



Investment Insights

The cashflow conundrum in a higher yield world

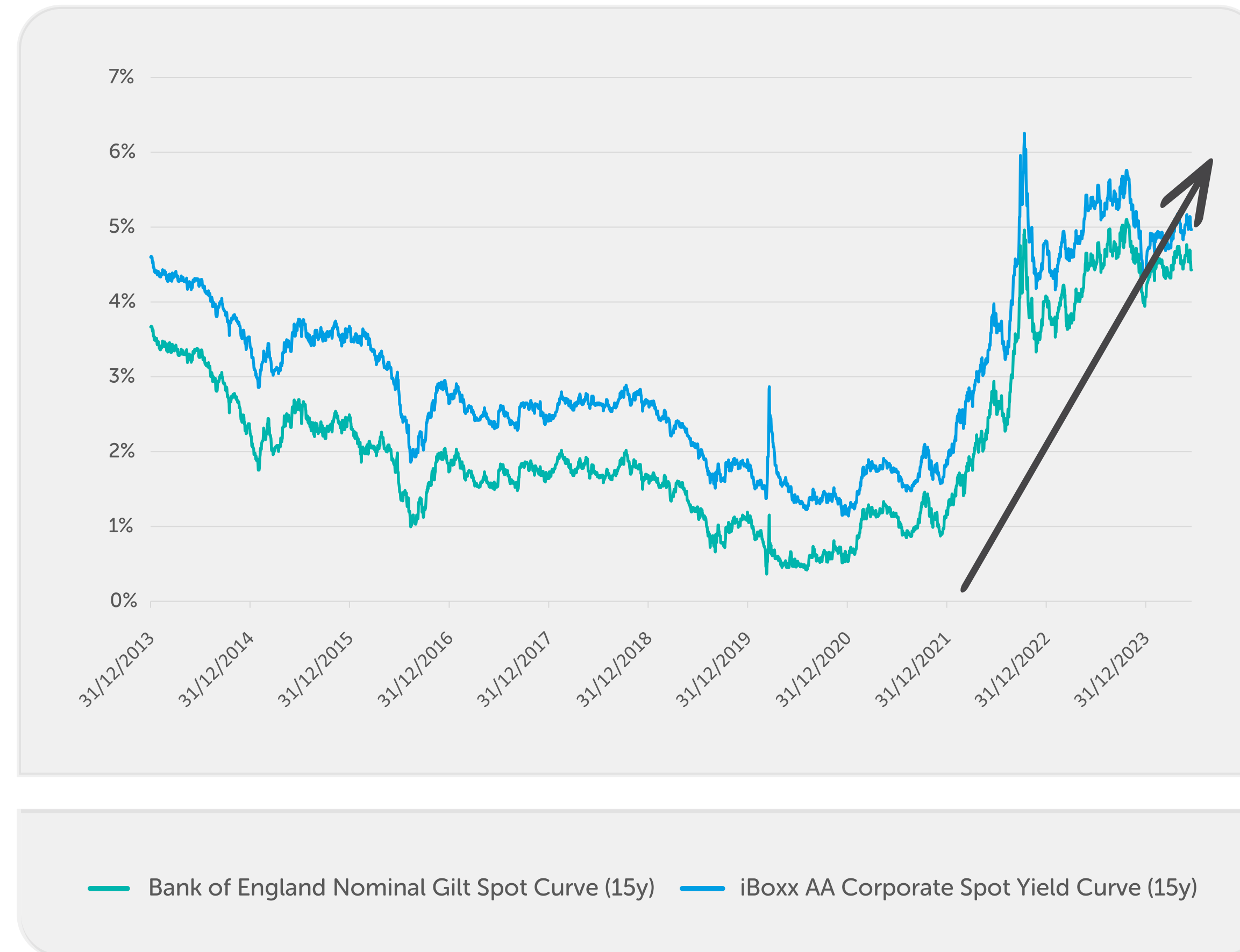


Introduction

Investment objectives traditionally focus on long-term risk and return. However, a crucial third objective for many investors is meeting shorter-term cashflows. Failure to meet these cashflows can lead to significant issues, making it imperative for investors to have a robust cashflow policy.

