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MULTI ASSET WAYS TO PAY YOUR PENSIONS

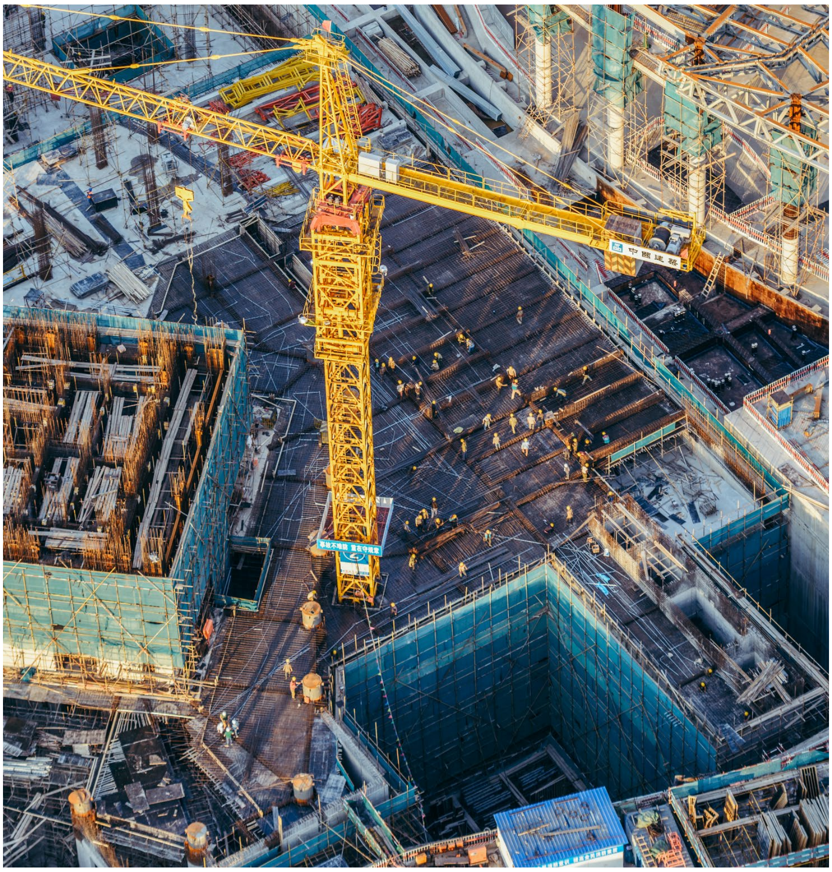
THE TASK AT HAND

Defined benefit (DB) pension schemes have faced many challenges over the years, ranging from burgeoning liabilities to disappointing returns. Today, in a world also grappling with Covid-19 repercussions, many schemes face a new test. This latest issue is cash flow negativity, where schemes require more cash to pay pensions than they receive in contributions and investment income.

Historically, many pension plans have relied on selling assets to fund cash flow requirements. This can be expensive or risky, or both. Trading costs, sequencing risk[1] and distortions caused by not being able to sell illiquid assets proportionately can all have an impact.

1. Sequencing risk - One of the challenges facing investors requiring regular income over a period is so-called 'sequencing risk', also known as 'path dependency'. This risk stems from the unknown sequence of periodic investment returns that assets will deliver over time. If an investor relies on capital drawdown – the sale of assets to realise 'income' – the overall financial outcome can vary significantly. Financial assets do not generate returns in a linear fashion, and even if the same compound return is achieved in two different scenarios, the paths to that return are likely to vary considerably. If a series of poor returns is experienced in the early years, capital drawdown can crystallise losses and lead to significantly worse outcomes in the long term.

Understandably therefore, mature DB plans can be tempted to increase their allocation to higher yielding assets, such as bonds. On the surface this can seem an appealing route, particularly when these assets are wrapped up under the banner of 'multi-asset credit', which has a reassuring ring of diversification, or 'contractual income' that sounds almost like a guarantee. But, while multi-asset credit managers can aim to navigate the risks around corporate credit, emerging market debt and structured finance, and may even preserve capital by doing so, their figurative palette is somewhat limited. It can produce a high income and, defaults permitting, perhaps even sustain it. In isolation, however, multi-asset credit has no real prospect of achieving income growth. And if income doesn't grow, it will be severely eroded by inflation over the long term.



