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My scheme is in negative cashflow. Do I need to do anything?

As Defined Benefit pension schemes become increasingly mature, more and more of them are moving into negative cashflow; i.e. paying more out in benefits than they receive in contributions.

This quarter James Gardner and Russell Oades from our investment team discuss the impact of moving into negative cashflow.

James: For the trustees you advise, what concerns them most about moving into negative cashflow?

Russell: The practicalities are generally the first concern. The first question is usually *"What should we sell to pay benefits?".*

Unless the amounts are extraordinarily large, my answer is to put in place a protocol that ensures you can get the money out quickly month after month. After all that's the main objective, pay the members' benefits on time.

James: So what might that protocol look like?

Russell: The first task is to set a target asset allocation. Schemes may already have set out this out in their Statement of Investment Principles. If not, they are likely to have agreed one when they last reviewed their investment strategy.

With this in place a protocol such as "Disinvest from the fund which is most overweight relative to the target" can be applied.

Subject to appropriate limits and checking processes, and having access to asset allocation data in a timely manner, the disinvestment process can be delegated to the scheme's administrator.

James: But what about that dreaded "forced seller" risk? Should pension schemes have a protocol that forces them to sell out of equities even if they've performed badly?

Russell: In the protocol I just described, schemes would generally be selling those assets that have performed better; their better performance is likely to be the reason for being overweight. This offers some protection against forced seller risk.

Also, because the disinvestment process can be done efficiently, it can be done on a "little and often" basis. Disinvesting 1% or 2% per month from an equity portfolio offers little potential to crystallise a fall in the stock market.

There is a case to say that you should hold less volatile assets when money is coming out – because the disinvestment crystallises losses. However, we've carried out some analysis to measure the effect on equity returns and we found that the effect is only marginal most of the time. Employer covenant and funding level are I think much more important drivers of how much risk should be taken.

{The analysis referred to is detailed on page 4}

James: In that case do you think there's a case for the products that fund managers have designed to "meet the income needs of pension schemes"? Things like "Cashflow Driven Investment", "Buy and maintain credit" and "Contractual Income"

Russell: I'm sceptical of claims that "Cashflow Driven Investment" can accurately meet benefit payments. For smaller schemes at least, the benefit payments are not predictable. In some, one member taking a large transfer value can make a big difference.

That said buy and maintain credit funds are, in our view, the best way of accessing longer dated investment grade corporate bonds. They provide investors with relatively certain return above gilts for a long period at a low cost. If only the gilt yields were higher.

Contractual Income funds have similar characteristics to buy and maintain credit. They aim to deliver their "relatively certain return" through the income distributed from infrastructure, property or private forms of debt. The main advantages over buy and maintain credit is an expectation of higher returns.

The main disadvantage is lower liquidity and a lower sensitivity to gilt yields. Schemes may be locked in to a fund for several years and these assets may not perform in line with movements in the value of a scheme's liabilities.

Summarising though, we are talking about some attractive investment classes here, with merit far beyond their "Cashflow Driven Investment" tag.

James: Isn't another advantage of the contractual income funds the fact that income is paid out?

Russell: The income is certainly helpful.

Taking income from an asset avoids transaction costs. That income will then not be re-invested, avoiding transaction costs on purchase, and other assets won't need to be sold to meet benefit payments, avoiding transaction costs on the sale.

Don't forget you can do this on other investments as well. Equity, bond funds and even DGFs can have income distributing share classes. The savings are usually marginal but, where switching to income distributing funds is straightforward, the saving is worth having.

