Speaker 0: Hello, Good morning and welcome to Asset T V's Master Class on Cash flow Driven Investment or CD. I.

Speaker 0: My name's Roanna Lynch, and I'm an investment consultant at Mesa. I'm joined by my colleagues, uh, James Rit and James Lewis. Uh, James Brundrette is a partner in Mercer's investment advisory business, and James Lewis is the UK CIO

Speaker 0: right to kick things off. I'm gonna come to you first. James Lewis, for the benefit of the audience. Could you just explain what cash flow driven investment is? And what, uh, cash flow driven investment strategy is trying to achieve absolutely so cash flow driven investment is a little bit like Ron and that it does exactly what it says on the tin so effectively. What we're trying to do is develop an asset strategy where we're very focused on matching the cash flows that come out of the assets with the liability benefit out go.

Speaker 0: So it's a little bit different from the more traditional approach of investing that perhaps, uh, trustees are more familiar with.

Speaker 0: It is designed to be a very low risk strategy as well. So what do we mean by that? Well, we want to be investing in assets, which are money good, so they've got secure and regular income payments. But at the same time, we also want to marry that up with having a strategy which has got low levels of funding level risk and low levels of V R. And we think if you put all that together, a cash flow driven investment strategy effectively gives you smarter cash flow management

Speaker 0: to help you avoid being perhaps a seller of assets at depressed prices, alongside the more traditional balancing the return and risk required in the strategy with a high level of hedging and ultimately good funding level stability

Speaker 0: and and how does it different from what we might call a more traditional approach? So a portfolio made up of growth, assets and fixed income? Sure well, that more traditional approach has typically been trying to do something else in a portfolio. So the traditional approach is where you take asset risk to try and close a funding level gap.

Speaker 0: A CD I strategy tends to be employed more at the later stages of the journey when you already have a high funding level and therefore you're not looking to close up a funding gap in the same way that you were earlier in the journey. That, of course, enables it to be lower risk. But it also means that we can kind of look through the other lens of trying to match the cash flows that come out of the asset strategy with the benefit out go as it falls due. So it's a little bit different in that way from a traditional and DB pension asset strategy.

Speaker 0: The other thing I would say, though, is well, it's a little bit different from what people have done in the past in DB. It's quite similar, actually, to the way that insurers invest their bulk annuity book in that they are very focused on managing risks but also making sure that they can match the cash flows as they fall due in terms of the liabilities that they're taken on.

Speaker 0: OK, James Brunick can bring you in Now, Um, could you tell us a little bit about, uh, the kind of typical, um, assets or instruments you might see in a CD I portfolio?

Speaker 1: Of course. Yes. So the cornerstone of a very good CD I portfolio is usually, uh, some corporate debts. So some investment grade corporate bonds of a high quality,

Speaker 1: uh, but not invested in line with the market cap weighted, uh, invest in a way that matches the cash flows clearly, uh, so that usually means within long dated cash flows. So long dated credit. Uh, and in order to get the required level of diversification, we often advocate a global portfolio. So that's your kind of cornerstone of the portfolio, and that will be accompanied by some guilts, uh, to help match those cash flows, shape, shape the the cash flow matching,

Speaker 1: uh, and potentially some derivatives to manage any residual risk of inflation in interest rate risk. Um, so that that is the kind of cornerstone of those two components. But if a bit more return is required, then we would be looking to kind of growth fixed income asset classes so that could be secured finance. Where, um, you've got securities which have some kind of collateral backing the income such as, um, consumer debt or asset backed securities. But again of an investment grade, high quality and highly liquid,

Speaker 1: Um, or some long dated, uh, illiquid assets could have a role in this. This this structure. Um, if it met the clients objectives. So there you're talking about, uh, infrastructure, long dated property perhaps, uh, PRI private debt. But some caution on investing in a liquid assets here because, you know, um, clients often preference the the more liquid corporate and consumer debt approach.

Speaker 0: James Lewis, are you seeing many of your clients, um, implementing CD I strategies at the moment?

