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# Cashflow investing in action

## From LDI to a cashflow solution

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

The transition of a pension scheme to a fully cashflow-driven mandate is evolution rather than revolution, usually a series of incremental changes or "de-risking" events over time. The exact path differs for every scheme depending on the shape of its starting investment portfolio, funding position, the nature of its liabilities and the sponsor's covenant.

A precise cashflow match may not be achievable or advisable immediately, but adopting a more cashflow aware strategy enables a scheme's consultant and trustees to consider how current and future investments might suit its long-term goals. This can allow a scheme to lower its risk relative to its payment liabilities as the funding level improves.

Patience and flexibility are essential. Investment opportunities change as markets develop, new asset classes evolve and markets sell off in times of uncertainty so a scheme should look to incrementally improve its risk position on an ongoing basis.

## The objective: increasing investment in physical matching assets

We worked with the trustee and consultant of a large UK defined benefit pension scheme to reduce the complexity of the scheme's liability-driven investment (LDI) portfolio, lower its counterparty risk, and increase investment in physical matching assets that offered the potential for additional yield and opportunities to smooth the cashflow profile.

The scheme's asset portfolio consisted of:

### Traditional LDI mandate

- Inflation swaps
- Interest rate swaps (fixed/floating and Sonia/Libor)
- Passively held government bonds (conventional and index-linked gilts) and government-guaranteed bonds

### Collateral pool

- Portfolio of predominantly conventional and index-linked gilts swapped to provide a floating-rate (Libor+) return to support the LDI swaps

### Matching bond and property mandates

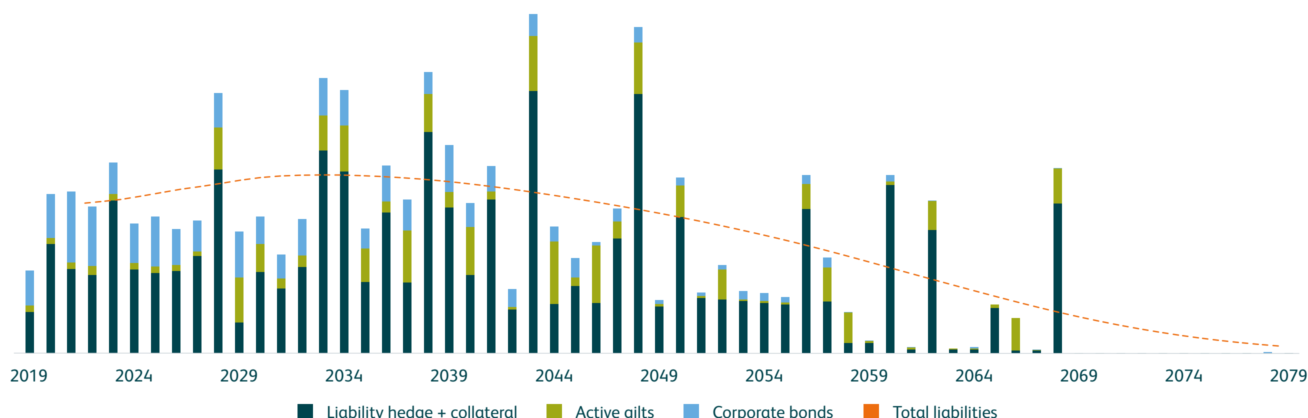
- Conventional and index-linked gilt portfolios actively managed against a bespoke benchmark reflecting a portion of scheme liabilities
- Actively managed corporate bond portfolio seeking to capture credit risk premium
- Long-dated buy and maintain bond portfolio seeking to target a specific cashflow profile in addition to capturing credit risk premium
- Alternative assets portfolios, for example long-lease property seeking to provide high-quality, inflation-linked cashflows at a significant extra spread to bonds of similar credit risk.

The scheme is well-funded with interest rate and inflation risks fully hedged through the LDI mandate. However, it is mature and the proportion of pensioner members exceeds the combined active and deferred membership. It has been in net cash outflow for some time.

Alongside income from investments, payments to pensioners have so far been met from the proceeds of de-risking such as sales of equities, traditional property and other growth assets. The scheme is now relying on the remaining assets to provide the remaining cashflows required.

Figure 1 below is a model of the projected cashflow liabilities compared with the expected "matching" asset cashflows received over the same 60 years.

Figure 1: Projected pension scheme liability and asset cashflows, next 60 years




Source: M&G, illustrative. This is a model of the projected pension scheme cashflow liabilities and the expected matching asset cashflows to be received from its assets over the same time horizon.

## The big swap: releasing gilts for cashflow matches

We substantially simplified the scheme's interest rate and inflation swaps, which resulted in the release of a significant amount of gilts from the collateral portfolio. Known as a 'compression trade', the project rationalised the scheme's swap portfolio by cancelling out equal and opposite swap contracts. The trade had no impact on the scheme's overall rate and inflation protection, but significantly reduced the scheme's counterparty exposure, and the gilts released became available for investment in physical bonds.

A granular analysis of the scheme to compare its fixed and real asset cashflows against fixed and inflation-linked liabilities revealed specific cashflow deficits to address. Assets are now available for investment in physical bond portfolios, both public and private.

The trustee has requested a long timeline to ensure the entry point at which the bonds are purchased adequately compensate for the risk taken.

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