a final redemption payment. These contractual cashflows are relatively predictable (although consideration should be made for potential future defaults). So schemes can look to use these to effectively match liability cashflows.
Typically in a CDI strategy, there is an allocation to high-quality investment-grade public corporate bonds, managed on a buy-and-maintain basis (usually held to maturity). These may sit alongside other assets that provide alternative sources of contractual income – perhaps various types of private credit or long-lease property. Finally, it is essential that the CDI strategy sits alongside a liability driven investment (LDI) strategy to reduce any residual interest and inflation risks.
The idea is that the income that is received (such as the coupon and redemption payments from a bond), match the scheme's future cashflow requirements. If a scheme is in a position where it can implement a CDI strategy, then this approach can provide trustees and sponsors with greater certainty of meeting the scheme's benefits than if they held more volatile assets – equities for instance.
So far, so logical. Surprisingly though, relatively few UK pension schemes have adopted this type of approach to date. The majority of mature DB schemes are now cashflow negative, paying out more benefits than income received from contributions. If they are investing in a traditional way, they may become forced sellers of assets to meet cashflow requirements. This is a significant risk for pension funds – having to sell assets with volatile prices, perhaps at times when markets are depressed. That's why we believe adopting a CDI approach may be a better option.

"A CDI approach can deliver a much more predictable outcome, because the scheme will hold bonds to maturity"

The benefits

There are several key potential benefits of moving to a CDI strategy. As outlined already, it can provide a greater certainty of outcome. If a scheme holds more traditional growth assets, like equities, there is a wider range of potential outcomes. A CDI approach can deliver a much more predictable outcome, because the scheme will hold bonds to maturity.
Related to this, a CDI approach also means that the scheme is not paying for unnecessary upside. Holding equities, for example, may potentially generate positive performance gains that the scheme doesn't actually need to meet all its benefits. Conversely, with corporate bonds that are held to maturity, the scheme will never receive more than the contractual income and the redemption proceeds. And that's fine because the aim is to match cashflows, not exceed them. If the pension scheme doesn't actually require that upside performance, then why expose it to the increased risk required to achieve it?
Speaking of risk, a CDI approach also relies less on potentially subjective risk-premium assumptions than a traditional 'growth plus liability driven investment (LDI) approach'. That's because investors already know the yield on a bond when they buy it. Government bonds and investment-grade corporate bonds are usually considered low-risk assets, but their values can be volatile over time. However, with a CDI strategy, because the intention is to hold bonds to maturity, the scheme will be less concerned with price volatility. This is particularly the case if there is an integrated funding and investment approach, where the discount rate is linked to the yield on the assets held by the scheme.

Regulatory rigour

A very pertinent and timely consideration for all pension schemes is the DB funding consultation issued by the Pensions Regulator in March this year. Under its proposals, schemes will be expected to set out their long-term funding objective to achieve their endgame ambition. Crucially, the regulator stated that, "By the time they are significantly mature, we expect schemes to have a low level of dependency on the employer and be invested with high resilience to risk."

Elsewhere, the Regulator highlights the need for mature schemes to demonstrate resilience to risk, a high level of liquidity and high average credit quality. We believe a CDI approach very much aligns with these directives.

Size really doesn't matter anymore

> ***" Good indicators of suitability include whether a scheme is mature, cashflow negative, and looking to reduce its reliance on its sponsoring employer "***

Historically, a CDI approach was only really available to larger pension schemes. However, innovations in pooled fund solutions mean that schemes of all sizes can implement this type of strategy, efficiently and at a low cost. Trustees can now choose from a full range of pooled buy-&-maintain credit funds and pooled LDI funds. They can tailor these to meet the unique cashflow and hedging requirements of their schemes, whatever the shape or size.