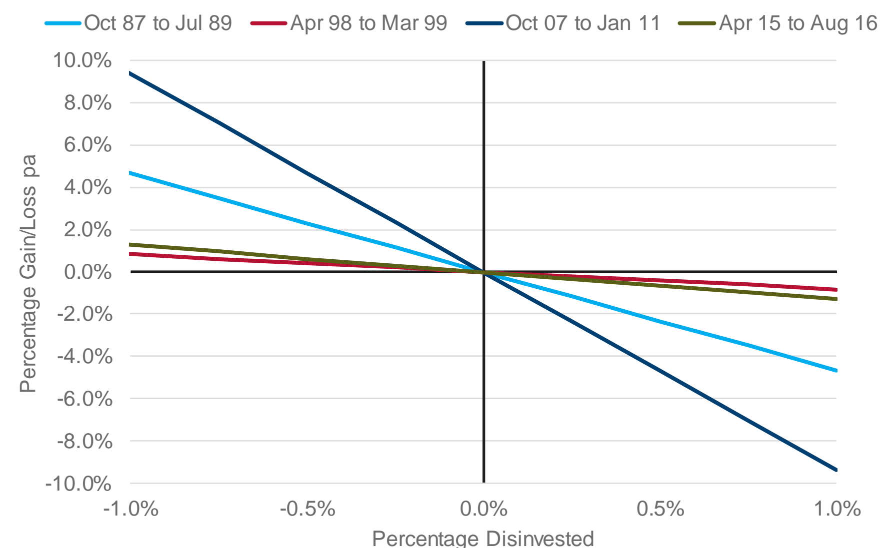
Summary – Things to do as your scheme moves into negative cashflow

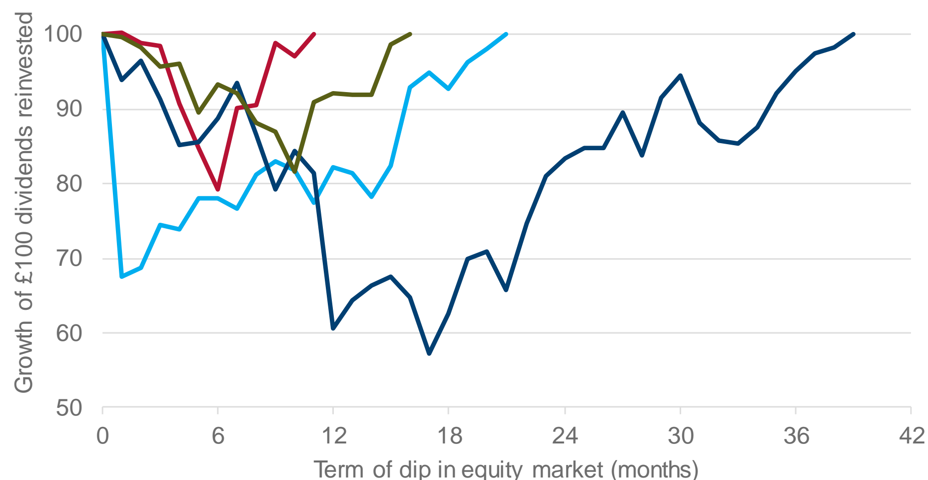
Set and document a disinvestment protocol – make the process of disinvesting to pay benefits efficient so that benefit payments can be met in a timely manner.

Consider the level of volatility you're running – negative cashflow may mean you want to run less volatility, but other factors such as employer covenant and funding position are likely to be more important drivers.

Switch to income generative assets – avoiding reinvesting income only to sell assets will save money.

Analysis: The impact of disinvesting from equities in a dip





In the charts opposite we show the impact on disinvesting during falls in the equity market. We considered the last four major falls in the UK equity market. The most severe of these were:

- October 1987 to July 1989, Black Wednesday and the subsequent recovery.
- October 2007 to January 2011, the "Great Recession" following on from Leyman Brothers collapse and the Credit Crunch.

The analysis confirms that disinvesting while equity markets are depressed does indeed crystallise a loss. In the most severe markets, disinvesting 1% of the starting assets per month* would have led to a permanent loss of capital of just under 10% of the initial amount.

We note however that:

- There was no sudden "cliff edge" in the gains and losses arising when moving from being a net investor to a net dis-investor. Instead, the gains and losses arising were proportionate to the rate of investment or disinvestment.
- Under less sustained falls in the equity market, such as from April 98 to April 99, the permanent loss of capital from disinvesting regularly is much less significant
- In practice a high allocation to equities would lead to a deficit arising during these periods. The resulting contributions may then be invested when the market remained depressed and so the scheme would have benefitted more strongly from a recovery in the stock market.
- Also, in practice, a pension scheme that is heavily cashflow negative would be unlikely to be invested entirely in equities and so the losses would be smaller.

*We expect 1% per month to be broadly similar to the pace of disinvestment for a scheme entirely made up of pensions in payment.

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