CDI: Does it make sense for UK DB schemes?

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Cashflow Driven Investment (CDI) has recently become one of the most discussed topics in the UK pension industry. A popular and well established form of fixed income investing in the insurance sector, could CDI also be appropriate for the defined benefit (DB) pension sector in the UK, which does not have the same regulatory capital constraints? We believe so based on the following three reasons:

First, the sector is still generally underfunded, gradually maturing and turning increasingly cash flow negative (i.e. pension payments exceed contributions and income). This trend will only accelerate over the next 10-15 years which will likely create a drag on asset portfolio returns and an implicit liquidity need.

Secondly, and because of their underfunded position, many schemes have been invested on a growth plus liability-driven investment (LDI) basis, which increases the scheme's vulnerability to market downturns and forced-selling if they are cash flow negative.

Finally, the impact of a rising rate environment on levered LDI portfolios could potentially increase liquidity needs due to higher collateral requirements.

The conditions listed above are clear risks to underfunded and cash flow negative schemes - but are they sufficiently significant to justify a switch to CDI?

The effect of cash flow negativity

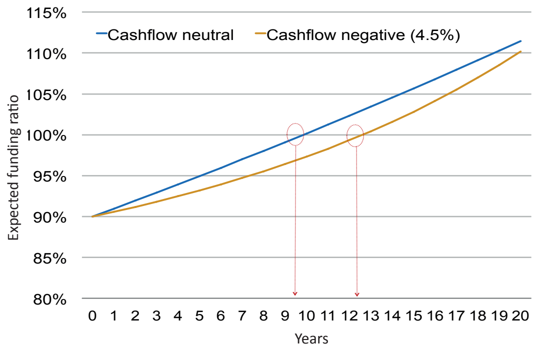
A reduction of the asset base diminishes the overall compounding effect of a pension plan. This lengthens the time that the scheme needs to achieve full funding.

Let's use an example: imagine two hypothetical pension schemes, both 90% funded, and both with identical expected excess returns of 1.1%.[1] The differences are:

Scheme 1: is cash flow neutral over the next 10 years.
Scheme 2: is cash flow negative to the tune of 4-5% per annum over the same period. This means that net outflows are approximately 4-5% of the asset value.

Once we run the numbers, and as we see in Chart 1, we find that the cash flow neutral fund is expected to reach full funding by year 10, a timeframe that extends to 13 years for the cash flow negative scheme. This happens because the cash flow negative scheme loses compounding power as the asset base is reduced in order to pay for liabilities. From this we infer that even without other impediments to achieving full funding, the cash flow need alone is significant to impair that timeframe.

Chart 1: Cash flow negative schemes need more years to reach full funding



Vulnerability to a market downturn

Applied to our example, let's assume that each of our two schemes allocates a typical 40% to Equities and 60% to Liability Driven Investments (LDI). Imagine that equity markets drawdown by 25% in the first year, but they recover over the remaining nine years, so that the total return of the portfolio over the 10 years equals the expected return at the outset.

As seen on Chart 2, we find that the cash flow neutral scheme recovers full funding in year 10, as it happened in our previous baseline scenario. However, the cash flow negative fund, see Chart 3, reaches full funding by year 18, five years later than under the neutral market, and eight years later than the cash flow neutral scheme. This extra time needed to reach full funding comes as the market drop depletes the fund's asset base even more, further reducing the compounding effect. For a cash flow neutral scheme only the cumulative returns matter. However, for a cash flow negative scheme, the sequence of returns over time matters. This illustrates the risk for cash flow negative schemes to fund liability cash flows from asset disinvestment, path dependency.[2]

Chart 2: Funding level projection on a cash flow neutral scheme

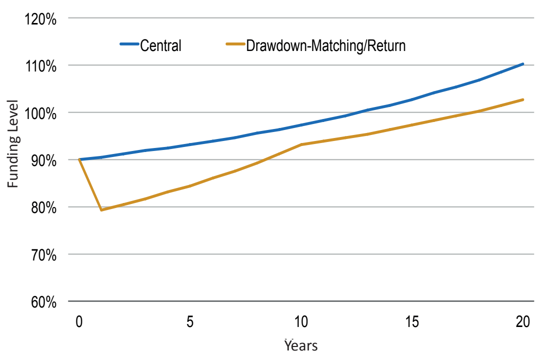
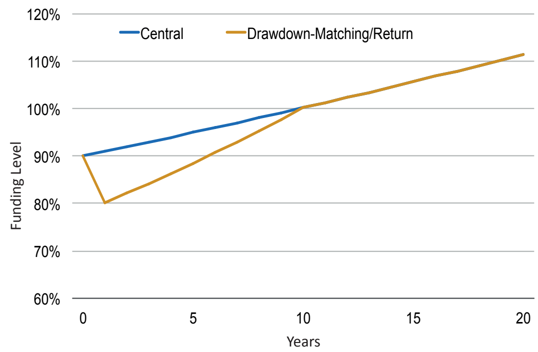


Chart 3: Funding level projection on a cash flow negative scheme



What can be done?

1. Capital Efficient Solutions

Combining existing beta exposures such as equity futures collateralised by a core bond portfolio could help free up liquidity. However, this may not be appropriate for those schemes with an already levered LDI portfolio as it would add further leverage.

2. Equity-defensive strategies

These strategies typically cover trend-following, tail –risk hedging via explicit option buying and alternative risk premia diversifiers which when combined can help mitigate equity risk while delivering higher positive expected returns.

3. Cash Driven Investing

Anchor the portfolio around income generating/self-liquidating assets that can meet a certain portion of liability payouts with a high degree of certainty. While the mix of assets that could meet that approach include equity dividends, infrastructure, long term lease property and other illiquid fixed income assets, we believe the core of most CDI portfolios will be allocated to high quality investment grade credit. However, CDI is only a means to an end, and should not be employed at the expense of achieving required growth to close a funding gap.

This is the first in a three part series; next time we'll discuss important implementation aspects of the core part of CDI portfolios.

To see whether CDI is right for you and how to implement it, please speak directly to:
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FOOTNOTES

1 This is designed to be the required excess return (of assets over liabilities) of a 90% funded cash flow neutral scheme to achieve full funding in 10 years

2 The assumption of annual re-balancing is a strong one, and only used for illustration purposes. Schemes could of course make a variety of different asset allocation decisions at the end of year one (e.g. lever up their equity allocation)

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