Furthermore, with interest rates at a 15-year high, the yields available on fixed income assets can make a material difference to the income generated on investment portfolios. The gilts crisis of 2022 also emphasised the importance of liquidity, highlighting the severe consequences of insufficient liquidity for defined benefit pension scheme investors. All investors can learn from this.

This note sets out our latest thinking on how to maximise the likelihood of meeting your cashflow requirements when they fall due, while also managing transaction costs.



Source: Bank of England and iBoxx



Why is cashflow policy important?

Where an investor has cash outflows to meet, the closer it can align the income from its assets with cashflow requirements (both in terms of amount and timing) the more efficient an asset portfolio will be. The other option is to sell down assets, but this comes with a number of downsides that investors need to be aware of.

What are the risks?

First of all, selling assets usually comes with transaction costs that will eat into returns. Having predictable cashflows generated automatically through income reduces this cost.

Furthermore, there are two closely linked issues to be aware of with having to sell assets to meet cashflows: firstly, being forced to crystallise losses and secondly the increased impact of downside risk.





1. Forced selling

Cash inflows < cash outflows → cashflow deficit

Being in a cashflow deficit means the investor is forced to sell down its assets to meet its cashflow needs. We think the key issue is finding a way to do this without crystallising losses.

Why is this important? If you sell an asset at a loss, then the remaining assets will have to work that much harder to recover that loss. For an investor in this scenario, it is therefore no longer sufficient to generate the assumed level of return on average; it now needs to be achieved on a consistent basis.

2. Downside risk

It is important to consider how much downside risk investors can take. By this we mean the risk of an investor running out of money due to the value of their investments falling in value.

For investors targeting high returns, then over the short term, we expect a higher level of volatility in the assets. This means that there is a greater chance of any short-term loss being crystallised when withdrawals are made (i.e. forced selling) which could result in an unrecoverable position. The investor may then find themselves in a position whereby the returns on assets (even if stable) are less than the cashflows out; and the assets will be depleted over time.

When timescales are short this increases the issue because there is less time to recover any losses.

In both of these risks, the size of the cashflow relative to the total assets is significant. Given the current high yields, this has increased discount factors which in turn decreases asset valuations in many cases. However, short-term cashflow requirements are less affected by changing yields and so cashflows of the same nominal amount are a higher proportion of total assets.

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The combination of both of these risks together is what we call 'sequencing risk', the risk that the order and timing of cashflows are unfavourable for an investor.