Speaker 0: Absolutely. I would say that this is becoming increasingly popular, but it's not something that's happened just overnight. So if we actually look back as far as you know, roughly a decade ago, that's when we first started developing these strategies and implementing them for our clients. And its popularity has really grown, particularly in the last few years. And I think there are probably three key things which have kind of driven this acceleration towards more of a focus on cash flow driven investing.

Speaker 0: The first is that we have seen DB pension scheme funding levels improving very significantly if you think about what's happened over the last couple of decades, in fact, the pensions regulator has been encouraging sponsors to make sure that their schemes are well funded through deficit contributions. or through an investment strategy and working together with those contributions to close that funding gap that's worked over the last couple of decades, and we're seeing funding levels tick up.

Speaker 0: In fact, when Mercer carried out its survey of the FTSE 3 50 pension schemes in the UK, it's the biggest 350 pension schemes in the UK. They saw comparing 31st of December 2021 with 31st of December 2022 100 and £11 billion reduction in the size of the deficit. And in fact, it went from a deficit to a surplus. So the funding levels really have improved materially

Speaker 0: and linking that back to the comments that I was making earlier on. This really is a strategy where you've already achieved a high level of funding and you're looking to either run on as a going concern or potentially run off as a route to buy out. So the first thing is funding levels have improved. It means it's an opportunity now for a greater number of pension schemes in the market.

Speaker 0: The second thing is to do with yields now, yields is actually one of the reasons why in 2022 we saw that big funding level improvement, particularly if you were a DB pension scheme and you had a less than 100% hedge ratio. It might have been a tailwind improving your funding level over 2022 so therefore, when you look at the overall balance sheet that a pension scheme has got and you allow for those deficit contributions, which are often a fixed pound amount,

Speaker 0: you actually might be closer to your end destination or a low risk self sufficiency portfolio than you were before. So that change in yields has caused an acceleration. But if we go one step further and linking back to what you were saying James about credit being the bedrock of the strategy, we've also seen higher credit spreads as well. And again, that makes the CD I type strategy more affordable to clients. So we had funding level improvements and we had those rising yields and increase in spreads.

Speaker 0: The third thing that is really leading to a tailwind in terms of clients moving to this strategy is regulatory, so we know that the pensions regulator has issued its draught funding code that's not actually going to come into effect now. This year it would push back till 2024. But it's very interesting that there's a continued focus on long term objectives

Speaker 0: and also on what a low risk asset portfolio would look like. And they actually talk about the definition now as one whereby the asset strategy is designed to broadly mirror the cash flows from the benefit out go. So they're effectively talking about CD I type strategies, and I think that will be an acceleration through time as we see more schemes adopting this type of approach. OK, so it feels like there's definitely a trend emerging. And for those kind of three main reasons that you've outlined there

Speaker 0: playing Devil's Advocate a bit here now, Uh, James what? What? The risks involved with the CD I strategy, particularly with a potential recession on the horizon.

Speaker 1: Yes, well, clearly when you're investing in credit and that's the main risk in the portfolio. Uh, there is the risk of higher defaults, uh, occurring. And if we have a recession and depending on what kind of recession it is, you could see that occur.

Speaker 1: The consensus view currently is quite a light recession and default rates are currently at historic lows, so there might be a small uptick. But we can't rule out some uncertainty around that that consensus view. So if interest rates had to go up a lot to address stubborn inflation, that could stress collateral pools that are back any kind of hedging.

Speaker 1: Um, and of course, with a deeper recession, you would expect an uptick in in default rates. But the the CD I mandates are designed with that in mind. And there's, um, an element of to address that. So historically, if you look at the credit premium from investment grade credit, it's always, uh, outweighed the negative impact of of of Defaults. So, uh, more than rewarded, uh, and that that kind of is a cornerstone.

Speaker 1: Uh, but and and markets are always quick to price in that risk of default, as we've seen in which James has talked about with credit spread, uh, widening as, uh, a yields of risen.

Speaker 1: But by design as well, the mandates that we put in place look to address these risks. So, uh, particularly in the investment grade credit portfolio, we would favour a buy and maintain approach where the managers are really focusing on buying money, good bonds, so bonds that they have a high likelihood of delivering the cash flows and the principal payments. And everything the manager is doing is looking to avoid default, risk and and downgrades as well.

