With cash flow driven investment, the details are important.

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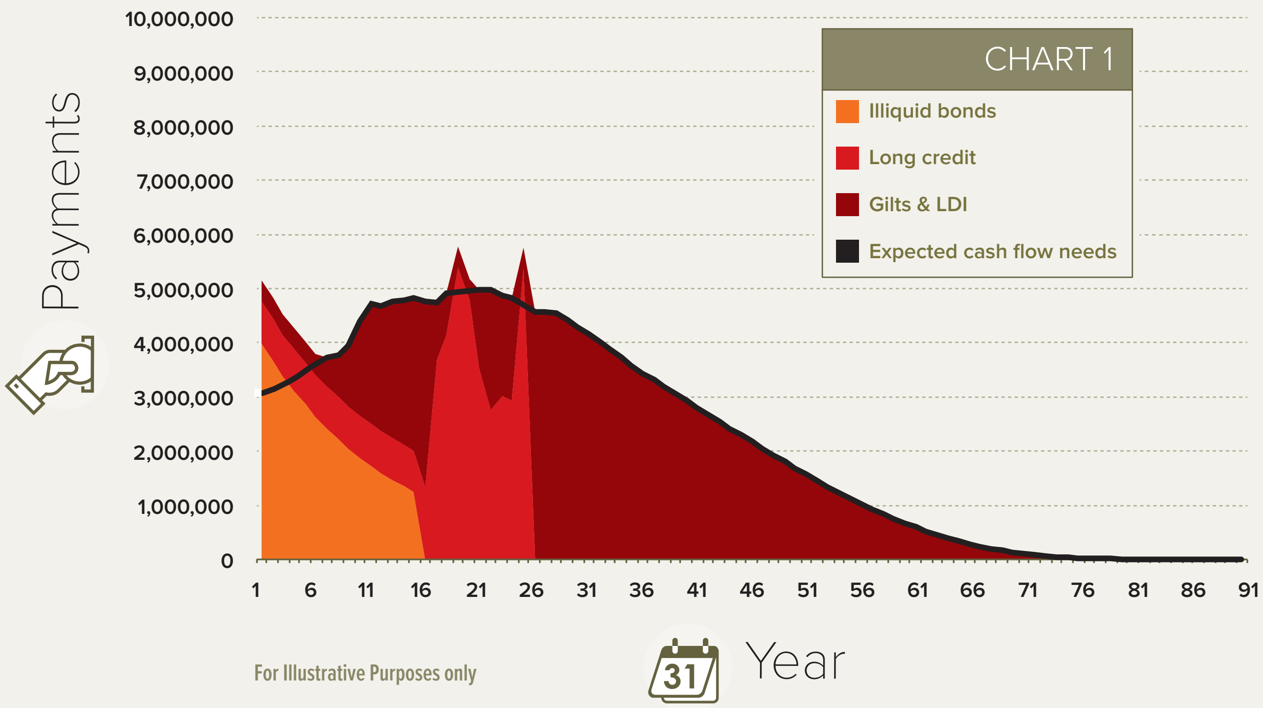
With many defined benefit pension schemes tending towards negative cash flow situations, a growing number are contemplating alternative strategies to meet their pension liabilities and achieve their long-term objectives.

These include cash flow driven investment (CDI), which has become an increasingly popular consideration. CDI involves building cash flow matching portfolios using higher yielding instruments, such as domestic and overseas credit, illiquid debt, loans as well as the usual gilts with derivative leverage. It can thus be considered as a simple extension of traditional liability driven investing (LDI) rather than a radical departure. In Chart 1, you will see an example scheme where a CDI strategy has been implemented. The shaded area represents the assets used to cover expected cashflows which are indicated by the black line.

With CDI, credit is typically held on a buy-and-maintain basis and can include overseas credit exposures appropriately hedged back to sterling. Illiquid debt is a rather broad definition and can include insurance-linked securities, direct lending, ground rents, real estate debt, infrastructure bonds and housing association bonds.

In addition to delivering higher returns, via allocation to credit, CDI embeds cash flows into the LDI portfolio so that cash is delivered when it is expected to fall due. Furthermore, the scheme actuary can reference the instruments held when valuing the scheme. This can reduce funding volatility, for example, due to increased risk aversion in credit.