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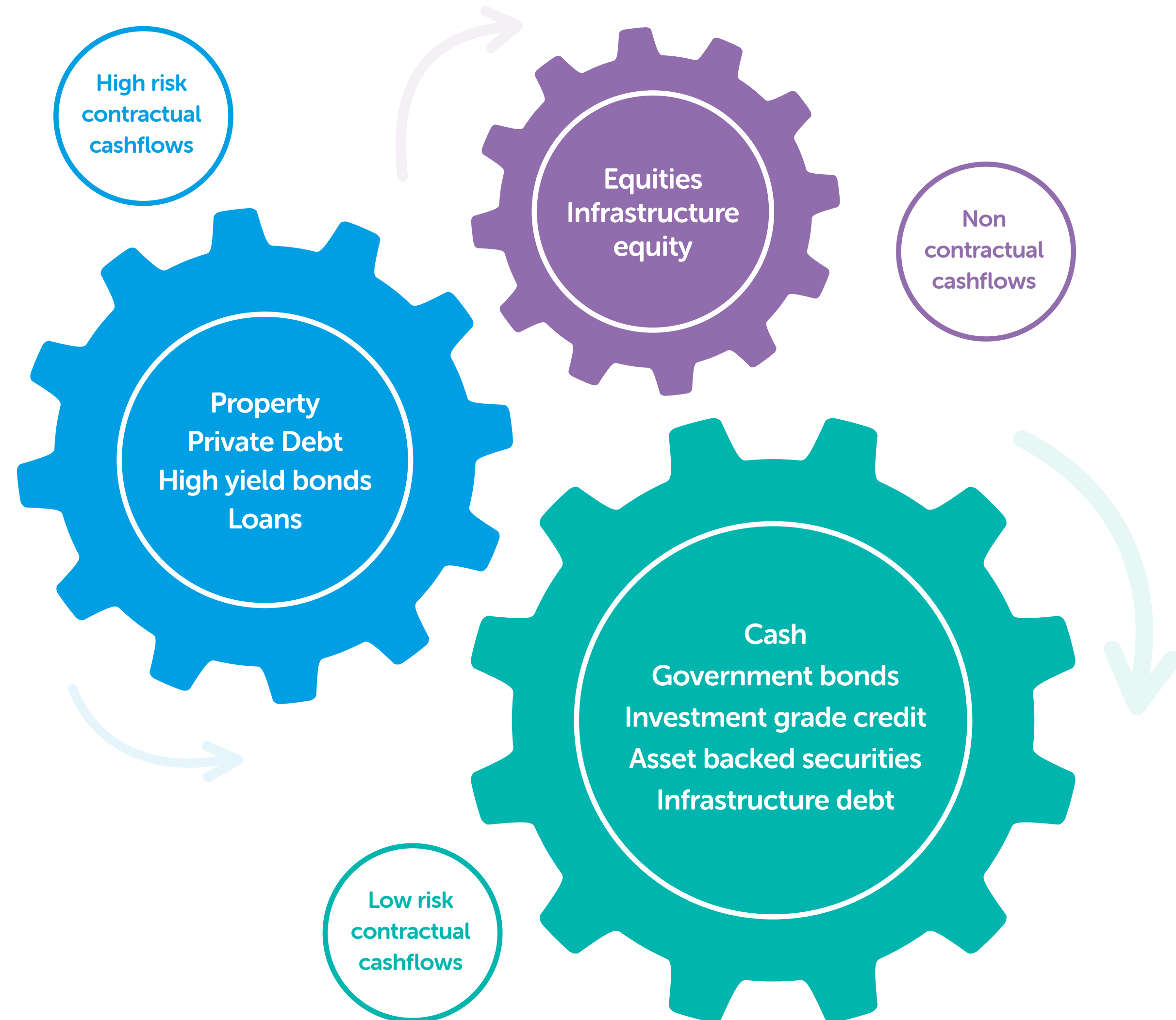
Meeting cashflows - Overview

Almost all asset classes generate some form of cashflow which can be distributed to the investor. This means there is a wide opportunity set investors can look to generate cashflows.

Key considerations when selecting assets for cashflow generation include:

- Expected level of income yield.
- Timing of income payments.
- Level of certainty around the income, e.g. whether it is contractual or discretionary, and the risk attached to the payment not being made (i.e. default).

Having a cashflow 'focused' framework helps to make your investment strategy more robust – even if yields do move, this doesn't change the expected cashflows being paid out of an asset versus the short-term cashflow needs of the investor.

