Using secured finance for cash flow management

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Every local authority pension fund aims to cover both short-term liability payments and meet long-term commitments. A fund that plans ahead and preserves some allocation to long-term return-seeking assets can be more certain of achieving those goals.

When a pension fund has to pay out more than it receives in the form of contributions or investment income, it may be forced to sell its return-seeking assets at an untimely moment. Being a forced seller at the wrong time could impair a pension fund's ability to meet future obligations. This would have the same effect as raising the long-term return target of the fund, because the pool of return-seeking assets will have been shrunk by the forced sales.

This is a problem that is confronting many pension funds and their advisers. But if they acknowledge the situation and plan for future disinvestments, pension funds can construct a portfolio that makes use of maturing credit assets to tackle these challenges.

Credit has traditionally been used to diversify growth and provide steady income. However, pockets of the credit market face serious headwinds. Liquid securities such as investment-grade corporate bonds offer low yields, while obtaining greater income through high yield debt risks potential losses and big mark-to-market moves if there is a turn in the default cycle. Other, less liquid, options such as subordinate debt offer higher yields, but provide little security in a credit downturn.

Secured finance investments are an alternative that could overcome these shortcomings, and can offer an opportunity for investors who want to generate excess returns while preserving credit quality and remaining relatively liquid and unlevered. For many local authority pension funds, secured finance investments can also provide a valuable bridge between long-term return-seeking assets and short-term liquid assets. Contractual cash flows available from secured finance can provide control and certainty over the timing of returns. The predictable nature of the return stream from these investments can also help long-term investors to avoid being forced to sell down return-seeking assets to meet short-term cash flow needs.

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A new opportunity for investors

The opportunity in secured finance is increasing as banks continue to face pressures to scale back their lending activities and boost capital held in liquid instruments such as government bonds. Insight anticipates that regulation will continue to drive the evolution of capital markets and that is creating a structural investment opportunity for non-bank lending strategies such as secured finance. Our team has invested in this field over the past nine years and it is a core asset class in our fixed income offering. Secured finance strategies provide access to high quality credit investments via collateral-based lending. They typically offer attributes that are valuable to long-term, conservative investors including: potential for excess returns when evaluated alongside comparable alternatives such as corporate bonds with equivalent credit ratings, contractual cash flows, seniority within the capital structure, access to non-credit related risk premiums, and diversification. Insight Investment currently has £9.2 billion[1] invested in secured finance strategies.

Examples of secured finance investments include: providing finance to companies to write mortgages; real estate lending, where finance is provided to companies to acquire assets like offices; and investments in asset-backed securities. The quality of the underlying assets is paramount – they are typically senior secured against collateral and have conservative loan-to-value ratios.

This excess yield can be achieved due to the largely under-researched nature of the assets. Secured finance markets are complex, inefficient and often mispriced. A premium is available from the asset class that is associated with the complexity and sometimes, illiquidity, of the underlying assets. Assessing risk and opportunity in secured finance therefore requires a specific skillset and a deep understanding of the complexity of the underlying assets.

We believe Insight Investment's edge comes from a deep understanding of secured finance investing. Investment opportunities must be underwritten, valued, structured and quantitatively modelled, and our team of specialists has the expertise to perform these tasks. With relatively few investors able to pinpoint value, there is little eligible demand for these investments. In our opinion the ability to tactically rotate between private lending markets and public secured finance markets enables our strategy to maximise the credit spread premia available across credit markets at any point in time, without necessarily taking on additional credit risk. The strategy employs proprietary asset allocation and illiquidity premia models to inform portfolio construction and rotation.

