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Cashflow based investment strategies

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Agenda

- What do we mean by cashflow based investment strategies?
- What do cashflow based investment strategies look like?
- How do they evolve over time?
- What are the benefits of adopting such a strategy, and the implications for funding?
- Which pension schemes are they suitable for?

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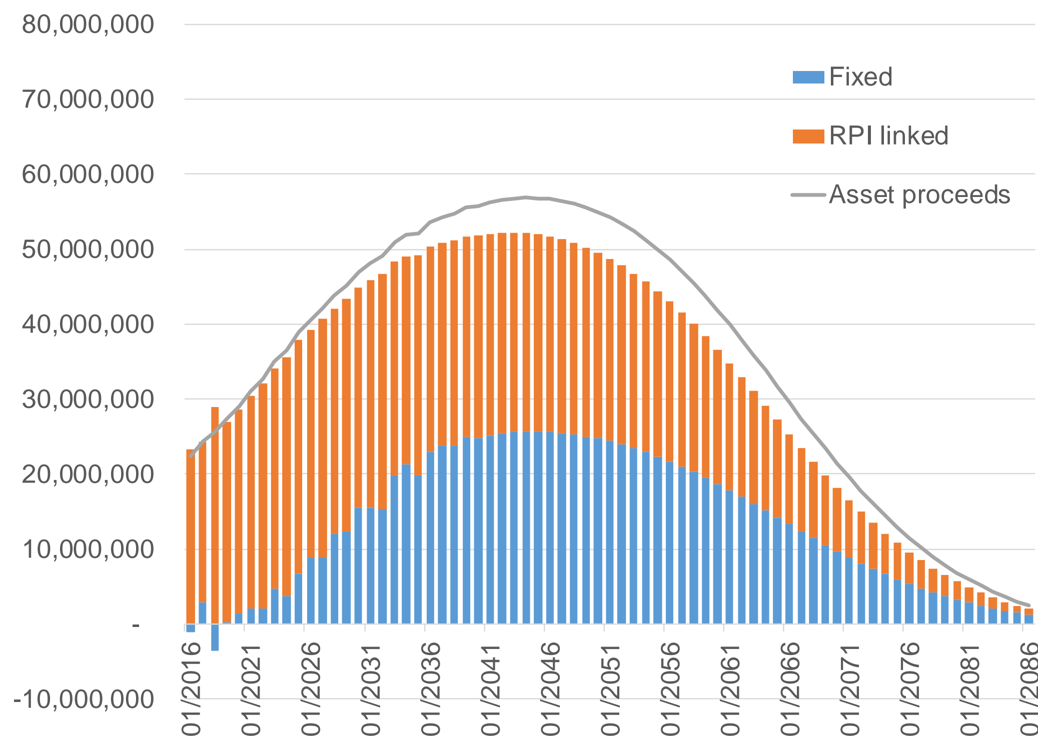
What is a cashflow based investment strategy?

- An investment strategy that aims to deliver **sufficient income and capital proceeds** to cover some or all of the expected future cashflows
- Fixed interest bonds, index-linked bonds, and other assets with **predictable future proceeds** (eg property leases, illiquid debt) are key building blocks
- Where assets have credit risk, an allowance for losses should be made



