LGIM bespoke cashflow matching

Meeting your scheme's cashflow needs

Legal & General
INVESTMENT MANAGEMENT

Bespoke cashflow matching portfolios

Cashflow matching (using contractual income to pay expected liabilities) is an important proactive tool that helps give schemes more certainty around the income they can expect to receive from their asset portfolios. These portfolios typically adopt a buy and maintain strategy, where bonds are held to maturity in most cases. For schemes with specific requirements, a bespoke approach is often necessary.

COMMITMENT AND SPECIALIST UNDERSTANDING

LGIM has significant scale and experience in efficiently implementing and managing bespoke cashflow matching portfolios for defined benefit (DB) pension schemes. As evidenced via our long-standing insurance heritage, we also manage our own group capital for the £51bn[1] annuity fund on behalf of L&G Group.

Critically this extensive experience means we have gained a unique understanding of managing this type of strategy across market cycles and times of market stress, as demonstrated by our strong track record of avoiding defaults and downgrades, preserving value and delivering cashflow.

OUR TEAM AND APPROACH

Our Solutions Group has ownership of all outcome-orientated strategies for our clients and is responsible for the design and management of cashflow matching portfolios. The team draws on the extensive expertise of individual areas of investment excellence within LGIM – principally our Global Buy and Maintain Credit team and LDI Funds.

The key aspects of our approach are as follows:

1. **Solutions-driven –** Providing the investment link between our asset management and insurance businesses to bring together the specialist knowledge required to implement this strategy

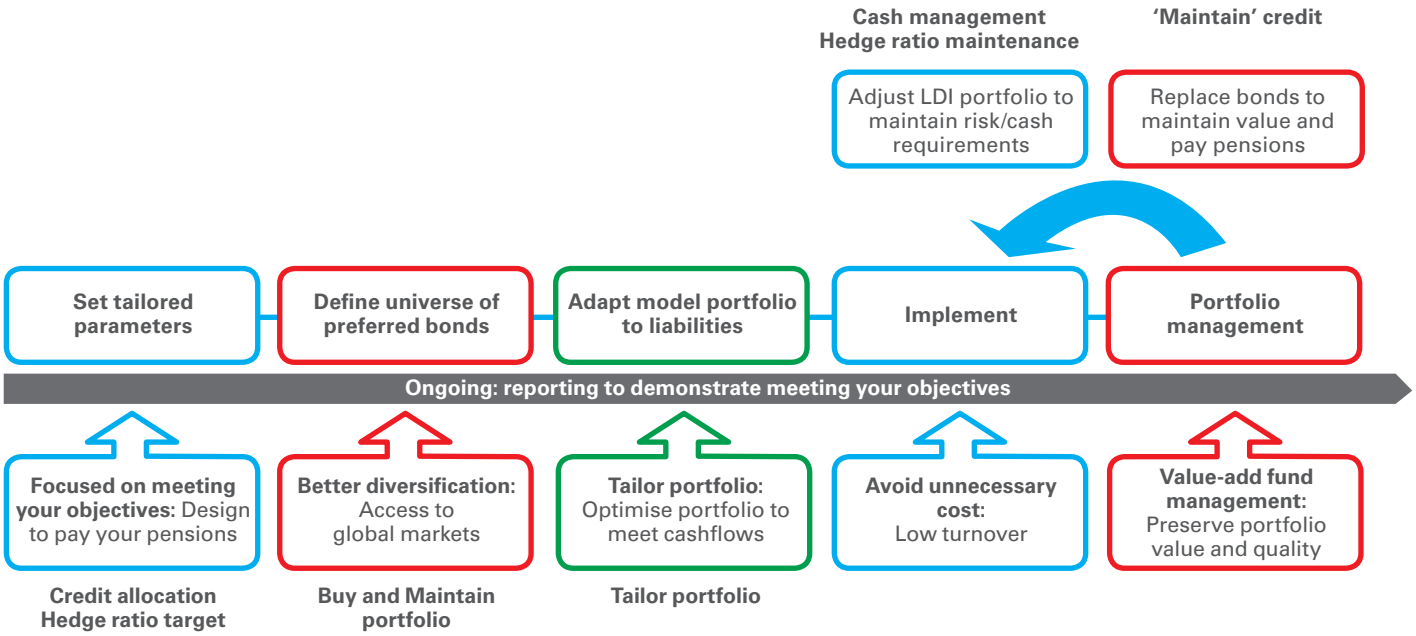
2. **Bespoke to you –** Working collaboratively to incorporate all income-generating assets into the initial design, including discretion over investment restrictions and constraints

3. **Active ongoing management –** Ensuring the integrity of the cashflow match is maintained from the first to last cashflow

1. Source: Legal & General Group PLC Year End Results, as at 31 December 2017.

Portfolio construction

The process we follow when constructing cashflow matching portfolios is an iterative one, from the initial portfolio design to implementation, through to ongoing management and review.



