For professional clients only

Pension Insights

The Income Balancing Act

How to meet
long-term liabilities,
deliver sustainable
growth and achieve
positive cash flow.

Executive summary

Welcome to the latest edition of our thought leadership series, Pension Insights.

When examining the current state of the UK pension fund market it is clear many pension schemes are faced with a number of significant challenges. The two most prevalent are the ability to meet future liabilities in an environment where negative real yields have rapidly become the norm and how to achieve a sustainable level of growth required to reduce a seemingly ever increasing deficit. As schemes put measures in place to meet these challenges a third issue has arisen, achieving adequate cash flow to meet near term commitments in an era of declining pension contributions.

The common convention for pension schemes is to rely upon gilts as the default matching asset for scheme liabilities. But as gilt yields remain at or near all-time lows, with little sign of recovery pension schemes have been forced to consider alternative methods of meeting long-term scheme liabilities.

Pension schemes also typically utilise return seeking assets to deliver growth. The primary driver of growth within these asset classes is the reinvestment income.

The maturing profile of UK pension schemes has led to the harvesting of yield from these return seeking asset classes. This and increasing correlations between core asset classes during periods of extreme market volatility have forced investors to consider a wider range of income orientated and diversified return seeking assets.

Whilst the first two challenges have received significant levels of attention, we believe less thought has been given to tackling the looming problem of cash flow negativity. Scheme closures and austerity have impacted on contribution levels for both private and Local Government Pension Schemes, for so long a stable source of cash flow.

Industry research suggests that pension schemes are, to date, adopting a piecemeal approach in addressing cash flow negativity such as stripping income, selling down assets or holding cash balances which can impinge on growth and crystallise scheme deficits.

Gaining a balance between matching liabilities, achieving growth, and achieving a stable cash flow presents an investment and a governance challenge.
In this paper we will assess the investment options schemes have for addressing these three issues and how robust governance arrangements can help schemes achieve their long-term objectives.

Introduction

In this paper we will examine how pension schemes are currently addressing a number of challenges, including methods employed to meet future liabilities, how schemes are achieving a sustainable level of growth and tactics to maintain a regular level of cash flow to meet near term commitments.

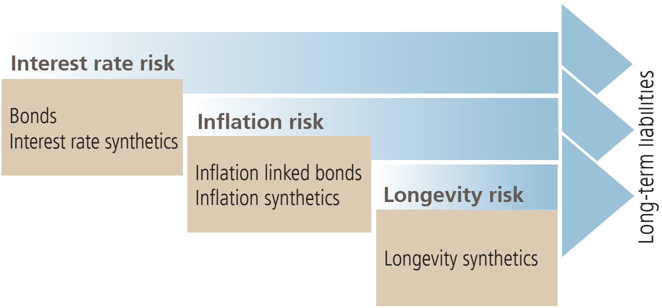
Given the low yield environment, the current size of scheme deficits and declining or cessation of contributions, we have set out a range of alternative methods which schemes could consider to address these particular challenges, including alternative liability hedging, income orientated return seeking assets and a brief look at asset class considerations and investment approaches for addressing cash flow negativity.

Current methods to match long-term liabilities

Defined benefit pension schemes are beset by a number of risks, the degree to which these risks have been mitigated are often dependent upon where schemes are in their journey to full funding. Some pension schemes have taken steps and attempted to hedge some of these risks.

One method typically employed by pension schemes is to de-risk scheme assets, by allocating to asset classes and utilising instruments which closely match outstanding liabilities whilst hedging against inflation and interest rate risk as shown in Figure 1.1.

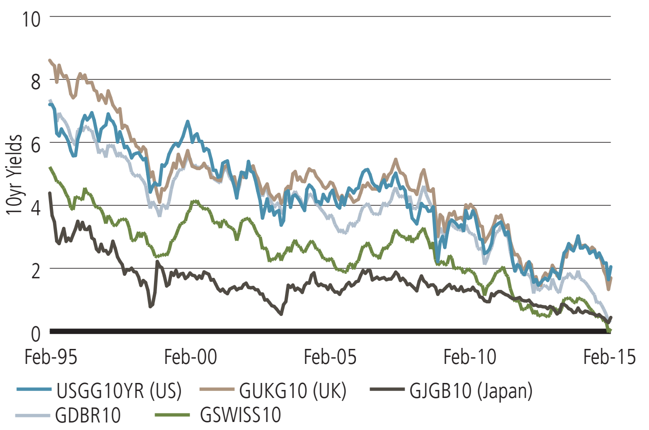
Figure 1.1 Pension scheme risk management



Source: UBS Global Asset Management. For illustrative purposes only.

