MANAGING CASH FLOW RISKS WITH GREATER CONFIDENCE USING FIXED INCOME

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As pension schemes mature many are reaching the tipping point at which payments to retirees exceed contributions and income from investment. Insight Investment's Olaf John highlights how secured finance investments can help pension schemes manage cash flows while generating growth

After a long period of positive returns as yields have fallen, bond investors now face potentially higher risk and lower returns. If bond yields rise more than is already priced by markets, the capital element of fixed income investments will fall in value. In spite of this, we believe there are potential current opportunities for bond portfolios to both deliver risk managed cash flow and generate positive returns.

Specifically, there are opportunities available to buy assets that are high quality, but less mainstream and liquid. We believe such assets can play a significant role in maturing pension funds' portfolios.

SECURED FINANCE: A POTENTIAL SOURCE OF HIGHER YIELDS WITH SOLID CREDIT QUALITY

While there has been a recent increase in investment grade credit spreads as the cycle reaches a more mature phase, particularly in the US, spreads are still relatively low. Investors looking to maintain attractive returns are generally faced with the equally unpalatable choices of reducing credit quality (buying high yield) or raising leverage, via strategies such as risk parity.

We believe less liquid/more complex investments, such as secured finance assets, are an attractive alternative. Secured finance assets are credit investments secured against other assets, such as residential mortgages, commercial real estate and corporate loans. Because they are secured against collateral, the ratio of return to expected default probability is materially higher than that of standard corporate bonds. Secured finance investments are also typically floating rate in nature, so income should increase when interest rates rise.

By investing in secured finance, investors can pick up a significant premium over investment grade credit while retaining a portfolio with high credit quality *(see Figure 1)*. In addition to relative illiquidity, the excess yield can be explained by the under-researched nature of the assets, as well as a shortage of expertise required to understand the mechanics of investing in this area of fixed income: as a result it is known as the "complexity premium".

HOW SECURED FINANCE CAN HELP PENSION SCHEMES TO MANAGE CASH FLOW RISK

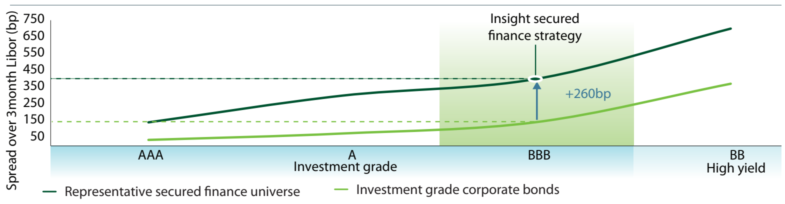
Pension funds face a myriad of challenges. Austerity is increasing pressure on contributions and, as funds mature, cash flow risk management is becoming a priority. Every pension fund aims to cover both short-term liability payments and meet long-term commitments. A fund that plans ahead and preserves some allocation to long-term return-seeking assets can be more certain of achieving those goals. However, when net cash flow is neutral or negative there is a new imperative: timing.

If cash flows are insufficient to meet current liabilities, a fund may be forced to sell its return-seeking assets at an untimely moment. Being a forced seller at the wrong time will impair a pension fund's ability to meet future obligations. This would have the same effect as raising the long-term return target of the fund, because the pool of return-seeking assets will have been shrunk by the forced sales.

This is a problem that is confronting many pension funds and their advisers. By definition, fixed income assets offer predictable cash flows, and will have a significant role to play in meeting this challenge. Liability matching offers the simplest answer, but most funds do not enjoy surpluses and do not want to lock in deficits. Added to these concerns is the market backdrop: uncertainty remains about the direction of monetary policy, and the impact any future central bank action might have on the bond market.

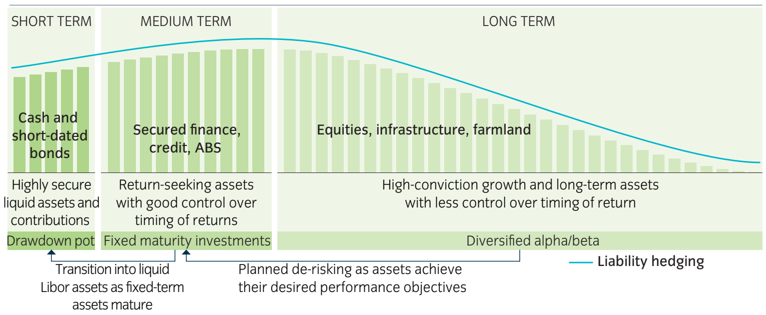
An investment strategy that incorporates secured finance can help maturing pension funds to manage their cash flows. For maturing pension schemes, one component of an effective cash flow risk management plan is the creation of a "drawdown pot" consisting of highly liquid, short-dated assets: largely money market instruments, cash and short-dated bonds. When the fund is required to pay income to retirees, it can draw from this pot. For example, a pension fund may set aside a drawdown pot to cover the next five years of payments.

Figure 1: Risk/reward from investment grade secured finance versus comparable bonds



Source: Insight as at 31 December 2015. The spreads shown are for illustrative purposes only and are not indicative of the strategy spread.

Figure 2: A holistic approach to meeting the income needs of pension funds



Source: Insight. For illustrative purposes only.

Over time this drawdown pot can be added to. This is where assets with fixed maturity dates are valuable, and secured finance investments fit well into this framework as they are typically structured with fixed maturities, pay regular interest, and repay capital at maturity. If a pension fund has a high level of confidence that assets will mature and generate a certain amount of cash each year it can be confident that its drawdown pot will be replenished. With these building blocks in place a pension fund can invest in assets for the long term with greater confidence that it will not be forced to sell them to meet cash requirements.

If long-term assets achieve or exceed their targets, they can be sold to reinvest in medium-term assets with fixed maturities. Long-term assets could, over time, be converted to the fixed maturity assets designed to generate cash for the drawdown pot. This process can retain the upside generated by long-term assets while reducing exposure to volatility, therefore helping to increase the probability of achieving a long-term investment objective *(see Figure 2)*.

This planned approach to cash flow risk management, with its emphasis on income generation and capital security in a fixed income allocation, enhances the overall portfolio. It means return-generating assets can be ring-fenced and allowed to do the job they were originally bought for: for example, long-term buy and maintain credit strategies can be left to generate performance over the long run.

In this context, secured finance investments can help pension schemes to meet both their short-term cash flow needs and long-term objectives.