



Cash is king for DB pensions

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Cash-flow driven investing (CDI) could be pivotal for defined benefit (DB) pension funds navigating their end-game. Norbert Fullerton, Head of Institutional Client Strategy, EMEA, explains why it is suitable for sponsors who want to reduce pension funding risks on their balance sheets. He also outlines that for trustees, it shifts the focus to managing both funding level volatility and ensuring they have enough income to pay members' benefits when they fall due.

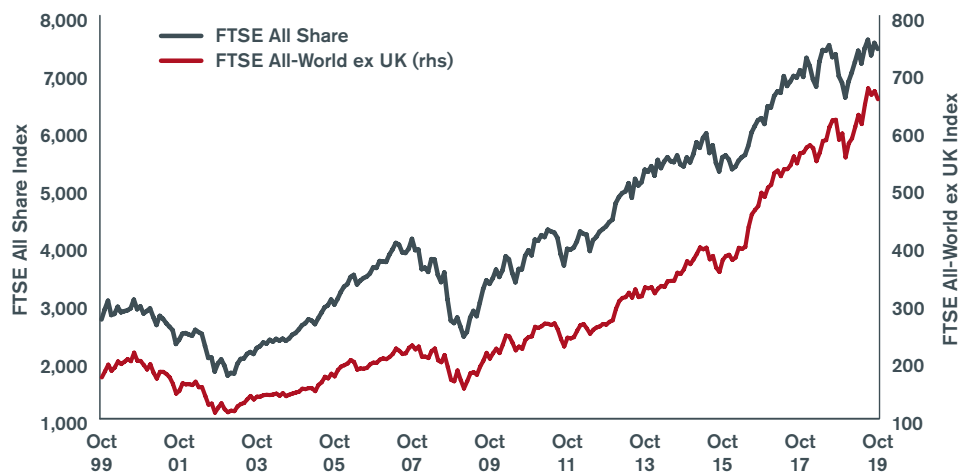
The changing landscape

In 1998, one of my first tasks when I entered the actuarial profession was to work out the level of DB pension fund surplus that could be refunded to the corresponding sponsoring employer or shared with members via uplifts to their pensions.

Today, the DB pensions landscape has changed dramatically. Most DB pension funds have increased in maturity, while still managing various risks associated with their sponsor, assets and liabilities. Funding levels have also improved, thanks to the last decade of deficit payments from sponsoring employers and a bull run in equity markets. Trustees and sponsors have, therefore, shifted their focus towards conservative end-game strategies.

Whether the end-game strategy is to achieve self-sufficiency (ie there's low dependency on the sponsor), or to transfer liabilities to a commercial DB consolidator, or buyout with an annuity provider, the challenges are the same. While funding levels have been improving, the vast majority of DB pension funds still need to become fully funded, on a conservative measure, so that they can pay all members' benefits when they fall due.

Figure 1: Equity gains have supported funding levels



Source: Bloomberg, Total Return, GBP, at 31 October 2019.

Why CDI?

Within 10-15 years, according to various pension consultants' surveys, nearly 90% of DB pension funds are expected to be cash-flow negative, meaning that they do not have enough income to pay their outflows such as members' benefits and expenses. This is crucial because having a deficit and a cash-flow shortfall of 5% of assets or more changes the dynamic of a DB pension fund's risk profile and requires a re-think of the investment strategy.

What are pension funds doing to manage the cash-flow negative problem? Most of them are disinvesting assets to pay pensions. That's not a sustainable solution. If they sell their assets at the wrong time, especially when market values are depressed and their pension fund is in deficit, then they could run out of money fairly quickly or need extra sponsor support.

In uncertain financial market conditions, instead of focusing only on reducing funding level volatility, it is vital to be able to pay benefits and provide enhanced certainty of investment returns. Trustees and sponsors should now re-shape their portfolios and adopt CDI strategies that are tailored to their circumstances. That will help them produce the income they need – especially if their pension funds are already (or about to become) cash-flow negative.

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What is CDI?

While not a silver bullet, CDI is a potential solution to the problem. CDI combines various income-generating assets (eg fixed income, liability-hedging assets, equities and alternative/illiquid assets), in a combination tailored to meet specific client pension fund needs, such as meeting benefit payments, boosting returns and managing risks. The beauty of these assets, when correctly blended, is that they help to generate returns with greater certainty and provide cash-flows to pay expenses, pensions and other benefits. This approach works even better when the discount rate assumption, used to value the pension liabilities, is prudently and directly linked to the yields on the assets held.

Ultimately, under a CDI solution, it is possible to end up with an overall low-risk income-generating portfolio that, either broadly or closely, matches the expected cash-flows.

Three key considerations:

(a) What is your end-game strategy? Surveys from various pension consultants indicate that most DB pension funds have conservative long-term objectives of self-sufficiency insurance buy-out or a commercial DB consolidator. Each of these targets, including the current funding ratio on which they are based, requires different considerations and proper planning.

For example, for pension funds that are well-funded and near their buy-out target, a CDI solution with high levels of liquid assets would be appropriate. For those that are below 80% funded on buy-out without future sponsor contributions, implementing a CDI solution should be delayed until funding improves. For others with a strong employer covenant and self-sufficiency target, a diverse CDI solution could be implemented, taking account of other design specifics outlined below.

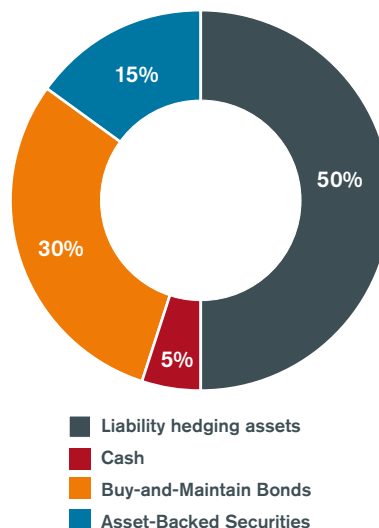
(b) Think carefully about the design of the CDI solution.