Whether or not pension schemes utilise Liability Driven Investment (LDI) strategies most are heavily reliant upon gilts as the default liability matching asset. The downward trend in gilt yields, as shown in Figure 1.2, which has been exacerbated by the low real and nominal interest rate environment, has resulted in many pension schemes embarking on a search for alternative sources of long term yield.

Figure 1.2 10-year government bond yields



Source: UBS Global Asset Management. For illustrative purposes only.

Current methods to achieve sustainable growth
For pension schemes that have to reduce a deficit, any attempt to match long-term liabilities must also be complemented by achieving a sustainable level of growth. Income reinvestment is the primary driver of growth for core asset classes such as equities and real estate, but as schemes mature it is often this income which is harvested to meet liabilities, a problem should the scheme remain in deficit.

A further consideration for pension schemes is where this growth is derived from. Historically pension funds relied upon diversification to achieve stable growth; this was on the premise that when equities underperform, other asset classes would outperform. However what we have witnessed during periods of market volatility is a trend towards higher levels of correlation between a range of asset classes.

Pension fund trustees are now charged with finding both diversified sources of income and growth.

The onset of cash flow negativity
Pension schemes have also attempted to de-risk scheme liabilities through closing schemes both to new members and to future accrual. Previously these acted as a source of regular cash flow allowing schemes to efficiently meet their near term cash flow needs. Whilst Local Government Pension Schemes which remain open theoretically have the comfort of receiving ongoing contributions the reduction in the public sector workforce have seen contributions decline rapidly.

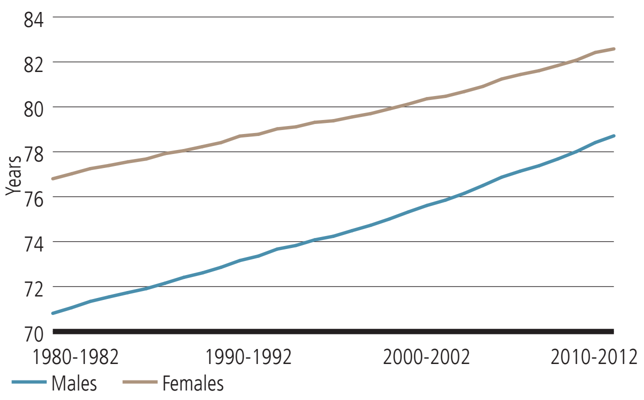
"The public sector workforce grew by over 600,000 over the 2000s. Even so the scale of the reductions expected over the next few years looks challenging. If delivered, the 1.1 million drop in general government employment forecast by the OBR between 2010–11 and 2018–19 would be almost three times larger than the previous drop during the early 1990s."

Jonathan Cribb, Research Economist at Institute for Fiscal Studies

As members reach retirement schemes are likely to face unpredictable lump sum drawdowns and transfers, an increasingly likely prospect given the recent freedom retirees now have in the DC pension market.

The structural factors detailed have also been compounded by demographic factors, in particular increased life expectancy which can be seen in Figure 1.3.

Figure 1.3 Life expectancy at birth, United Kingdom, 1980-1982 to 2010-2012

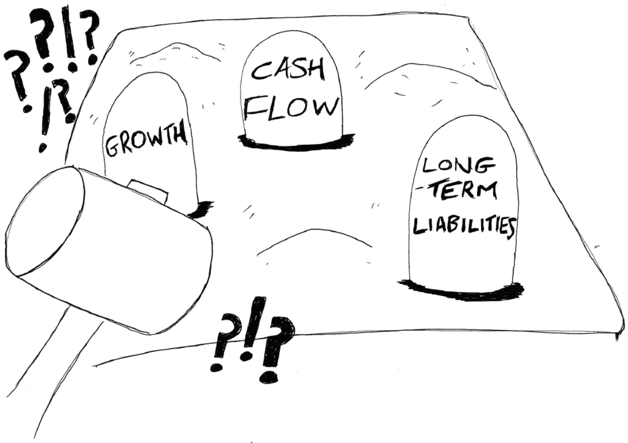


Source: Office for National Statistics

The increased lifespan of pension members means that the pension pot now needs to go further. This is a recognised trend but we are approaching a new phase in the journey where pension funds have found themselves becoming cash flow negative just as increasing numbers of members have begun to retire, placing greater demands on the need for cash.