Speaker 1: And those mandates are designed with the the first principles of diversification in mind. So moving away from a kind of market cap weighted approach, Uh, and having good diversification. We prefer global approach because it's a more diversified and better liquidity. The UK credit market is actually quite small, uh, and can be illiquid in times of stress.

Speaker 1: Um, and it also means that those mandates have low allocations to some sectors, such as finance banking that come over from systemic risk as as well, so that diversification, coupled with that high quality credit, provides some protection. Uh, and in the design, when we're looking at expected returns, uh, and we make allowances for defaults, and we're at the conservative end of that.

Speaker 1: So when you're designing this, uh, particularly with working with this scheme, Actuary, you're looking to value the liabilities with a lot of conservative, uh, estimates made for things like default.

Speaker 0: So, yeah, obviously, default risk is a key risk when we're thinking about CD I strategies. But what are the risks? Are there more broadly?

Speaker 1: Sure. So, uh, one of the risks is reinvestment risk. Um, so simply put, if you're receiving income and you don't need to pay it out, you've got excess income. You need to reinvest it. And there's a chance that you reinvest it at interest rates that are lower than you're assuming So again, in designing the the the portfolio and expect a return on the portfolio. And an allowance is made for that

Speaker 1: in actual fact, that reinvestment risk can be your friend as well. So we're just coming out of a period of extremely low interest rates and low nominal returns, Um, and entering into a period of higher interest rates, high spreads high returns effectively, so reinvesting it means that you're you're you're getting more bang for your buck. So it's It's been a good thing.

Speaker 1: Um, operational risk is certainly there. This isn't a set. And forget, uh, investment strategy. I think sometimes people think that it is, um, and in actual practise, there's quite a lot going on under the surface and making it work. So a lot of close work with the scheme. Actuary, in updating cash flows for membership changes that kind of thing. Um, and managing the cash flows and terms of reinvestment, uh, and and and and so forth

Speaker 1: clients often change the the the focus of their monitoring. Um, to move away from looking at risk from a a value at risk kind of perspective of, uh, and move more to the first principle of paying the the cash flows as they fall due. You know, Have you created the cash flow? Um, if not, why not? Um, where do you need to to reinvest income? Any, uh, changing credit quality default experience? Anything happening that's unexpected.

Speaker 1: Um, and then the final one is probably basis risk. So if you're still valuing your liabilities using guilt but you're investing in credit, mainly, you're gonna have some some volatility relative to that guilt basis. So one approach is to actually change that basis to be more like the assets you're you're investing in.

Speaker 0: And now thinking about applying this to recent times, particularly the crisis we've seen you know of late James Lewis. How have, UM, CD I strategies performed, for example, during the gilts crisis of last year or when Covid first hit?

Speaker 0: It's a good question. And, uh, while James has been sort of highlighting the risks, hopefully I can now bring out some of the benefits through those crises that we've seen recently. So let's start with COVID. Um, it's very different from the crisis that we saw last year, of course, being caused by a global pandemic. And what we really saw was a very sharp shock to, uh, risk seeking assets. So it was a very risk off type environment

Speaker 0: and thinking back to what James was saying about the different types of assets that you have in this CD I portfolio. It's worth kind of going through that and then seeing how they perform through that covid crisis to understand what might have happened to a client strategy. So, first of all, thinking about the guilt that you hold in the portfolio

Speaker 0: now we know that one stress to a L. D. I type portfolio would be rising yields, but we didn't really see that through covid. We saw vast support from central banks and governments in terms of monetary and fiscal policy to ensure that the world kept going, and as a result, there wasn't really a strain on the L. D. I side of the portfolio

Speaker 0: thinking about the credit, the bedrock of that strategy that was impacted because that's an asset where you're taking risk to generate a return, even when you are focusing on the highest quality.