Undiscounted amounts shown

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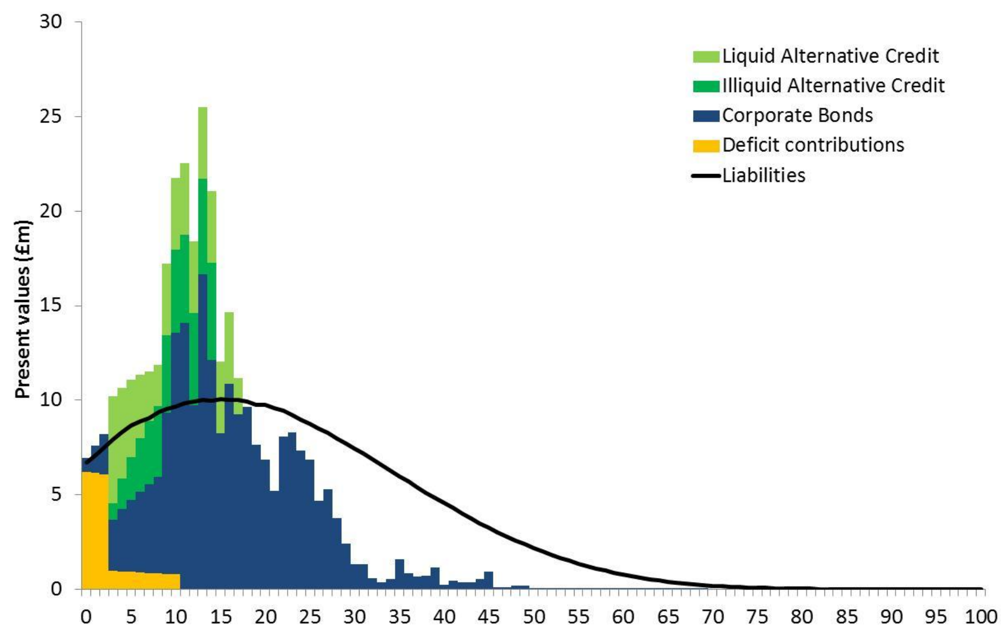
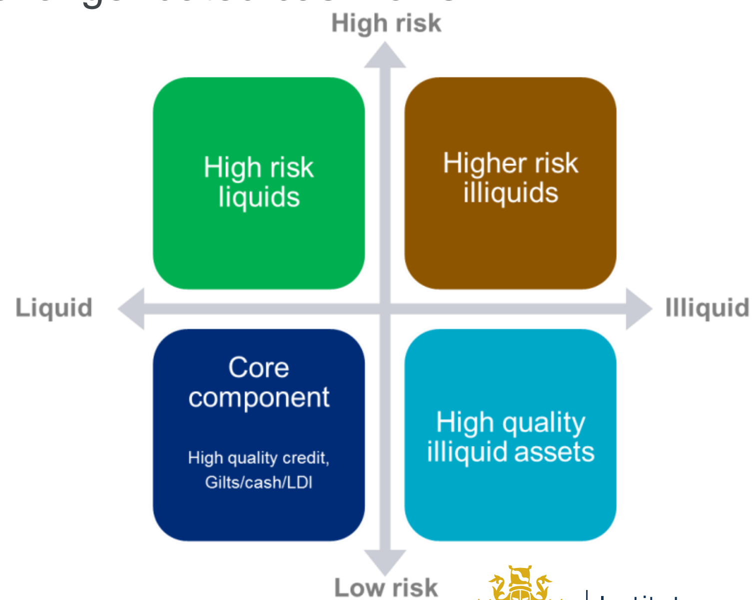
What does such a portfolio look like?

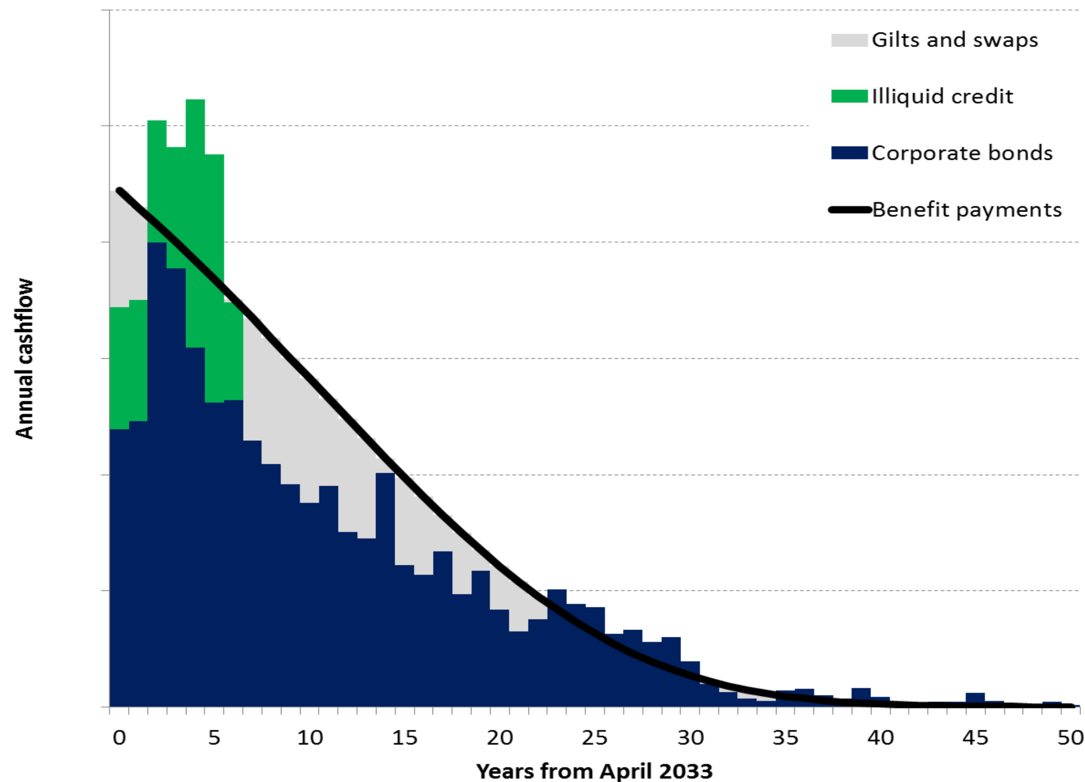
- High allocation to **investment grade** and **alternative credit**
  - These provide predictable future fixed/floating cashflows, ***if*** no losses due to defaults or downgrades
- **Equities** and **diversified multi-asset** strategies held to increase expected returns
- **LDI** needed to need to source inflation and hedge longer dated cashflows





How will the position evolve?