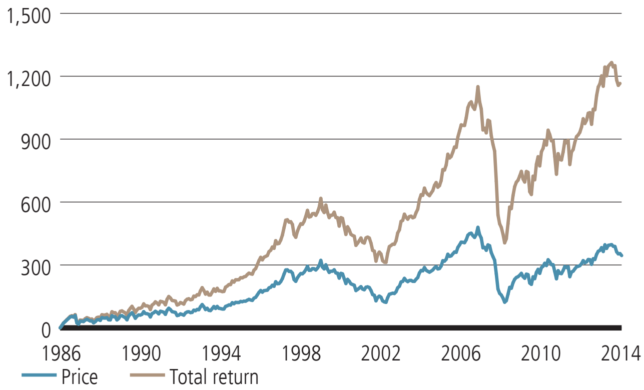
Interim measures to meet short term cash calls… but are they the right ones?

Some pension schemes have recognised this trend, but the methods employed for dealing with this issue can actually crystallise or exacerbate any existing funding gap.



Utilising dividend income from existing investments can present a similar governance challenge. The impact on growth should not be underestimated, for example it is the compounding power of dividend re-investment which has historically helped drive equity returns and can be seen in Figure 1.4.

Figure 1.4 Capital return vs total return when dividend income is reinvested



Source: Lipper. Data in Sterling terms to 31/12/2014

Some pension schemes simply utilise a cash balance to meet near term cash calls. Whilst this provides schemes with a liquid pot from which to draw funds, some pension schemes have taken to allocating 5-10% of scheme assets to cash. With cash rates at historic lows, this cash allocation returns very little, particularly when factoring in inflation, and can prove to be a drag on portfolio performance.

Another solution has been to draw down investments to fund near term cash calls. The decision about what asset to sell, when to sell, how to avoid expensive transaction costs and effectively becoming a forced seller can present a huge governance burden. Achieving this without impacting on growth may be a challenge for even the savviest of trustees.

LDI is essentially a cash flow matching programme. However, the underlying instruments can be illiquid and long dated and it can be very difficult to produce an exact match to liabilities. Furthermore, these programmes are usually aimed at matching longer term liabilities rather than short term calls on cash, so pension schemes may wish to consider what a suitable cash flow solution could entail.

A new approach

Alternative liability hedging
The 'hunt for yield' has almost become a mantra for the investment community in recent years. Given the decline in gilt yields and the increases in pension liabilities, trustees are asking themselves what investment options exist for meeting long-term liabilities?

There are alternatives to traditional liability matching asset classes, however before an allocation can be considered trustees should consider the following:

- Are the assets yield focused with future cash-flows protected?
- What is the maturity profile of the investment?
- How often is yield paid out?
- Are the assets diversified from traditional sources of yield?
- What is the liquidity profile of the asset?

Trustees may find that by expanding the range of asset classes within a liability hedged portfolio they are provided with greater choice and flexibility in matching pension scheme liabilities.

In Figure 1.5 we assess the relative merits of some of the asset classes that may form part of an alternative liability hedged portfolio.

Sustainable growth
To achieve full funding a sustainable level of growth is required. Diversification between return seeking assets is critical.

Many of these return seeking assets will also produce income, with the reinvestment of this income often factored into the scheme's overall return assumptions. It is this approach which can help plug the funding gap.

However as schemes mature and liabilities fall due there could be a temptation to harvest yield rather than reinvesting. To ensure that schemes can achieve sustainable growth whilst meeting long-term liabilities, growth assets can be complemented by allocating to assets where there is a recognition that income will be distributed rather than accumulated. Whilst producing income an attractive asset may also entail an element of capital growth and should be diversified from core asset classes.

In Figure 1.6 below we assess the relative merits of some of the asset classes trustees can consider.

Cash flow
There appear to be a number of options for meeting long-term income requirements whilst securing growth, but pension schemes may find that demands on short term cash increase as the maturity profile of schemes evolves.