WORKING WITH YOU FROM THE OUTSET

The starting point for all our cashflow matching portfolios is to work closely with you and your investment adviser to understand the aims, requirements and desired outcomes of the portfolio and how those fit within your scheme's overall strategy. At this point the objectives of the mandate can be clearly set and any further client specific guidelines or investment restrictions incorporated.

Examples of the conversations we typically have with clients as part of the initial design include return requirements, global versus domestic bond universe, BBB rated credit allocation and ESG considerations, e.g. excluding tobacco stocks.

DEFINING THE UNIVERSE OF BONDS

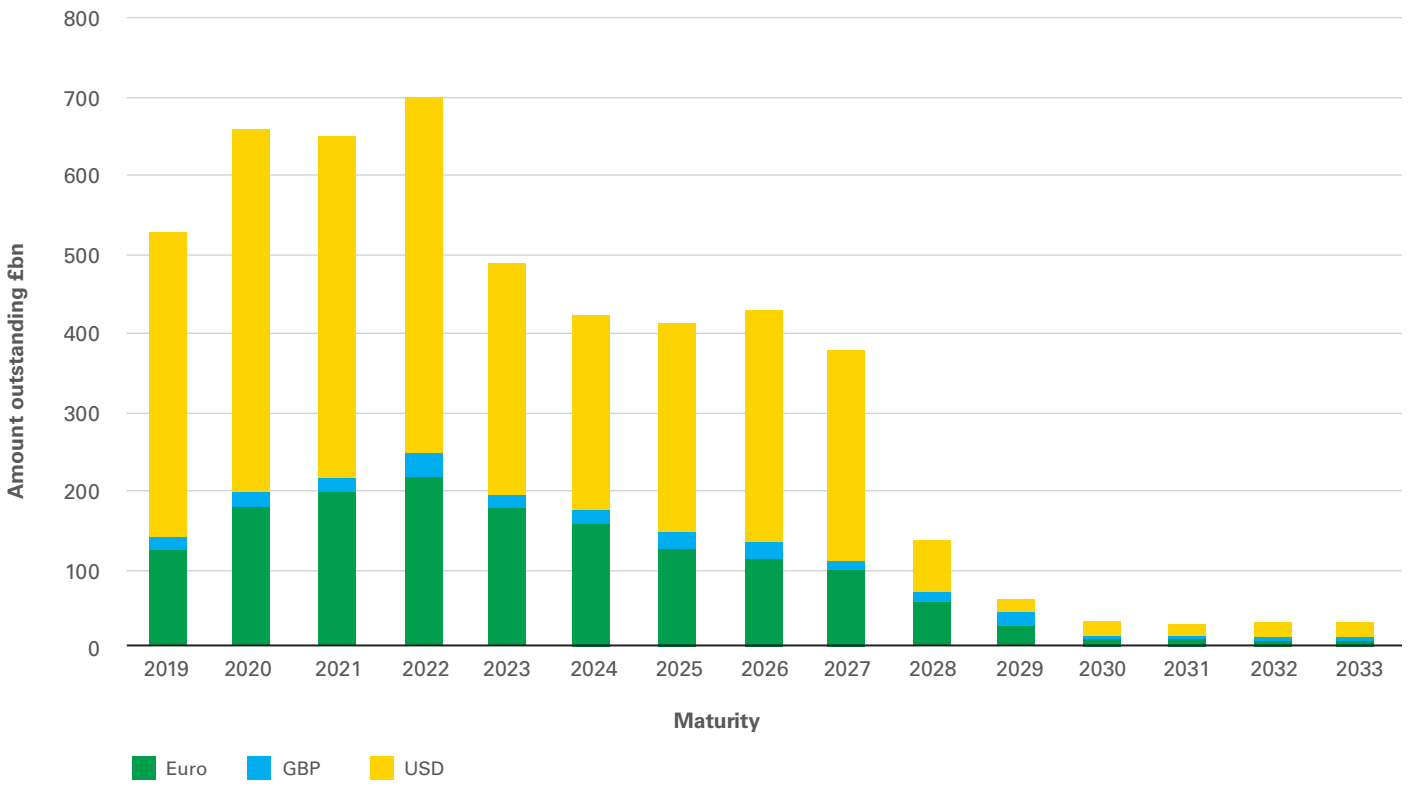
The opportunity set of corporate bond securities from which to meet your scheme's unique cashflow requirements is drawn from our preferred list of issuers which we believe demonstrate the characteristics to provide stable or improving credit quality characteristics over the life of the investment.

