

Plugging the income gap

June 2017

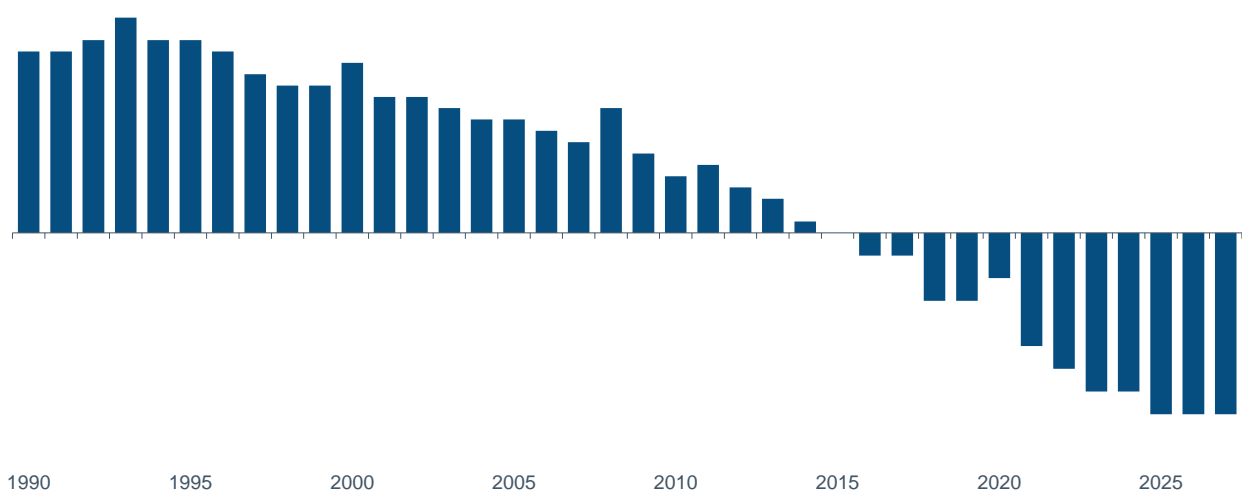
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Many pension funds are going cash flow negative

Example of annual cash flows from a pension fund



This is a separate issue from funding status

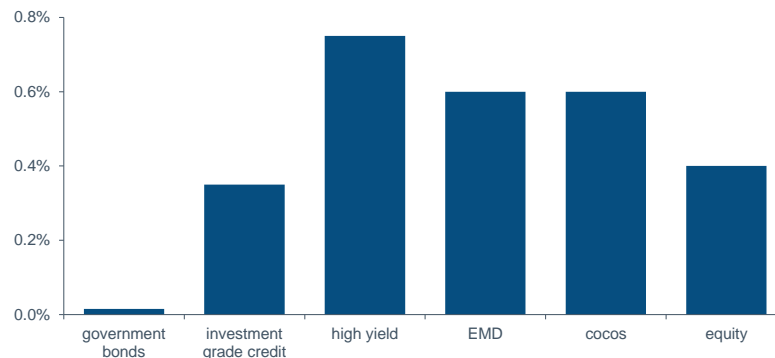
Source: Fidelity International, May 2017.



Cash demands can be funded either by income or liquidating assets

Liquidating assets have transaction costs

Current round trip transaction cost per asset class



Investment via a fund might result in a different type of liquidation costs: e.g. exit charges, swing pricing