- If contributions *plus* achieved returns *plus* future expected returns are sufficient to cover the remaining liabilities…



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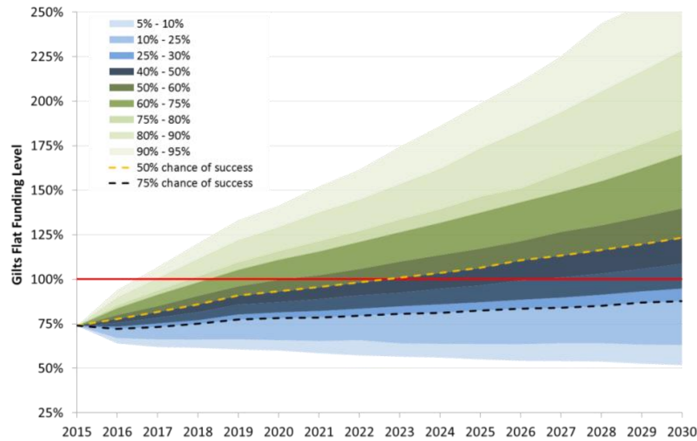
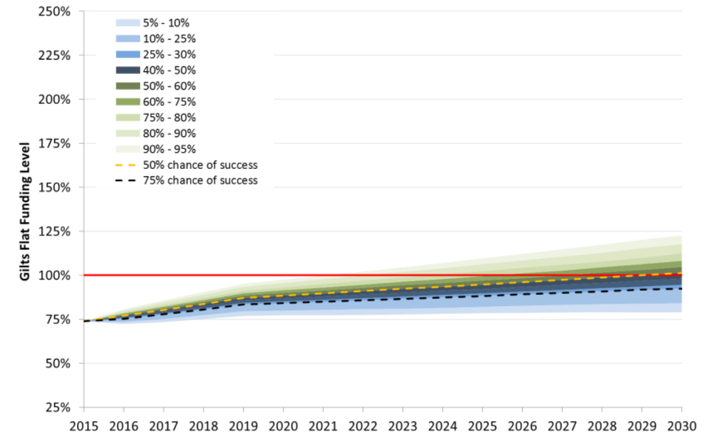
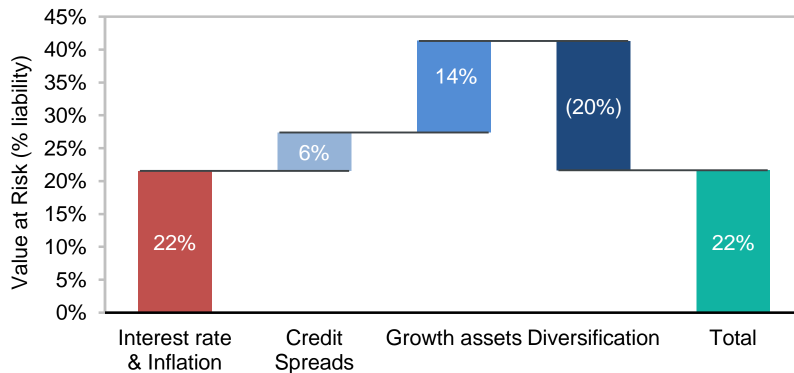
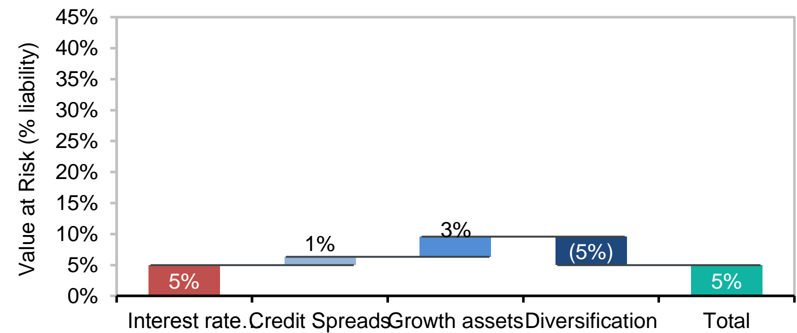
Example risk dashboard

Current Approach	Cashflow matching approach









So should **everyone** be doing this?