In general terms, a CDI approach is typically most suited to schemes considering or approaching their endgame. Good indicators of suitability include whether a scheme is mature, cashflow negative, and looking to reduce its reliance on its sponsoring employer. Equally, even for schemes that are less mature, there can be benefits of starting to become more 'cashflow aware' as part of a journey to a CDI approach.

One final pointer is that with a CDI approach, it is not a case of setting the strategy and leaving it to run. Trustees need to regularly monitor it to check it is on course to meet the scheme's objectives, which can change over time. They must also assess whether there will be sufficient cash available to pay all remaining benefits as they fall due. In other words, no reliance on the sponsoring employer.

Finally, assumptions, given their very nature, aren't guaranteed. As an example, there could potentially be a higher number of transfer values than anticipated. Additionally, the strength of the employer could change – positively or negatively – over time, while there could be potential downgrades and defaults.

Keith McInally
Senior Solutions Director - Pensions

Final thoughts...

We hope we've provided some food for thought on a CDI approach. We believe it can provide many key benefits for mature, well-funded DB pension schemes, especially as they plan their endgame journey and look to de-risk. And the good news is that it's now an option for schemes of all shapes and sizes.

For more information on our DB endgame solutions visit www.aberdeenstandard.co.uk/lto

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Cashflow Driven Investing: Where are the opportunities for pension schemes today?

CDI's popularity

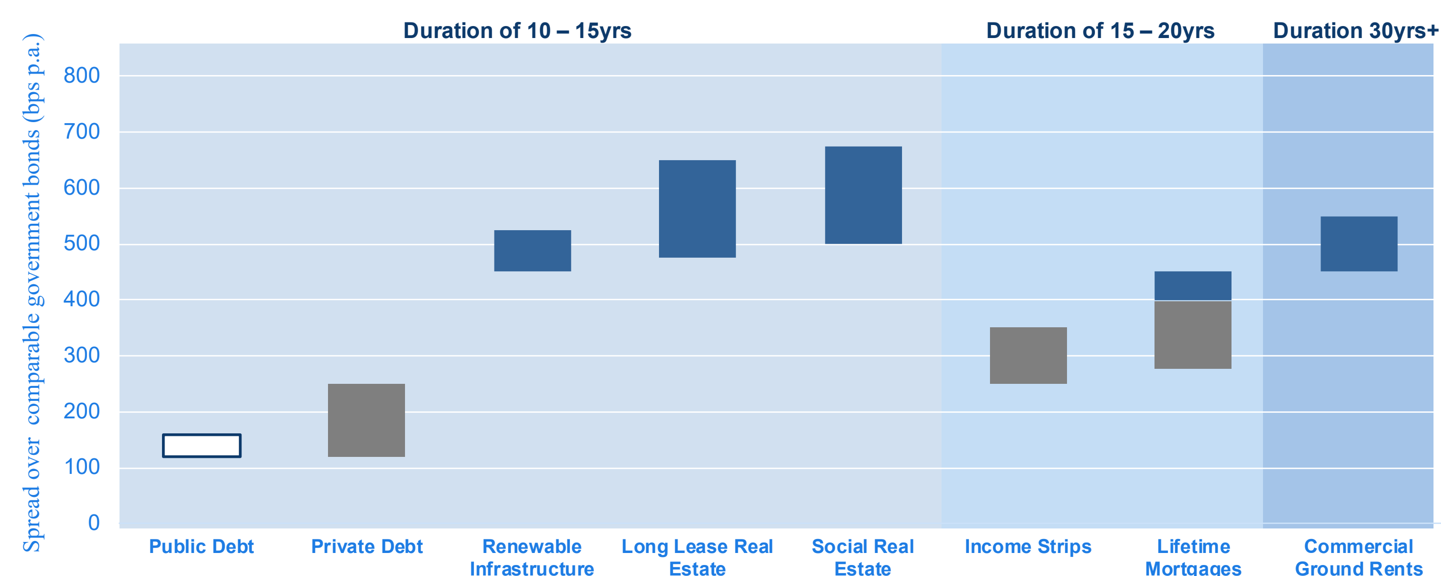
Pension schemes are increasingly focused on strategies that seek to maximise the chances of meeting their liability cashflows. This momentum is set to continue as the majority of UK defined benefit pension schemes are already closed and becoming cashflow negative[2] and these trends are the primary drivers of the growing interest in Cashflow Driven Investing ("CDI").
CDI is designed to generate predictable cashflows to help match liabilities, whilst also delivering investment returns to help close funding gaps, so target assets must have a high degree of cashflow predictability and security.

