Investment Insights

The cashflow conundrum

Quarter three - 2016

For many years pension schemes have been trying to balance the conflicting objectives of generating the required level of return (and hopefully more) whilst also minimising the risk of the funding position falling. More recently a third objective has had an increasing role on the investment stage; meeting cashflows out of schemes.

The past ten years have seen a succession of defined benefit (DB) schemes closing to future accrual (over 34% of all DB schemes are closed to accrual compared to 12% in 2006)[1] and schemes are now much more mature (almost 40%[1] of members of DB schemes were pensioners as at 31 March 2015). This means that, deficits aside, contributions are no longer being received to meet the pension payments out. Another source must now be found to bridge this gap.

This paper looks at how much weight should be given to this third objective – meeting cashflows – when designing an investment portfolio and if there are specific features cashflow negative schemes (i.e. schemes where outgoes exceed income) should look for in their investments.

[1] *The Purple Book 2015*

'Plan A'

What was the original plan to meet cashflows?

Pension schemes were set up to pay pensions out of assets so, arguably, this transition to being cashflow negative was inevitable - particularly for closed schemes - and should not be a concern.

However, it wasn't supposed to happen in quite this way.

The intention under the majority of funding strategies was that by the time schemes needed to make disinvestments to pay pensions they would be fully funded and largely invested in low-risk assets, such as high-grade investment credit and government debt. These assets would provide regular coupon payments, alongside their final redemption payments, that could be used to meet the scheme's benefit payments.

This strategy manifested itself in schemes holding a 'growth' portfolio of risk assets and a 'protection' portfolio of gilts and sterling credit with an intention of switching from growth to protection as the scheme matured over time and further pensions became payable.

Why has the original plan 'failed'?

The funding models underlying this approach assumed gilt yields would stay between 4% and 5% forever and that low-risk credit would give a further 1% p.a. in returns. These were reasonably sensible assumptions at the time as this was what the market was pricing in. In practice, as readers will be well aware, yields did not do what was assumed and it is no longer possible to buy low-risk assets with yields at 4-5%.

For most schemes the result of this is that, despite assets keeping pace with funding assumptions over that last decade, expectations of future returns have been lowered resulting in funding gaps increasing rather than schemes reaching their fully funded targets.

Coupled with the closure of DB schemes, this has led to schemes becoming cashflow negative sooner than expected and with larger deficits than intended. The question is: how do we deal with this issue?

Issues with being cashflow negative

Before we start to look at possible solutions, let us first consider whether this is an issue at all, recalling that at the start of this note we stated that being cashflow negative was what schemes were essentially set up to become.

There are two closely linked issues to be aware of with being cashflow negative: firstly being forced to crystallise losses and secondly the increased impact of downside risk, the latter of which is exacerbated if starting from a deficit position.

Forced selling

Being cashflow negative means the scheme is forced to sell down its assets to meet its pension payments. We think the key issue from turning cashflow negative is finding a way to do this without crystallising losses.

Why is this important? Well, if you sell an asset at a loss then the remaining assets will have to work that much harder to recover that loss. 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.

Trustee takeaway

The key issue is to avoid volatility in overall asset value when cashflow negative.

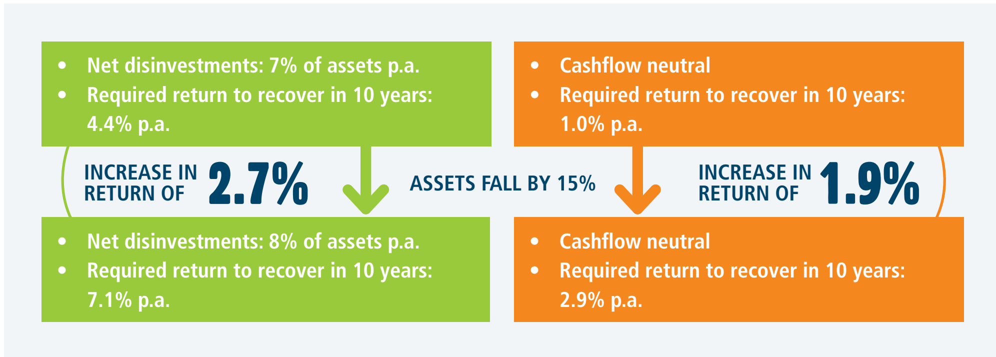
An unrecoverable position

Closely linked to the above is the impact of being cashflow negative on how much downside risk schemes can take. By this we mean, 'by how much could the deficit increase and the scheme still recover?'