Speaker 0: But although we saw a spike in terms of credit spreads, which hasn't been seen previously since the global financial crisis, a well designed CD I strategy was able to avoid defaults and downgrades and actually remained a money good investment. So we might have seen a temporary fall in funding levels as those assets repriced. But ultimately they were still able to deliver the cash flows through the crisis that's required,

Speaker 0: and then thinking about the supporting assets around, um, those guilts and credit portfolio holdings, we would have seen some strain there as well. So obviously, in that risk off environment, you would have seen a fall in the value of things like multi asset credit, high yield et cetera. But it did come back quite quickly, and with it the funding level recovered as well.

Speaker 0: In terms of the liquids that you might have seen in the portfolio, you get that kind of lag smoothing effect. So initially going through the crisis when markets were drawing down, perhaps those asset valuations were shown to be a little bit higher than the other assets. But then they would have been slower to recover.

Speaker 0: But putting that all together, what do we see from a CD I strategy? Well, again, it was a bit like that bronze seal analogy. They did what they were expected to do. So they delivered the cash flows in a reliable way, as they were expected to. There were some small falls in funding level, but generally it was about 1/5 of the size that we saw in a more traditional strategy, chasing a similar level of return. So it performed quite well.

Speaker 0: If we then fast forward to 2022 we saw a different type of crisis, you know, particularly following the mini budget with a really significant spike in guilt yields, like which hasn't really been seen, um, for for many, many decades, um, and there it was really about having done your homework So it's about how do you design that CD I strategy initially.

Speaker 0: And as I said, we believe it's really for clients which are more towards the end of their journey. So they've got high funding levels that they're looking to protect, and they're moving their risk lens to now start thinking about the incidence of cash flow, how they're going to be able to pay those benefits as they fall due and avoid potentially being a for seller in a depressed market.

Speaker 0: And so when we're designing those portfolios, we're thinking about making sure it's got resilience in many different ways. So James has touched on how we, for example, would prefer a global credit type approach to make sure that we're not too concentrated on just UK credit. But similarly, we try to make sure that we've got robustness from a collateral perspective on the guilt side of the portfolio

Speaker 0: and going into 2022. If you had a 1% resistant to shocks, that wouldn't have been enough. If it was a 2% resistant to yield rises, that also wouldn't have been enough. 3% would have just about been OK, so really making sure that you're building some resilience into that portfolio is going to help you weather those types of markets.

Speaker 0: The other thing with the CD I strategy that you need to think about is the balance between the different assets that you have in that portfolio. And what was very interesting in 2022 was that we saw a sell off in both risk on assets and risk off assets. So we saw as guilt yields rose, the value of government bonds was falling. It was actually falling more than other assets because of the duration in those assets.

Speaker 0: But then we also saw at the same time that we were seeing, like equities growth, fixed income type assets falling as well. So there wasn't really many places to hide from a kind of absolute return perspective.

Speaker 0: And so in that type of environment, what we actually saw was a bit of a rebalancing between the Guilt Portfolio or L D I portfolio and the credit portfolio. And what that meant was at the margin, people with CD I strategies were actually able to rebalance out of credit and into guilt to provide more collateral to the guilt portfolio. But without giving up on return because the spreads were widening at the same time.

Speaker 0: So a bit like through the covid crisis, but for different reasons, the CD I portfolios continued to perform well. They did what was expected of them, and they did provide a lower risk type strategy than a more traditional approach.

Speaker 0: Now, by no means does that mean that you can be complacent. You need to think about all those risks that James has highlighted and make sure you do the pre thinking beforehand to try and make sure that you've diversified the risks away as much as you possibly can. And you mentioned that the importance of the way a CD I portfolio is designed.

Speaker 0: What are the main considerations when you're designing a CD I portfolio? And what should trustees and their advisors be thinking about?