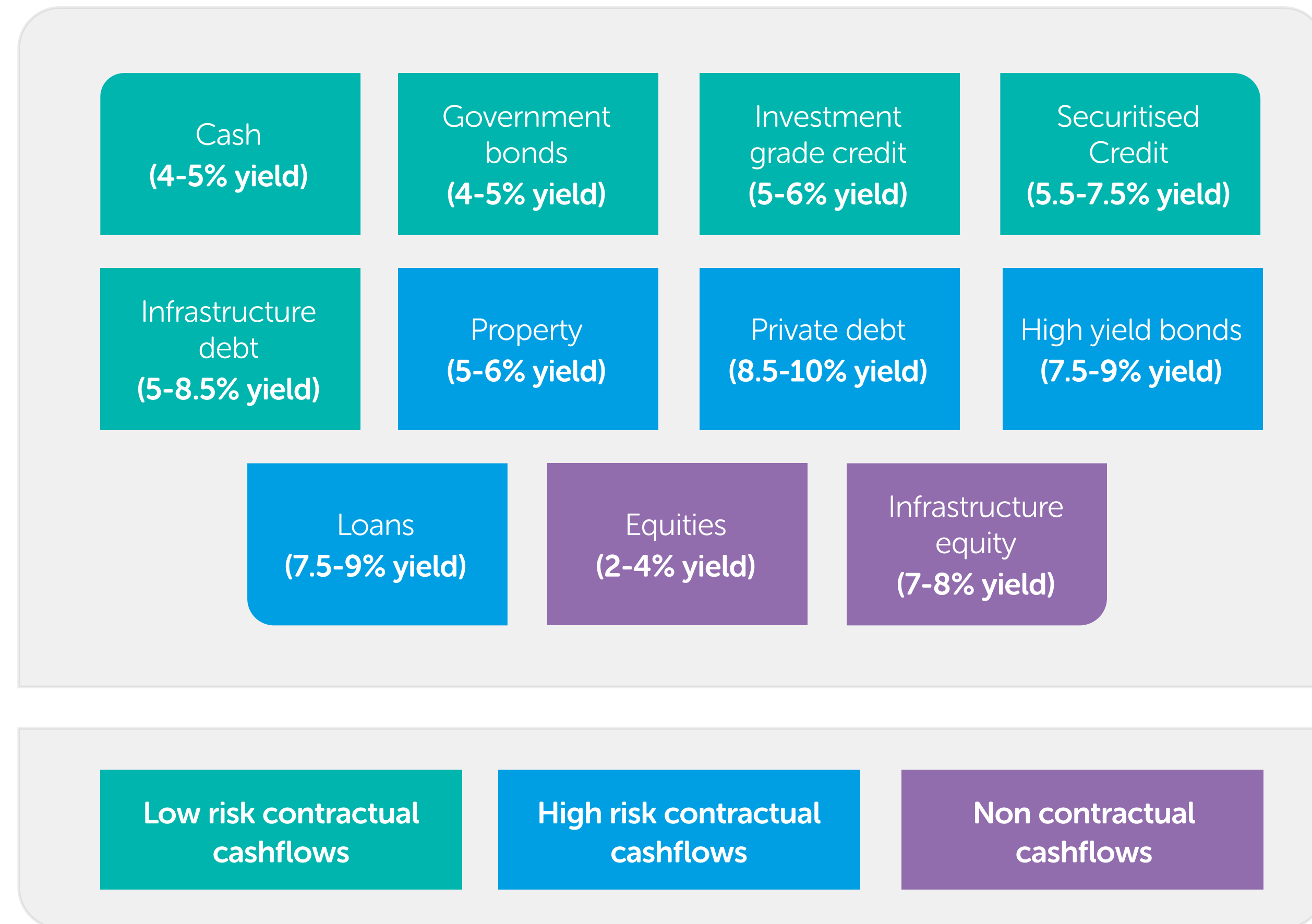


Meeting cashflows - Income generating assets

The information set out in the table is based on market conditions at the time of writing (August 2024). At this time, the majority of developed market central banks set their base interest rates in the range 4.5% - 5.5%. This has resulted in high yields from credit assets.

The yield figures set out below are based on a three to five-year time horizon.

Assets that provide a high income yield can make a significant contribution to cashflow needs. Considering parts of the market where an attractive spread above assets viewed as 'risk free' is available (e.g. cash and government bonds) is important when building your cashflow policy to ensure you are appropriately rewarded for taking on risk.



Source: BWARM 10 year median assumptions at 31 March 2024.



Key cashflow considerations

Over the next few pages, we have set out example cashflow policies, which have clear differences depending on what type of investor you are.



DB schemes - Key considerations

Cashflow Driven Investment (CDI)

- CDI is an established concept where income generation aims to broadly meet the expected liability cashflows where possible.
- Given the uncertainty of cashflows (both in terms of amount and timing) we tend not to target a very high degree of matching due to spurious accuracy.

Sponsor covenant

- Schemes with a strong covenant may be more inclined to use less liquid and more varied cashflow generating asset classes, i.e. where the cashflows are less certain and the expected return is higher. This is because the sponsor is more likely to be able to pay in cash if a cashflow shortfall arises. The opposite is true for schemes with a weak covenant.

Investment governance budget

- Schemes with more available time to focus on investment matters are likely to be able to access less liquid and more varied cashflow generating asset classes.
- Schemes with a smaller investment governance budget are more likely to use a simpler approach like a pooled buy & maintain credit funds.

