Cashflow-Driven Investing

FLASH REPORT

WELCOME!

In September 2020 **mallowstreet** – in partnership with **Aberdeen Standard Investments** – surveyed 28 UK pension schemes representing combined assets in excess of £95bn.

We asked them about the opportunities and risks they see in cashflow-driven investing (CDI), as well as the properties and composition of the ideal CDI portfolio. This flash report presents our findings.

We hope you find it insightful.

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CEO

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EXECUTIVE SUMMARY

- **THERE IS STRONG INTEREST IN CDI STRATEGIES**: CDI can help schemes avoid the forced sale of assets, secure future benefits and achieve their endgame. Nearly 40% of schemes have already implemented CDI in some form in their portfolio, and over half of those who haven't are likely to do so as their cashflow position evolves and they progress towards their endgame.

- **BUT CDI MANAGERS ARE NOT IN HIGH DEMAND**: the inability to achieve perfect cashflow matching and the lower returns from CDI portfolios is making schemes look for other ways to secure income first. Nearly 40% of UK pension funds are looking to reallocate existing assets to match their projected cashflow needs, while only 7% are looking to appoint a CDI specialist. This indicates a misconception about the value-add of CDI managers which needs to be addressed.

- **CASHFLOW DELIVERY MATTERS THE MOST IN CDI**: while liquid public credit is preferred, there is room for more illiquid assets in CDI portfolios, as long as they do not expose UK schemes to default risk and deliver the cashflows they need. Many risks are of lesser concern when investing for future cashflows than they would be otherwise, but ESG must be embedded in CDI solutions.

THERE IS STRONG INTEREST IN CDI STRATEGIES

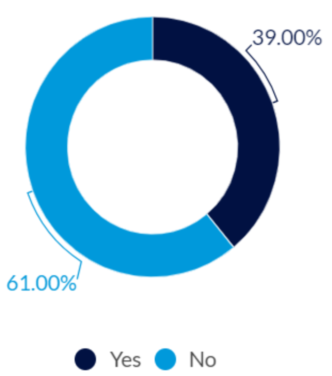
CDI can help schemes avoid the forced sale of assets, secure future benefits and achieve their endgame.

Nearly 40% of schemes have already implemented CDI in some form in their portfolio. Amongst the remainder, 59% are likely or highly likely to use CDI in the future.

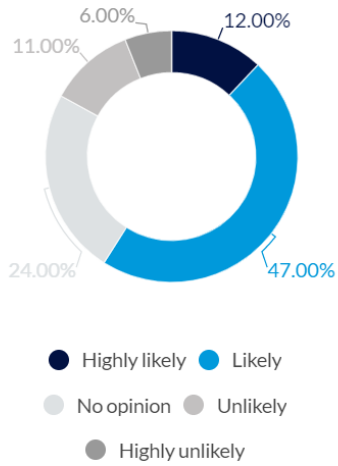
The main appeal of CDI lies in helping schemes avoid the risk of forced selling – 43% name this as a key reason for their interest. Over 38% of UK schemes say they are already cashflow negative, while an additional 10% will become cashflow negative soon, which would make them more interested in CDI approaches.

Apart from increasing the likelihood of paying full benefits in the future, 38% of UK schemes also look to CDI to increase the probability of reaching their endgame. A quarter would consider CDI specifically because they are looking for insurance-friendly assets, while one scheme said that such an approach would be interesting after they achieve low sponsor dependency.

