Greatest Asset of a Pension… TIME!

by
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I recently spoke at the FPPTA conference in Orlando on pension risk management. One of the speakers was Mike Welker, CEO of AndCo Consulting, who I thought had the most incisive comment of the conference. Mike said, ***"the greatest asset of a pension is time."*** He was referencing that pensions have a long-time horizon to work in… perhaps, perpetuity. With such a long horizon, short-term distractions and corrections should not make a pension detour from its long-term goal and strategy. Mike is very right.

Ryan ALM believes that the best way to buy time is to *cash flow match a pension plan's liabilities chronologically.* Almost any performance return study on asset classes shows that given time most, if not all, asset classes perform in line with their return and risk expectations. We've also observed that pension plans generally sweep cash from all asset classes each month to fund current benefits and expenses (B + E). We urge plan sponsors not to provide liquidity in this way, as S&P 500 data suggests that 47% of the S&P 500 index returns come from dividends and the reinvestment of dividends over 10-year rolling periods since 1940.

We urge plan sponsors and their consultants to separate liquidity assets from growth assets. Let bonds be the liquidity assets. Let bonds fund B + E chronologically for as long as the time you need for the growth assets to grow unencumbered. Based on S&P data, equities outperform bonds 82% of the time on a rolling 10-year basis, which seems like a proper time horizon for a cash flow matching strategy. Buying time should be a major strategy for pension plans and its liquidity needs.

Cash Flow Matching

Cash flow matching is a very old and well tested fixed income strategy. It used to be called Dedication in the 1970-1990s. It is an accurate and tedious process to build a bond portfolio whose cash flows (principal + interest) will cash flow match the liability cash flows (B + E) monthly. It is a future value (FV) matching process not present value (PV), which differentiates it from Immunization and duration matching strategies that are subject to great volatility and uncertainty of cash flows since they are focused on present value matching. Interest rates change every day across the yield curve and term structure of liabilities making PV matching mission impossible. The greatest value of bonds is the certainty of their cash flows (FV). Liability cash flows tend to be quite certain as well, especially for Retired Lives. That is why bonds have been used historically to fund liability cash flows. Today it is referred to as cash flow driven investing (CDI) especially in Europe and Canada. Ryan ALM believes that the value in bonds is the ***certainty of their cash flows***. We do not view bonds as performance or growth assets. We see bonds as the liquidity assets!

Buy Time!
By cash flow matching B + E for the time you need
Let bonds be the liquidity assets and fund B + E chronologically
Let the performance assets grow unencumbered for the time you need (7-10 years)