Aon Hewitt
Retirement and Investment

Aon Investment Research and Insights

Cashflow Management Strategy

Cashflow Driven Investment Series

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Empower Results®

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About Aon Investment Research and Insights

Aon Hewitt's robust portfolio of ideas, tools and researched solutions support trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

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Executive summary

A key responsibility of trustees is meeting members' benefits when they fall due. As pension schemes have matured, many are now cashflow negative, meaning outgo outweighs contributions. Furthermore, the cashflows relating to pension schemes' assets and liabilities are also becoming increasingly unpredictable. In these circumstances, trustees should have a well thought out cashflow management strategy.

This paper considers:

1. **Assessing whether action is required by you**
2. **Understanding cashflows:**
    a. Of liabilities
    b. Of assets
3. **Cashflow management approaches:**
    a. Disinvest from assets
    b. Use investment income
4. **Considerations when setting a cashflow management strategy**

Assessing whether action is required by you

Trustees should consider the scheme's expected asset and liability cashflows and their current approach to meeting payments to assess if change is required.

Understanding cashflows

When considering a cashflow management strategy, or investing in assets to help meet benefit payments, trustees should be aware that liability and asset cashflows are unpredictable for a variety of reasons.

Cashflow management approaches

Where contributions into the scheme are not sufficient to meet cashflow requirements, there are two standard approaches to meeting payments: disinvestment from assets or use of investment income.

Key considerations

When deciding a scheme's cashflow management strategy, trustees should consider many other factors which could influence the mix of drawing down income, or disinvesting from assets.

Introduction

This paper is the first in a series of three papers which consider how meeting cashflows can be incorporated into wider considerations about schemes' investment strategies. It sets out the features of a scheme's asset and liability cashflows and considers different approaches that can be taken in setting a cashflow management strategy.

The other two papers, *Endgame Strategies* and *Cashflow Driven Investment Assets* discuss, respectively, endgame target portfolios and how a portfolio of assets with relatively predictable cash flows can be constructed to target some or all of a scheme's expected payments.

Assessing whether action is required by you

Trustees should consider the scheme's expected asset and liability cashflows and their current approach to meeting payments to assess if change is required to their cashflow management strategy.

1. **Net cashflow profile not a concern**
   If the trustees are comfortable that, looking forward, their current approach to meeting cash outflows allows for the scheme to deal with unexpected payments and market shocks without damaging their progress towards their objectives, then it is unlikely any changes are required.

2. **Cashflows could be a concern**
   If the trustees feel that, at present, cashflows are not causing a concern, but increases to payments or significant market movement could result in undesirable disinvestments being made then they should consider reviewing their cashflow management strategy. It may mean that investment strategy should be made more income generative or that the approach to capital disinvestment can be improved.

3. **Cashflows are a concern**
   If the trustees are concerned that current cashflow payments are causing a drag on the scheme's progress against its objectives immediate action should be taken. This could involve speaking to the employer about contributions but also reviewing the scheme's strategy to increase liquidity and/or cash generative assets.

4. **Cashflow position unknown**
   If the trustees do not know the expected impact of cashflows on their flight plan, or do not have a cashflow management strategy in place, we recommend they consider reviewing their position a priority.

Trustees should review, and test the robustness of, their cashflow management strategy at least every three years and more frequently if circumstances change.

Understanding cashflows

When considering a cashflow management strategy, or investing in assets to help meet benefit payments, trustees should be aware that cashflows are unpredictable for a variety of reasons.

Liabilities

Trustees should be aware that the liability cashflows are unpredictable for a variety of reasons. In particular:

- **Member choice**
  The ability of members to choose to convert their pension payments into a cash lump sum at any point up to retirement (either as a transfer value or retirement lump sum) means the shape and size of pre-retirement members' benefit payments has to be estimated. The increased flexibility brought in by the recent Pensions Freedoms makes monthly cashflows even more difficult to accurately estimate.

- **Longevity**
  Unless the scheme has hedged its longevity risk (via an instrument such as a longevity swap), the period over which pension payments need to be made is unknown. How life expectancy will change over the long term is very difficult to predict, so could result in significant changes, particularly to longer term cashflows.

- **Inflation**
  Many benefits are linked to measures of inflation, so the absolute value of the cash payment in the future is not known. Using inflation linked assets to hedge this volatility can help to ensure the scheme has sufficient assets to meet the payment, but does not make the payment required any more predictable.