Competition for assets

However, the supply of suitable assets is limited and competition for them is commensurately high. Pension schemes have to compete both against each other, and with insurers who are long-established and significant investors in CDI.
Pension schemes nevertheless benefit from not being constrained by the same stringent investment restrictions as the insurers. Simply put, they do not need to chase the same 'overbid' assets that insurers are competing for.

Asset universe

Alongside Gilts and corporate bonds, CDI assets include a number of private assets (alternative credit sources), and the diagram below shows the typical gross spreads available relative to comparable government bonds for some private asset sectors. The spreads for public debt (i.e. investment grade quality corporate bonds) are included for comparison.



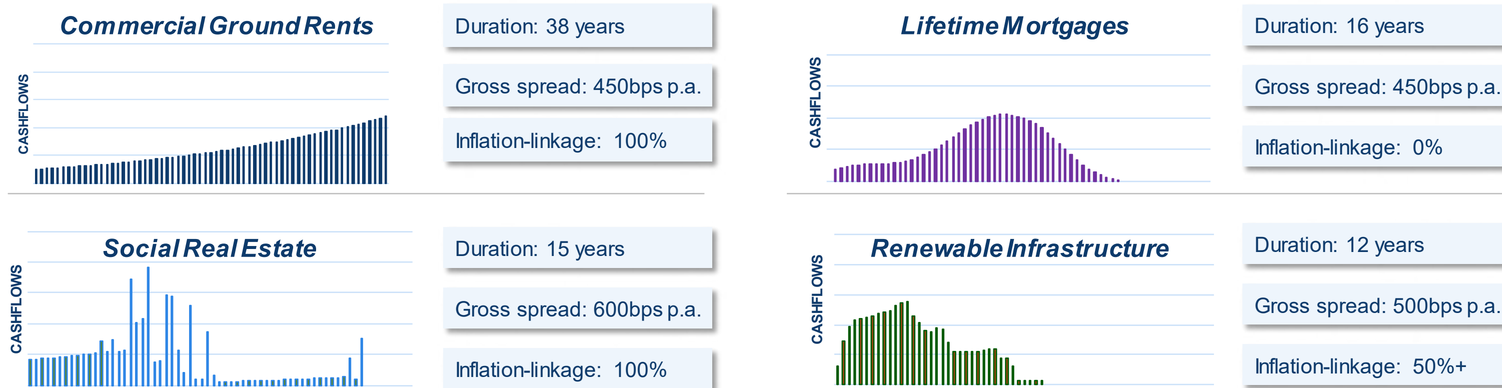
Source: Alpha Real Capital, indicative levels as at 30 September 2020. For illustration purposes only. The future returns and opinions expressed are based on Alpha Real Capital internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Alpha Real Capital nor as advice of any nature.

- A wide range of assets could be considered alongside government bonds and public debt for CDI
- As duration increases, choice narrows, with only commercial ground rents at durations of 30+ years being an alternative to longest-dated government bonds
- The private assets that insurers typically invest in (highlighted in grey) command the lowest spreads over Gilts
- The spreads on those assets which pension schemes are best positioned to take advantage of typically command much higher spreads over Gilts (highlighted in blue)

Key considerations

Cashflow predictability and security are key components of CDI assets, alongside some other important considerations, including inflation linkage and ESG credentials. The balance between these elements varies across different CDI assets.

