Cashflow aware investing

A brief overview

Legal & General
INVESTMENT MANAGEMENT

A CHANGING DB LANDSCAPE

As pension schemes mature and close to future accrual, they are increasingly reliant on using assets to meet outgoing payments, rather than contributions. One way to meet these payments is simply to sell assets as payments fall due. However, we believe that there can be benefits to taking a more pro-active approach.

Cashflow matching (using contractual income to pay expected liabilities) is an important tool to help give schemes more certainty around the timing of 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. However, cashflow matching is not always appropriate. Generally this option is better suited to those schemes with higher funding levels.

Our analysis shows that given a lot of the longer-term risks that schemes face (such as covenant and longevity risk amongst others) many schemes may actually need to take more risk than they might think.

For schemes looking to be pro-active but without sufficient assets to match cashflows directly, there is a complementary approach called cashflow aware growth investing.

CASHFLOW AWARE GROWTH INVESTING

Bonds are not the only assets that pay an income. In fact, almost all asset classes pay a stream of cashflows. However, there is clearly a trade-off between the certainty of the cashflows and the expected returns of the asset.

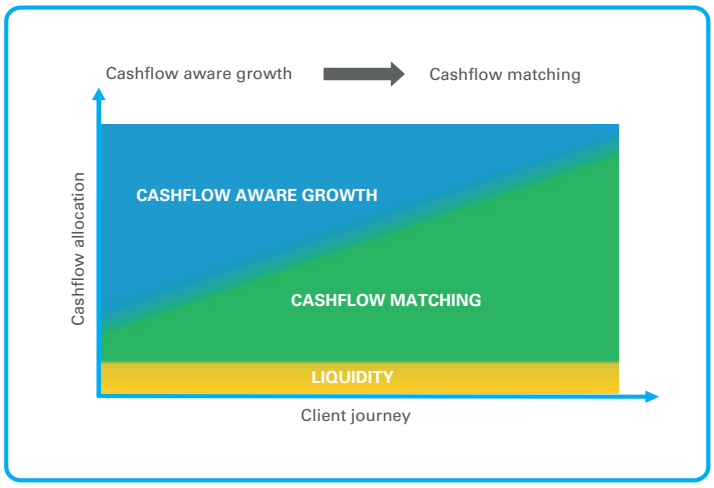
Schemes may therefore wish to focus on generating sustained cashflows over the longer term by investing in a diversified mix of assets. These could include assets that generate income but also offer higher growth potential, such as global high yield bonds, emerging market debt, or equities. In this way, cashflow aware growth investing can help schemes that are looking to generate cashflows to meet benefit payments but also retain higher return potential to help improve long-term funding levels.

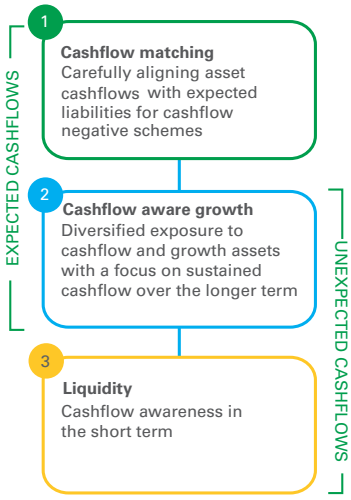
CASHFLOW AWARE INVESTING

The chart below shows how a scheme can combine the approaches of cashflow matching and cashflow aware growth investing to invest in a cashflow aware manner overall. The allocation to each investment strategies will change as schemes move closer to their endgame.

Schemes may also wish to hold an allocation to a highly liquid asset such as cash or absolute return bond funds to cover any short-term unexpected payments that may arise. Two common unexpected payments are transfers out of schemes and LDI portfolio 'top-ups' in the event that rates rise faster than expected.

