# Cashflow Driven Investment

**Ultimate solution to the pensions problem, or just glorified LDI?**

In recent months, Cashflow Driven Investment (CDI) has very much been the "talk of the town". But for every voice in the pensions industry, there seems to be a different version of what CDI actually means.

What is particularly striking is the way in which CDI has been marketed in some quarters as the "ultimate solution" to the pensions problem, capable of improving returns and removing volatility, all without an increase in contributions. At the same time, others see it as the fairly obvious extension of the sort of hedging programme (also known as Liability Driven Investment, or LDI) that has been around for years.

The truth, as always, lies somewhere in-between and depends heavily on context. Here we will compare the various recommendations that have been put forward in the world of CDI.

## What can we agree on?

Let's do the easy bit first, and set out what everyone can agree on, in terms of applying the principles of CDI to Defined Benefit (DB) pension schemes. By holding low-risk assets that can reliably provide the right level of income, a scheme no longer needs to worry as much about having to sell assets at an unfavourable moment (e.g. after a fall in price) to meet its obligations. This removes the exposure to much of the impact of market price changes in the asset portfolio. Insurance companies have been using a similar approach for years and, with the continued improvement in funding levels, more and more DB schemes are following suit.

However, once we look beyond this overarching principle, we find significant differences in the many important areas which we will explore below.

## Types of CDI portfolio

Our general observation here is that the principle of "Maslow's Hammer" seems to apply: "If all you have is a hammer, everything looks like a nail." In other words, the types of portfolios that are suggested by each investment consultant, fiduciary manager or asset manager is closely linked to the expertise and sourcing capabilities of each. Whilst there is much variety between firms, these CDI portfolios can be grouped loosely into two main categories:

Figure 1. **Typical CDI portfolios**

| | Credit focused | Secure income focused |
|---|---|---|
| **Description** | Investment grade and sub-investment grade credit pull most of the weight in the portfolio. Less likely to include pensioner buy-ins. | Secure income assets (e.g. income streams from infrastructure projects, real estate debt etc) pull most of the weight. Used alongside a (smaller) allocation to credit. |
| **Pros** | ▪ Simple to understand and implement<br>▪ Transparency in asset prices for monitoring purposes<br>▪ Liquid assets add flexibility | ▪ Longer duration income streams mean less reinvestment risk<br>▪ Higher yields for relatively low risk<br>▪ Diversification across return sources |
| **Cons** | ▪ Low yields, or higher risk if investing in lower credit rating<br>▪ Concentration risk in one asset class (another financial crisis?)<br>▪ Reinvestment risk due to shorter duration than liabilities | ▪ More complex implementation to tie together income streams<br>▪ Less transparency in asset prices, e.g. no daily valuation<br>▪ Illiquid assets may hinder near-term buyout |

Figure 2. **A credit focused CDI strategy**

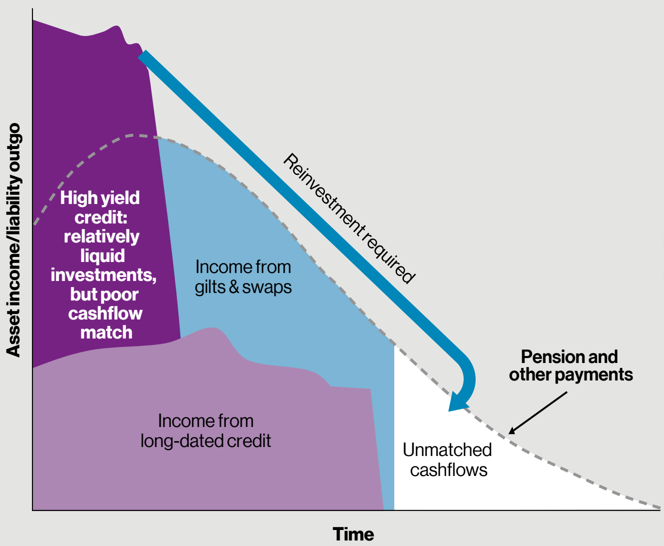
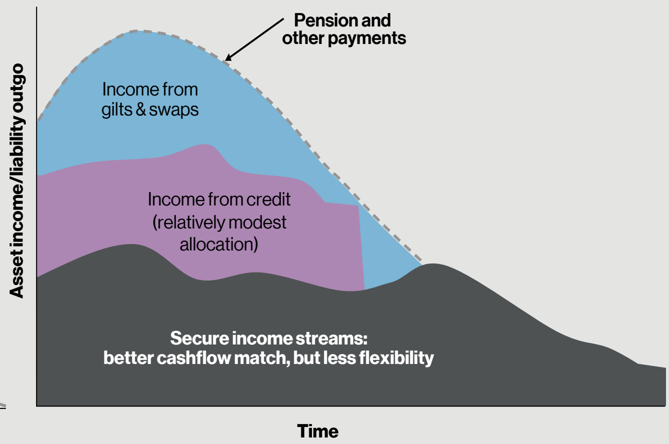



Figure 3. **A secure income focused strategy**




**The secure income focused strategy provides a better match for liabilities, as long as there is no imminent need to sell the secure income streams.**

Likewise, those with special expertise in insurance (or linkage to an insurer) will tend to favour insuring a substantial part of the liabilities (e.g. all the pensioners), or a solution that naturally leads to a full buyout with the partnered insurer (along with some sharing of investment upside between the scheme and provider).