Forced selling in distressed markets hurts long term value

Source: Fidelity International, May 2017

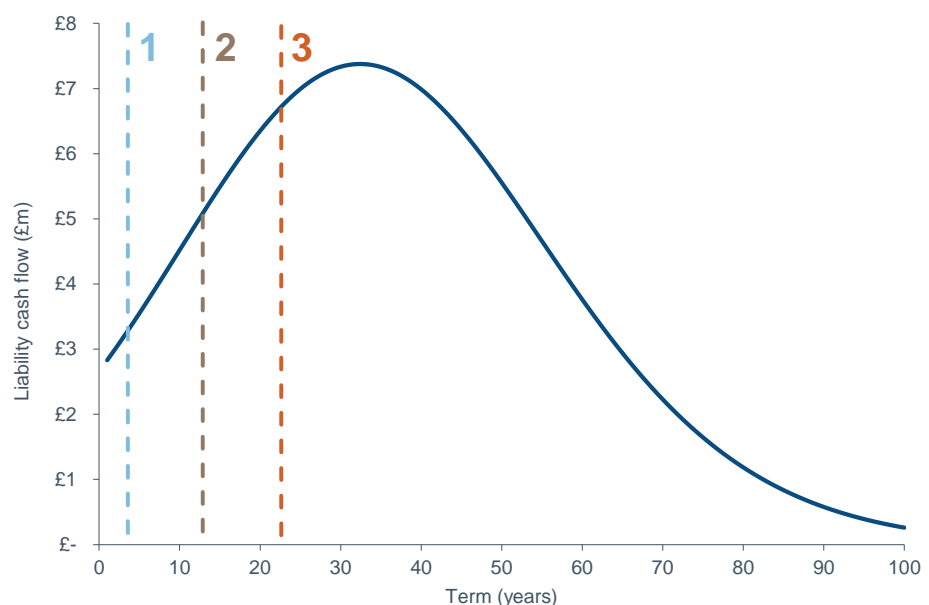
UK DB pension scheme rising income requirements

Schemes with differing cash flow requirements

No scheme is the same but can broadly be split into:

- 1** Contributions currently cover pension payments but schemes need to start planning as they will become cash flow negative within 5 years
- 2** Becoming cash flow negative and need <c4% income (as a percentage of assets)
- 3** Cash flow requirements are higher than c4% of assets and must be met out of capital as well as cash flow income

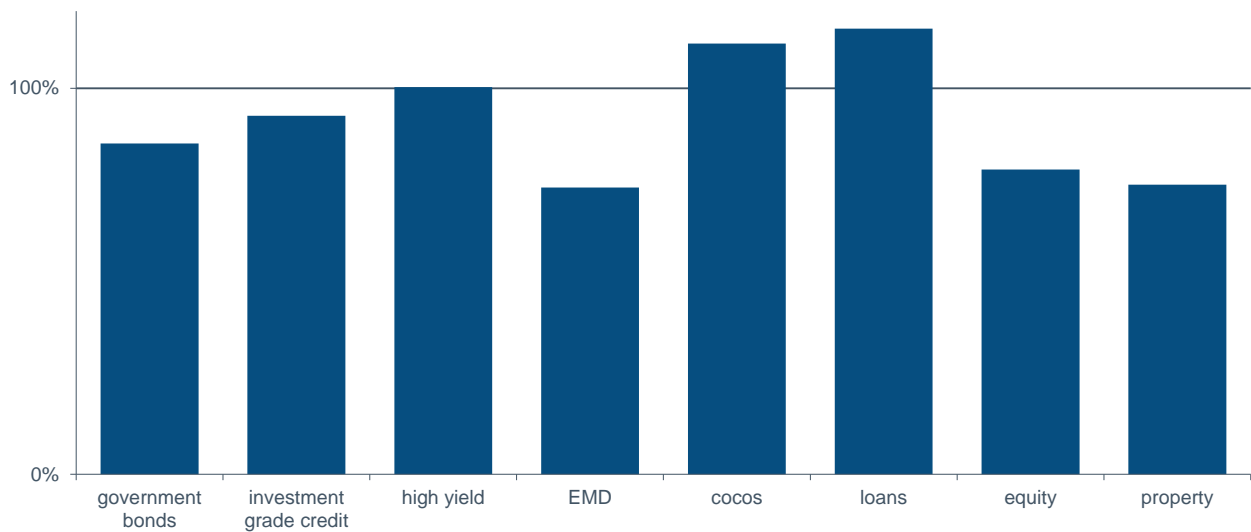
Typical UK pension scheme liability curve



Source: Fidelity International, as at February 2017.

