Government Actuary's Department

Investment News

Monthly Bulletin from the Insurance & Investment Team

September 2018

Last Month in Brief

UK Wages have seen faster than inflationary growth in the last quarter to July, with increases of 2.9% compared with a year ago. Unemployment has continued to fall, dropping to 1.36 million, with the jobless rate remaining at its lowest level for over 40 years.

The value of the Pound against the US dollar began to rally and show improvement after falling for the previous four months, sitting at around $1.30 in late August. The increase has been attributed to a softening of Germany's trading stance with Britain and following progress regarding Britain's future relationship with the EU, and it is likely to continue to be subject to fluctuations relating to this.

There have been increasing tensions in world trade due to ongoing tariffs between the US and China, and sanctions on Iran due to its ongoing nuclear programme. Despite this, strong macroeconomic data led to a rise in the US equity market.

Amazon briefly become the second publicly traded company with a value of US$1 trillion in early September before dipping back below the mark. Apple has continued its strong performance and is now worth US$1.1 trillion.

Chart 1: Equity Indices
North American equity markets rose over August but FTSE and EMU fell.

Chart 2: Sterling Credit Spreads
Spreads were stable over the month.

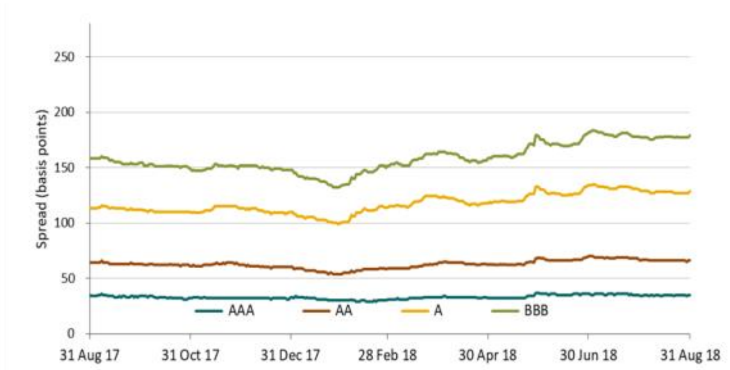


Chart 3: Gilt Yields
Real and nominal gilt yields for the 5 year bonds fell over August, with the 25 year gilts increasing over the month. The real yields showed larger movement than the nominal yields.

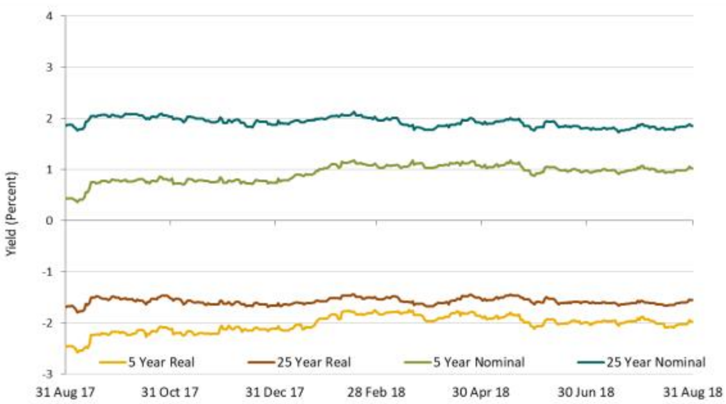
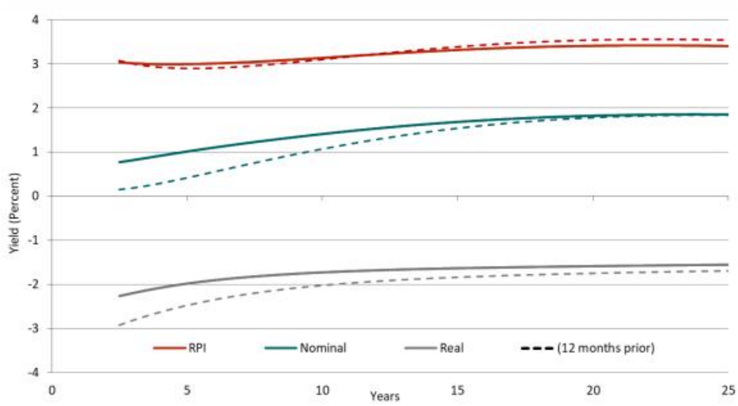


Chart 4: Gilt Spot Curves
The yield curves were stable over August.



Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

	Latest	Previous		Latest	Previous
CPI (annual change)	+2.3%	+2.4%	**Base rate**	0.75%	0.5%
PPF 7800 funding ratio	96.1%	96.3%	**$/£ exchange rate**	1.30	1.30
Halifax house prices (monthly change)*	+0.1%	+1.2%	**VIX (volatility) index**	14.15	12.86

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

Cashflow driven investments (CDI)

Over the years, pension schemes and their advisers have continued to refine the way they invest to meet their pension payments as they fall due. Liability Driven Investment (LDI) and now Cashflow Driven Investment (CDI) have been two names given to such strategies.

