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Sixty second summary

Go with the (cash)flow

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Cashflow negativity: What is it? How big a risk is it really in the LGPS? And what does it mean for my investment strategy? In the following article we set out a number of thoughts on this important, but often misunderstood, topic.

What is cashflow negativity?

Simply put, cashflow negativity is when benefits to members – outflow - is greater than cash coming in. Inconsistency can arise when it comes to defining inflow e.g. is it contributions only, or does it include the income generated from assets?

Why does focusing on cashflow matter?

The overriding requirement of all pension funds is to pay benefits to members. Indeed most LGPS funds have "the ability to pay cashflows as they fall due" as a main objective. To meet this objective, Committees must understand how their Fund's cashflow position is likely to evolve over the longer term, and ensure it takes sufficient priority at Committee meetings.

In our 2017 survey of 19 independent advisors to the LGPS, only 60% said that cashflow was discussed regularly at meetings.

National position is neutral…

The Scheme Advisory Board's 2017 Annual Report noted that LGPS contributions in England and Wales were around £484m lower than cash outflows (i.e. a 0.2% shortfall as % of total assets) and funds were relying on investment income to meet the shortfall. Given this relatively small shortfall, we classify the LGPS as a whole as being broadly cashflow neutral. The position across Scottish LGPS funds is also broadly neutral[1].

… but local positions are diverse

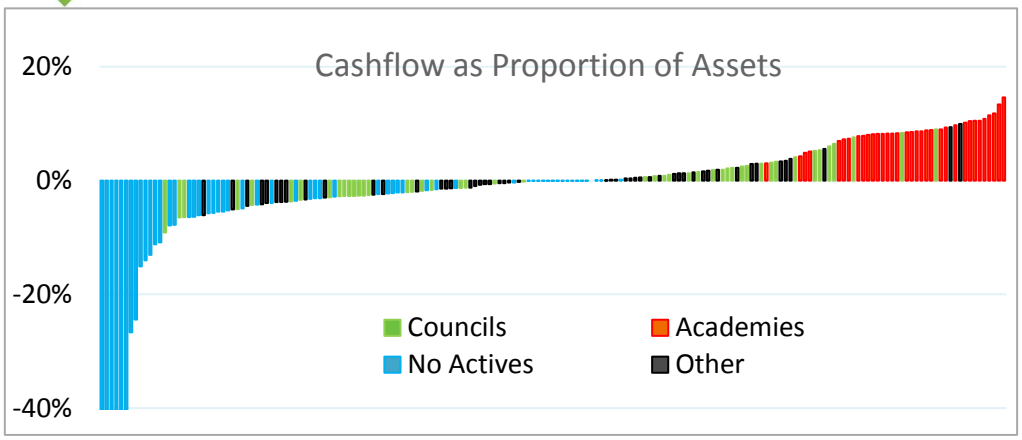
At fund level

There is considerable variation across individual funds depending on the evolution of their salary roll and the impact of austerity or outsourcing programmes. In addition, as funds mature, and funding improvements reduce deficit recovery payments, the gap between contributions and benefit outflow is expected to grow, placing more reliance on investment income to bridge the gap.

At employer level

This shows significant dispersion - net cashflow positions can vary significantly depending on employers' maturity profiles. For example, an academy is likely to benefit from a more positive cashflow position than an admitted body close to cessation (see the following chart). Funds are increasingly developing bespoke employer funding and investment strategies to cater for these differences.

[1] See Scottish SAB's 2016/17 annual report at www.lgpsab.scot/wp-content/uploads/2018/03/SAB-annual-report-2017-1.pdf



The chart on the left relates to an LGPS Fund that we work with. Each line represents the net cashflow position of an employer in the Fund.

Almost half of the Fund's employers pay out more in benefits than are received in contributions. It also shows that some have strongly negative net cashflow positions, with a significant number paying out more than 5% of assets.

Strategic considerations

As a funded scheme, the LGPS is in the fortunate position of having the ability to generate returns and income from its assets. The ability to pay cashflows, alongside return generation, should underpin strategic decision making. A lack of appropriate planning for how funds will pay cashflows now, and for the longer term, could lead to "cashflow ravaging". This occurs when a Fund (or employer) is a forced seller of assets at times when markets have fallen in value. By being forced to sell assets at an inopportune time, a Fund could potentially lock in to poor investment returns. This approach can prove costly for funds, and is not supportive of an ambition for the investment strategy to support longer term affordability and sustainability for the LGPS.

Strategically, this supports funds investing in more income oriented assets, like infrastructure, to dampen return volatility and increase income generation, taking care to understand the implications to funds' total risk return expectations. In some cases we see certain employers designing specific income-driven investment strategies to provide a better match to their liability profiles albeit, to date, such strategies are relatively few in number.

What can funds do?

Acknowledging that the ability to pay cashflows as they fall due is key for the LGPS, the net cashflow position both now and longer term should be examined.

LGPS funds should establish a clear policy for meeting cashflows both now and in the future. Once the Fund's cashflow position is understood, along with its likely evolution over the longer term, Committees should consider how to support the payment of cash from the assets as they fall due. In practice, we believe a combination of the following two (and potentially three) methods will be appropriate for most funds:

Taking investment income	Strategic rebalancing	Cashflow matching portfolio
Avoids transaction costs	*Expected to generate governance dividend over the long-term of selling the "outperformers"*	*Most likely for certain specific employers*

Stress-testing and scenario planning of funds' expected cashflows and considering how you meet these cashflows during market stress will give more insight into sensitivity to factors like inflation, market shocks or structural membership changes at employers. Committees can then consider implementation approaches reflecting their Fund's needs.

Summary

The aim of this note is not to suggest there is a sudden cashflow issue in the LGPS – far from it. Based on the 2017 Scheme Advisory Board information, even a moderate investment income from assets will cover any shortfall. Instead we are highlighting that there are some factors that might change this position over time (and sometimes suddenly e.g. a major employer restructuring programme) and that there can be considerable variation when you look at employers. Understanding your Fund's position and employers' circumstances will allow you to implement approaches that reflect your needs.