To illustrate how severe this erosion can be, imagine a pension fund which will be paying out income to pensioners for the next 20 or 30 years, to meet entitlements which are largely inflation-linked. Let's suppose that inflation stays at 2% a year. To keep up with it in 20 years' time, the fund will need to be paying out £150 for every £100 it was paying out at the beginning. So, although they can be a useful boost to income, bonds cannot be the whole answer because they are not ordinarily an inflation-linked asset. What's more, inflation-linked bonds are currently so expensive that they have negative yields, so they aren't the solution either.

ADDITIONAL SOURCES OF INCOME

That's why over the past four or five years there has been an increasing focus on assets such as infrastructure – or real assets as they're often known. Whether it's a private finance initiative (PFI) type asset, or one related to renewable energy or even toll roads, there is scope for an income that is both high and grows with inflation. An asset like that can certainly be part of the solution to generating solid income over the long term.

The question we would ask, as pension schemes plan for cash flow negativity, is why stop at infrastructure? That's particularly pertinent because there are several other real assets that schemes can invest in to achieve inflation protection while generating a good level of income to help pay pensions. Property is perhaps the most obvious. It typically has some kind of inflation protection in it as well, because rental payments usually feature an annual increase, often in line with inflation. So, property can be another great asset to put into the mix.

Many sophisticated investors, however, are now contemplating the transformative step of investing in equities for income, of figuratively having all the colours on their income palette. That's because equities have the potential to negate the effects of inflation over time, and to generate above average, inflation beating growth in income.

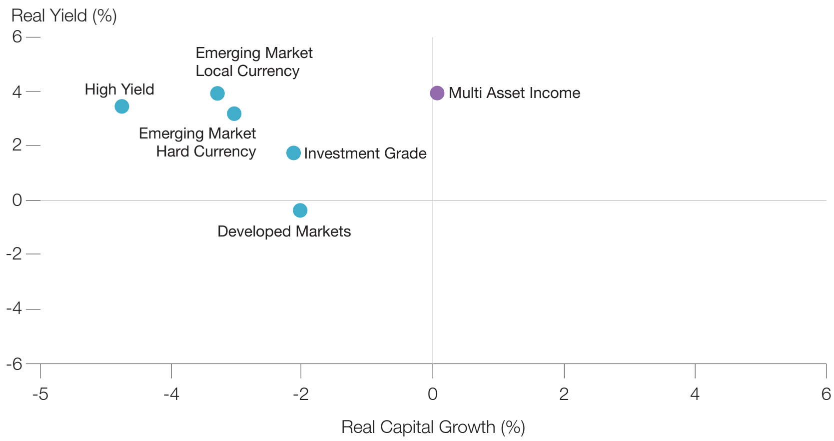
Not all equities can fulfil this role of course. For a start, many companies pay no dividends. Others have cut their dividends, which is rather unhelpful too and, as has been demonstrated by companies such as Shell in recent months, it is often the highest yielders which are most vulnerable in times of crisis. Many have poor growth prospects or face threats from competitors or regulators, or even the impact of climate change concerns. But there's a sub-set of equities available to investors, let's call it 'dependable equity income', which can pay strong and rising dividends that should beat inflation over time. These equities can be particularly helpful in meeting this challenge of providing a good income stream to pay pensions over the long term.

STRENGTH IN BREADTH

Returning to the broader challenge, the approach of looking across the full spectrum of income paying asset classes is typically called a multi-asset approach to income, or a multi-asset income strategy. The largest pension schemes can potentially put these building blocks in place themselves, but doing so requires a significant governance and research burden and ongoing responsibility for asset allocation and for income generation. An alternative is to invest in a fund which itself aims to provide a diversified, resilient and growing income stream by investing across the full opportunity set, and by being highly selective at the underlying security level. The latter is especially important in multi-asset income investing, because equity income is not contractual. And, as has been demonstrated by the property sector in recent months, even contractual income is only as good as whoever or whatever issuer, asset or tenant stands behind it.

But leaving the importance of individual asset selection to one side, it's worth illustrating why such multi-asset approaches can be helpful, why they can work so well. At first glance the chart below looks incredibly complicated, but on closer inspection it is straightforward. It's divided into four squares. Starting in the bottom left square, let's call it 'the quadrant of despair', these are assets that today have a negative yield, negative income after inflation, and capital that is being eroded by inflation. So, assets such as developed market government bonds are in there.

Real Yield vs Real Capital Growth



In the top left quadrant are multi-asset credit asset classes, which at least give a positive yield after inflation, although capital is still being eroded over time and, as we have said, income will be too.

What we believe, based on our own modelling and long-term return expectations, is that, if you add infrastructure and property and the right type of equities into the mix, their inflation matching or beating characteristics should allow for a shift to the sunny uplands in the top right.

