The latest differentiator in the fiduciary management market

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Building a better working world

Trustees need to think seriously about whether their fiduciary managers are taking full advantage of the breadth of assets at their disposal as they seek to match their scheme's long-term cashflows, and explore ways to mitigate residual risks if precise matching is not attainable.

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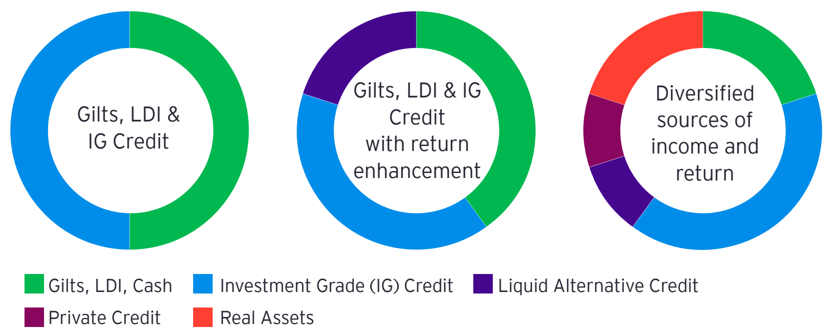
As many pension schemes in the UK approach the latter stages of their lifecycles, trustees are having to consider how best to manage the liquidity of their portfolios, while still meeting their funding targets. One solution seems to have come in the form of cashflow driven investment (CDI) strategies, partly due to their suitability for multiple objectives, including long-term runoff and buyout. This paper outlines our research into CDI strategies and, in particular, discusses the key differences between the strategies used by different fiduciary managers.

The market volatility following the Autumn 2022 "mini" budget reminded us that liquidity is not to be underestimated, and CDI strategies have a lot to offer pension schemes in that regard.

Executive summary

EY research finds that:

1. **Fiduciary managers are increasingly finding interesting and innovative ways to construct CDI portfolios in their search for high-yielding, long-dated assets.** While many portfolios still use gilts, liability driven investments (LDI) and investment grade credit assets as core holdings, some managers are diversifying their portfolios further by adding private credit and real assets such as real estate and infrastructure. The charts below show the main types of portfolios used by fiduciary managers in the UK, highlighting the differences between the traditional gilt and credit portfolios and the more diversified approach. The allocations below are for illustration and allocations for different schemes will vary depending on requirements.



   Each CDI strategy will have different benefits (and limitations), and trustees will need to consider how each strategy suits their scheme's own circumstances as well as their investment objectives and beliefs.

2. **Cashflow-driven does not necessarily mean cashflow-matching.** It is important that trustees are not lulled into a false sense of confidence that their CDI portfolios will provide full coverage of the scheme's liability outgo. The extent to which matching is possible often depends on the scheme's benefit structure and the type of assets that the fiduciary manager can access. In reality, precise matching is difficult to achieve and many schemes will need to accept a degree of mismatch and put in place measures to manage risks arising from this mismatch.

3. **CDI requires monitoring and continuous portfolio management.** A skilled fiduciary manager should be able to make swift and efficient adjustments to the portfolio as and when required, ensuring that the portfolio continues to deliver sufficient cashflows as scheme and market conditions change.

What is CDI?

As the name suggests, CDI is an investment strategy which is primarily designed to generate cashflows that are similar in nature, duration and magnitude to liability cashflows. This focus on cashflow generation differentiates CDI from another popular investment strategy – liability driven investment (LDI) – which aims to match the sensitivity of asset and liability values to changes in factors such as interest rates and inflation.

Much of the appeal for a CDI approach comes from potential cost savings by schemes 'self-insuring' their liabilities instead of buying out at relatively higher premiums, or as an interim step before buy-out becomes affordable as the level of funding improves and the scheme matures.

How do managers use CDI to meet different scheme objectives?

Fiduciary managers tailor their CDI strategies to meet varying objectives by using different combinations of assets based on each asset's characteristics as broadly illustrated in the table below.

	Short duration matching	Long duration matching	Inflation matching	Additional return over gilts
Gilts and LDI	✓	✓	✓	
Investment grade credit*	✓	✓		✓
Private credit		✓		✓
Real assets or Secure income assets		✓	✓	✓
Return-seeking assets (e.g. alternative credit)				✓

*There are some long-dated credit issues in the UK market although in limited supply

What should trustees consider when deciding to implement a CDI solution?

Trustees will need to be comfortable that the approach taken by their fiduciary manager is appropriate for the scheme's specific circumstances, and in line with the trustees' investment beliefs and objectives.

In the table below we provide an indication of when each type of CDI strategy might be suitable depending on the profile of the scheme and trustees' objectives.

Scheme profile or objectives	Gilts, LDI and IG credit	Gilts, LDI and IG credit with return enhancement	Diversified sources of income and return
Objectives	Runoff or Buyout	Runoff or Buyout	Runoff
Return requirement			
Liability duration			
Ability to sell portfolio, if required			
Scope for inclusion of ESG-oriented assets			
Fee budget			

Key: Low High

Another critical consideration for trustees is the extent to which the CDI strategy is aligned with the scheme's liability discount rate policy and other funding requirements. One consideration is the **ease with which expected returns can be reflected in the discount rate.** There is a high governance demand to ensure actuaries and fiduciary managers are clear on any knock-on impact of changes to the portfolio structure.

While the above provides a useful starting point to assess the appropriateness of one CDI strategy over another, it is important to note that in reality the decision will be quite complex, and trustees will need to be mindful of the construction of the rest of the portfolio.

How can EY teams assist trustees select and implement the right solution for their schemes?

The wide range of strategies adopted by different fiduciary managers, and the different pros and cons of each strategy, shows a need for discernment when considering the suitability of a manager's CDI strategy for a scheme. EY teams can assist trustees in all aspects of fiduciary manager selection and oversight, including (but not limited to) the following areas:

- Help in establishing the terms of the CDI mandate, reflecting the scheme's specific circumstances, beliefs and objectives.
- Selection of a fiduciary manager.
- Setting CDI-specific performance metrics for the fiduciary manager and providing ongoing monitoring and evaluation against these metrics.

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