HYMANS ROBERTSON

Briefing note

Managing cashflows in the LGPS – what are your options?

Nick Jellema

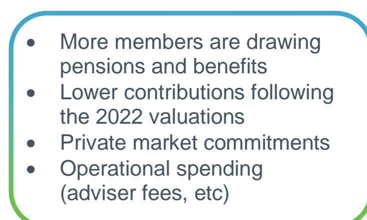
Senior Investment Consultant

Abhishek Srivastav

Senior Investment Consultant

Income vs outgo – a balancing act

Those responsible for LGPS schemes recognise an uncomfortable truth: increasing demands on the collective purse, aka outgoings, could outweigh income – and sooner than expected. On the one hand, income flows in regularly from contributions, and irregularly in the form of investment income and the realisation of capital from closed-ended illiquid investments. On the other hand, outgoings are mounting as LGPS membership matures, members start drawing their pensions, and the number of new, contributing, members is uncertain. Inflation is an exacerbating factor affecting LGPS outgo, with very high CPI increases coming into force from April 2023. But even if inflation retreats from its current above-target levels, it will remain a source of pressure on LGPS funds.



- Regular income from contributions
- Irregular investment income from close-ended, illiquid mandates

Against this backdrop, LGPS funds may want to take a more hands-on, structured approach to managing their cash and highly liquid assets. For example, higher base rates and credit spreads create better returns for those willing to take on a modest amount of term, liquidity or credit risk. This could result in an additional return that could be as much as 2%*[1] pa (or £200K per £10 million invested) in the context of some of the solutions we explore below. Cash can also be kept for strategic asset-allocation reasons.

Illiquid assets and cashflow demands

Many LGPS funds have been reducing their exposure to listed equities, while increasing their allocations to illiquid, private-market mandates. The managers of such mandates can request this money with little notice, often just 5–10 business days. Consequently, LGPS funds need to hold highly

[1] For illustrative purposes only, based on typical investment targets for the solutions described in Tier 3 in the following pages.

liquid assets to cover these commitments, which are typically called up over a 2–4-year period. To be in a good position to meet their commitments, LGPS funds have used a variety of tactics.

Some have retained their equity growth-asset exposure until the point at which the manager of the illiquid assets asks for the commitment to be honoured. Other funds have transferred their equity exposure to a less volatile, more liquid asset class, such as multi-asset or diversified growth funds. And some funds have divested entirely from equities, holding cash or cash-like investments. However, using growth assets, such as equities, to meet liquidity needs means potentially selling them at a loss. This requires the fund to either up the ante in terms of risk, or invest for longer to achieve its funding goals and, clearly, illiquid assets are difficult to realise quickly enough to meet such cashflow demands.

What are the investment options?

In terms of more specific solutions, the options can be grouped into three tiers:

1. **Cash vehicles, such as current accounts** – this first option offers immediate liquidity, with base rate returns or lower, and investment-grade exposure to a small number of banks/issuers (maybe even only one). This is notwithstanding the current liquidity and confidence issues affecting the banking sector. So, liquidity should be highest, but returns are lowest.
2. **Cash-like instruments, such as money market funds** – the second solution involves slightly less liquidity (typically daily liquidity but with the potential for delayed settlement) but offers corresponding higher than base rate returns, with good diversification across strong investment-grade lenders and short maturities. Again, due to concerns over the stability of the banking sector, we note the mass migration of capital from the first to this one.
3. **Cash-enhanced options with credit and/or term risk** – this least liquid of the categories has one-week or one-month liquidity (with potential gating or similarly restricted access to redemptions in stressed environments) but offers the highest returns (base rate +1–3%). Issuers comprise a mix of investment-grade or sub-investment grade and a variety of lending structures with underlying liquidity – ie asset-backed securities (ABS), absolute-return bonds (ARBs) or trade finance.

How do these tiers compare?