A cash flow solution should provide cash flows which are predictable and frequent. Additionally, the underlying asset should be readily realisable in the event that the cash flows it produces are insufficient to meet the immediate liability. It should also have some degree of capital stability so that if it does have to be sold, the amount that can be expected to be received is also fairly certain.

Figure 1.5 Alternative liability hedging options

Reduced Liquidity ↓

Asset	Yield	Diversification from traditional assets
High Yield	Yes	Yes
Leveraged Loans	Yes	Yes
Bank Loans	Yes	Yes
Real Estate Debt	Yes, future cash flows built into loan terms	Yes
Infrastructure Debt	Yes, future cash flows built into loan terms	Yes

Figure 1.6 Income orientated growth options

Reduced Liquidity ↓

Asset	Capital growth	Income	Inflation protection	Diversification from traditional assets
Student Accommodation	Yes	Yes	Yes	Yes
Social Housing	Yes	Yes	Yes	Yes
Direct Real Estate	Yes	Yes	Yes	Yes
Long Lease Property	Yes	Yes	Yes	Yes
Direct Infrastructure	Yes	Yes	Yes	Yes
Ground Rents	Limited	Yes	Yes	Yes

Source: UBS Global Asset Management. For illustrative purposes only.

Asset classes considered

In this section of the paper we take a brief look at asset class considerations for addressing cash flow negativity.

Equities

Equities offer a number of desirable characteristics for pension schemes such as the opportunity for capital growth, potentially higher cash flows which may grow in-line with inflation and carry little re-investment risk. Equities may not, however, provide the most reliable source of income. The income they produce may be relatively infrequent, unpredictable and the underlying asset whilst being liquid can be volatile.

Evidence suggests that some schemes may be tempted to sell assets, particularly equities due to their more liquid nature. But this brings with it a number of challenges, not least from a governance perspective; what assets to sell, when to sell them and who is responsible for considering the longer term implications. The rally of the past few years may also give a false sense of security. It has been easy to determine something to sell in an environment of sharply rising asset prices but it may prove more challenging to determine something to sell when asset prices are falling sharply, which may lead to a focus on the need for more considered income solutions.

Fixed Income

At the other end of the spectrum is high quality, short-duration fixed income. This provides a cash flow which is highly predictable and equally as important, regular. Capital volatility is typically fairly limited and also benefits from being liquid. Short-duration fixed income could offer schemes a number of the desirable characteristics of a cash flow solution, but at the cost of any opportunity for capital growth, and with the prospect of lower yields could be negative after the impact of inflation is taken in to account.

By buying longer dated fixed income instruments or bearing credit risk and buying lesser credit quality issues, the size of the cash flow earned will increase but investors need to be mindful of the additional risks they would be bearing in these circumstances.

Buying longer-dated high quality fixed income, and achieving a higher yield through earning a term premium, may allow investors to retain the nominal value of their investment at maturity. However, should a pension fund experience an unexpected increase in short-term liabilities and have to sell down the asset before maturity, it is possible that a mark-to-market loss could be realised.

It is also possible to earn extra yield through being exposed to credit risk. Trustees should be aware that bearing exposure to lower quality issues, in addition to the risks above, could subject the pension fund to the lower liquidity of the corporate bond market, where trading costs are markedly higher. Indeed, exposure to default risk means there is no guarantee that an investor would maintain the nominal value of their investment even if they were able to hold it until maturity. Finally, either option could subject the pension fund to significant reinvestment risk at some point in the future.

Real assets

Some real assets such as property can provide excellent sources of long-term income. However in the event of unforeseen circumstances the capital may not be readily realisable.

Ultimately, the point is that no single asset offers a panacea for the challenges that face UK pension funds, and that the solution will look very different from one pension fund to another. Characteristics such as whether the scheme is open or closed; the size of its governance budget; and whether it is in deficit or fully funded will likely influence how the scheme prioritises meeting long-term liabilities, generating growth and achieving positive cash flows.

Figure 1.7 Considerations for addressing cash flow negativity

	Cash	Bonds	Real Assets	Equities
Stable & predictable cashflow	High	High	Medium	Low
Frequent cash flow	High	Medium	Medium	Medium
Size of cash flow	Low	Low	High	Medium
Capital growth	None	None/Low	Medium	High
Volatility of capital	Low	Medium	Medium	High
Inflation protection	Low	Low	Medium	Medium
Liquidity of underlying	High	Medium	Low	High

Source: UBS Global Asset Management. For illustrative purposes only

How a scheme prioritises these challenges will in turn influence the asset mix which it employs. It might be that a combination of different asset classes through single solutions with the ability to navigate the market cycle may be more appropriate and could help to alleviate the ongoing governance challenges schemes face.