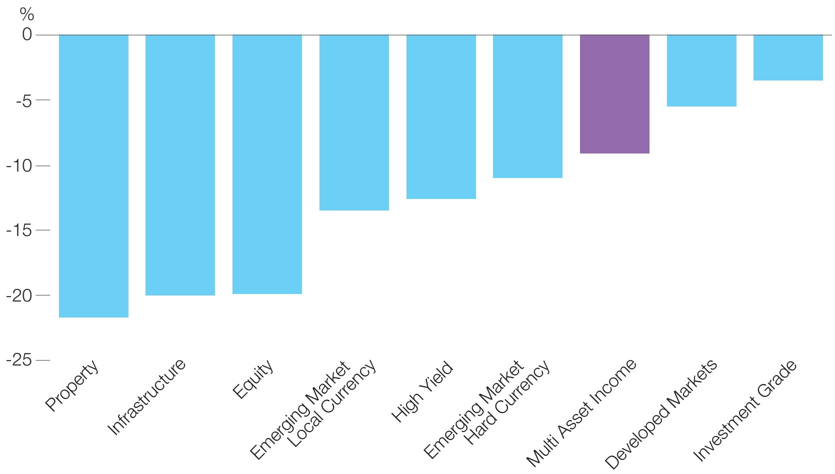
In that quadrant, using a multi-asset income approach, schemes or managers could be generating about a 4% yield which, compared with cash and government bond rates, is very attractive. At the same time, both the income stream and capital value can keep ahead of inflation. If they can do that it would be a great place for schemes to be, as it would mean that they would be in a much stronger position to keep paying pensions, and to deal with cash flow negativity.

So that growth element, or matching of inflation, is a big part of the attraction of this way of investing for income. The second advantage of this approach is to do with diversification, particularly diversification of income. Indeed, it is the benefits of diversification which also help to overcome the traditional objection to including assets such as equities in an income-oriented approach; namely, that the income they produce can be quite volatile.

The chart below shows the most extreme drops in income of around 20% that we saw for infrastructure and equity through the Great Financial Crisis in 2008/09. So how does that fit with generating a nice, steady income stream to help pay pensions? By taking a multi-asset approach you are blending in those developed market government bonds, investment grade bonds – not so good in inflation terms, but fantastic at delivering a very resilient and reliable annual income stream. So, the modelling suggests that, by pairing those together with more volatile income streams, the result would have been that a multi-asset approach would have given a resilient and smooth income stream, particularly if emphasis is placed on income resilience when selecting stocks.

In fact, as the chart illustrates, even in the most extreme circumstances through the financial crisis, our modelling pointed towards a drop in income of only 10% or so in that year, this resilience being a benefit of diversification.

Maximum Income Decline



Of course, we are now in the midst of an even more extreme stress test and this year income from UK equities, for example, is expected to fall by over 40%. Reassuringly, our latest projection for our own Multi Asset Income Fund's income for 2020 is that the drop in income will be limited to less than 10%.

ADDING VALUE

The last benefit of this type of multi asset approach is the scope to add value. In relation to asset allocation, where there are several asset classes in the mix there's the potential to do this by avoiding those that look particularly expensive and trying to favour the ones that look cheaper. This applies whether it's trustees or investment committees and their consultants, or a specialist multi-asset income manager, seeking such opportunities. This flexibility is particularly important in times of uncertainty and volatility, when an asset class which is expensive or risky today could well be an attractive long-term proposition only a few weeks down the line. And such flexibility is not always available where schemes choose to invest directly in illiquid assets such as private debt, property and infrastructure.

As mentioned above, the scope to add value and increase resilience applies within asset classes too, and this is especially important in the realm of income investing, where individual companies, bond issuers, governments, properties and infrastructure projects can collectively pay a high and growing income stream to pensioners, although this is not the case for ex-growth, over-indebted companies, under-utilised assets, empty properties or neatly packaged and securitised toxic debts.

Charles Dickens wrote in Little Dorrit that credit is a system whereby "a person who can't pay gets another person who can't pay to guarantee that he can pay". OK, so he was really writing about debt guarantors, but it does provide a useful reminder that a promise or obligation to pay income may not be worth the paper it is written on.

The comfort provided by credit ratings, contractual income or declared dividend policies may prove to be illusory, particularly in the current challenging environment. Diversification, on the other hand, genuinely reduces income risk. Together with selective and flexible investment, sensitive to price, focusing on the resilience and dependability of underlying cash flows, and incorporating an element of growth, it is the key to paying pensions over the long term.

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