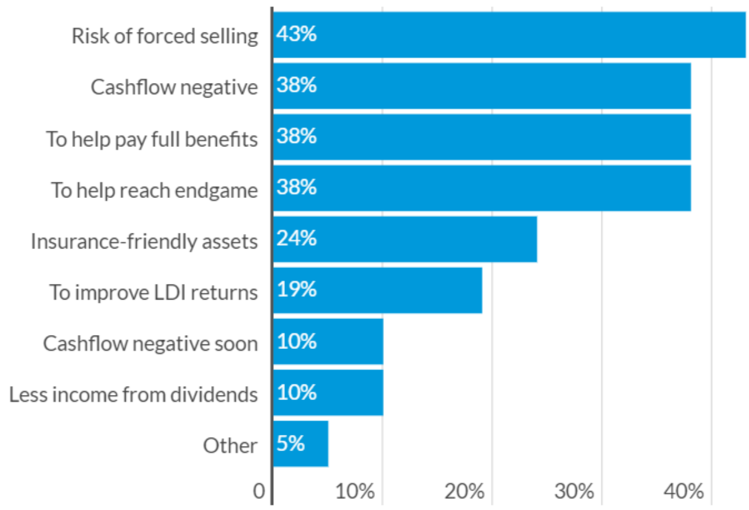
ALREADY USING CDI



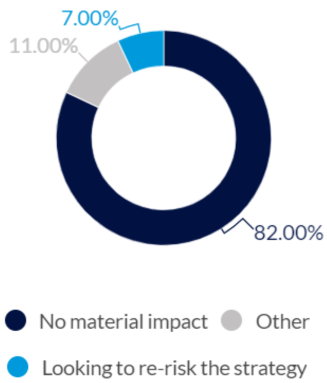
LIKELY TO USE CDI IN THE FUTURE



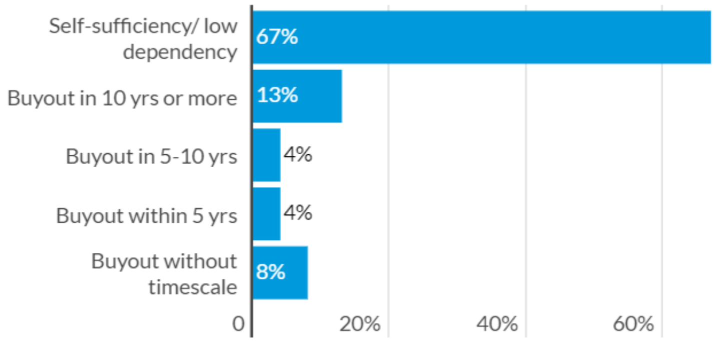
FACTORS DRIVING INTEREST IN CDI



COVID-19 IMPACT ON INVESTMENT STRATEGY



LONG-TERM FUNDING OBJECTIVES



Two-thirds of schemes are working towards low dependency, while a third target buyout. COVID-19 has not had any material impact on their future investment strategy.

CDI MANAGERS ARE NOT IN HIGH DEMAND

The inability to achieve perfect cashflow matching and the lower returns from CDI portfolios is making schemes look for other ways to secure income first.

A third of pension funds say that they are unwilling to allocate more towards CDI approaches because they need higher returns than such portfolios can offer.

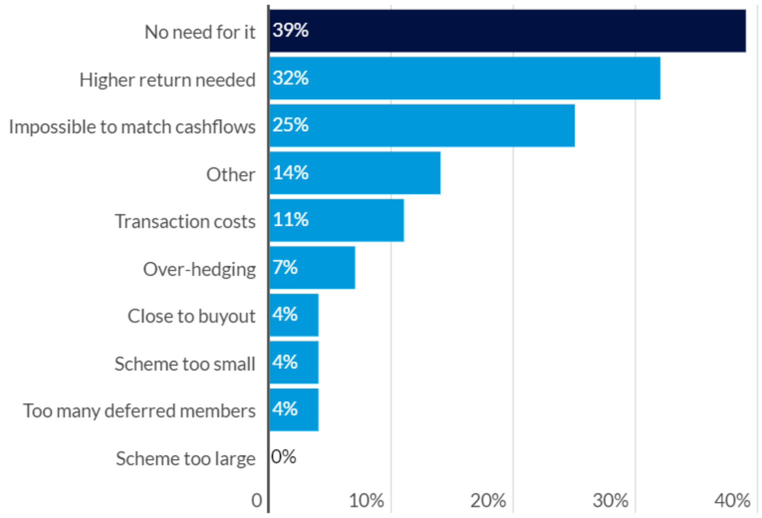
Additionally, 25% are reluctant to increase their allocations because it is not possible to perfectly match future cashflows.

Other obstacles include the scheme's overall need for liquidity, collateral requirements in other parts of the portfolio, the availability of quality assets offering the right yield, and future accruals generating cashflow.

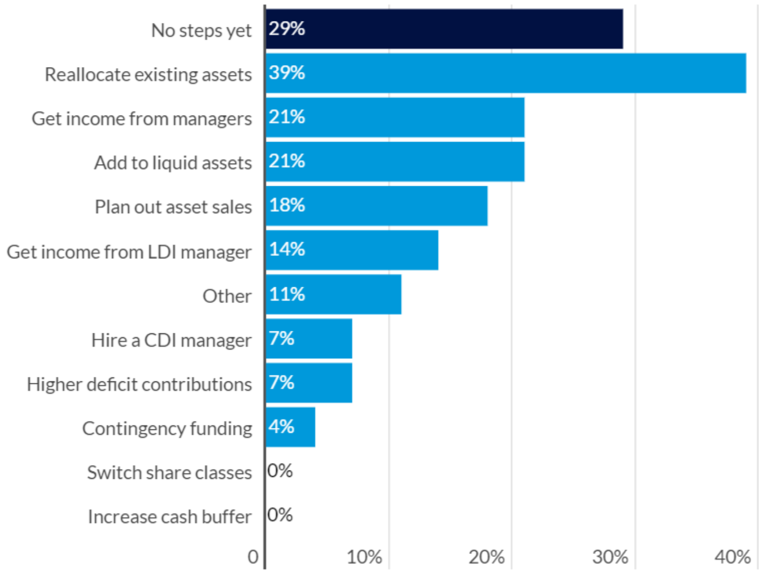
As a result of these challenges, 39% of UK pension funds are looking to reallocate existing assets to match their projected cashflow needs, while 21% are asking their managers to start distributing income rather than re-investing it. Additionally, 21% are looking to increase their allocation to liquid assets.