The governance challenge

A consequence of expanding the range of asset classes within pension scheme portfolios is the increased governance burden placed upon scheme trustees. Not only will trustees have to contend with a potentially greater number of managers to select and monitor, but they will also be required to ensure these managers are making a positive contribution to the scheme's overall objectives.

Trustees will therefore need to consider what the end goal of the pension scheme might be. Buy-in? Buy-out? Perhaps a date when benefit payments cease can be predicted, but schemes that wish to achieve self-sufficiency will require short, medium and long term streams of cash.

Following on from this, considerations should also be given to individual schemes' funding levels when utilising a cash flow solution. For example, not only should a cash flow solution not hinder schemes' growth requirements but some additional benefits may be derived from some solutions which actually provide the opportunity to achieve capital growth or even inflation protection.

Partnering with providers who can provide pooled and bespoke solutions can alleviate this governance burden. Suitability will be dependent upon schemes' aims as well as their existing governance budget.

Schemes with a larger governance budget may wish to allocate to individual asset classes or may create bespoke portfolios focused on a specific outcome, be it long term inflation linked income or alternative liability hedging.

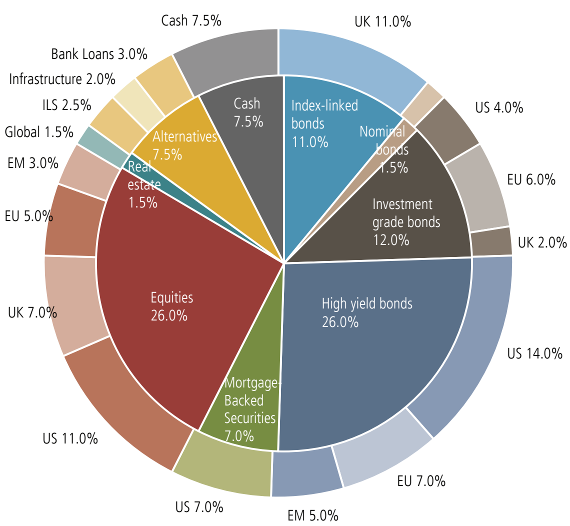
For schemes with a smaller governance budget the utilisation of a pooled solution may be optimal. In a similar vein to the advent of diversified growth funds which can help schemes to achieve their growth goals whilst alleviating the governance burden, diversified income funds may help them address some of their short term income needs.

Figure 1.8 Governance budget

Higher ⟷ Lower

Scheme consideration	Individual Allocation	BLENDED APPROACH	Pooled Solution
Growth	Equities		Diversified Growth
	Private Equity		
	Hedge Funds		
Inflation and long term income	Property		Multi-Asset Real Assets
	Infrastructure Equity		
Liability hedging	Gilts		Pooled LDI
	Synthetics		
Alternative liability hedging	Private debt		Multi-Asset Private Debt
	Direct Lending		
Cash flow	Corporate bonds		Multi-Asset Income
	High yield		
	Direct Lending		
	Equities		
	Listed Infrastructure		
	Listed Real Estate		
	Derivatives		

Figure 1.9 Broadly diversified multi-asset income strategy



In Figure 1.8 we show how schemes may consider allocations to either individual assets, pooled solutions or a blend depending on their specific needs and in Figure 1.9 how a multi-assset income portfolio might look.

Asset allocation considerations

Once pension schemes have an understanding of their governance budget and how new asset classes and investment approaches can be implemented, their attention might then turn to their overall asset allocation.

