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# Building your own annuity book

## Cashflow solutions at M&G

For Investment Professionals only

# Achieving the attainable

"Tantalus's punishment was being forced to stand in a pool of water, underneath a fruit tree, for all of eternity. Every time, he would reach for fruit from the tree, it would grow beyond his reach."

**Jeremy Richards, Fund Manager**

Tantalus was a son of Zeus who committed a grisly set of crimes. After being caught stealing ambrosia from the gods and incurring their wrath, he tried to ingratiate himself once more by killing his son, cooking him and serving him up at a banquet for the gods.

Even by the pretty low standards of the Greek mythological gods, this was deemed to be poor parenting. So, Tantalus was forever punished with reaching for the unattainable and this story gives rise to the word "tantalise".

This feeling of trying to attain something that seems to forever move out of reach is familiar to many UK pension schemes and their trustees. Meeting their cashflow liabilities is becoming an ever-increasing challenge.* 56% of pension plans surveyed by Mercer are currently cashflow negative and, of those that are not, 83% are expected to become so over the next 10 years.

As pension schemes endeavour to reach a better funding position, they realise that the cost of a fully insured buy-out is much further away than they first thought. They know that the buoyant growth in equity markets is offset by rock-bottom discount rates and that the expense of such a solution could remain well beyond their reach.

## Reaching the unattainable?

Meanwhile, many analysts point to the current valuations of traditional risk premia versus historic averages and make gloomy predictions on returns. This is one of the reasons many pension schemes are moving allocations away from equities towards fixed income and other matching assets, with the effect of de-risking their portfolios.

Even when buy-out and buy-in has become cheaper, there has not always been a corresponding change to the underlying bond rates, leading some schemes to question the quality of those guarantees. The implication is that self-sufficiency is what many pension funds should instead aim for in order to manage their pension commitments.

A further challenge facing schemes is that the use of liability-driven investment (LDI) swaps, used to hedge out duration risk, will soon become more expensive under the regime of central clearing. Thus, the certainties that the trustees of many schemes rightly seek in order to obtain security in matching their liabilities appear to recede from attainability.

## Building an annuity book

It is for such reasons that many pension schemes have been asking us what our annuity books look like. If these, run on behalf of Prudential plc, have been meeting pension payments for many decades, then how have we been doing this? What assets have we used? What lessons have we learned? In short, is it possible to help schemes close their funding gaps, reduce reliance on synthetic duration solutions and still pay pensioners by delivering the right level of cashflows when required? The short answer to this last question is "Yes".

The long answer is what this paper addresses, as we set out why building your own annuity book involves being flexible and asset agnostic, what assets we have used as the building blocks and the process of putting together such portfolios. From a pension scheme's perspective, the good news is that they do not have to adhere to the same regulation regime that insurers do, so we can help them to build their own, more commercially efficient, version of an annuity book.

# Lightsource, UK

- M&G provided nearly £250 million in debt refinancing in 2015 for a large portfolio of fully operational solar plants
- The portfolio had a total installed generation capacity of just over 100 MWp – enough to power over 30,000 homes
- Long-term inflation-linked cashflows generated are backed by the government solar feed-in-tariff, a form of UK renewable energy subsidy
- Security of cashflows provided by seniority
- Conservative covenant package, including prepayment protection

## Is it time for a different kind of certainty?

Matching a pension scheme's liabilities primarily through physical assets can achieve a different kind of certainty, hedging risk not via swaps alongside a growth portfolio, but by using a mix of assets to ensure pensioners' payrolls are met, sponsors are protected and the scheme is de-risked over time. This is how we have managed our annuity books successfully for many years.

Physical asset exposure offers an alternative route to tackling some of the risks, such as interest rate risk, that are met with traditional LDI portfolios and importantly, it can fulfil a wide range of outcomes. LDI using long-dated government bonds does not typically deliver the level of cashflows when required. While we can help reduce a scheme's reliance on swaps, it is likely that some exposure will still be necessary, especially for inflation risk. We therefore work closely with our clients' LDI providers to ensure all of their requirements are met by building cashflow solutions asset by asset.