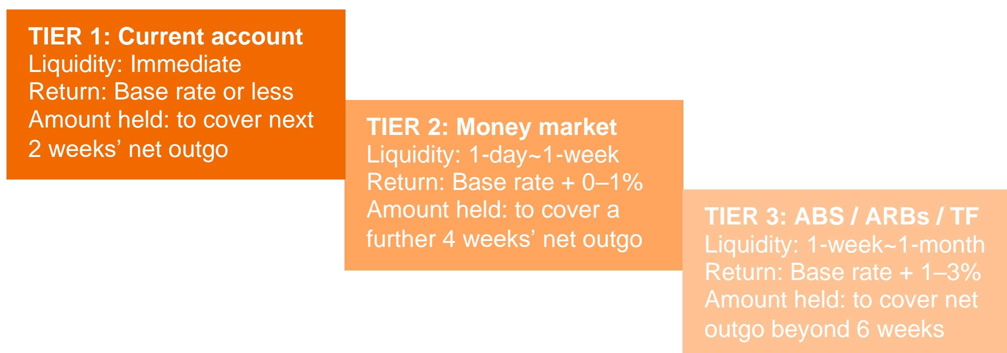
Considerations	Current account	Money market fund	Enhanced cash funds
Return	Worst	Better	Best
Volatility	Least	Minimal	Most
Liquidity	Best	Good	Worst
Counterparty/credit Risk	High	Low	Average

A bespoke structure is key

It's important to note that, in practice, most schemes would benefit from a combination of all the options highlighted above. There's no need to pick just one, because one investment approach won't necessarily fit all circumstances and a tiered approach is often best to maximise liquidity and expected returns.

A well-structured programme could take advantage of each of the options by combining them, based on their characteristics, against the needs of the fund in question. Ultimately, the two key considerations would be liquidity and investment horizon, with a secondary objective of maximising risk-adjusted returns.

Here's an illustration of a tiered approach:



As you can see in the illustration above, all of these options could be used in combination as part of one solution, depending on the fund's circumstances – the size of each allocation could be scaled accordingly. The underlying principles, however, would remain the same: greater investment and liquidity risk can be taken with capital that can be invested for longer. But the shorter the timeframe, the more liquidity and risk minimisation should be prioritised and, indeed, this principle applies to the various options within Tier 3.

Other points to consider

The solutions we've outlined above aren't the only ones available – there are other options, such as using evergreen open-ended investment vehicles for private markets through to designing, and implementing, a cashflow-driven investing (CDI) strategy. Seemingly basic steps, such as switching on income distribution, can also make a material contribution. The important thing to remember is to vary the solution to fit the problem.

From a longer-term perspective, and given the direction of travel towards cash-flow neutrality and negativity, we have also been suggesting a greater emphasis on income assets, relative to growth assets, as part of a cashflow-management programme. Put simply, there's a requirement for investors to be more 'intentional' in their approach to cashflow management.

Key takeaway

Although few LGPS funds were invested in liability-driven investments (LDI), the gilts market volatility of September and October 2022 shone another light on why it's absolutely critical for investors to make detailed plans well in advance. That includes knowing exactly what to do if liquidity becomes scarce, and regularly reassessing collateral adequacy in relation to derivatives and leverage-based strategies. If you want to learn more about constructing a cashflow-management programme, please speak to your usual consultant.

If you have any questions on anything covered, please get in touch with your usual Hymans Robertson consultant.

HYMANS ROBERTSON

This communication has been compiled by Hymans Robertson LLP, and is based upon their understanding of legislation and events as at date of publication. It is designed to be a general information summary and may be subject to change. It is not a definitive analysis of the subject covered or specific to the circumstances of any particular employer, pension scheme or individual. The information contained is not intended to constitute advice, and should not be considered a substitute for specific advice in relation to individual circumstances. Where the subject of this document involves legal issues you may wish to take legal advice. Hymans Robertson LLP accepts no liability for errors or omissions or reliance on any statement or opinion.

Hymans Robertson LLP (registered in England and Wales - One London Wall, London EC2Y 5EA - OC310282) is authorised and regulated by the Financial Conduct Authority and licensed by the Institute and Faculty of Actuaries for a range of investment business activities. A member of Abelica Global. © Hymans Robertson LLP.