Other steps taken to secure future cashflows include planning out the future sale of assets, increasing in-house income-generating assets and securing income from LDI managers. Only 7% are considering hiring a CDI manager.

OBSTACLES TO INCREASING CDI PORTFOLIO



STEPS TAKEN TO SECURE FUTURE CASHFLOWS



Assuming that a growing proportion of UK schemes are likely to consider CDI approaches in the future, it is surprising that so few schemes are looking to hire a specialist. Whilst we cannot determine the exact reasons for this from survey data, there may be a misconception about the value-add of CDI managers, given the difficulties in matching cashflows and securing returns that UK schemes face.

CASHFLOW DELIVERY MATTERS THE MOST IN CDI

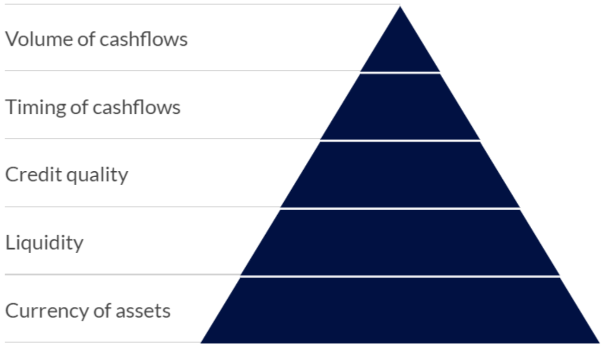
While liquid public credit is preferred, there is room for more illiquid assets in CDI portfolios, as long as they do not expose schemes to default risk and deliver the cashflows they need.

The volume and timing of cashflows are top priorities for schemes when it comes to cashflow-driven investing. It is much more important for a CDI manager to match accurately both the size and the duration of future cashflows than to invest in sterling liquid assets of high credit quality.

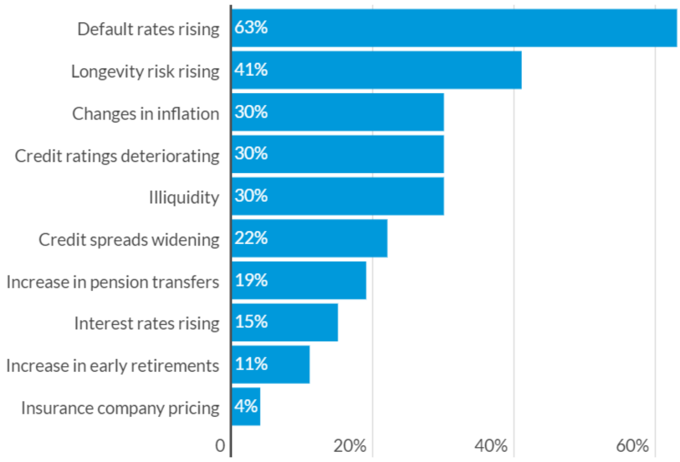
With many schemes looking at long lease property and private credit, there is clearly room for less liquid assets in CDI, if they deliver the right cashflows.

This focus on cashflow delivery also explains why many risks that are otherwise prevalent in fixed income investing take second stage in CDI. UK schemes worry less about interest rates and credit spreads than they do about inflation and defaults reducing future cashflows. They are also less concerned about increases in early retirements and pension transfers than they are about increases in longevity.

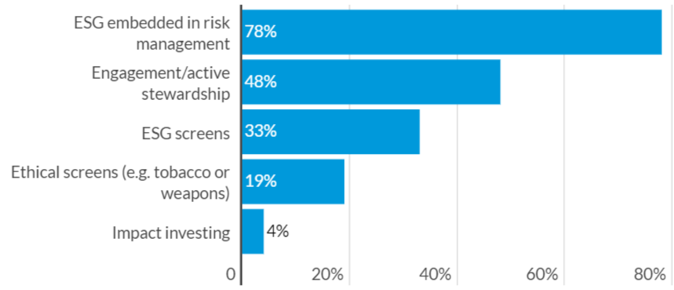
However, UK schemes do expect ESG to be embedded in the risk management of their CDI portfolio. Almost half also expect their asset managers to take an active engagement and stewardship approach with borrowers.



TOP RISKS IN CDI



ESG APPROACHES IN CDI



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