EXPERT VIEW

Generating value from excess liquidity

Guy Freeman explains the value of liquidity

Pension funds have a strong advantage over many other investors in being able to tolerate long-term illiquidity in their asset portfolios. The uncertainty around cash flow needs is primarily due to the non-pensioners who might transfer out or retire early as monthly pension payments to pensioners are very predictable in the short to medium-term.

Most pension funds therefore have a surprisingly high degree of certainty over their cash flow commitments. Provided a portion of a pension scheme's portfolio is invested in assets that can provide cash flows required to pay member benefits in the short term, liquidity in the rest of the portfolio is largely redundant and pension funds can earn an additional return from this excess liquidity.

Whilst many pension funds still retain a very high degree of liquidity, those that want to derive a return from excess liquidity have typically tended to look to asset classes such as private equity, property, credit instruments and infrastructure assets. These will all generally tend to bring volatility in pension fund solvency levels.

If however the return from illiquidity could be isolated in a stable cash-flow matched structure with minimal default risks then the pension fund is likely to have established a good risk/ reward trade-off by generating a slightly better return. The fund would still have the risk that the structure did not match its cash flow needs due to unexpected variations in the level of benefits to be paid eg due to demographic risks. The fund might then become a forced seller of some element of its portfolio and potentially negate the benefit from the illiquidity premium. This is a hard risk to analyse, let alone quantify in a risk/reward trade-off.

Pension funds can instead gain access to the extra return available from illiquidity by buying bulk annuities to cover their liabilities. Effectively they are getting the annuity provider to seek the higher return from illiquidity for them and to structure a bespoke solution that matches the benefit payments precisely and incorporates the additional protections they require –against namely longevity, spouses, interest rates, pension increases, reinvestment and other risks.

Annuities used to partially de-risk (buy-ins) include the required flexibility to move to full buy-out so purchasing them does not impede the end-game of full insurance. The pricing of annuities reflects the illiquidity spread available in the market and annuities are generally priced to offer implied yields (net of the cost of providing the additional protections) close to the yields on gilts. A simple switch that uses the return from illiquidity to remove some risk without giving up return. ■

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DE-RISKING

Mark Carney has certainly made waves since he started his job as Bank of England governor at the beginning of July.

His first step after arriving at Threadneedle Street has been to flag up, together with his counterparts at the European Central Bank, that interest rates will remain at their historically low levels until next year at least.

Carney will not let rip on inflation as soon as he steps across the door, argues Neil Williams, chief economist at BT pension fund asset management arm Hermes. "He will be joining at the wrong time in terms of inflation: by the time he takes over, Consumer Prices Index inflation will have gone back up again from roughly 2.5% to 3.5%. I doubt very much that he's going to loosen the reins significantly."

For pension schemes, the key issue will be Carney's approach to quantitative easing. The sensitivity surrounding the withdrawal of QE was illuminated by the market jitters that followed comments by Ben Bernanke, Carney's counterpart at the Federal Reserve, about ending the US central bank's QE3 programme.

"Investors are happy to see the economy pick up but they are nervous about the Fed tapering off the cheap money that has been supporting the price of riskier assets," says Albert Kuller, chief economist at Capita.

Carney voted against extending QE by £25bn at the first meeting, which he chaired of the Bank's interest rate-setting monetary policy committee (MPC) last month. However, those hoping for a rapid withdrawal of the controversial policy by the Bank of England are likely to be disappointed.

Williams says: "Although QE has only been partly successful in promoting growth, the major economies are too weak to be taken off their policy steroids."

There may even be a fresh round of the electronic cash injection, warns Kuller: "If the economy doesn't take off, Mark Carney is likely to be more trigger happy about firing off some more QE."

> "You can't expect too much: people have been treating him like a second Messiah"
>
> David Norgrove, Pensions First

Williams points out that last time QE was tried was in the US after the Depression in the 1930s, when it took the government until 1951 – 14 years – to fully unwind the policy.

"We've never known a fully independent central bank turn off QE. QE is no flash in the pan, and so we are looking at a relatively long period of low bond yields."

Historically low interest rates and QE are likely to remain a feature of the economic landscape for the rest of this year and 2014 too, he predicts.

Williams suspects that Carney's key short-term changes are likely to be "more presentational than real", giving as an example his plan to hold monthly press conferences rather than the quarterly events hosted by King.

This greater transparency is likely to extend to greater