Each pension scheme's funding deficit and cashflow requirements are different and so one size does not fit all. When working with clients in this area, we focus on creating bespoke solutions that evolve through the life of the scheme to match changing cashflow requirements efficiently and as better value assets emerge. This bespoke approach puts a scheme's specific cashflow needs at the heart of the process, ensuring that every asset selected for inclusion fulfills a specific outcome.

As a scheme becomes more mature and has greater numbers of pensions in payment, the predictability of cashflows becomes more certain, while the need for liquidity is less important, as vulnerability to transfers-out decreases. For these schemes, we would usually consider blending a variety of private, very secure assets with high-quality cashflows, with more liquid public debt assets.

For younger schemes, high levels of liquidity and flexibility are important, and therefore the illiquid assets used tend to be of a shorter maturity and it is not as important to be utterly prescriptive when matching assets to precise liabilities. A much greater reliance upon public debt assets is usually a feature of the portfolios we would build for younger schemes.

# Alder Hey Children's Hospital, Liverpool, UK

- M&G Investments provided funding for the redevelopment of Alder Hey Children's Hospital, which treats 275,000 children each year
- Annuity-like repayment profile provides stable cashflows with revenue derived from the NHS trust
- Conservative covenant package provides lender protection
- Structure provides credit support and additional security