For once the mathematicians have a role in this. You will have heard commentators say that Greece can never pay back its debts; the reason for this is that the outgoing payments are in excess of the returns it is able to generate (i.e. growth in its gross domestic product).

The same is, in effect, true for a pension scheme. If it finds itself in a position whereby the returns on assets (even if stable) are less than the cashflows out; plus the interest on the deficit, then the deficit will grow larger. The difficulties of being cashflow negative are therefore compounded by the low-return environment we now find ourselves in.

For example, take two schemes both in deficit but one of which is paying out 7% of its assets each year to meet pension payments, whilst the other is cashflow neutral. If the value of the assets of these two schemes suddenly fell by, say, 15%, the increase in the return required to get the schemes back to full funding would be much higher for the cashflow negative scheme, as illustrated below.



The way to break this, as with Greece, is for an outside entity to pay into the scheme to correct the imbalance. The challenge as we have seen, at the risk of extending the analogy too far, is that back end loading that relief does very little to resolve the issue and that upfront payment is key but is unaffordable for many sponsors.

Trustee takeaway

The key issue here is that the current low return environment makes deficit recovery even more challenging when cashflow negative.

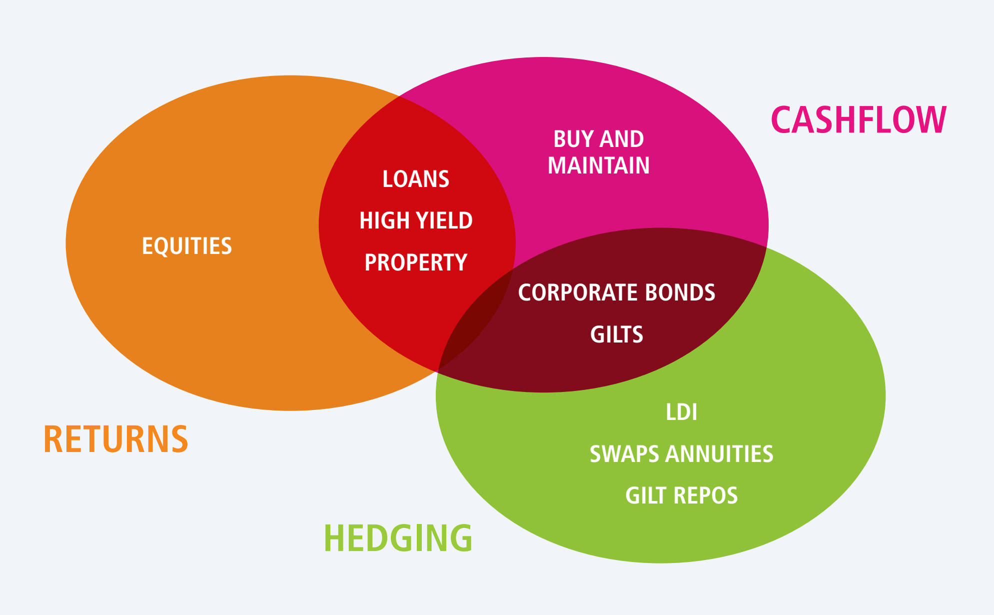
How to deal with cashflow - the 'updated' model

So as trustees, how do you tackle this third investment objective? In practice the old growth/protection portfolio actually covered many different areas and we believe considering the role that each asset class plays within the pension portfolio is key. We believe there are essentially three aims that a portfolio will have:

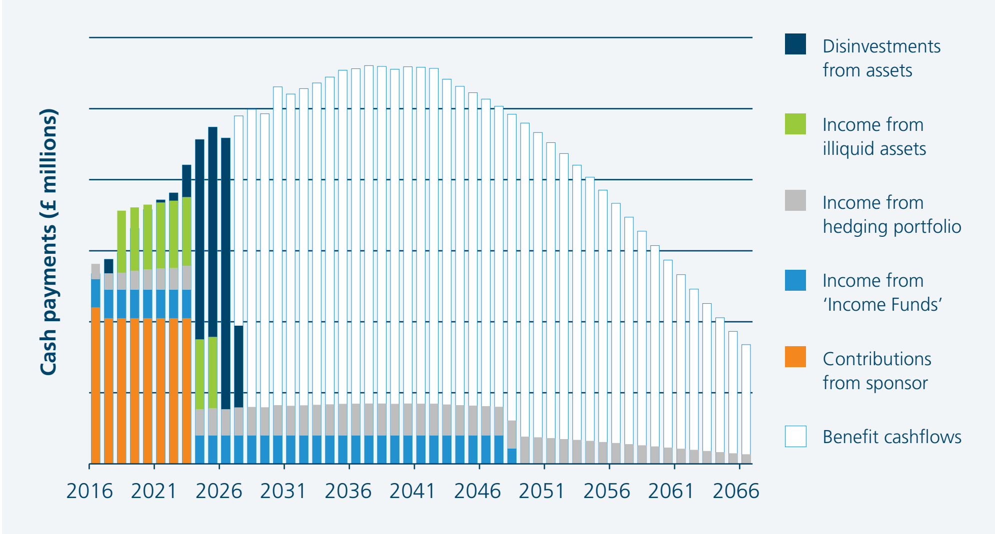
- Hedging against liability movements;
- Generating returns required to meet funding requirements; and
- Providing the cashflow to meet the benefit payments.

The first task for trustees will be to identify the importance of each of these. For example, some schemes may be unconcerned about hedging short-term liability movements; others may not have any cashflow concerns due to contributions from the sponsor.

The outcome is an assessment of the role each asset has within the scheme's portfolio; a high level example of which is set out below (this is not intended to be an exhaustive list of asset classes).



Undertaking an assessment of the cashflow needs for your scheme is a relatively straightforward and worthwhile exercise. The output of this type of analysis might be the following chart, which sets out how the scheme plans to meet expected cashflows:



As well as analysing expected cashflow requirements, we feel it is worthwhile considering cashflow requirements under a 'stressed' scenario, i.e. an unexpected and significant cash call or a sustained fall across multiple markets. Coupled with the analysis of the required level of hedging and the required investment return, such an approach will help schemes blend their overall asset allocation.

In the next section we go on to explore what features to look for within the 'cashflow' bubble.

DC Schemes

Courtesy of George Osborne, the defined contribution (DC) industry is arguably one-step ahead of the DB. DC members have had to recognise that a 'deficit' has arisen and that buying an annuity at retirement isn't going to provide the expected level of income. The result – taking more investment risk for longer in the form of drawdown. Whether that risk pays off is for another note, but we feel many of the themes set out in this note for DB schemes will be relevant for members in DC as they approach that decumulation phase.

Additional considerations for cashflow negative schemes

Investing for income

Focusing on income is put forward as one solution to the cashflow issue and seems to be the approach favoured by many fund managers who have been busy dusting off their old 'income' funds to offer as a solution to cashflow negative schemes. Some of these will be focused on equity, some on debt and others on illiquid assets. The argument is that by only using income you are never forced to sell your assets at a loss, thus avoiding the 'forced seller' issues highlighted earlier.

But is this the answer? Whilst this might be part of the story, we think this somewhat overplays the role of income only. In particular, not re-investing income could be considered akin to disinvesting from that asset on a regular basis, irrespective of how that asset class has performed, which brings about the same issues as raised on page two.

The key, as ever when looking at manager solutions, is to start by making sure you understand what you are trying to achieve and then review their solution against your objectives.

In practice, being able to choose where to disinvest from – and choosing to disinvest from assets that have recently performed well – likely results in a better end-position for the scheme.