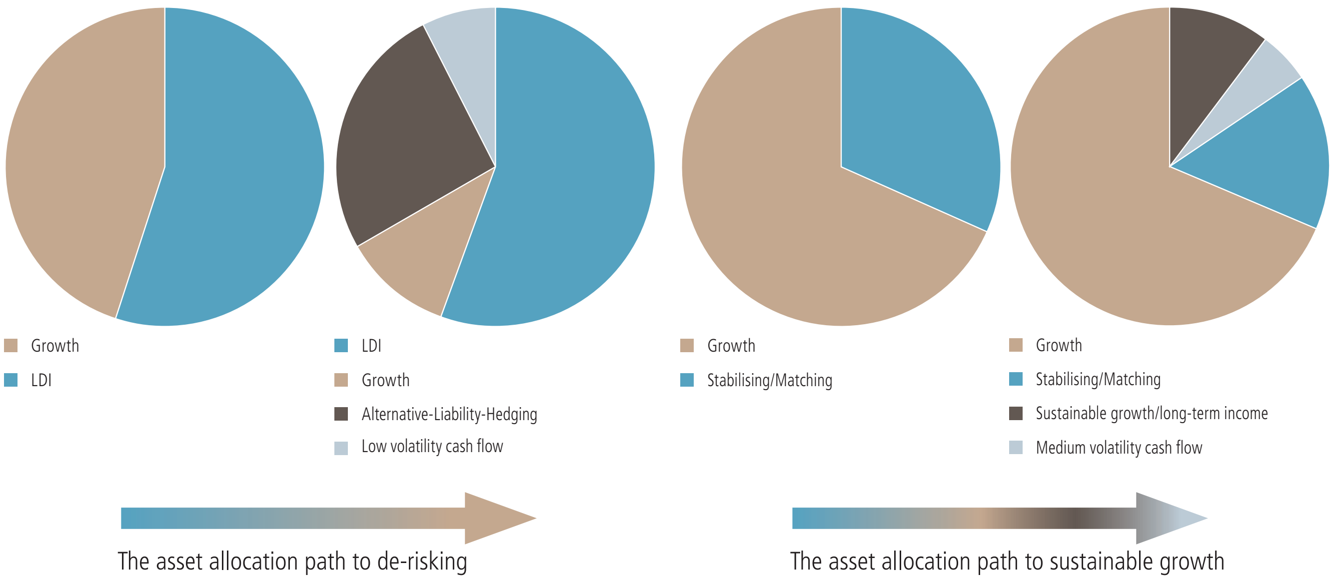
For closed pension schemes that have a deficit but are in the process of de-risking the priority will be to achieve growth in a more risk conscious manner. This must be achieved alongside meeting long-term liabilities but also meeting short term cash flow requirements.

As schemes move along the path to full funding and members begin to draw down their pensions we may see a rebalancing away from more volatile growth assets to alternative liability hedging assets with lower rates of growth and to low volatility cash flow strategies.
.

For schemes which have a deficit but remain open the priority will be to achieve sustainable long-term growth. Although with this need for greater growth, their risk tolerance may be higher. This must be achieved alongside meeting long-term liabilities whilst preparing for or meeting short term cash calls.

As schemes attempt to plug deficits, ease the volatility in their funding ratios and the number of members drawing down their pensions increases, it is possible that the existing overweight to growth assets is diversified across sustainable growth and long-term income asset classes in conjunction with allocations to medium volatility cash flow strategies.

Figure 1.10 Asset Allocation considerations



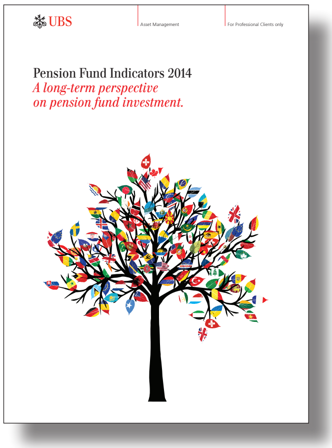
Source: UBS Global Asset Management. For illustrative purposes only

What next?

Balancing the requirements for growth, matching long-term liabilities and achieving a stable cash flow presents both an investment and a governance challenge.

Add to this the increasing range of considerations schemes must factor into their asset allocation strategy and it is clear that UK pension schemes are facing an increasingly complex world.

Pension schemes should therefore consider the full range of options at their disposal in order to meet their long-term objectives.



At UBS Global Asset Management we produce a range of thought leadership and industry insight papers, including Pension Fund Indicators, Investing in 2015 and Global Asset Views.

To request a copy, please contact us, or visit www.ubs.com/uk/en/asset_management/institutional.html.

Contact
Gavin Lewis
Institutional Business Development, UK & Ireland
020-7901 5472
gavin.lewis@ubs.com

www.ubs.com

UBS