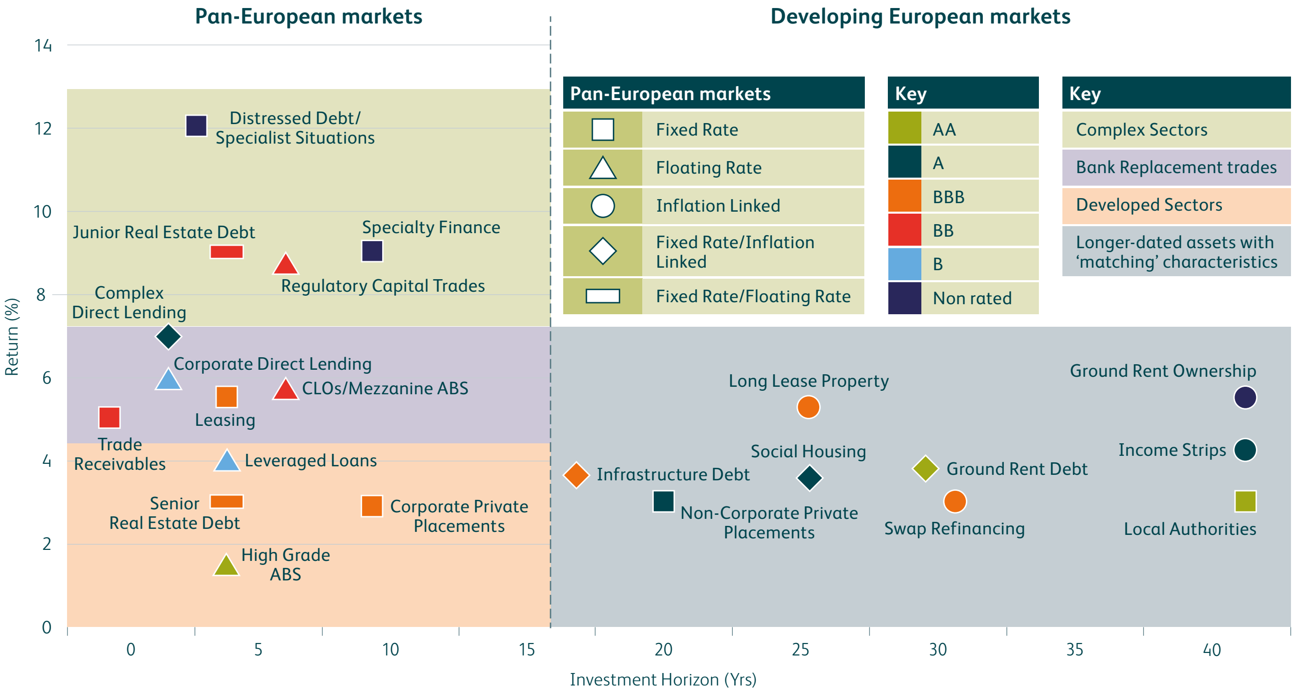
## Building you a matching portfolio

We build matching portfolios from a broad range of reliable, cashflow-generating assets. These encompass different forms of financing, which are public, private, fixed, floating, index-linked, secured, unsecured, junior, senior, asset-backed and so on. The common theme is a contracted cashflow and the flexibility to use a wide variety of assets which allows schemes to, in effect, build their own bespoke annuity book.

Without access to all of the assets sourced across public and private markets, any portfolios built will have potentially significant inefficiencies. If you only have a hammer, then every job will look like a nail; if you have only public debt, then every solution you find will potentially overlook more appropriate solutions.

This investment process involves considering each asset individually to evaluate the risk/return trade-off, beyond the headline benefits or if they in vogue. For example, rather than using private assets because they offer extra security and are fashionable, balance up the illiquidity they possess with the extra returns and security and then ask, "Are we being properly compensated for the risk and what outcome is intended?" Private debt, for example, can be used to hedge inflation risk, with assets offering long-dated, inflation-linked cashflows.

In the illustration below is a non-exhaustive sample set of the asset types we consider on behalf of our own annuity books and our external cashflow clients:




Source: M&G illustrative, Bloomberg UK Sovereign curve. Graph indicates total return of asset classes.

## Flexible asset agnostic approach

We recognise that risk mitigation is the first objective of any cashflow-driven solution, as simply adding credit risk is not a straightforward answer to generating higher cashflows. An experienced and pragmatic approach is essential and it is most important that the portfolio reflects each client's trade-off between return, risk and liquidity.