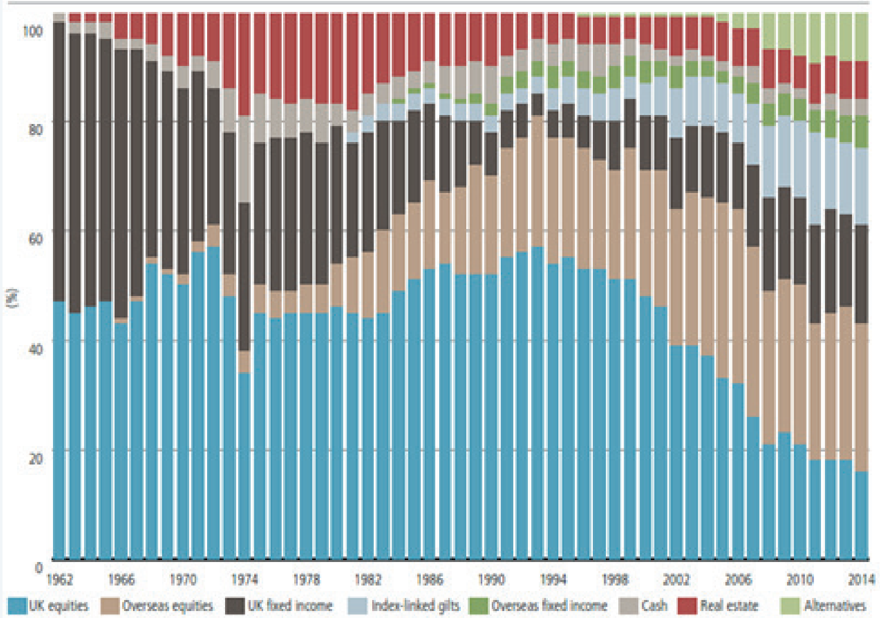
Overall, our view is that income producing assets may form a part of the portfolio and may provide some temporary relief in the event of a sustained market downturn but moreover they provide diversification which, as we discuss below, is key for cashflow negative schemes.

Diversified portfolio

If we look back in history we find that if we can hold a relatively diversified portfolio and take regular disinvestments, we are rarely forced to sell and crystallise losses; therefore diversification is the greatest ally for a cashflow negative scheme.

This is something pension funds have already been considering over the last few years – as the chart from UBS Pension Fund Indicators shows. Over the last ten years schemes have started to move significantly away from relying solely on equities and UK bonds and this is a trend that is likely to continue in the coming years.

Figure B.1 Asset allocation – average pension fund, 1962-2014



Source: Office for National Statistics (until 1995), WM (1996 onwards). As at end December 2014

One of the key things to consider is ensuring you are truly diversified across return sources and not just superficially by asset class. For example, you may feel owning high yield bonds and emerging market equities provides good diversification; however, both are very heavily exposed to oil and when oil fell heavily, both markets fell in line with each other. If you had coupled those with a UK equity portfolio you would have been in difficulty. This is just one example of many.

A combined approach

Ultimately, a combined approach may be most appropriate.

Holding assets in income generating investments to aid short term cash needs is likely to be useful. However, Trustees will need to take an 'intelligent' approach towards cashflow needs. By being flexible in their sourcing of cash, with a fully diversified portfolio, they will maximise their chances of their cashflow needs not acting as a drag on long-term performance.

Key conclusions

The emergence of cashflow as a consideration for many schemes over the past few years has started to lead to slight changes to investment allocations. Schemes should be prepared and have a plan in place for meeting their cashflow needs, both on a business as usual and a 'stressed' scenario. This doesn't just mean having 'liquid' assets – something many schemes have far more of than they strictly need – but consideration of which assets are fit to meet these cashflow requirements.

In summary we believe schemes that are in negative cashflow should:

1. **Have a cashflow plan**. Factor a plan into your investment strategy for meeting cashflows out of the scheme – both how they will be met in the short-term and how your strategy will need to change to accommodate cashflows in the longer term. In determining your cashflow plan, we feel both the business as usual and 'stressed' conditions (i.e. can the cashflow plan sustain a market downturn across multiple markets) should be considered.
2. **Ensure that the portfolio is truly diversified**. Ensuring a variety of sources of return is key, rather than focusing on the high level asset class name. Income investments have a role within such a portfolio but are far from the only solution.
3. And perhaps most the difficult element – **consider how much downside risk you can accept as a scheme**. As a cashflow negative scheme in deficit, the trustees and sponsor may have to consider larger upfront payments if they want to avoid a situation where the deficit is so large, recovery is impossible in the current return environment.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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