- **Small membership**
  As the size of the membership reduces, demographic assumptions regarding benefit payments become less accurate and cashflows can be skewed by a small number of members with large benefits.

- **Scheme expenses**
  Whilst these should be small in relation to the assets, scheme expenses may also form a proportion of cashflow requirements.

Assets

The cashflows produced or required by a scheme's assets can also be unpredictable. In particular:

- **Collateral payments**
  Particularly relating to geared Liability Driven Investments (LDI), but applicable whenever derivatives are used. The use of derivatives can result in significant cashflows being required (or received) as a result of collateral payments. These payments are unpredictable and could easily exceed the usual monthly cashflow payments.

- **Closed-ended investments**
  These holdings will have a period of drawdown (from a few months to a few years) where the cashflows to be paid in will be requested at short notice. Following this the distribution period will result in relatively unpredictable cashflows being received (in terms of timing and/or amount).

- **Asset income**
  Income from high quality sterling bond investments should be predictable, but will be more variable from lower quality bonds, equity or non-sterling holdings.

Other payments

In addition, trustees should consider the predictability of other 'regular' payments from other sources:

- **Future accrual contributions**
  These will vary with the size of the active membership and can end at relatively short notice were the scheme to be closed to future accrual.

- **Deficit contributions**
  While normally predictable in size, they may not necessarily be predictable in timing, for example employers bringing forward payments for tax reasons.

Overall, the cash required by a scheme in any particular month can vary considerably from the amount expected (based on a set of best estimate assumptions) and the payments into the scheme may also be difficult to predict. An effective cashflow management strategy should be constructed with awareness of these and have sufficient flexibility to deal with this uncertainty.

"The cash required by a scheme in any particular month can vary considerably, an effective cashflow management strategy should be constructed with awareness of this and have sufficient flexibility to deal with this uncertainty"

Cashflow management approaches

Where contributions into the scheme are not sufficient to meet cashflow requirements, there are two standard approaches to meeting payments: disinvestment from assets or use of investment income.

1. Disinvestment from assets

Schemes may take a range of approaches to making disinvestments from the scheme's capital, for example:

- **Using excess collateral in a derivative portfolio**
  Where a scheme has more cash and gilts backing derivative exposure than it believes are required, assets can be redeemed without impacting the scheme's exposure and at relatively low trading costs.
- **Disinvesting a cash lump sum in advance**
  Making a disinvestment a couple of times a year to cover several months of cashflows allows trustees to take more time assessing the best source of the funds, and gives them the freedom to redeem from less liquid assets. This disinvestment is often incorporated as part of a larger rebalancing exercise.
- **Selling assets to rebalance a strategy**
  Disinvest from overweight asset classes to help keep allocation in line with strategy. Ensures redemptions are made from better performing assets and helps capture the 'diversification bonus'.
- **Selling assets to take tactical positions**
  Using the cashflows to take off-benchmark positions in line with current medium term market views.
- **Selling the assets with the lowest (round-trip) trading costs**
  These assets will generally be very liquid and so this allows the cash to be released quickly and with minimal explicit costs.

2. Use of investment income

Investing in assets which give off regular income streams can give trustees comfort regarding source of cashflow and avoid the risk of needing to redeem the assets at an inopportune time to meet cashflows or to incur redemption costs. It can take a variety of forms, for example:

- **Investing in 'secure income' assets**
  Assets such as high quality corporate bonds in a buy and maintain portfolio or a segregated gilt portfolio or bank loans, direct lending and property debt can provide the scheme with a fairly predictable income stream. Detail on these types of assets is provided in the 3rd paper in the Cashflow Driven Investment series, self-titled *Cashflow Driven Investment Assets*.
- **Purchasing annuities**
  This is an extreme example of investing in assets which will perfectly match a set of cashflows.
- **Using income from all asset classes**
  Income is a key component of many 'growth' focussed asset classes, for example equities and property. Clients with segregated mandates can request their managers to pay-out, rather than reinvest, all or part of this income. Furthermore, some pooled funds offer 'distribution' share classes that release income.

"In practice a cashflow management strategy may allow for a combination of these 'disinvest' and 'income' approaches to be taken"

Considerations when agreeing a cashflow management strategy

When deciding a scheme's cashflow management strategy, trustees should consider many other factors which could influence the mix of drawing down income, or disinvesting from assets.

