Raising cashflow awareness

Effective cashflow management for DB pension schemes

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Executive summary

- As defined benefit (DB) pension schemes mature and become cashflow negative, cashflow management becomes increasingly important
- Schemes, particularly underfunded ones, may be better off focusing on being cashflow aware than being cashflow matched
- Being cashflow aware means seeking to use not only the cashflows from bonds, but also the natural cashflows from other types of investment such as real assets and equities. Growth asset security selection can also be shaped more closely to a scheme's liabilities
- Cashflow awareness does not replace cashflow matching. In the short to medium term it usually makes sense to at least broadly match benefit payments. As funding levels improve, cashflow aware solutions can evolve into more precise cashflow matched solutions
- Trustees should also prepare for unexpected cashflows such as transfers out. This involves taking pre-emptive steps to boost liquidity and having a plan should borrowing or forced sales be required

What is causing the cashflow issue?

DB pension schemes are maturing. According to Mercer[1], 73% of UK DB pension schemes are cashflow negative, up from 66% in 2018. Cashflow negative schemes are paying more out in benefits than they are receiving in contributions.

At the same time, there are other pressures that mean precisely matching all benefits is not necessarily possible or ideal. These include:

1. Underfunding ie. assets today are lower than liabilities
2. Longevity risk ie. the risk that scheme members live longer than expected and therefore the scheme has to pay pensions for longer than expected
3. Sponsor/covenant risk ie. the risk that the sponsor becomes insolvent, forcing the scheme to wind up

1. Mercer European Asset Allocation Survey 2019

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These last two mean that an allocation to return-seeking assets can make sense even for well-funded schemes. However, for cashflow negative schemes, a higher growth allocation increases the risk of becoming a forced seller of distressed assets during a downturn. A cashflow negative scheme will not have the luxury of using contributions to pay pensions while waiting for a more favourable environment or pricing level to sell assets. The scheme must pay benefits and may be forced to liquidate assets at any cost to do that.

Schemes may also face the need to meet unexpected cashflows such as those generated by transfers out or from margin requirements on derivative positions. These add to the challenge.

We believe focusing on being 'cashflow aware' can help schemes meet their objective of paying all pensions as they fall due.

What can schemes do to better manage their cashflows?

The most important aspect of managing cashflows is getting the broad asset allocation right – trustees should not lose sight of the big picture. We recommend examining the long-term distribution of outcomes the scheme might face using a model that takes into account the scheme's circumstances, including how cashflow negative the scheme is. Success is thought of as the scheme's assets outlasting the liability cashflows and failing 100% success, meeting as much of the liability cashflows as possible. In other words, success is either paying all pensions as they fall due or paying as high a percentage of those pensions as possible.

Trustees can choose the investment strategy with the most attractive profile of future outcomes. Such a modelling exercise should help trustees decide how much to allocate across broad asset classes (including cashflow matching assets).

However this is not the whole story – assets should also be structured in a cashflow aware way subject to this broad split. We suggest the following additional steps:

1) Prepare for expected cashflows

a) Target cashflows in the short to medium term

We recommend structuring assets so that a high proportion of cashflows are met by natural cashflow generation from assets for approximately the first 10 years. Under normal circumstances this structure would be regularly rebalanced. However, in an extended liquidity/market crisis, the scheme can instead 'run off' ie. rebalancing stops and benefits are paid from natural cashflow generation as much as possible. The idea is that distressed and illiquid assets are retained and therefore market exposure is maintained through the trough of a crisis without the scheme becoming a forced seller. Transaction costs and sequence risk[2] are also reduced. The extent to which this sort of strategy is followed may depend on market conditions and active views – for example, current market conditions suggest that matching using very short-dated credit is not particularly attractive.

The scheme can also enter 'run-off mode' if it becomes very well-funded and de-risks, even if market conditions are benign. The scheme is then largely cashflow matched and rebalancing may not be needed.

b) Turn on the taps – use all natural cashflows

Bonds and some real assets generate contractual cashflows. These can help reduce scheme risk even if the cashflow match is imperfect. Although they are not contractual, dividends from equities are also usually fairly stable in the short term and can be aligned with pension payments to help reduce transaction costs (as the scheme does not need to sell assets to meet benefits).

c) Use an appropriate growth strategy to meet longterm cashflows

There is a variety of different approaches available to trustees targeting a more cashflow aware growth strategy.

- One option to consider is an income-generating multi-asset fund. These funds incorporate sophisticated cashflow management strategies such as running off some of the assets in a downturn. This allows trustees to access cashflow management techniques through market cycles at low cost and with minimal governance burden for the investor

- There are also equity strategies that focus on selecting companies with sustainable dividends that grow with inflation. This approach can help meet pension cashflows and provide `implicit' liability hedging allowing the scheme to reduce both its allocation to explicit LDI assets and target a higher return

Higher income growth assets can help reduce transaction costs. But the additional income generated by these assets can be small compared with bond cashflows.

In all cases, trustees need to balance the improved cashflow generation and liability hedging properties of these potential approaches against any possible impact on diversification (both across and within asset classes) or expected return at the overall scheme level.

2. The risk that the same returns on an asset occurring in a different chronological order lead to different outcomes

2) Prepare for unexpected cashflows

a) Pre-emptively increase liquidity

There are various potential ways of increasing liquidity in a pension scheme without compromising its risk return profile:

- **Increase flexibility and efficiency of leverage:** LDI offers leveraged exposure to rates/inflation and therefore frees up cash; synthetic equities and synthetic credit offer leveraged exposure to equity markets and credit markets and therefore use less cash than buying physical equities or physical bonds. Schemes should also be efficient with all cash collateral to seek to maximise available cash

- **Consider tailoring growth asset exposure:** adopt a cashflow aware strategy and avoid excessive allocations to illiquid assets

- **Consider using uncorrelated funds or market neutral funds with a low expected maximum drawdown as a safety net:** eg. absolute return bond funds

b) If asset sales are needed, allow for costs and any active views

Most schemes currently use up cash and then increase leverage in their LDI portfolio to meet unexpected cashflows. If this is not sufficient or leverage levels are already high, they may also make use of cashflows available from growth strategies.

Once these avenues are exhausted, it is likely that the scheme may need to sell assets, possibly in stressed conditions.

Schemes should sell assets that move the scheme towards the most attractive asset allocation today (allowing for any carefully researched active views at a scheme level) but bearing in mind transaction costs in doing so. These decisions could form part of a smarter rebalancing process that may focus on ensuring the most cost efficient way of getting to an appropriate risk and return rather than simply moving back to the initial allocation.

In particular, trustees should not (in general) simply sell what has gone up the most. Rather than anchoring to historic performance, today should be seen as the first day of the rest of the scheme's life. Similarly, trustees should avoid the 'endowment effect' where they are reluctant to sell stocks that have fallen in value, even when they admitted they would never buy those assets at their current market prices.

3) Be proportionate

A simple plan or priority order may sometimes be appropriate, especially if schemes have a limited governance budget. For example, some trustees might consider selling relatively liquid growth assets first, followed by LDI and leaving the sale of illiquid assets as a last resort. Others might prefer to reduce their hedge ratio before selling growth assets.

Overall, it remains important not to consider cashflow management in isolation of other scheme risks, so that schemes invest to improve ultimate outcomes for scheme members.

Contact us

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