Why cashflow driven investment is changing the pension investment landscape

Interview with Sebastien Proffit, Head of Portfolio Solutions, Fixed Income, AXA Investment Managers.

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How is the defined benefit pensions market evolving?

In the mid-2000s, when liability-driven investing (LDI) was in its infancy, the issue of whether to hedge unrewarded risks such as interest rates and inflation was strongly debated across the UK pension scheme market.

In a pre-LDI world, when pension schemes were open and growing, the focus was on investment returns and asset growth. But as they started to close, LDI moved from the margins into the mainstream, and today is much more commonplace in investment strategies. The focus therefore was onto balance sheet management.

Strong movements in equity markets, increased transfer activity, and changed longevity assumptions have since led to a significant improvement in funding positions.

Many pension schemes have started to move their primary objective away from maximising returns, to safeguarding their assets. More than half, at 56%, of UK pension schemes are currently cashflow negative, and of those that are not, 49% are expected to become so over the next five years.[1] Therefore the cash they generate from their investments – as well as scheme members' contributions – is lower than the amount they need to pay out as pensions.

This scenario has been exacerbated by schemes being closed to new members, which in turn has reduced the amount of money coming in. But this environment has brought cashflow driven investment (CDI) strategies into focus, with income statements now rivalling traditional balance sheet management for prominence.

What is the role of credit in CDI solutions?

As an asset class, corporate bonds (or 'credit') satisfy all the pre-requisites for reliable cashflow generation strategy. They offer a predictable cashflow profile with no floating payments, along with duration exposure and a premium over government bonds. This, in addition to their relatively liquid and flexible nature, forms a compelling argument for pension schemes to look to corporate bonds as the main building block of their cashflow driven strategy.

With credit as its cornerstone, CDI solutions can then be complemented by other satellite elements such as real assets. Real estate, for example, can help in liability and cashflow management, although its suitability is limited to very long-dated cashflows due to its illiquid nature.

A clear indication of the shift in focus to the income statement can be seen by how schemes are investing their credit allocations: increasingly, these are being tailored to focus on cashflow delivery rather than generating returns.

Previously a typical investment objective for a credit allocation would involve actively beating a benchmark or passively track a given index – both of which represent strategies purely focused on investment returns and closing deficits. Now, well-funded schemes are increasingly taking a benchmark-agnostic approach, focusing instead on safeguarding the assets they have and paying pensions due. This new objective calls for a different investment approach – and 'Buy and Maintain' strategies are very well suited to helping schemes achieve it.

Why are Buy and Maintain strategies popular?

Because it can be tailored to scheme-specific circumstances, and match the scheme's expected cash requirements to meet pensioners benefits, Buy and Maintain credit is emerging as a core component to cashflow-matching investment strategies.

But adding corporate bonds to a portfolio means that management of credit risk and default risk becomes crucial in this approach. That means devoting a substantial amount of energy to credit research, with analysts delving deeply into the fundamentals of each and every company the manager invests in. Extra financial considerations such as environmental, social and governance (ESG) criteria should be included in the analysis. A business must demonstrate that it has a sustainable model which can thrive in changing economic and regulatory conditions.

In this way, Buy and Maintain credit provides investors with the advantage of long-term fundamental credit analysis that is missing from a typical passive index-tracking approach. Additionally, whereas active management will focus more on short-term valuations, a Buy and Maintain approach looks more deeply into the company's future potential to deliver income for decades to come.

What's more, by holding quality bonds to maturity, and ensuring that cashflows materialise as and when expected, the scheme will not need to sell assets to meet benefits – so a Buy and Maintain approach is able to drastically reduce transaction costs, and even more importantly would prevent the schemes to be forced seller during a market sell off.

As pooled LDI solutions can help manage both inflation and interest rate risk, is pooled CDI the answer?

With LDI, we saw products developed with a duration profile matching that of the 'average' pension scheme's liability profile. Similar thinking could be adapted to cashflow-driven investment, whereby the cashflows generated by the underlying assets of the fund would match those expected by the 'average' scheme. An important factor to consider is that a CDI strategy does not need to precisely match the scheme's cashflows, but rather needs to take a "cashflow aware" approach by maximising the quantity of future cashflows, ensuring that cashflow is available as and when expected. However, precise matching in credit can be both costly and risky. The cost aspect arises due the fact that, in order to precisely match a specific cashflow, schemes might end up purchasing an expensive bond that offers only a limited premium over gilts. In terms of riskiness, schemes could end up being over-concentrated on a single issuer in their pursuit of precise matching of a given cashflow, which could have a material impact in case of a credit event on this issuer. It is also important to bear in mind that the future value of liabilities is uncertain, depending on transfer value activity, and that CDI is likely to be the main but not sole contributor to future scheme liquidity requirements, related to paying pensioners benefits. In this environment, schemes might also need to downsize their equity exposure in order to contribute to benefit payments. Lastly, LDI will remain responsible for ensuring that schemes remain appropriately hedged. For these reasons, taking a cashflow aware approach with a fund that matches the "average" scheme's cashflows is a sensible approach to manage its future liquidity needs.