## Does CDI remove funding volatility?

There have been some claims that CDI can remove most if not all of a scheme's funding volatilities, meaning a scheme will remain close to 100% funded at all times. Whether this is true in practice will depend on the approach for funding calculations, and the willingness of the actuary (as well as the Trustees they advise) to "pass through" any market price movements directly onto the liabilities.

Unsurprisingly, the stability of the funding results is related to how unwavering your belief is that the strategy will always deliver the cashflows under different market conditions. A more balanced view is likely to take at least some notice of market movements and changes in credit ratings.

## Partial or total CDI?

Some advocate a CDI portfolio covering the next 10-15 years worth of pension payments, leaving a more "traditional" portfolio (consisting of the usual return-seeking and liability-matching components) to cover the rest of the liabilities. Others design portfolios with income streams covering all, or a portion of all, future benefit payments.

This comes down to the matter of deciding what is more important. Is it better to meet the cashflow requirements over the medium term, or manage the more volatile, longer dated liabilities? Is it more important for the Trustees to minimise risk on the payments they will make, or to ensure the next generation of Trustees will inherit a scheme in the best possible shape?

Certain investments will lend themselves to a particular type of strategy. For example, some investments in ground rents can provide long-dated cashflows at a very attractive yield – these would work much better in a strategy that involves matching the cashflows for younger members.

## Higher or lower return?

Again this is a matter of finding the right trade-off. Targeting a lower return means more reliable cashflow matching, but requires the scheme to build up more assets. A higher return means a more readily attainable CDI strategy, at the expense of greater residual risk. The view of the sponsor covenant, both now and over the longer term, is key to striking the right balance.

## Should we just insure the liabilities instead?

The current favourable pricing for insuring pension liabilities has prompted the question:

*"Why bother with CDI at all, when an insurer can do all of this for you?" The answer, of course, has to do with cost.*

CDI is sometimes described as "DIY insurance", given the similar approach and the types of assets that make up a CDI portfolio. The main difference is that, by staying out of the insurance regime, a pension scheme has fewer restrictions on its investments (and so can achieve a better price/higher return) and avoids paying for the insurer's profit. As such, when insurance is cheap, a CDI strategy should be even cheaper.

In practice, for many schemes, adopting a CDI strategy may be seen as a transitional phase, until a full buyout becomes possible some years down the line. The aim in the meantime is to reduce risk as far as possible, whilst waiting for insurance pricing to come within striking distance as scheme members continues to age, and non-pensioners transfer out or retire. In most cases, CDI leads to a lower risk (but slower) route to buyout, rather than an alternative to buyout.

## Pensioner buy-ins

Schemes adopting CDI as self-insurance should at least consider insuring subsets of their liabilities, for which the premium looks particularly attractive.

Some schemes will allow for one or a series of planned buy-ins as part of their CDI strategy, not least as an effective way for removing longevity risk which would otherwise become dominant in a low-risk strategy. Others prefer to implement a buy-in only to the extent that the overall cashflow match across all liabilities is not compromised. The right choice here is likely to depend on the level of funding and the pricing for a particular transaction.

## Is CDI for large schemes only?

There is often a presumption that only large schemes are likely to adopt a CDI strategy, and that it is more economical for smaller schemes to buy out their liabilities. This generalisation does contain some truth at the extreme ends of the spectrum – a £20bn scheme may find it difficult to insure all of its liabilities in the foreseeable future, whilst for a £20m scheme the cost of running the scheme for a number of years may exceed the shortfall to the buyout premium. However, whilst it is true that the largest schemes are amongst the first to implement CDI, schemes with assets of £100m or even £50m have also done so – these smaller schemes are more likely to make use of pooled solutions in some areas of investment.

## Other alternatives to a CDI approach

Whilst CDI has sometimes been described as an alternative "end game" to insuring the liabilities, as discussed above, both of these could feature within a scheme's long-term strategy. Likewise, whilst the possible rise of the commercial pensions consolidators may present an extra option for Trustees to consider, these consolidators are likely to adopt some combination of CDI and insurance as part of their own strategy for managing the liabilities that they take on.

## Conclusion

A low-risk CDI strategy can be an attractive choice for a well-funded scheme that is not yet in a position to buy out in full. However, there are different versions of the strategy, and it is important for Trustees and Sponsors to assess the pros and cons of each in the context of their own circumstances.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