Different asset classes pay different proportions of total return as income

Proportion of average total return from income

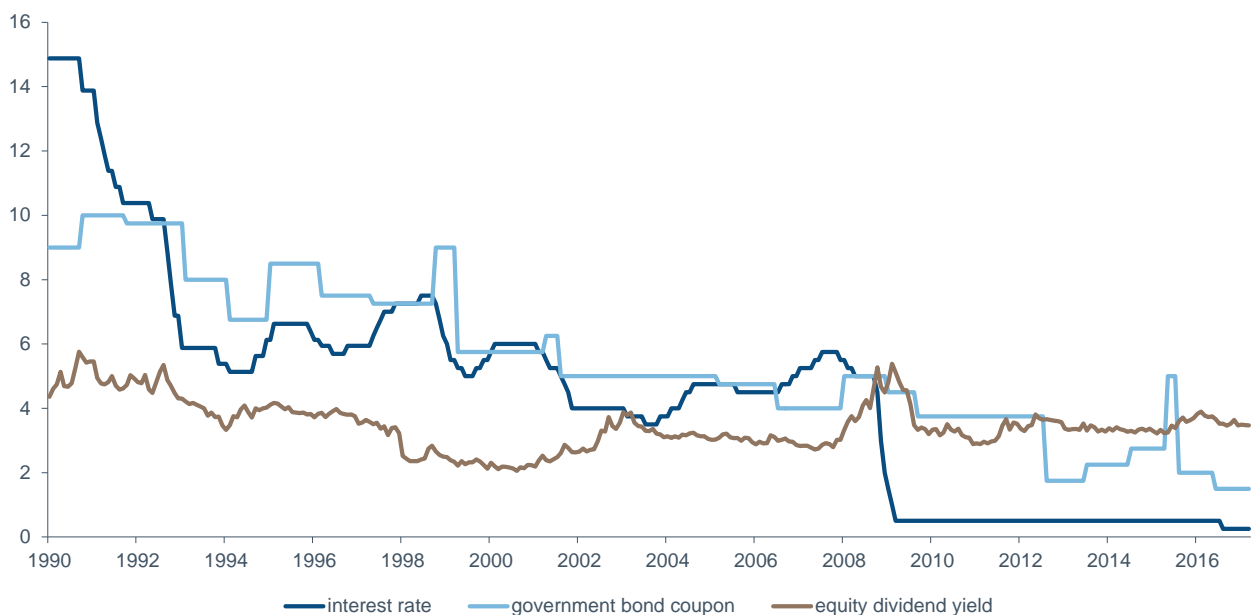


Bonds pay almost all return as income, equity and property have capital growth too

Source: Fidelity, Thompson Reuters, Bloomberg, May 2017

What kind of income is available?

Income from bonds is related to the interest rate, while equity dividends are more constant



Source: Thompson Reuters, May 2017.

The yield dilemma is as present as ever...