Cashflow aware investing





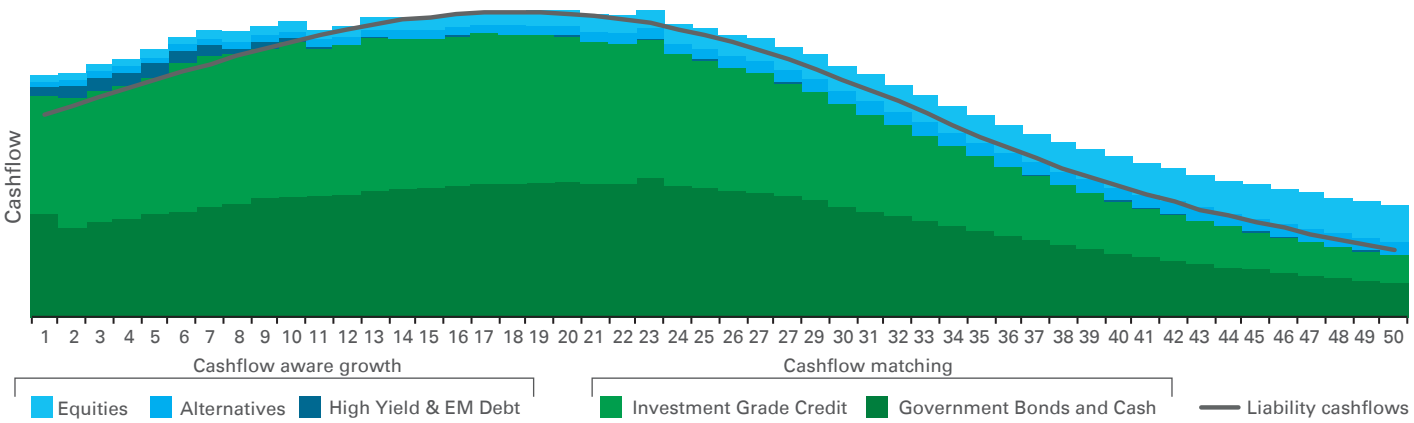
CASE STUDIES

In the charts below we illustrate two possible case studies; one for well-funded defined benefit pension schemes and one for less well-funded schemes. It is possible to construct portfolios like these we have shown by using pooled vehicles, a segregated structure or a combination of the two. The following examples are based on using a combination of pooled funds.

Example 1 – A very well-funded scheme primarily using cashflow matching

A very well-funded scheme has little need to retain significant growth potential in the portfolio, and therefore can focus on generating the secure cashflows required to meet benefit payments. In the example below therefore, the scheme largely employs a cashflow matching strategy, shown in green, by investing primarily in a mixture of credit, government bonds and cash.

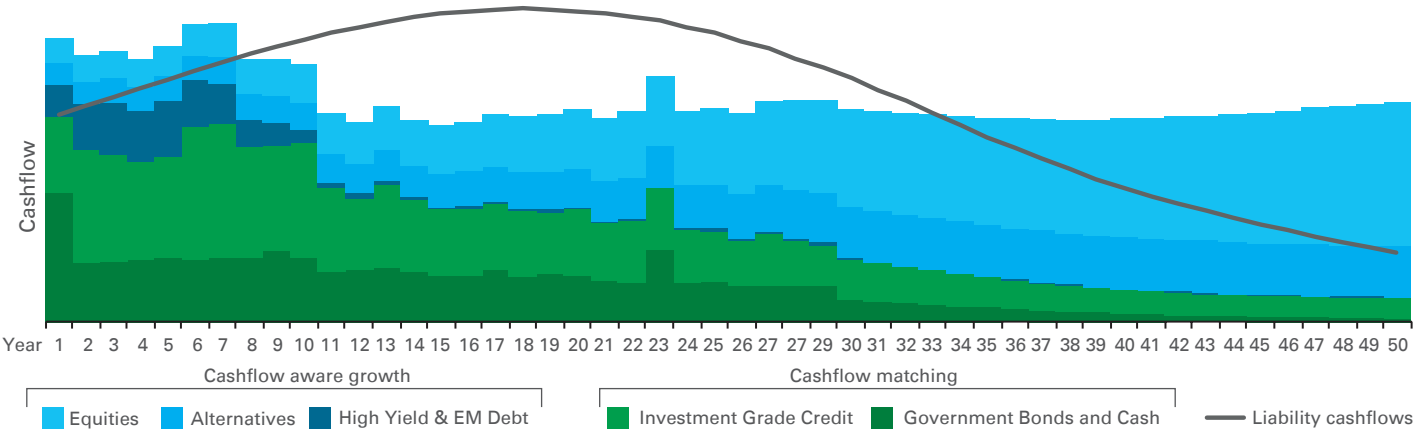
Expected asset cashflows – very well funded scheme



Example 2 – A less well-funded scheme primarily using cashflow matching aware growth

A less well-funded scheme needs to meet benefits but also requires greater growth potential to target improved funding levels. In the example below, therefore, the scheme has a much greater allocation to cashflow aware growth strategies, shown in blue. As you can see there are some cashflow short-falls that will require some limited sales but the scale (and therefore potential negative impact) of this has been much reduced.

Expected asset cashflows – less well funded scheme



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Important information

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The fund-specific data presented in this document is supplemental information to its relevant GIPS composite report, an example of which can be found in the Appendix. All GIPS composite reports are available on request.

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