Speaker 0: I think it's really about having a joined up approach. The first thing is really to make sure that you really understand the liabilities. So after all, when you're designing that asset strategy, it is to try and match the benefit outcome which is coming from the liabilities and as you will know from looking at actual valuations, in the past. These are, um, estimates of what the cash flows are likely to be

Speaker 0: on a huge number of assumptions. So you've got your demographic and financial assumptions, which all feed into the expected cash flow pattern. Now, what that should be telling you is that there is some variability, and there's going to be changes in that cash flow pattern over time. So you need to make sure that when you're designing that CD I strategy, you know what the benefit out go looks like. But you also build in a degree of flexibility to update and change those cash flows through time because they will change as as you go through the cycle,

Speaker 0: I think also taking a step back and thinking about the environment you're in is really important, too, because it can affect the assets that you hold. So, taking 2022 as an example again, we saw an unprecedented rise in guilt yields in a very short space of time. What that has actually done is shortened the duration of pension scheme liabilities or put another way, the cash flows are not being spread out for as long as they were before in terms of their overall sensitivity to interest rates and inflation.

Speaker 0: What that means is that credit can now do more for you in the portfolio. So if you're able to invest in a buy and maintain high investment grade quality portfolio, which is long dated, so has a longer duration that is going to hedge more of your liabilities than it would have previously and also ease up on the amount to which you're having to lever that L. D. I portfolio. So reflecting that market environment might change the balance between the credit, the type of credit you hold and also the guilts in the pool.

Speaker 0: But then thinking about the other assets that we hold in the portfolio as well, it's really important that we consider what the ultimate destination is for the client. It might be to run on for the long term, in which case, trying to Ava the A liquidity premium and investing in long dated perhaps real assets might be a good strategy. Now, remember, those cash flows are going to be variable, so you probably don't want to too precisely match them in case you get locked up.

Speaker 0: However, if your exit strategy is perhaps a buyout in the near term, then you probably want to retain more liquidity in the portfolio to facilitate a transfer at a later date. So I think trying to factor in all of those things is really, really important when you're building that, um CD I type strategy

Speaker 0: and everything that's been said so far it it really does sound like CD. I is a very attractive, um, strategy for a number of, uh, DB pension schemes. So it's James. Are there any schemes that you would say? A CD? I strategy isn't, um kind of suitable

Speaker 1: for Yes, of course there is. Yes. So, um as we heard, it's a low risk returning a strategy. So if schemes need to close a big deficit and relying on investment returns to do a lot of the heavy lifting, then it's not going to be appropriate.

Speaker 1: Uh, as as James says, um, recently DB schemes has seen the duration of their liabilities come in. But if schemes are still open to new members or any closed to new members, uh, soon and got very long dated liabilities that results in more assets having to be in guilt and matching assets and less in credit so again that that could could could put a strain on the concept.

Speaker 1: Um, and also, uh, sometimes see this concept being being stretched a bit, So we we would we argue against against that? Um, that can be a risky strategy. So if you try and introduce too much return through investing in investment sub investment grade credit and maybe sweating the the collateral, um, pool by having, you know, less collateral backing any hedging assets,

Speaker 1: Uh, and maybe tying up more money in the liquid assets to get a higher return. Those could be not sensible things to do as well. So not trying to making sure you don't try and stretch the concept too. Too far effectively.

Speaker 1: I'm just changing the

Speaker 0: focus a little bit, I suppose. How easy is it to integrate E s G factors into a CD I portfolio?

Speaker 1: Yeah, sure. So, um, this is a long term strategy. We're matching long term cash flows. So e s G, uh, considerations are generally long term and absolutely fit in with the management of these. These assets, um, whether it's climate change or reputational risk, we're looking at you know

Speaker 1: there's many good bonds, and the managers are looking to make an assessment as to whether or not there's going to be any impairments in in those those businesses paying back those those those loans and bonds. So it's not a surprise, therefore, that the majority of the managers that we rate highly in this space, uh, absolutely get e s G and bake it into their investment in investment process.

Speaker 1: Um, you're also going to be holding some guilts, and you typically look to the government's policy on things like climate change there, uh, to make an assessment.