The chart[2] below highlights how the sterling investment grade universe makes up only c5% of the global corporate bond market meaning at certain maturities, there is limited UK issuance.

We therefore believe a global investment universe – including UK, US and European bonds (hedged back to sterling) – enables schemes to benefit from greater diversification (across sectors, ratings, issuers and geographies) and participate in more new issues for a more robust hold-to-maturity cashflow matched strategy.

That said, we can tailor our approach according to individual client preferences and investment views.

Figure 2: Diversifying globally



OPTIMISING THE PORTFOLIO TO MEET CASHFLOWS

The portfolio design process incorporates both quantitative and qualitative elements to ensure not only are your objectives met but importantly that the solution is investible and the level of credit risk being taken is appropriate for the long-term nature of the strategy.

All quantitative cashflow matching modelling is owned by the Solutions team and managed holistically to allow for other income-generating assets, external assets and contributions. We can also seek to build around an existing corporate bond portfolio retaining positions (where appropriate) in order to reduce the level of expected turnover at inception.

2. Source: Barclays Bloomberg corporate indices as at 28 February 2018.

The objectives of the **quantitative process** are to:

- Meet your scheme's cashflow requirements whilst seeking to maximise the return on the portfolio
- Retain a robust overall portfolio by setting investment limits to ensure appropriate diversification by sector, rating, issuer and geography

In order to achieve these objectives the fundamentals of each individual bond, including cashflows, are modelled making allowance for long-term expected default rates as well as any impact and collateral costs associated with hedging exchange rate and interest rate exposure of overseas-denominated bonds back to sterling. The approach is completely benchmark agnostic thereby enabling more balanced sector exposures as demonstrated in the chart below.

Figure 3: Typical market value weighted index sector allocation

- Govt Related
- Industrial other
- Consumer Non-Cyclical
- Consumer cyclical
- Transportation
- Communications
- Utility - Electric
- Utility - Other
- Utility - Gas
- Banking
- Insurance
- Financial Other
- ABS
- REITS
- CMBS

Figure 4: Cashflow matching credit sector allocation

Following the optimisation a **qualitative review** is undertaken by the Global Buy and Maintain Credit manager in partnership with the Solutions team which may trigger further iterations. As well as reviewing credit risk and diversification across all portfolio positions this stage integrates practical implementation considerations based on market conditions and liquidity to help ensure the agreed portfolio is investible.

The approach taken to implement the credit portfolio can take a number of forms and the decision will largely depend on the starting assets used to fund the portfolio and client preferences over taking a rapid or phased transition approach. Inevitably there are pros and cons to each which need to be weighed up on a case by case basis and we would provide you with the information and context to help you make the most appropriate decision for your circumstances.

INCORPORATING LDI

Alongside the credit portfolio an LDI completion hedging portfolio can be operated, if required, consistent with meeting your scheme's strategic interest rate and inflation hedging objectives taking into account all other duration-contributing assets and cashflows (including external manager assets). The hedging portfolio will be designed taking into consideration your existing assets and with any transition managed in a cost and risk-controlled way to avoid out of market exposure. The hedge is then constructed and maintained over time with access to the full LDI toolkit seeking to maximise yield through instrument selection and relative value opportunities where these considerations are in line with your objectives.