The second evolutionary step in pooled LDI was the development of 'maturity bucket' funds, where schemes could design a semi-bespoke hedge against their assets by allocating them across different 'buckets' in different proportions. However, as mentioned previously, while precise matching is key in the LDI space, it is less of a priority in the CDI space. In contrast, the main emphasis is on appropriately managing the

credit risk to minimise the likelihood of experiencing any credit event such as impairment or default. In order to do so, schemes need to be efficiently diversified across the maturity spectrum, meaning that every bond needs to be interconnected. For example, schemes must ensure that the longest maturity bonds are the safest ones, which is only affordable if the riskier bonds offering a high credit premium over gilts are incorporated within the shorter end of the maturity spectrum. By managing their CDI strategy using 'maturity bucket' funds, schemes will not have the right tools to efficiently manage the level of diversification. However, 'bucket' funds that focus on a specific asset class, such as high-quality credit or secured financing (e.g. CLO, ABS), would ensure the right level of diversification, while allowing schemes to tailor their investment depending on their liquidity, risk and return requirements.

Such CDI open-ended funds have been created recently and we expect this to continue.

Does CDI work for all schemes?

Like the incorporation of LDI within pension schemes' portfolios, cashflow generation does not have to be an all-or-nothing strategy. Pension schemes did not move from 0% to 100% hedging with swaps or leveraged gilts in one go; the hedging strategy would have been built up over time.

The same can be said for CDI, given that the transition to a 100% cashflow-matching strategy represents a significant portfolio change. As with LDI, a change in mindset is needed first. In the case of CDI, this starts by focusing on how cashflows will be met over the short-to-medium term.

We recognise that the move towards cashflow matching will be a gradual process and in the meantime pension schemes will continue to utilise more traditional techniques (such as available income, utilising surplus collateral, selling equity to de-risk) to meet their cashflow requirements.

As funding level improves, it is natural that well-funded schemes will seek to eliminate risk by substituting growth assets for ones that are more suitable for cashflow delivery such as corporate bonds or gilts. However, even for less well funded schemes, which are further away from their endgame, the consideration of how future pensions are paid is of equal importance to how deficits will be closed. In order to tackle this challenge, schemes need to move away from a pure focus on asset growth to deal with the redistribution of assets back to the members they were designed to service.

We therefore expect that in the near-term, decisions and methodologies to meet cashflows while retaining a growth asset element will become more prominent and more keenly debated across the pension scheme landscape.

What can pension schemes learn from insurers?

Cashflow has long been central to the insurance sector: managing liabilities using credit is at the heart of an insurers' business. This is typically achieved under the Solvency II matching adjustment framework, which requires both a precise level of cashflow matching and a heavy reliance on in-depth fundamental research. This "insurance-like" mindset is one which DB schemes nearing full funding will need to start adopting – although this level of change may prove challenging for some trustees. Rather than focusing primarily about where to invest the scheme's money, they will instead need to decide where they are going to disinvest assets from. However, while schemes can benefit from using insurers' techniques to manage their Buy and Maintain portfolio, they will not need to act under the same regulatory framework. For example, they can manage their investments using a cashflow aware approach, which is typically more cost efficient than a precise matching solution. They can also benefit from attractive investment opportunities that tend to be ignored by insurers, given the cost of regulatory capital.

How do you see the market developing?

As DB pension schemes enter the next phase of their journey, and move a stage closer to end game, a requirement to take further risk off the table will lead to the pursuit of assets which provide contractual and more certain income streams.
When asked about end game, many pension schemes will expect to reach the utopia of a buy out, with this market continuing to expand where deals are breaking records every year. However, care should be taken when reading these headlines since a market capacity of £30bn per year will provide a final end point for many schemes. Nevertheless, with a total market of £2,000bn, only a small portion can expect to reach this point in the near term, and this demand/supply imbalance will eventually lead to implications on pricing.

CDI will therefore offer an alternative, or interim, solution for schemes who look to de-risk their investment strategies and focus on delivering cashflows with which they can pay member their pensions securely.

The type of assets which schemes look to incorporate into their CDI portfolios will develop over time. At the current time, our view is that investment grade credit will be the core of any CDI based strategy, however, with schemes showing a preference for sterling, we advocate that clients begin their cashflow journey though allocations to GBP credit whilst it is still liquid and affordable to do so. It will not take too long before this market becomes saturated and alternative strategies will need to be considered.

We expect that core CDI will develop as schemes look to complement sterling credit in the short to medium term with dollar and euro names as liquidity and, potentially, market levels drive this decision making.

We expect it will be the assets which complement a core CDI offering that will see the highest level of evolution, as banking regulation causes the withdrawal of traditional bank lenders. The non-traditional credit market will offer significant opportunities for pension schemes to acquire contractual assets which provide pick up compared to their core CDI offering due to the additional premium offered as compensation for the higher levels of illiquidity and complexity.

Whereas traditional insurance markets and even core sterling investment grade credit may face capacity issues due to the global nature and regulatory back drop, the opportunities available in this non-traditional space will offer plenty of assets with ability to be incorporated within a CDI based strategy.

FOOTNOTE:
1 According to Mercer's European Asset Allocation

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