Key considerations are:

- **Scheme objectives**
  The return required and the length of the recovery plan, or flight plan, will be a key consideration when designing an investment strategy, and so, for example, these factors may limit the extent to which the scheme can invest in illiquid assets or lower yielding assets such as high quality secured income investments. Trustees wishing to minimize funding level volatility are also likely to be driven to invest in assets which will be valued in a similar way to the scheme's liabilities.

- **Endgame target portfolio**
  Trustees should be working towards a particular goal and strategy and this target portfolio should be considered when making strategy decisions now. We discuss this in more detail in the paper *Endgame Portfolios*.

- **Governance constraints**
  The time available to the trustees to deal with investments will impact the complexity of the investment strategy and the degree to which the cashflow management strategy will need to be operated without trustee input.

- **Trustee beliefs**
  As illustrated by the Develop stage of our Viewpoints process, Trustees may have strong beliefs about what assets and strategies they are comfortable using, for example the role of illiquid assets, credit, active management and the benefits of diversifying return sources.

- **Asset cashflows and their predictability**
  As discussed above, the trustees should consider the expected cashflows relating to their portfolio or any anticipated changes to investment strategy, along with the uncertainty relating to them, particularly in stressed scenarios. For example, using geared LDI may reduce the volatility of the scheme's funding position, but is likely to result in increased volatility of cashflow requirements.

- **Liability cashflows and their predictability**
  As discussed previously, the liability cashflows are not known with certainty. However, for large schemes with a significant pensioner population and low inflation linkage they will be much more predictable (and potentially easier to match) than for immature schemes with a high proportion of inflation linked benefits.

- **Liquidity and transaction costs**
  In order to ensure that the portfolio is sufficiently liquid that the trustees can meet their duty of paying members' benefits as and when they fall due, it's key that the cashflow management strategy is sufficiently flexible to meet unexpected cashflows. Redemption from less liquid assets could result in material transaction costs (the purchase and sale of an investment grade corporate bond could cost around 0.7%), and from some asset classes may not be possible at all or extremely expensive.

- **Locking in losses**
  Risk of disinvesting from an asset which is undervalued. The risk of this could be reduced through diversification and/or using income.

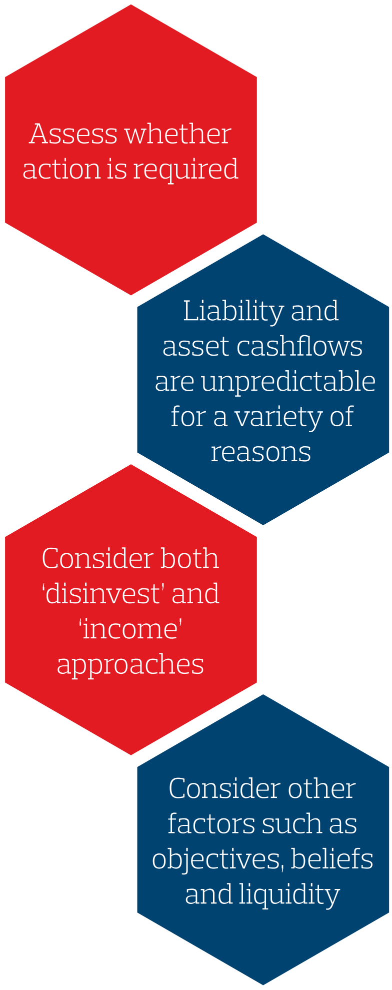
- **Cash drag**
  If holding too much cash in anticipation of cashflows.

- **Rebalancing policy**
  Asset allocation can drift as a result of market movements and selling assets or income for cashflow. This can lead to the assets being allocated differently to the trustees' desired investment strategy. Furthermore, there is evidence that regular rebalancing, i.e. selling assets that have outperformed and buying assets that have underperformed, adds value. Trustees should have a policy regarding rebalancing.

Conclusion

A cashflow management strategy which has been designed based on a scheme's requirements and priorities can help trustees to achieve their objectives and reduce the risk of cash redemptions having a negative impact on returns.

Trustees having a full understanding of their expected cashflows (both from the liabilities and assets) will help ensure the cashflow management strategy meets the scheme's needs. Your consultant will be able to work with you to review your current strategy and ensure you have an appropriate solution. We suggest that the cashflow management strategy is reviewed at least every three years.



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