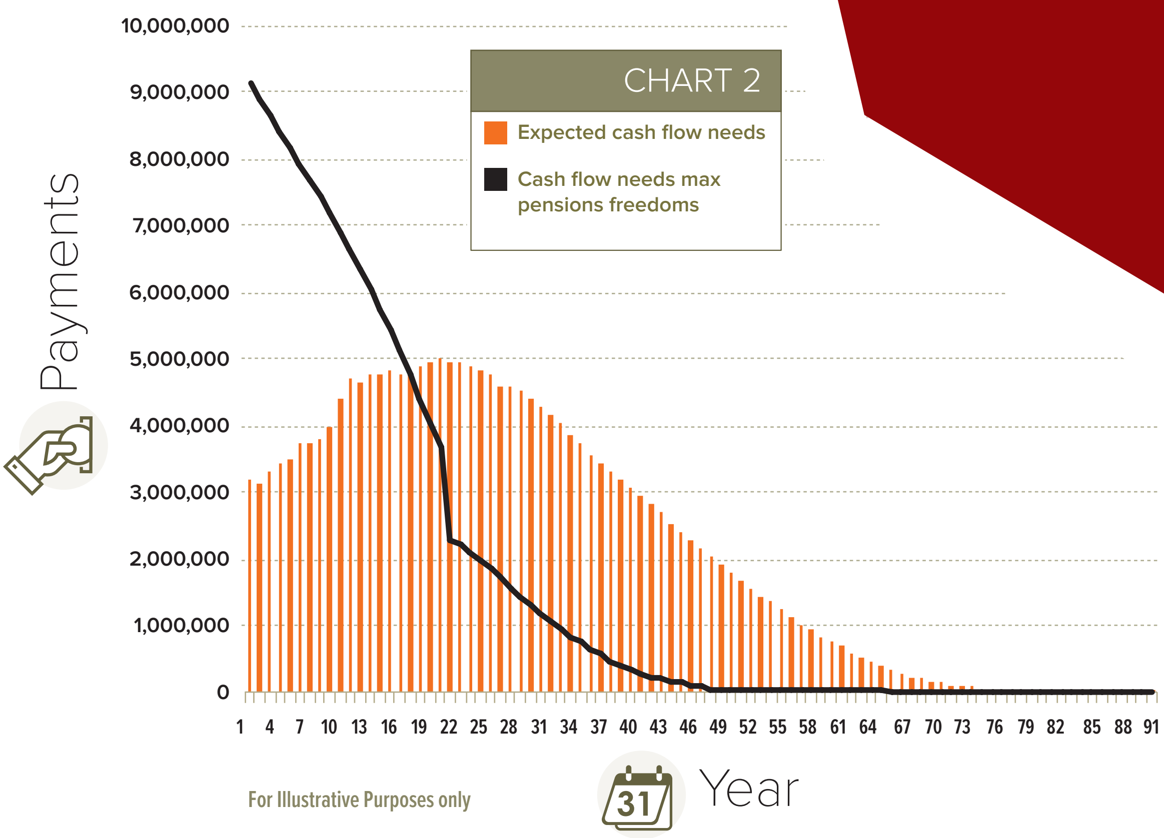


CDI is not without its challenges

This all sounds well and good, but the reality is that today, more than ever, it is difficult for pension schemes to accurately predict their future cash flows. Traditional LDI approaches assume that members will stay in the scheme and take a pension upon reaching retirement age but the landscape has now changed radically.

With both deferred and active pension scheme members, there is increased uncertainty about the timing and incidence of future payments because of the pensions freedoms, which came into effect on 6 April 2015.

Chart 2 illustrates the uncertainty in the cash flows of an example scheme. The black line reflects what may happen to a scheme's cash flows if the non-pensioners decide to take their benefits to a DC plan to access drawdown in retirement.