Central banks are forcing investors up the risk spectrum

Cash

Government Bonds

Inflation Linked

Investment Grade Credit

Hybrids

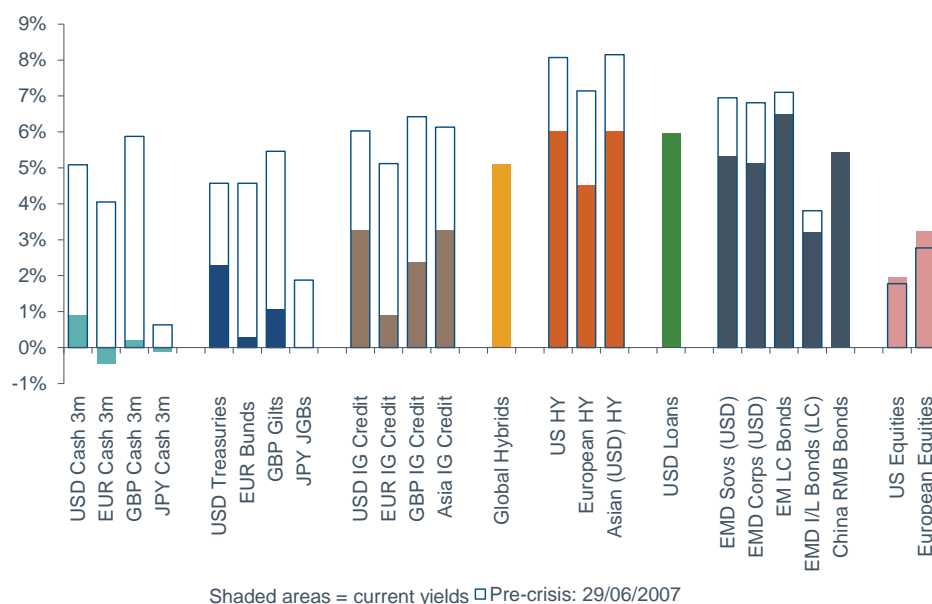
High Yield

Loans

Emerging Market Debt

Equities

Yields across asset classes



Generating income from international investments

Using overseas assets to generate income has some benefits

Income can be generated from overseas unhedged assets

- The income is exposed to FX moves... But same if reinvested.
- Income repatriated, thereby reducing FX risk

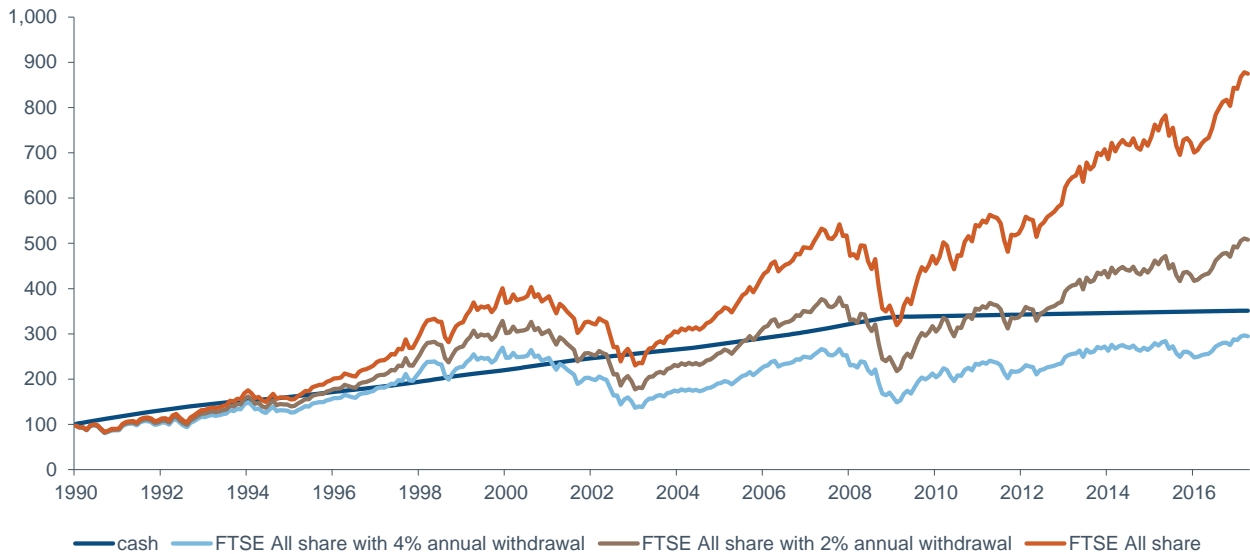
Income can be generated from overseas hedged assets

- Currency hedging requires cash flow management
- Therefore, managers of hedged assets are familiar with managing with cash flow in mind

Distributing income impacts the growth of investment

If pension fund is net cash negative, don't de-risk as much

Wealth growth from equity investing with various degrees of capital withdrawal



If 5% income is withdrawn annually from an equity portfolio, cash like returns should be expected

Source: Thompson Reuters, May 2017. Past performance is not a reliable indicator of future results. The value of investments [and the income from them] can go down as well as up and investors may get back less than they invest. Returns may increase or decrease as a result of currency fluctuations