Liability Driven Investment (LDI)

- LDI should maintain funding stability and provide inflation protection.
- LDI assets can contribute to cashflow generation as leverage required naturally falls over time so assets can be paid out.
- Collateral calls can lead to significant sequencing as calls are often met from disinvesting other assets within a portfolio at an unpredictable time.
- LDI managers are now offering more creative ways of posting collateral to support LDI, e.g. using credit. These are primarily considerations for large schemes given the associated costs.

Scheme maturity and funding level

- Mature schemes with strong funding levels are more likely to be cashflow negative (as less likely to have significant contributions from employer and a high level). As more members retire the annual payroll will increase and in this high interest rate environment be a higher proportion of the overall assets. Therefore, the sequencing risk is higher.
- Cashflow policy is also important for less well funded schemes, i.e. they will likely still be receiving contributions but still need to consider the risks for unexpected cashflows (e.g. members transferring out of the scheme and LDI collateral calls).

Sustainability

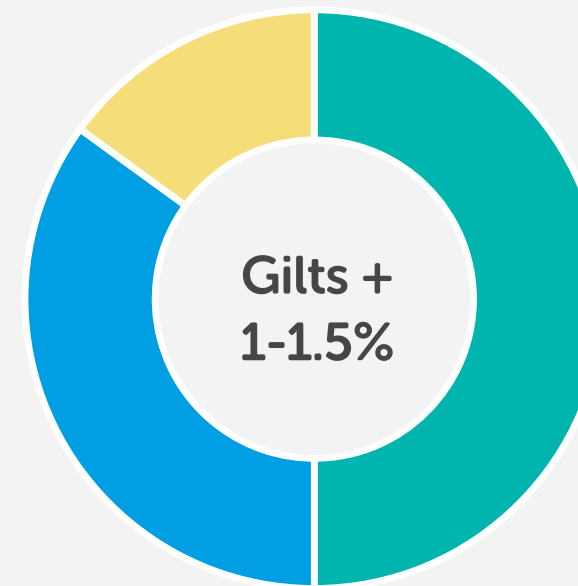
- The longer the time horizon an investor has the more sustainability needs to be considered. In particular, schemes looking to run-on.

DB schemes - Case study

Here we have shown an example of how you can build a cashflow generating portfolio of assets for a DB pension scheme. We construct a portfolio which targets gilts +1-1.5%, reducing the risk level overtime.

This portfolio design allowed the scheme to meet the majority of cashflows from income automatically distributed from the assets, minimising the likelihood of needing additional withdrawals (except for unexpected cashflows such as cash equivalent transfer values). Forced selling and sequencing risk was minimised and cashflow efficiency was maximised.

This type of analysis should be reviewed at least every three years in line with the actuarial valuation and any adjustments made to maintain the efficiency.