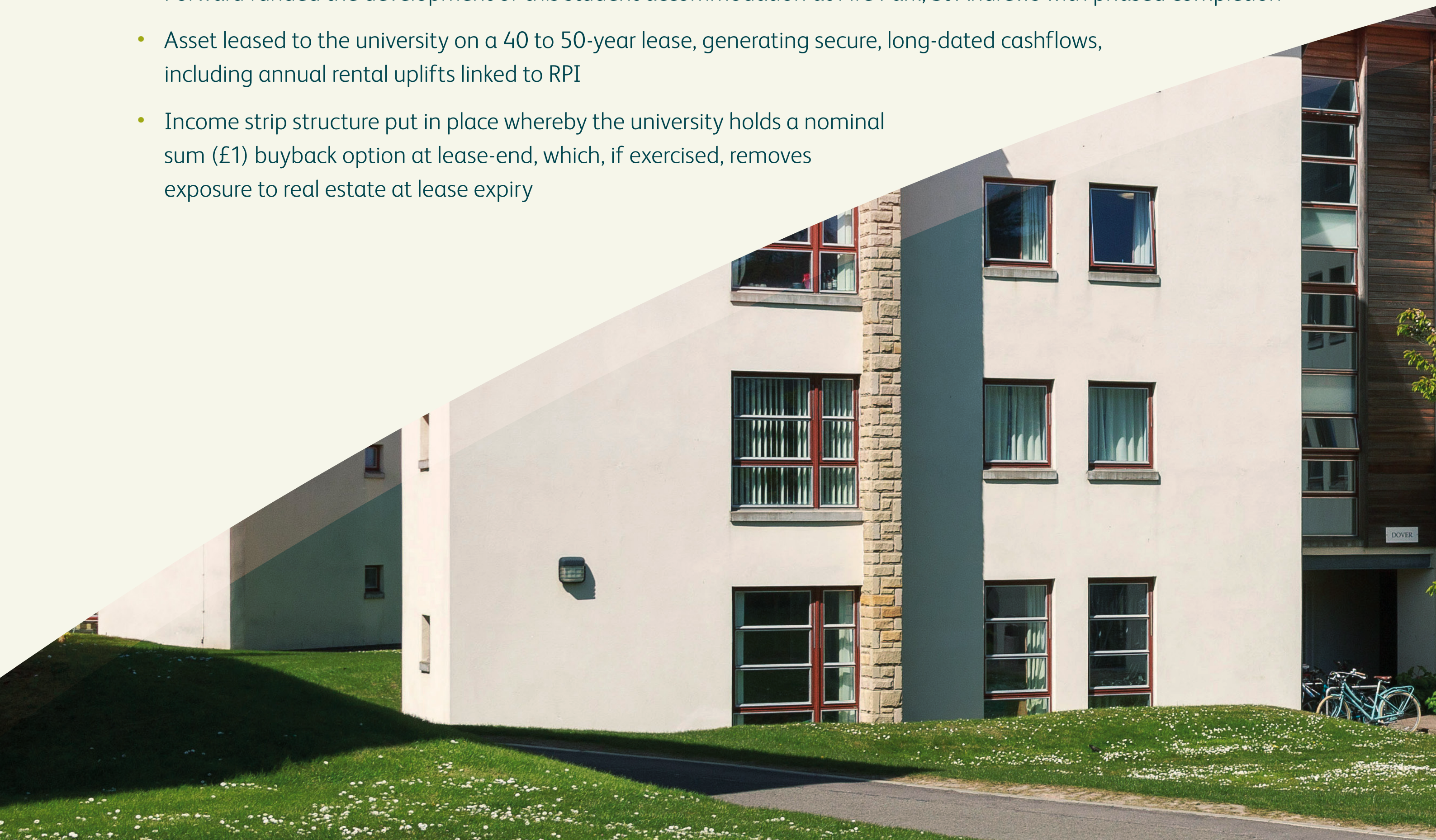
We build all portfolios from the bottom-up, using extensive research and a strict value-based approach. It is essential to remain entirely opportunistic and agnostic to the type of asset for inclusion, while there are no "asset allocation" decisions, as that presupposes an assessment made now will still apply in the two or three years' time that it may take to source complex, private assets that fulfil a specific task.

This means we only take risks for which our clients are being compensated and reduce the risks in their portfolios by removing the need to make predictions about the future direction of markets.

Furthermore, all the cashflows do not need to be matched at once, nor should these portfolios be built once and assumed to work in this static form into perpetuity. Our own annuity books look very different from how they did 15 or 20 years ago. Markets evolve and it is key to buy the right asset at the right time, and at the right price. We always like to keep some powder dry to access reliable cashflows when they become cheap.

# The University of St Andrews, Fife, Scotland

- Forward funded the development of this student accommodation at Fife Park, St Andrews with phased completion
- Asset leased to the university on a 40 to 50-year lease, generating secure, long-dated cashflows, including annual rental uplifts linked to RPI
- Income strip structure put in place whereby the university holds a nominal sum (£1) buyback option at lease-end, which, if exercised, removes exposure to real estate at lease expiry



## Conclusion

Through creating cashflow matching solutions in this way, we not only ensure that pension payments are made as required, but also that schemes can be de-risked as part of this. The attributes necessary to manage our own annuity books successfully for many decades have been resource, patience and discipline; this is exactly the same approach we use when building efficient cashflow-matching portfolios for our external clients.

Such solutions are not akin to a 'Buy and Maintain' portfolio, but instead require the flexibility to evolve through the life of the scheme to meet changing cashflow requirements. This means not paying for liquidity that is not needed in the short term and by aiming to capture higher cashflows, value opportunities can be captured as they emerge. By taking an asset-agnostic approach, this allows for the creation of diversification, lowering the risk of portfolios.

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