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Pros and cons

- ✓ Benefit from illiquidity premia
- ✓ VaR can be reduced
- ✓ Funding level can be more stable (especially if discount rate based on asset yield)
- ✓ More predictable contributions (but not necessarily lower)
- ✓ Less likely to overfund
- ✓ **Effective approach for fairly well funded schemes who are happy to hold bond assets**

- ✗ Assets not purely selected on economic (risk and return) grounds
- ✗ Concentration in credit (spread sensitive) assets
- ✗ Won’t help much in a significant underfunding situation (and could make things worse)
- ✗ Portfolio could cost >1% to move to an insurer
- ✗ **Doesn’t automatically lead to “self-sufficiency”**

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Key question – what end game is being targeted?

- Possible end-games for a closed and maturing pension fund:
    1. High risk run-off
    2. Low risk run-off
    3. Buy-out
- Tax and regulation rules out Option 1 in the UK private sector
- So most pension funds will be aiming for Options 2 or 3, some quicker than others (depending on affordability and resources).

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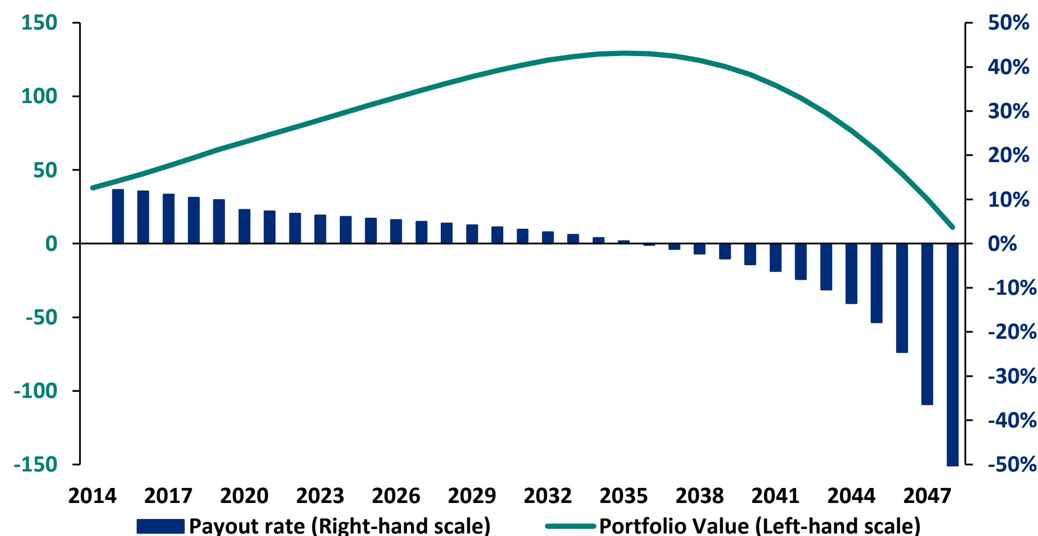
Liquidity – how important is it?

- **Buy-out:** insurer friendly assets are useful but long-term income is secondary to hedging the premium basis
- **Low-risk run-off:** aligning assets to cashflows is important. Vital to avoid forced asset sales and manage reinvestment risk
- **Other schemes:** leverage needed to manage risks so need LDI and collateral. Aim to improve funding level in a risk controlled way



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Impact of end-game on investment strategy

- Different priorities emerge as end-game is approached:
  - **Low risk run-off target**: cashflow mindset, mark-to-market risk tolerable if reinvestment risk well controlled. Focus on "money good" assets not volatility
  - **Buy-out target**: less tolerance of mark-to-market risk, need to sensitivity match an annuity premium, liquidity / cashflow matching secondary
- Investment strategy implications:

	Low risk run-off	**Buy-out**
Time horizon	Long	Shorter
Long-term illiquids?	✓	✗
Credit spread tolerance	✓	?
Focussed on bulk annuity premia	Not really	✓
Assets need to be transferred to an insurer at low cost	Irrelevant	✓

Key question is how far away is this?

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Action plan

Develop a plan

Review long-term objectives and develop a clear plan – buyout or self-sufficiency. There may be an extended "journey plan" phase

Manage the journey

Add new asset classes with regard to the end-game (eg illiquid credit if targeting self sufficiency). Be flexible especially if far from end-game

Keep it simple

Use appropriate governance & risk management arrangements

Delegate to adviser, proactive Investment Committee, fiduciary manager, etc

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Questions

Comments

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