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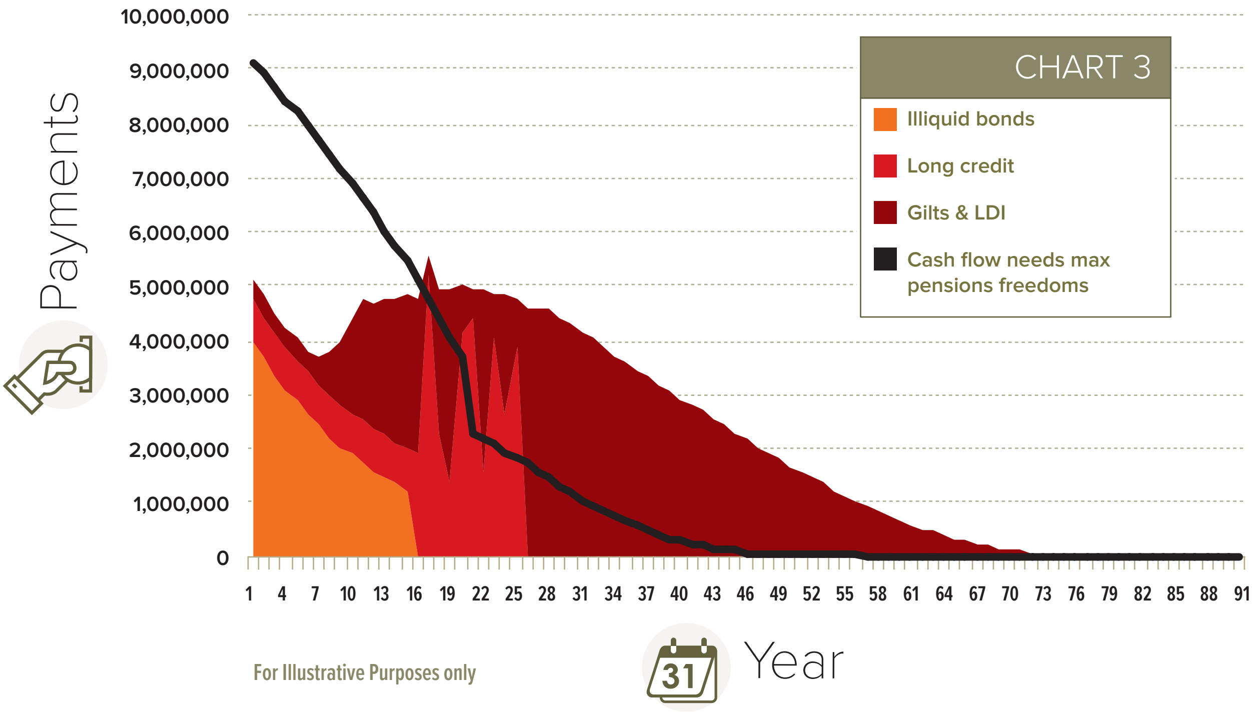
In Chart 3, we have illustrated how, in practice, there may be significant cash flow gaps that may necessitate liquidations of the CDI portfolio to fund.



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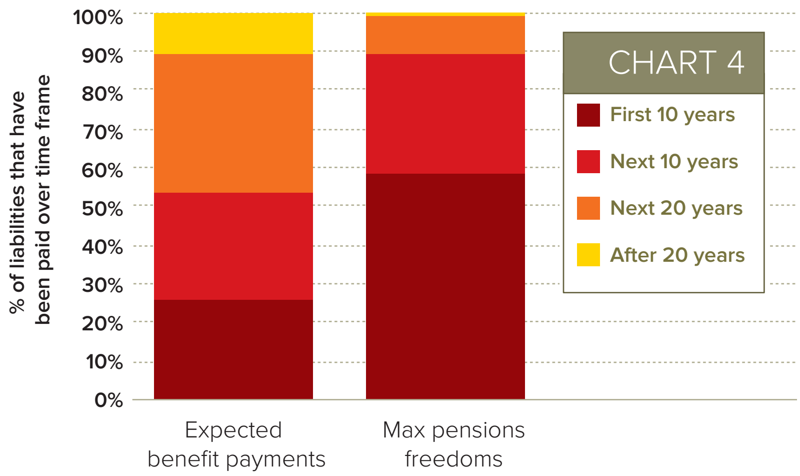
Whilst transfer options have always been available, pension freedoms have motivated members of pension schemes to consider consuming their benefits in a different way. With interest rates currently so low, transfer values for members might seem even more enticing. Of course, sponsoring employers also have a strong incentive to undertake enhanced transfer value exercises to reduce their liabilities and the size of the scheme. If the size of the scheme is sufficiently reduced, it is easier for the sponsor to buy the scheme out.

As discussed, CDI involves investing in more illiquid instruments that are likely to generate a higher yield. However, in building a portfolio out of illiquid instruments to meet cash flows that in practice do not occur, the scheme may be forced to sell some of these assets at distressed prices to meet the unanticipated cash flows.

Chart 4 shows the importance in the timing of liability payouts.



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Careful construction is essential

That is not to say that CDI strategies are inherently flawed, but rather that they require expert construction. For example, careful consideration should be given to the degree of illiquidity permitted within the portfolio for the reasons discussed. Equally important is the selection of asset classes themselves. Illiquid bonds will invariably come with a higher yield, but it is important to ensure that the bonds remain money-good, i.e., that all interest and principal payments are made on time.

Consider a total portfolio approach

CDI strategies entail the use of credit and illiquid instruments as well as gilts with leverage. But it would be remiss not to also consider the important role that equities play in generating cash flows to pay future benefits.

Scheme actuaries traditionally use gilts and bonds to discount liabilities, and this holds a certain logic. A scheme investing in gilts, swaps and credit is investing in instruments that not only match the cash flows but also the valuation of those cash flows over time. This is not the case when considering equities. There is no easy way to create a liability-matching portfolio using equities. Therefore, from a valuation perspective, equities are risky relative to a liability.