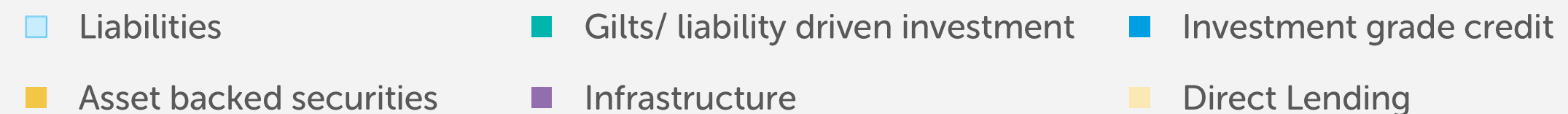
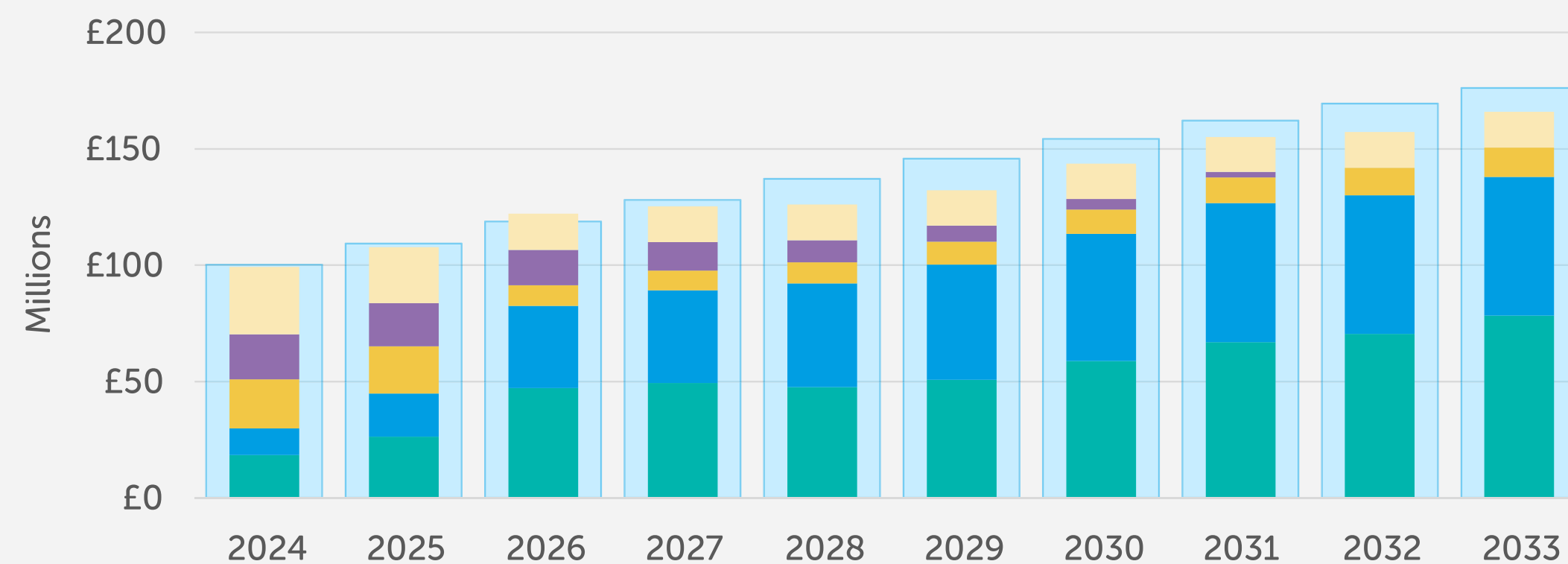


A small allocation to illiquid income and liquid growth to provide outperformance and supplement income.

Hedging and collateral assets make up a large part of the portfolio to protect against interest rate and inflation risks.

Investment grade credit provides low risk contractual income to help meet cashflow needs.

Asset and liability cashflow overlay



DC schemes - Key considerations

Sequencing risk

- This is particularly important for DC members in drawdown because they run the risk of running out of money. With widespread concern that DC contributions are too low, addressing sequencing risk offers a clear opportunity to improve member outcomes.

Inflation protection

- Achieving real returns is important but finding investments that directly match short-term movements in realised inflation is challenging – arguably limited to short-dated index-linked gilts. Many investments only provide indirect protection (e.g. floating rate credit) or long-term inflation protection (e.g. traditional growth assets). Inflation protection in DC may be best addressed at a strategy level rather than by the cashflow generating assets alone.

Investment horizon and risk appetite

- As members age and their investment horizon shortens, a lower level of risk is likely appropriate. Ensuring the cashflow generating assets held are aligned with members' cashflow needs and investment horizons offers clear potential to limit sequencing risk.

Accessing scale

- There is strong support for consolidation in the DC market. By pooling resources, providers may be able to offer members access to more diverse and sophisticated cashflow generating assets. However, practical hurdles may be relevant when handling cashflow (e.g. the ability of platforms to support income distributing share classes).

Assets held elsewhere

- DC members often have assets held outside their pot which will impact their cashflow requirements. For example, a separate DB pension may mean they don't need to draw cash from their DC pot regularly, or an illiquid asset such as property may mean their DC pot is their main source of income. In addition, most members will start to receive a state pension at some point during their retirement, this will provide supplementary income to any income drawn from their DC pot.

Standard of living

- Annual income required to maintain a member's expected standard of living will likely be a consideration when making cashflow decisions, but the member may be restricted by the other considerations on this page.



