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Cashflow isn't such a negative

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In this brief paper we set out our take on why cashflow negative has become a misguided focal point and what in our view are the real factors that pension schemes should be crystal clear on.

You can't attend a pensions conference these days without hearing the words 'cashflow negative' being given great emphasis. Cashflow negative refers to when a scheme has more outgoings than incomings. It feels important intuitively and you will often hear that if your scheme is cashflow negative you should be managing risk carefully and consider an investment strategy that delivers income to better match cashflows because your scheme will reduce in size over time.

This sounds all very reasonable, but is greatly puzzling. It is hard to argue that these considerations are not important. But why should carefully considering investment strategy, managing risk and considering strategies that better match cashflows be any more relevant for a cashflow negative scheme than a cashflow positive one?

There appears to be a belief that if you are cashflow negative this one piece of information conveys a significant amount of information about:

- The financial health of a scheme
- Your ability to take risk
- Relevance of cashflow matching and hedging in your investment strategy

However, the net cashflow of a scheme is muddied by many factors including future service contributions and deficit payments. Consequently, knowing a scheme is cashflow negative conveys little useful information other than the scheme's liquidity requirements, which is very different to understanding a scheme's financial health and its risk tolerance.

Why the focus on cashflow negative?

The focus on being cashflow negative has arisen due to its potential implications on so-called 'path-dependency' and 'mean-reversion' of returns.

'Path dependency' means that for cashflow negative schemes, underperformance followed by outperformance will result in a worse outcome than outperformance followed by underperformance. This is because cash is being taken out of the Scheme before the good performance arrives. But this phenomenon is nothing new to pension schemes – all the while that schemes have been cashflow positive schemes have suffered disproportionately from outperformance followed by underperformance. Therefore, path dependency is something that all schemes should be mindful of, not just cashflow negative ones.

> **The industry has got side tracked — being cashflow negative is largely irrelevant to risk decisions.**

With 'mean-reversion' it is often claimed that because a scheme is cashflow negative, there is only a short length of time for any near term underperformance to revert and so being a 'forced-seller' needs to be avoided. This is flawed as it places reliance on being able to call the markets, which the average investor will not be consistently successful at.

In our detailed paper we discuss both of these issues in more depth.

The heart of the issue – scheme maturity

The genuine underlying issue most people mean when they describe an issue of being 'cashflow negative' is actually shortening scheme maturity. Scheme maturity has relevant and important implications for the risk tolerance of a scheme.

A mature scheme has a shorter time horizon than an immature scheme. Where a scheme suffers a funding shock and a new deficit emerges (or an existing deficit widens), a given amount of asset outperformance is required to close the gap. However, a scheme with a shorter maturity will have fewer years over which to spread the required outperformance.

Ultimately it is only with the support of a suitable covenant that would permit this additional risk to be taken. As such the risk tolerance for any scheme, mature or not, is still closely linked to the strength of the sponsor. However all else the same, a more mature scheme could have a more burdensome impact on near term sponsor cashflow in the event of a downturn.

This rationale is substantially more robust than the conventional wisdom that says cashflow negative schemes should avoid risk and invest in cashflow matching assets. It does not assume that markets are mean reverting, nor does it assume that being cashflow negative equates to knowing the scheme's cashflow maturity or risk tolerance. The only way to form a judgment on these matters is to undertake analysis of the scheme's cashflow duration, funding level, and investment risk, and most importantly, weigh these all up in the light of the covenant strength.

In a nutshell, pension schemes need to consider their risk tolerance and investment strategy with great care, irrespective of whether or not they are cashflow negative.

For a mature scheme, more risk would need to be taken over the remaining life of the scheme to close a given fall in funding. This is the key issue.

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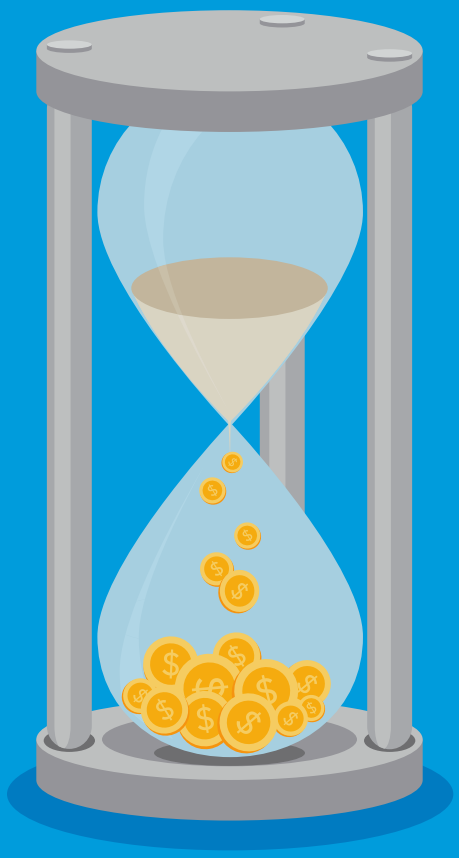

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