Synergies

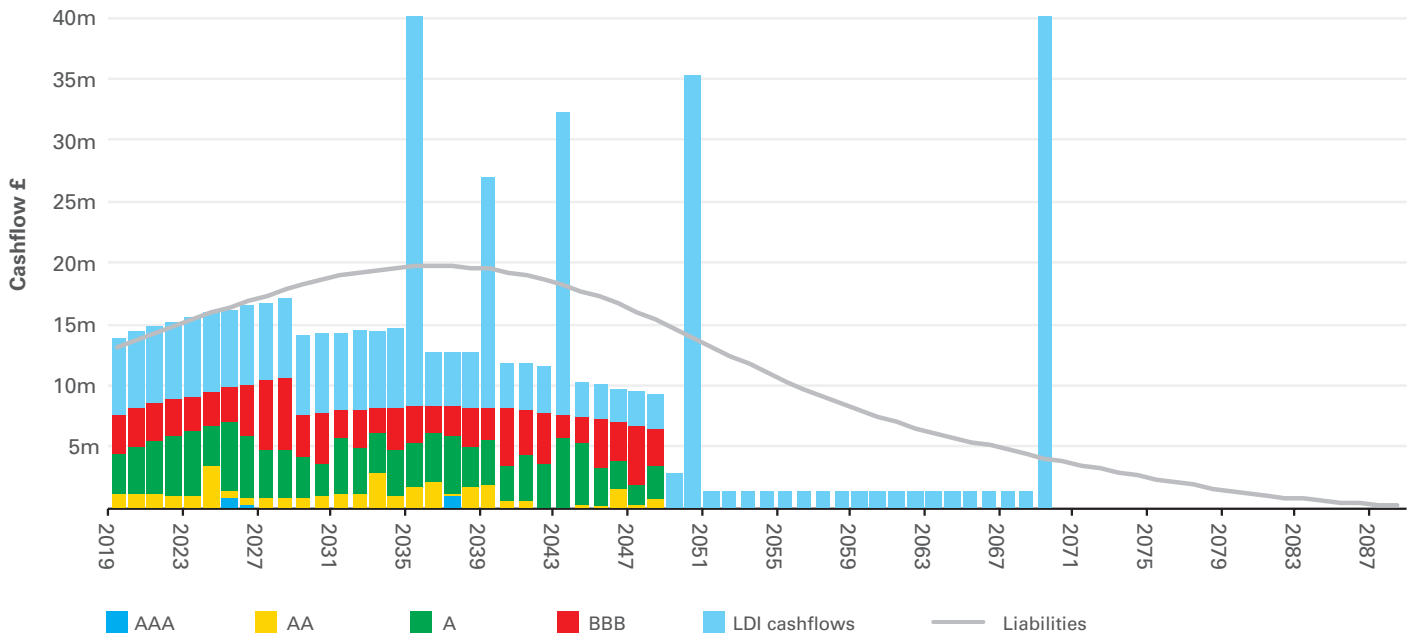
We are strong advocates of integrating LDI and Buy and Maintain credit strategies. Ensuring these two portfolios talk to one another and decisions are made in the context of your overall objective is vital. For example, the repo facility provided within an LDI portfolio can enable short-term cashflows to be met without having to sell corporate bonds. This can be useful where credit cashflows do not always line up exactly. Similarly, this enables us to manage the currency hedging over time within the Buy and Maintain credit portfolio by using collateral from the LDI portfolio.

Within our LDI portfolios we include potential for yield enhancement from time to time when attractive opportunities present themselves (for example, around times when bonds are supplied to market). It is important that these decisions do not compromise any cashflow match in place so having all portfolios talking to each other means that any switching continues to allow for the overall objectives.

In summary, a cashflow matching strategy where both the LDI and Buy and Maintain credit are managed together can offer a series of marginal gains and efficiencies in areas such as collateral and cashflow management as well as fund management and reporting.

An example of how a final cashflow matching portfolio could look is provided below. This portfolio was designed for a client incorporating both Buy and Maintain credit and LDI, where the scheme was looking to 100% cashflow match the first 10 years of its scheme liabilities.

Figure 5: Cashflow matching the first 10 years of liabilities



For illustrative purposes only

ONGOING PORTFOLIO MANAGEMENT

The Solutions team and the Global Buy and Maintain Credit manager work closely together on an ongoing basis (and in the initial transition/build-up phase) to actively monitor the portfolio for signs of deteriorating fundamental credit quality and decide whether any trading is required from a credit risk perspective to preserve the future value of the portfolio. Where there are concerns, positions can be exited and replaced with the aim of any trading activity being to maintain/enhance the overall return and quality whilst maintaining the cashflow profile over the life of the investment. The completion hedge portfolio is monitored and, where required, adjusted over time to ensure that it remains within tolerance as a result of any changes made within the credit portfolio (or other assets) or to capture opportunities that may arise to improve the yield or hedge profile net of costs.