- Risk – how conservative should your CDI solution be? For example, if buy-out is unaffordable or requires too much investment risk in the short-term, then it may be preferable to aim for a lower funding target (like self-sufficiency). Running a lower risk strategy, for a longer period, would result in better outcomes for members. And how will it be tailored to integrate with a liability-driven investment (LDI) strategy?
- Liquidity – is there scope for illiquid assets, and are they fair value? How far away is any desired buy-out target? For example, if buy-out is achievable in the short-term, then it would be preferable to hold mainly liquid assets.
- Certainty of cash-flows – The CDI solution would mainly comprise assets with contractual cash-flows, such as government bonds and buy-and-maintain credit. However, there may be appetite for assets that produce cash-flows with a high degree of certainty, but may not be guaranteed. For example, some DB pension funds have been matching some of their pension cash-flows with quality stocks that have low volatility and pay healthy dividends. Changes in financial conditions in recent years have led to government bonds yielding less than dividends in many markets.

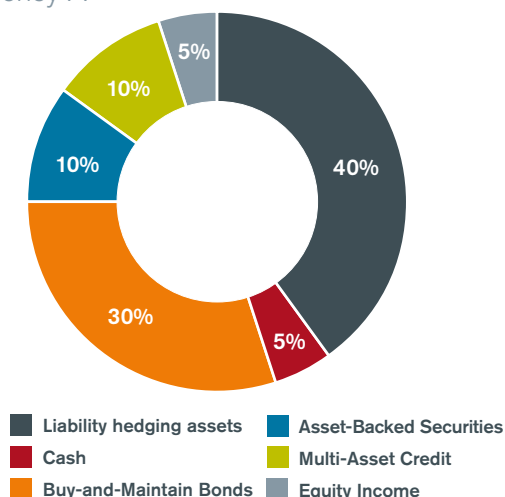
Figure 2 shows illustrative CDI portfolios depending on the desired end-game targets. The design of any CDI portfolio relies on a variety of factors including the circumstances of each pension fund's funding position, the strength of sponsor covenant, risk appetite and illiquidity budget to name a few.

Figure 2: Sample end-game CDI portfolios

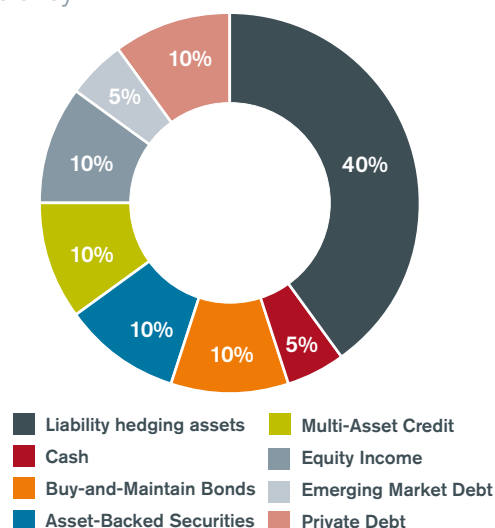
Buyout



Self-sufficiency A



Self-sufficiency B



Source: Janus Henderson Investors, for illustrative purposes only, based on a 90-100% interest rate and inflation hedging

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Especially for smaller pension funds, it is important not to complicate matters; it is possible to keep the CDI portfolio relatively simple without needing to be too diverse across asset classes.

Precise matching of income from a CDI strategy to all the expected outgoing cash-flows may also not be viable or beneficial in many instances. This is important, given the uncertainty of cash outflows, such as: pension payments, bulk transfers, collateral requirements for derivatives, expenses and so on. Therefore, in the early stages, it would be appropriate to hold assets that broadly match, or exceed, expected cash-flows. Over time, as your DB pension fund becomes more mature and funding levels improve, then a CDI solution should evolve to be more precise.

Also, consider how you allow for the long-term impact of environmental, social and governance (ESG) risk factors. A successful CDI solution will have ESG factors and long-term sustainability at the heart of the investment decision-making process.

(c) Implementation considerations. It is important for all parties to consider how they will manage any key pension and investment risks associated with the sponsor, assets and liabilities. For example, there could be unanticipated changes to sponsor solvency, interest rates, inflation expectations, currency, cash-flow needs, appetite for illiquid assets, and so on. Certainly, an intelligent and well-designed CDI solution can overcome these risks.

Think carefully about how and when you transition to a CDI solution. Allow for a degree of flexibility to invest opportunistically – eg don't delay when any of the target asset classes become available or the pricing becomes relatively attractive. Some assets may also be in high demand, particularly alternative real assets, which are targeted by insurance companies, banks and other institutional investors.

CDI may also not be right for every pension fund that is cash-flow negative. However, building a journey plan that targets a CDI portfolio as funding improves over time, is sensible.

It would also be helpful to use different managers for different asset classes, who can work together well to achieve the desired objectives. For example, separate managers would manage fixed income, real assets, liability hedging assets, income-focused equities, etc.

Take action

A well-designed CDI solution can deliver on the objectives of DB pension funds nearing their end-game. Trustees and sponsors should consider adopting a thorough integrated approach across investment, funding and covenant. It is then important to set the appropriate timing, from which the design, implementation and review process can be agreed to maximise the benefits of a CDI solution.

About the author



Norbert is Head of Institutional Client Strategy, EMEA, for Janus Henderson. He is responsible for the thought leadership and strategic investment

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Norbert has over 20 years' industry experience as a business leader, lead investment consultant and solutions provider at firms like Mercer, Russell Investments and Willis Towers Watson.

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