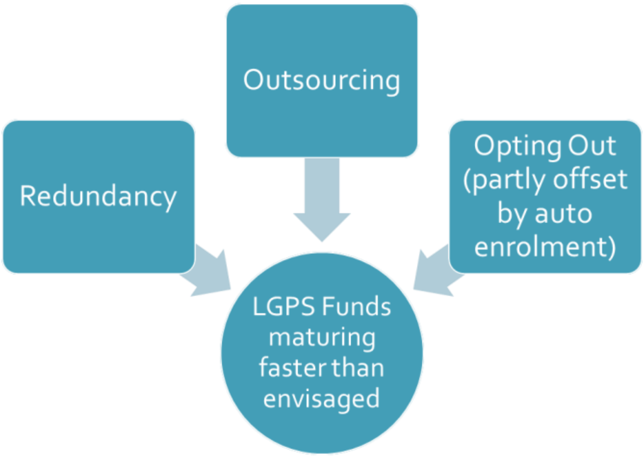
Current Issues – September 2017

Investing with a Negative Cash Flow

The Current Situation



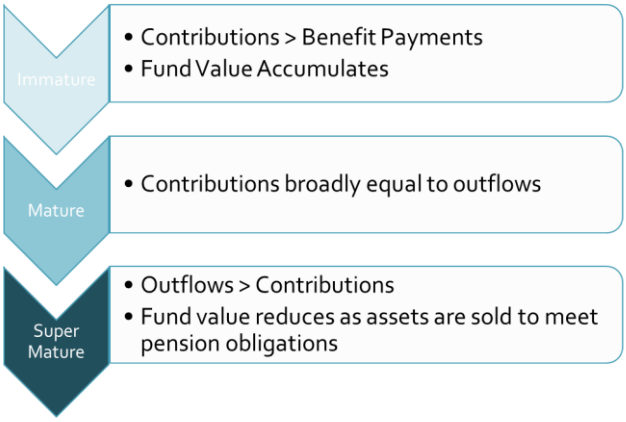
- Redundancy / outsourcing/ increased levels of opting out have all contributed to active member numbers (and associated contributions) reducing.
- Auto-enrolment beginning to provide some offset
- LGPS funds are maturing faster than they had expected.
- LGPS are moving to a position where the money coming in from contributions is less than the money going out to pay pensioners. Funds no longer have the luxury of being able to make all payments from contribution income and therefore need to manage cash flow more closely:

Questions to be Asked

- How much is required each month? (are there likely to be any 'lumps')
- How much income is received
- Where do we get the shortfall?

2016 Hymans survey saw that 20% of pension scheme CFO's saw the biggest risk to their financial health over the next five years being forced sellers of depressed value assets to fund their pensions

This is not a crisis. It is a natural phase of maturity for DB scheme. Three phases:



In most cases it does not require extreme immediate action or changes but can be taken into account through gradual changes over years.

Some Easy Fixes

Get back your income

- Many funds allow managers to reinvest the income generated. A simple way to increase income is to request this back from segregated arrangements or move to a distribution rather than an accumulation basis pooled investment.
- Property is currently yielding around 4.8%. Getting this income returned would add close to £4m for he average fund.
- The FTSE is currently yielding 3.5% and the MSCI ACWI 2.5%. Getting back this income would generate over £17m for the a £1bn fund with the average equity exposure (62%).
  However, funds would have to be aware of the negative performance impact on the equity return from not reinvesting the income.

If You Want a Cash Buffer – manage it well

- The rule of thumb is that a fund needs 3 times quarterly benefit outgoings as cash
- If funds feel a need to retain relatively high levels of cash to meet outgoings this needn't result in 'dead' performance.
- Derivatives can be used to maintain market exposure to ensure funds remain fully invested.

Manage Disinvestment

- Take funds for any from outperforming assets/ managers –should ensure fund remains close to benchmark allocation and is a good use of rebalancing.

- However – how to deal with illiquid assets? Some solutions are available e.g. private equity – a fund can stop further commitments and subsequent drawdowns so that it becomes cash flow positive.

Strategic Changes

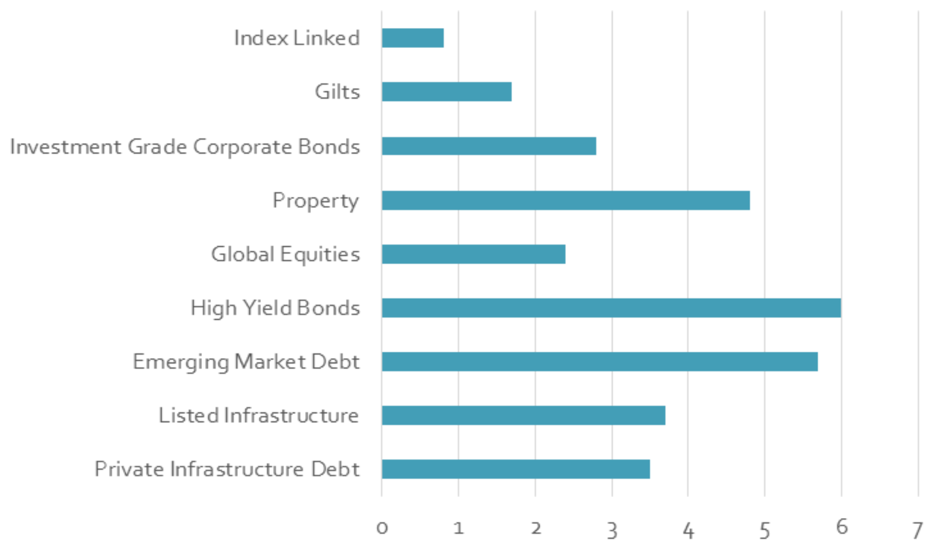
Existing Structure

- If a fund decides to take further action there are some relatively straightforward ways of increasing income:
    - Invest in high yield / income funds within the current asset structure
    - Increase allocation to property and other real, income generating assets, infrastructure

Changing Asset Classes

- Funds may feel they want to cut the volatility risk of their schemes to reflect their new situation, reducing equity exposure and investing instead in lower risk income generating assets.

- Bonds would historically have been the choice but the bond market has been as volatile as the equity market over recent years, and, at current extremely low yields (Gilts 2%, IL %, Credit 3-4%) not generating the required income levels.



Indicative current yields

- Funds are having to look instead at alternative choices to find lower risk / high yielding investments.

Multi Asset Credit

- Currently in vogue is multi – asset credit / income. This strategy is being offered to provide a broad based income stream across a variety of assets. It looks, at first sight very similar to diversified growth and the benchmark returns and risk profiles are often very similar.
- Some funds have absolute return targets, others just yield. Most LGPS schemes that have invested in this area are targeting Cash plus 4%.

Buy & Maintain Bond Portfolios

- Portfolio targeted at meeting cash flows through both bond income and maturity. Portfolio drains away over a defined time period with no assets left

Cash Flow Matching

- Really only an option for fully funded schemes but may be a solution for particular parts of the fund / admitted bodies with distinct requirements.

In Summary

- The move to being cash flow negative is a challenge, but for most funds not necessarily one that requires radical action currently.
- There are some simple steps that can be made to increase current cash flow and small adjustments to asset allocation that can increase income without having a major drag on returns
- The cash flow profile needs monitored so that further changes can be addressed as required.

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