Enhancing your return potential

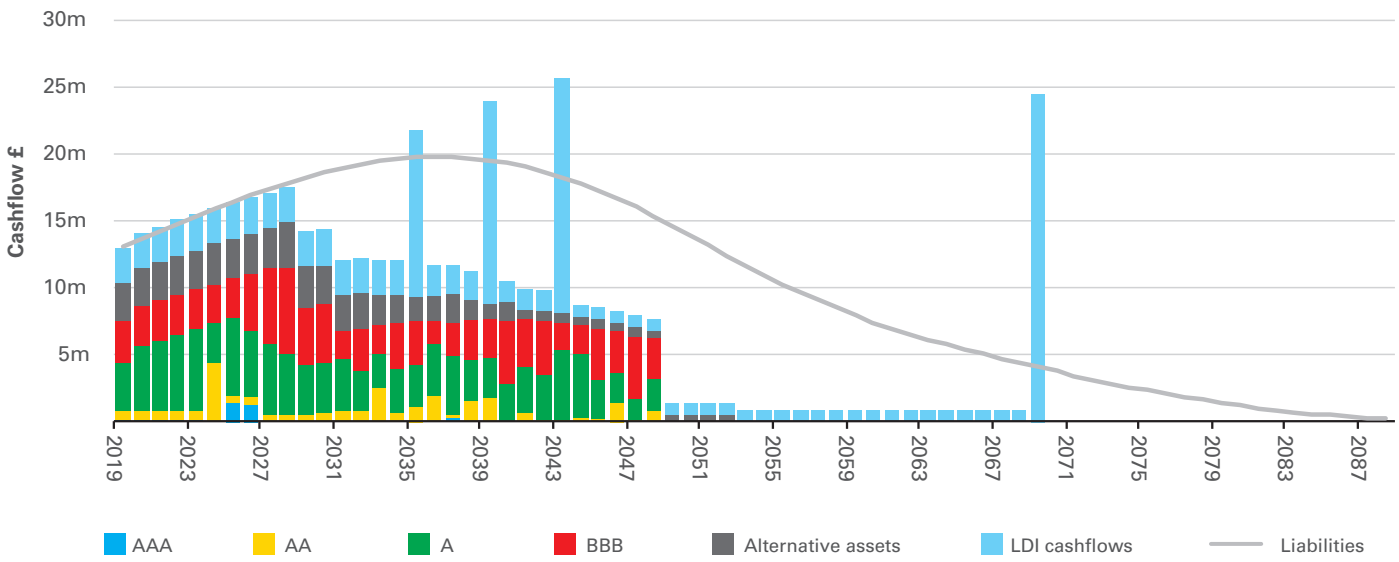
For schemes that are looking to increase the overall return potential of their cashflow matching portfolio, it is possible to look at cashflows that are available from other alternative asset classes.

For instance, private investment grade credit typically offers an illiquidity premium of around 0.5% p.a. compared to its public equivalent whilst continuing to match cashflows. Private credit markets can also offer additional diversification benefits compared to investing in public credit markets only and more often than not, come with greater security of cashflow in the event of an issuer defaulting.

For clients requiring even higher return potential with their assets, or if the accuracy of the cashflow match is less important, there are a wider range of assets that they could consider. By way of an example, global high yield or emerging market debt may be expected to increase returns further by 1.5-2.0% p.a. whilst still providing some ongoing cashflow. Similarly, retaining equity exposure, but opting to receive dividend income, would likely result in an even greater expected return. We call strategies that seek to deliver some degree of cashflow from these asset classes **cashflow aware growth strategies**, which are discussed more broadly in our Client Solutions article ***Raising cashflow awareness***[3].

The chart below demonstrates how the previous cashflow matching portfolio could be evolved to incorporate these alternative assets in order to realise a higher overall expected return whilst still achieving the same level of cashflow match.

Figure 6: Incorporating alternative assets into a scheme's cashflow matching solution



For illustrative purposes only

For schemes considering their cashflow management strategy and desiring greater certainty of cashflow to help meet benefit payments, a bespoke cashflow matched solution can help meet this objective. For those further from their endgame objective, a cashflow aware solution can then evolve into more precise cashflow matched solutions as funding levels improve.

3. http://www.lgim.com/uk/en/insights/our-thinking/client-solutions/raising-cashflow-awareness.html

CONTACT US

For further information on how we could design a bespoke cashflow matching solution for your scheme, please contact Toby Orpin, Senior Solutions Distribution Manager:

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Important information

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

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