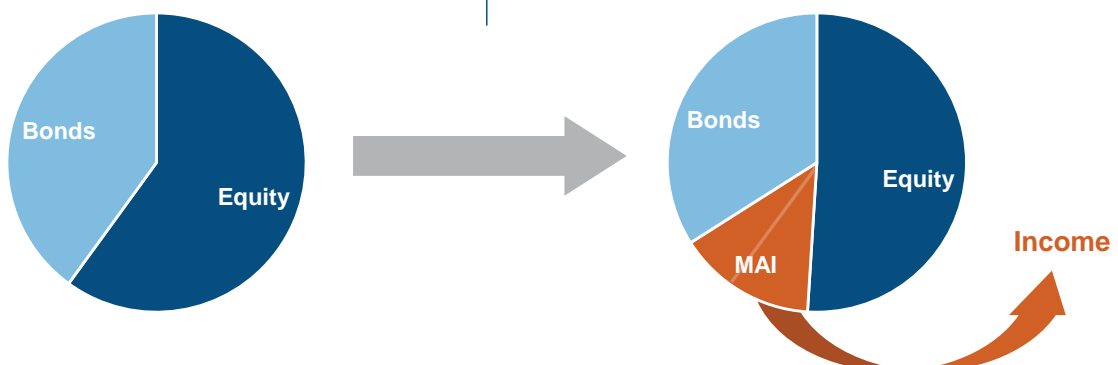
My recommendation on dealing with negative cash flow

Assess your asset allocation

- Do you need more risk now you are distributing income?

Use a multi asset income solution

- Leave your underlying equity and bond managers untouched
- Preserve the asset allocation
- Explicitly targets income
- Isolates the cash flow problem
- Can be bespoke or pooled



Improving income

Key point:

You cannot increase total return of an asset, you can only convert capital gain into income

4 Suggestions to improve income:

Use investment grade bonds instead of gilts

- Long dated gilt yield: **1.37%**
- Corporate yield: **2.95%**

High dividend equity

- UK growth – dividend yield: **2.7**
- UK value – dividend yield: **4.6**

High coupon bonds

- 2021 Gilt issued in 2015 coupon: **1.5%**
- 2021 Gilt issued in 1996 coupon: **8%**

Call overwriting

- Sell an option on your equity (receive a payment to sacrifice capital gain)
- Cap capital gain on FTSE to 1.5%: receive **2.8%**

Source: Bloomberg, May 2017

Cautionary tales (1)

Income % of NAV

- If cash flows expressed as % of **current** fund value – ensure the fund doesn't lose capital.

Drawdown

- If fund shrinks, a higher % of income needed.
- A big loss on a portfolio can make income generation difficult thereafter

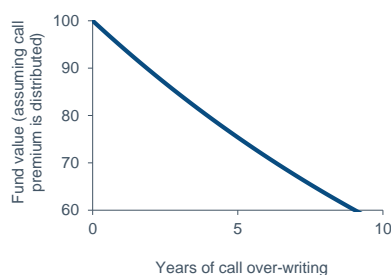
Capital protection

- There is a cost to protecting a portfolio – this reduces total return

Cautionary tales (2)

Call overwriting

- Sacrificing too much capital appreciation, shrinks a fund
 - Don't be too greedy



Overseas

- Foreign yields high if foreign interest rate high
- Hedged total return = foreign return + local interest rate - foreign interest rate

Distributing foreign income from a hedged portfolio with positive carry will shrink a fund¹



High coupon bonds

- 2021 Gilt issued in 2015
coupon: 1.5%
price: £104.34
- 2021 Gilt issued in 1996
coupon: 8%
price: £131.25

Source: Thompson Reuters, May 2017. ¹(US interest rate 1%, US bond yield 2.4%; UK interest rate 0.1%, UK bond yield 1.2%)

Summary

- Match your liabilities with investment grade credit rather than gilts
- Use a product aimed at income generation
 - The multi asset ones enable you to ring fence your income generation
 - You can construct yourself using income building blocks
- Revisit your asset allocation to ensure long term growth targets are met after income is paid out
- Check you're not accidentally drawing down more than you intend

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