Speaker 1: Um, and in the alternative kind of credit space, uh, the underlying information isn't as readily as there as it is in listed markets, but that doesn't mean to say there's not an impact you can have. Actually, sometimes you can have more impact from an E S G perspective. So things like social housing could could fit in to such a strategy, or or more impact, investing through through private markets and private debt

Speaker 1: infrastructure as well. New renewables

Speaker 0: and James Lewis. You've already touched on endgame solutions a couple of times, but just, um, to kind of go over it. Would a CD I strategy be suitable for a scheme? Um, that was perhaps looking to ensure the liabilities in the next couple of years.

Speaker 0: It's a It's a good question. It's a question we get asked quite a lot as well, in terms of that compatibility with with different endgame options. And the answer is yes, it it's really about how you design that CD I strategy. So I think there's three ways that you can design a CD I strategy. First of all, if the client is very clear that they have no intention to buy out, they're actually happy with the covenant from the sponsor. They believe it's better than an insurer or some other reason why they're just not going to go down the insurance route.

Speaker 0: Then I think building a portfolio, which um, has got more liquidity in it is a good thing to do, and you can avail of that a liquidity premium and boost returns and reduce risk

Speaker 0: then for clients who are not sure. So at the moment they wish to run on, but over time they might decide that they wish to go down the buyout route. It's about understanding what the time frames for that might be, and you may be able to avail of summer liquidity in the portfolio so you might be able to invest in semiliquid strategies. And then there are clients who in the next few years are intending to transact, um with an insurer. And that's a little bit different because you probably want to make sure you're maximising the liquidity and flexibility in the portfolio,

Speaker 0: particularly as insurer pricing can vary quite considerably. And that time frame, which might be expected to be two years, could easily turn into to six months, depending on conditions.

Speaker 0: Now the good news is, the way CD I strategies are actually constructed is very similar to the way that bulk annuity providers actually invest the assets themselves. So by adopting a CD I strategy and having that bedrock of a sort of hedging strategy alongside high quality um, investment grade credit and alternative credit assets, it's mirroring the kind of strategy that insurers have.

Speaker 0: So what that means is you get a second order impact, which is to a degree, it's not perfect, but it's helping to hedge that insurer pricing as well. So on your way towards potentially a buyout, you will be investing in a more similar way to insurers, which might help you in terms of locking into a price at a future date.

Speaker 0: It might also help you as well, in terms of transitioning the assets to an insurer. Now, sometimes you can have the option to transfer in spec C. And if you're holding the type of assets that insurers like to hold as well, then that could lead to a lower premium being transferred across ultimately, and a more efficient transaction being done.

Speaker 0: I think I'm gonna pause there, and we've had a few questions come through from the audience. So, um, we'll answer a few of those. The first one, um, I think, is in relation to a point that you made James around changing the discount rate away from guilt based discount rates, Um, to more of a credit based discount rate. Um, perhaps James Lewis. Would you just like to talk us through what is a what we would call dynamic discount rate, Um, in a little bit more detail?

Speaker 0: Yeah. So when we are thinking about a dynamic discount rate, it's really about the way that the actuary is valuing the benefits and trying to tie that more closely to the asset strategy itself. So if you think about it, if you understand what the cash flow payments of the pension scheme are going to look like in the future,

Speaker 0: you then need to be able to value them. And the way that the ACTU values them can either be in a more simplistic way, which might be guilt plus a margin. And that margin might reflect the expected return over the long term from the asset strategy. Or it could be more directly linked to the assets, which are actually held so linked directly to changes in credit spreads. For example, if credit is the main asset alongside the guilts that you hold

Speaker 0: now, the advantage of adopting a dynamic discount rate approach is that the discount rate will vary with the return that you expect to get on the credit,

Speaker 0: and that therefore means that you have your assets and liabilities moving more in unison. So on the one hand, you've designed the asset strategy to try and meet the benefit out go as it falls due. That's great If it does that job, you know that you can sleep at night and pay all those benefits for that fall due as a trustee. However, it would also be nice to control some of that mark to market risk. And the dynamic discount rate enables you to do that in a more efficient manner.

Speaker 0: Now, there are other things that you need to think about with that. So I think James referred to it earlier. There's actuarial prudence that needs to be put into the discount rate, so you're never going to get a 1 to 1 relationship. But you should get a smoother ride and less funding level volatility with that type of approach.