For example the cashflow profile of four current opportunities and some of their indicative key investment characteristics are set out below.



Source: Alpha Real Capital, indicative cashflows and investment characteristics of the diversified portfolios of assets. For illustration purposes only.

Many investors may have a preference for the benefits of a diversified allocation, with asset weightings reflecting the investor's desired outcome/needs. For example:

- To maximise the duration: Commercial ground rents arguably provide one of the most attractive risk/return profiles of all the CDI assets whilst offering contractual inflation protection through the indexation of the rent reviews. Security is achieved through being the most senior in the structure as the freeholder with significant income and capital over-collateralisation. Accordingly, these investments would usually be rated equivalent to single A.
- Inflation-linkage is not a requirement: Lifetime mortgages provide an attractive risk/return profile whilst generating investment grade quality fixed rate cashflows, in an opportunity that is virtually untapped by pension schemes, who can access parts of this market that the insurers cannot.
- To maximise the spread over Gilts: Renewable infrastructure and/or social real estate could offer the most compelling yield pick-up. These assets also have tangible and quantifiable ESG / SRI benefits in the forms of carbon savings and social value creation, respectively.

All four of the asset types whose cashflow profile is shown above have performed extremely well throughout the COVID-19 pandemic. This is evidenced by the recent resilience of valuations across these structures. The robust rent collection rates for high-quality long income real estate assets (with remaining rent deferred not written off) also reflect and further reinforce social real estate and commercial ground rents status as defensive CDI asset classes.

Boris Mikhailov
Head of Client Solutions

Open to all

Until recently, these assets have been perceived by many to be the preserve of larger investors via bespoke portfolios; however, today there is nothing to prevent investors of nearly all shapes, sizes and governance budgets accessing these markets.

There are a number of investment managers who offer single strategy pooled funds (e.g. commercial ground rents) as well as multi-private asset funds.

Please don't hesitate to get in touch if you would like to learn more about this compelling, fast-growing area of investment.

[1] 88% of DB pension schemes are closed in the UK (Source: The Purple Book 2019, PPF)

[2] 66% of DB pension schemes are already cashflow negative and more than half (53%) of cashflow positive plans expect to become cash flow negative within five years (Source: Mercer 2020 European Asset Allocation Survey).

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* As at 30 September 2020, AUM includes committed capital; ** As at 30 September 2020.

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M&G INVESTMENTS

Positioning yourself for the endgame

As defined benefit (DB) schemes reach maturity, scheme decision-makers' are shifting their focus squarely on potential endgame options. For some schemes, the use of liability driven investment (LDI) strategies has successfully helped bridge the gap to a fully insured buyout, while others have come to realise that the cost of a buyout is much further away than they first thought.

Migrating towards a cashflow driven investment (CDI) solution, designed to increase the certainty of meeting liability cashflows as schemes de-risk, allows trustees the flexibility to pursue different endgame scenarios – whether aiming for self-sufficiency in the long run, a buyout with an insurer in a decade's time or opting for an alternative solution entirely.

A growing need for predictable cashflows

Meeting liability cashflows is an ever-increasing challenge for UK pension schemes and their trustees, with many schemes now closed to new members and future accruals. Almost three-quarters of pension schemes surveyed in Mercer's latest European Asset Allocation Survey are currently cashflow negative, up from 66% in 2018. As more schemes mature and become cashflow negative, there is a growing need to generate predictable cashflows to help increase the certainty of meeting a scheme's liability cashflow requirements and funding objectives.

" There is a growing need to generate predictable cashflows to help increase the certainty of meeting a scheme's liability cashflow requirements and funding objectives "

Many schemes have long been concerned with investment risk and funding level volatility, and have subsequently employed LDI strategies to hedge interest rate and inflation risk.