LDI considers investment risk by setting a strategy in relation to the behaviour of the scheme liabilities in order to increase the predictability of funding levels. It aims to improve the certainty of reaching full funding by hedging interest and inflation rate risks (i.e. the investments move in the same way as the liabilities in response to changes in these rates). LDI strategies often combine gilts and derivatives (e.g. swaps) in order to achieve this, but often continue to invest significantly in risky growth-seeking assets such as equities.

CDI places a greater emphasis on considering the future cashflows required to pay benefits. It has grown in prominence as a greater number of schemes start to have negative cashflows or approach this position. Factors causing this include the closure of schemes (and sometimes their improved funding level) resulting in reduced contributions and a larger volume of transfers out (due to high transfer values and DC pension flexibilities).

What is CDI?

At its simplest level, CDI involves using bonds (which could be gilts) to match the pension payments of a scheme as they fall due. However, instead of just using gilts, CDI can use a portfolio of income-generating assets (e.g. corporate bonds) which provide returns greater than gilts.

Notably, CDI focuses on the use of assets which generate regular income to meet a scheme's cashflow needs (i.e. paying pensions), this is instead of using assets which may require disinvestment, or which provide more uncertain income – such as the dividends from equities. Furthermore, CDI portfolios aim to hold these assets until redemption, thus avoiding the need to sell these assets at all.

CDI can use a wide array of investments which includes corporate bonds but also a wide variety of credit instruments such as emerging market debt, asset backed securities, real estate debt and direct lending. Since the 2007-2008 financial crisis there has been a greater availability of some of these instruments, such as direct lending, where banks have scaled back their activity.

Advantages and disadvantages of CDI

With CDI the assets are expected to be held until redemption, and hence it does not rely on the sale of assets to generate income. This means assets do not have to be sold at an inopportune time, that transaction costs on sales do not have to be paid and that the administrative burden of the strategy should be lower.

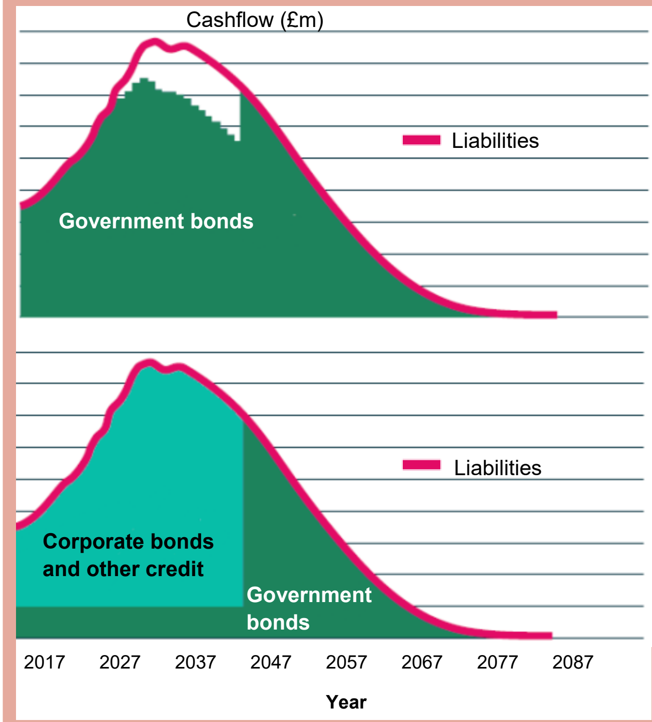
If there is confidence that the asset income will be received then there can be confidence that the benefits can be paid. CDI approaches may therefore be seen as less exposed to the volatility in market prices and less susceptible to market falls. CDI strategies are not however without risk and they are at risk of defaults before redemption, especially where higher yielding assets are used.

In order to achieve the same level of return, a scheme undertaking a CDI strategy is in effect likely to replace some of the equity risk in a traditional or LDI strategy with credit risk.

This will therefore change the nature of the risk that the scheme is exposed to and although it may make outcomes more predictable, scenarios where a large number of bonds default could be damaging.

Figure 1: Cashflow of LDI vs CDI strategy

This figure shows an example where the use of only gilts would be insufficient to meet the expected cashflows. Introducing corporate bonds through a CDI strategy results in greater expected income from the assets which is closely matched to expected outgo.



(Source: Pensions and Lifetime Savings Association)

Joint LDI & CDI strategies

CDI strategies often work most effectively when paired with LDI approaches which hedge interest and inflation risks. There may not be sufficiently long credit assets available to match the full term of the cashflow requirements. Hence although CDI may still be effective at the short and medium term, CDI can be used in conjunction with LDI to match the long-dated pension cashflows using gilts or swaps. LDI can thus be used to fill in any gaps that just using CDI will produce at longer durations.

Final thoughts

Overall, using a CDI approach, accompanied with LDI for longer duration cashflows, can be used to help meet future liabilities without using high risk assets such as equities. This reduces the uncertainty and exposure to short term market falls but will still leave schemes exposed to the risks of defaults on bonds (as well as other risks such as longevity).

Contact Information

Colin Wilson
Deputy Government Actuary
T: 020 7211 2672
E: colin.wilson@gad.gov.uk

Aidan Smith
Chief Actuary
T: 020 7211 2632
E: aidan.smith@gad.gov.uk

Andrew Jinks
Deputy Chief Actuary
T: 020 7211 2655
E: andrew.jinks@gad.gov.uk