Speaker 0: Um, now, the next question, I might come to you, James, and this is around. Um, if a scheme isn't in a CD I type strategy at the moment, how would we go about recommending that they transition into one?

Speaker 1: Yeah, Good question. Um, typically, schemes will have done some rising on on this journey to getting to be able to in a position where they can afford to adopt a CD I portfolio. So it's not like they're gonna typically be selling a whole lot of big allocation to great assets. They would have run that down and probably already invested a lot more in matching and and probably credit of sorts.

Speaker 1: So it might be a case of getting rid of the last bit of kind of equity or growth, uh, risk, Uh, and reallocating that. But also looking at what you've got and and reshaping it to to match those those cash flows, uh, and turn the focus away from kind of hedging P p 01 risk to matching, uh, actual, you know, present value cash flows,

Speaker 1: Um, so usually a bit of rebalancing around the the edges. But what's also is important is is the entry point. So if you are selling, uh, kind of equities or other assets to or anything else to buy credit and you're gonna hold it until redemption, you're looking to capture that spread at that point in time.

Speaker 1: So, um, you know, we we wouldn't advise looking to sort of time the market on a week by week basis. It's going to be cognizant as to whether or not that credit risk premier looks attractive by historic standards and and, you know, relative to potential any default risk.

Speaker 0: And I've got one last question which I think I'm gonna come back to you, uh, James Lewis on. And this is an interesting run around whether implementing a CD I strategy would kind of prohibit a scheme from being able to accrue a surplus. OK, um I mean thinking about that CD I strategy is designed more with a pension scheme in mind, which has achieved a high funding level and is then looking to manage risk through various different lenses, which we've talked about, um, today.

Speaker 0: But you can absolutely still use that strategy to continue to generate surpluses. And I would say the surplus is generated in a number of different ways. I mean, one observation that I'd make just taking a step back is if you pick up any triennial valuation report and you read the actuary best estimate value of the liabilities and then you compare that to technical provisions or perhaps the self-sufficiency estimate you will see the best estimate is a far, far smaller monetary amount.

Speaker 0: And that's because due to regulation, actuaries have to put prudence into various elements of the assumptions and therefore most pension schemes, particularly with T p R's new guidance, which is pushing you to have this long term funding objective, actually will have more money than the best estimate of what all those liabilities are expected to cost over time.

Speaker 0: So in a way, they've already got a surplus. And if you continue to run your scheme on using a CD I strategy, as opposed to immediately transferring to an insurer, you have the ability as that prudence unwinds to potentially distribute that to members, I guess, through things like discretionary increases, if that's in the gift of the particular rules that you have the other way that you can generate a surplus through the asset strategy itself, though, is through the unwinding of the prudence in the discount rate.

Speaker 0: So if you have a dynamic discount rate, it will allow for prudent levels of defaults and reinvestment, et cetera, which again are expected to not come about in the future. We want to reserve for them, of course, in case we have a bad outcome. But if we don't, then a surplus will be expected to be generated, and that margin above the liability and basis will be earned and effectively that will generate a surplus.

Speaker 0: So I think if you looked compared and contrasted a traditional strategy with a CD I strategy where the expected return was exactly the same, what you're really getting with a CD I strategy is a narrower funnel of doubt or funnel of hope, depending on how you want to refer to it. Um, and giving up some of that upside perhaps. But the reward is, of course, that you're managing that downside risk. And you're protecting against that hard fought funding level game, perhaps being lost.

Speaker 0: OK, I think that's probably all we've got time for um, today. So, first of all, thank you both very much for sharing your thoughts and insights with us. Um, it's extremely useful, I think. For me, the key takeaway is that CD I

Speaker 0: is certainly something which is very attractive for trustees at the moment. Given, um, market conditions where credit spreads are where yields are, Um, and also, as you mentioned, James, the regulations which are expected to come in next year,

Speaker 0: um, Mercer have produced a paper on this topic. Um, and there's a link underneath of the player at the moment. Uh, please do click on that. Alternatively, reach out to us at Mesa. If you've got any questions. Thank you very much for listening