Cashflow management becomes a key priority for DC investors during the decumulation phase – that is, once an individual has retired and starts to access their benefits.

Individuals with DC savings have significant flexibility in how they access their benefits. For trustees and providers of DC arrangements, investment strategy design is relatively straightforward where members are known to be targeting a single cash lump sum or taking an annuity. In those instances, cashflow considerations are less important. Although, annuity targeting strategies invest heavily in government and corporate bonds to mirror insurer investment strategies.

Cashflow considerations become much more important for individuals using income drawdown. Drawdown strategies can vary hugely, with some pots drawn over short periods of three to five years and some supporting members for 30+ years.

In our experience, trustees and providers alike have shown clear interest in understanding whether their at-retirement portfolios are appropriate for their members. However, they need to cater for large and diverse groups of members and, once wider sources of savings are taken into account, ensuring each individual's investment strategy meets their personal circumstances becomes even more challenging.

We support further innovation in the DC market to allow for more personalisation of investment strategies – with cashflow considerations ripe for development.



WATCH THIS SPACE: Our DC investment team will be publishing an insights article on investment strategy design in the decumulation phase later this year.

Charity, family office and other investors - Key considerations

Inflation

- Many investors target a high return of inflation +3-5% per annum, set to cover the investor's income requirement plus inflation to preserve real value of the 'endowment'. If the expense outflow is higher than their cash inflow, then a high proportion of this return target will be required to meet the cashflow deficit.
- An organisation's expenditure is expected to rise with inflation over time and therefore it is important for income to also grow with inflation. This tends to be through assets with an indirect link to inflation which are expected to increase broadly in line with inflation over the long term rather than assets with a contractual link to inflation. However, this is dependent on investor specific circumstances.

Tax

- In some jurisdictions, assets that generate high income are more favourable from a tax perspective compared to assets where their growth primarily comes from capital gains.

Capital preservation

- Capital preservation is important, assuming the organisation looks to be active into the long-term future. Some investors have permanent capital assets which cannot be liquidised in the short term. Therefore, it is important to have a robust cashflow policy in place for the remaining assets to ensure any unexpected cashflow needs can be met.

Risk tolerance

- The risk tolerance of the investor and sponsor organisation will often drive the choice of assets and allocations.

Sustainability

- As long-term investors, sustainability is often a consideration. In addition, views of the investor and sponsor organisation or public pressures on ESG and sustainability may need to be factored in.

Charity, family office and other investors - Case study

For some investors, running out of cash is a real possibility and we support them in planning to avoid this scenario long before it becomes an issue.

Here is an example of an investor where cashflow requirements are a key constraint on investment strategy. Going through our 'Aims, Beliefs and Constraints' process, we identified the cashflow requirements to be:



Our analysis highlighted that setting a robust cashflow policy was essential for this investor to minimise the risk of becoming a forced seller. We worked with them so they could understand and plan for a maintainable level of spending going forwards.

We are experienced in working with all types of investors to ensure their specific objectives and constraints are factored into their investment strategy. By helping them fully understand the implications of their strategy versus the alternatives, we deliver optimal solutions for our clients.



How can we help you

Having a robust cashflow policy is vital for every investor. We are working with investors to:

- Review cashflow policies to ensure they remain well constructed in light of the current high yield environment so that investors can meet their long term objectives.
- Take advantage of the opportunities in the market.
- Critically, reduce future risks (including sequencing risk), ensuring investors do not run out of cash.

As we have set out in this note, there are different ways of building an asset portfolio to generate income which we tailor specifically to each investors' objectives and constraints. There is often no one answer to the ideal balance of risk, return and income production, so it's important to understand how each factor impacts your expected outcomes. Furthermore, the changing financial environment means it may be a moving target.

Next steps

We have the experience, expertise and independence to provide advice bespoke to professional investors and find the solution that best fits your cashflow needs.

Whether you need a cashflow framework establishing while there is the opportunity presented by high yields or if there is already a policy in place but it needs a healthcheck to ensure you remain on track, we would love to help you. Please get in touch with Danielle Markham or your usual BW contact.



For professional use only. Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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