Over the last decade, these LDI solutions have allowed many schemes to stabilise their balance sheets by immunising portfolios against changes in overall interest rate and inflation exposure. However, given the increasing cost of LDI implementation alongside low gilt yields, the certainties that trustees seek in order to obtain security in matching their scheme's liabilities appear less attainable.

Challenges also arise when faced with elevated levels of volatility and uncertainty, as we saw earlier this year in light of the coronavirus-induced market instability, which created a spike in collateral and margin calls for derivative positions. If schemes are required to sell assets to meet a collateral call, this could leave them in the undesirable position of crystallising losses on non-LDI assets, negatively impacting returns.

Pursuing a different kind of certainty

Many schemes are now migrating towards matching liabilities primarily through physical assets, using LDI to 'fill in the gaps' via swaps where physical assets aren't available. Matching a scheme's liabilities in this way can achieve a different kind of certainty, hedging risks not via swaps alongside a growth portfolio, but by using a mix of assets to ensure pension commitments are managed (and ultimately met in full), sponsors are protected and the scheme is de-risked over time.

This approach can also lead to a more efficient allocation of risk exposures. A portfolio providing predictable cashflows versus specific liabilities while generating a return in excess of gilts, allows a scheme to spread the risk budget more evenly across the entire investment portfolio. Taking this approach reduces the capital required for an LDI portfolio, minimising the potential cost and 'collateral drag' on scheme returns. This is akin to how most UK insurers manage their annuity books.

Taking a flexible, asset-agnostic approach

From a pension scheme's perspective, the good news is that they don't have to adhere to the same regulatory regime that insurers do, so a CDI manager can help them to build their own, more efficient, version of an annuity book by utilising investment opportunities across a broader range of cashflow-generative assets.

These encompass different forms of financing, which can be public, private, fixed-rate, floating-rate, index-linked, secured, unsecured, junior, senior, asset-backed and so on. The common theme is a contracted cashflow and the flexibility to use a wide variety of assets, which in effect, allows schemes to build their own diversified annuity book.

Investing for the outcome you need, rather than focusing on a label or definition of an asset or asset class, ensures every asset that is selected for inclusion in the portfolio performs a specific role and fulfils a specific outcome. Investing on a relative value basis is equally important to build efficient matching portfolios, in our view, so you only take the risks for which you are adequately compensated for to minimise downside risk in a portfolio, and ultimately, to protect returns.

Fundamental credit research and analysis remains critical to the process. Managers with the resources on hand to analyse and compare potential investments from across the full credit spectrum, can look to build well-diversified asset portfolios and identify relative value. Furthermore, by integrating environmental, social and governance (ESG) factors at all stages of the investment process, managers have the potential to build greater resilience into portfolios and ensure they remain on track to deliver the required outcomes over the longer term.

"A flexible, asset-agnostic approach to portfolio construction is required to put a scheme's cashflow needs at the heart of the process"

Migrating towards self-sufficiency – evolution, not revolution

Depending on the individual circumstances of your scheme, migrating to a more precise self-sufficiency portfolio may not be achievable or advisable in the near term. For schemes that are earlier in their endgame journey, it's not important to be too prescriptive when matching assets to liabilities compared to more mature schemes. More mature schemes, with greater numbers of pensions in payment have more certain cashflows.

However, we believe a gradual transition to this strategy could allow a scheme to lower its risk relative to its payment liabilities as the funding level improves. Importantly the flexibility afforded by this strategy would allow the scheme to position for different end-game scenarios further down the line, particularly as portfolios of high quality corporate bonds can be transferred in specie to an insurer or alternative provider.

Building you an efficient matching portfolio

A flexible, asset-agnostic approach to portfolio construction is required to put a scheme's cashflow needs at the heart of the process. This will inherently be different for each scheme – given differing funding levels, sponsor covenants, liability structure et al – therefore it's crucial that solutions evolve through the life of the scheme to match changing requirements efficiently and on a relative value basis.

Patrick Schoeb
Fund Manager, Fixed Income, M&G Investments

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