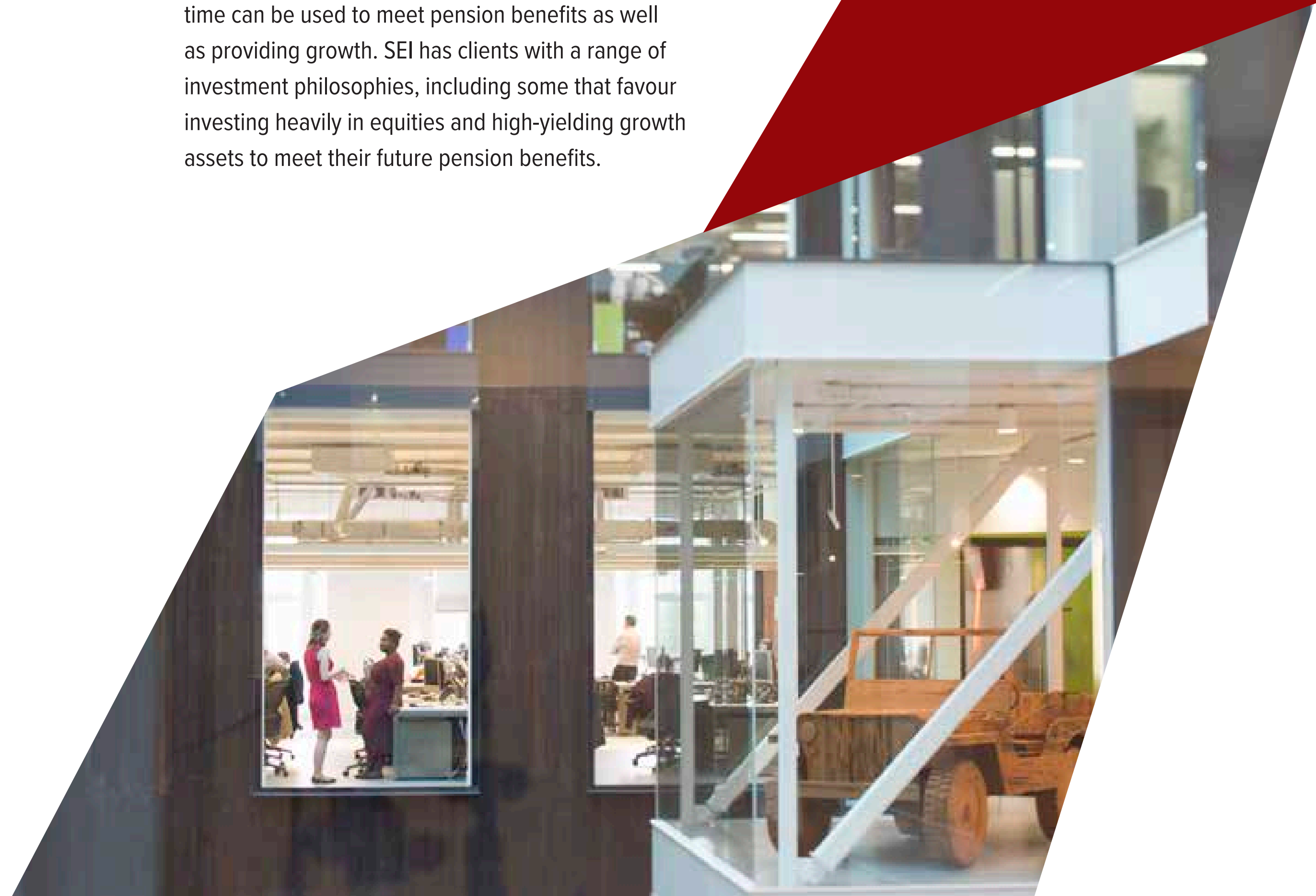
However, equities that focus on yield and stability over time can be used to meet pension benefits as well as providing growth. SEI has clients with a range of investment philosophies, including some that favour investing heavily in equities and high-yielding growth assets to meet their future pension benefits.

Pay regard to uncertainties

CDI is a natural extension of LDI rather than a radical departure. It targets a higher yield on required future cash flows using credit and illiquid debt instruments, as well as gilts with leverage.

However, future cash flow requirements, in reality, are highly uncertain. If cash flows are higher or occur sooner than expected, assets will need to be realised to pay the extra money due.

On balance, CDI strategies need to pay sufficient regard to potential unexpected fluctuations in schemes' cash flow requirements.



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