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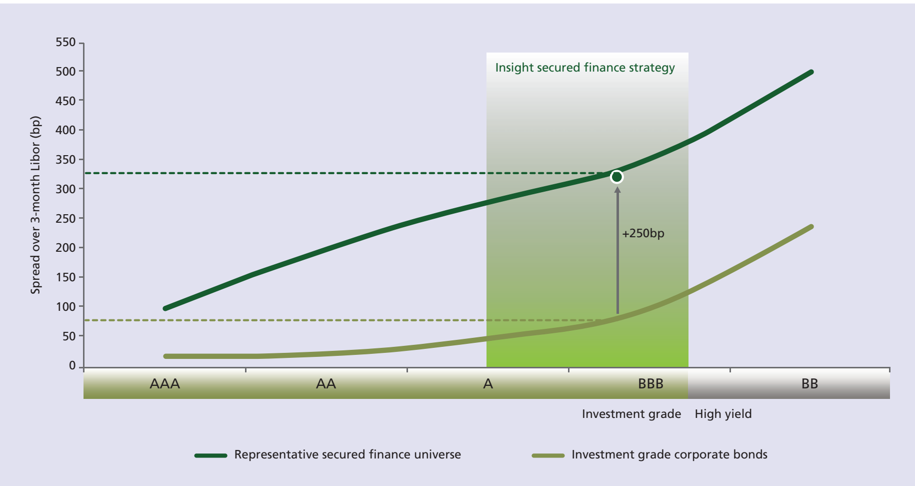
According to our analysis, the asset class can offer the potential for yields above those of investment grade corporate bonds with equivalent credit ratings (see Figure 1). Insight's secured finance strategy targets a total return of 400bps in excess of cash (defined as 3-month Libor).[2] In our opinion, therefore, secured finance is an attractive opportunity for long-term investors who can accept short- to medium-term illiquidity. We believe pension funds seeking to address their pension liability payments in coming years (while seeking to avoid becoming forced sellers of return-seeking assets) are ideally positioned to take advantage of this.

Figure 1: Secured finance can offer attractive risk-adjusted returns relative to investment grade credit



Source: Insight as at 31 December 2016. The spreads shown are for illustrative purposes only and are not indicative of the strategy spread.

How secured finance works within a cash flow driven strategy

A carefully constructed portfolio of assets that can deliver the required liquidity when needed without having to worry about the mark-to-market risks involved in selling assets can materially reduce the risk of negative cash flows.

One component of such a plan is to create a "drawdown pot" of highly liquid, short-dated assets that are less prone to mark-to-market risks: for example, money market investments, cash and short-dated bonds. The pension fund can use this "drawdown pot" to pay pensions. The collateral pool held by pension funds can often fulfil this function without needing to cause additional drag on returns.

Growth assets such as private equity and real assets including infrastructure (whether debt or equity) have the potential for long-term attractive returns but they are illiquid, and it may not be possible to sell them to pay pensions when required. Listed equities likewise may suffer from mark-to-market volatility and may not be realisable at a fair price when disposal is necessary. However, if pension funds maintain a drawdown pot, such investments can be left untouched and free to generate long-term performance.

To enable the drawdown pot to continue performing its role over the longer term, a portion of assets can be held in medium-term assets with contractual cash flows, which will naturally generate cash to top up the drawdown pot as the assets mature (i.e. without needing to sell assets). This process can retain the upside generated by long-term assets while addressing the potential adverse impact of negative cash flows. We believe the contractual cash flows typically generated by secured finance investments, coupled with the highly attractive yield advantage over cash, mean an investment-grade secured finance portfolio would be ideally positioned to perform this role.

Secured finance: enabling a tailored approach to managing cash flows

Pension funds can benefit from the targeted use of assets with defined maturities which offer the potential for an attractive return within a targeted timeframe. By doing so it is possible to ensure a pension fund can continue to pay pensions without selling assets. Secured finance investments fit well into this framework as they offer contractual cash flows, meaning they pay regular interest – and repay capital at maturity – with a high degree of certainty. By constructing a customised portfolio which reflects your pension fund's specific liquidity requirements, you can use secured finance investments to help meet your obligations over both the short and long term.

1. As at 31 December 2016, assets under management are represented by the value of cash securities and other economic exposure managed for clients.
2. This is not a guarantee, may not be achieved and a capital loss may occur. Funds which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.