Rising income requirements for UK DB pension schemes

Schemes with differing cash flow requirements

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

1. Contributions currently cover pension payments
   Will become cash flow negative within 5 years

2. Becoming cash flow negative
   Need <5% income (as a percentage of assets)

3. Cash flow requirements >5% of assets
   Capital drawdown needed

**Rule of thumb:** if cash flow exceeds your discount rate, you will drawdown capital

Source: Fidelity International, as at 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

Forced selling in distressed markets hurts long term value

Source: Fidelity International, Bloomberg, as 31 March 2017. Costs are estimates and not a guarantee. Estimates are based on Fidelity’s trading costs (Fund swing pricing, and bid-offer spreads). Costs may vary when investing in direct versus through a fund.
The yield dilemma is as present as ever...

Central banks are forcing investors up the risk spectrum

What kind of income is available?

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

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 International, Thompson Reuters, Bloomberg, as at May 2017
**Improving income**

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

<table>
<thead>
<tr>
<th>1</th>
<th>Use investment grade bonds instead of gilts</th>
</tr>
</thead>
<tbody>
<tr>
<td> Long dated gilt yield: <strong>1.37%</strong></td>
<td></td>
</tr>
<tr>
<td> Corporate yield: <strong>2.95%</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2</th>
<th>High dividend equity</th>
</tr>
</thead>
<tbody>
<tr>
<td> UK growth – dividend yield: <strong>2.7%</strong></td>
<td></td>
</tr>
<tr>
<td> UK value – dividend yield: <strong>4.6%</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3</th>
<th>High coupon bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td> 2021 Gilt issued in 2015 running yield: <strong>1.4%</strong></td>
<td></td>
</tr>
<tr>
<td> 2021 Gilt issued in 1996 running yield: <strong>6.1%</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>4</th>
<th>Call overwriting</th>
</tr>
</thead>
<tbody>
<tr>
<td> Sell an option on your equity (receive a payment to sacrifice capital gain)</td>
<td></td>
</tr>
<tr>
<td> Cap capital gain on FTSE to 1.5%: receive <strong>2.8%</strong></td>
<td></td>
</tr>
</tbody>
</table>

Source: Fidelity International, Bloomberg, as at May 2017.
Diversification is key
A multi asset versus a single asset class approach

Source: Fidelity International, Datastream, Bloomberg, Fidelity Multi Asset calculations. November 2004 to March 2017. The chart shows the relationship between the yield and the historical volatility of monthly total returns of various asset classes and a static blend of income asset classes, a long-term neutral reference point that serves as a back-test for our analysis. The Income Assets mix is made up of 70.0% BofA ML Sterling Broad Mkt; 15.0% FTSE All Share; 10.0% MSCI World ex UK; 5.0% SONIA. This is not a guarantee for the future.
My recommendation on dealing with negative cash flow

Assess your asset allocation

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

Use a multi asset income solution

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

Source: Fidelity International, as at 2017. For illustrative purposes only
## Improving income

### Cautionary tales (1)

### Income % of NAV

- If cash flows are expressed as a % of the current fund value – ensure the fund doesn’t lose capital

### Drawdown

- If the fund shrinks, a higher % of income will be 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

---

Source: Fidelity International, as at 2017.
Improving income

Cautionary tales (2)

Call overwriting

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

Overseas

- Foreign yields are high if foreign interest rates are high
- Hedged total return = US bond return + (UK interest rate – US 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: Fidelity International, Thompson Reuters, as at May 2017. ¹(US interest rate 1%, US bond yield 2.4%; UK interest rate 0.1%, UK bond yield 1.2%).
Plugging the income gap

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

Important information

Issued by FIL Pensions Management (FCA registered number 144345) a firm authorised and regulated by the Financial Conduct Authority. FIL Pensions Management is a member of the Fidelity International group of companies and is registered in England and Wales under the company number 02015142. The registered office of the company is Oakhill House, 130 Tonbridge Road, Hildenborough, Tonbridge, Kent TN11 9DZ, United Kingdom.

Fidelity, Fidelity International, the Fidelity International logo and F symbol are trademarks of FIL Limited.

Fidelity International refers to the group of companies which form the global investment management organisation that provides information on products and services in designated jurisdictions outside of North America. Fidelity International does not offer investment advice based on individual circumstances. Any service, security, investment, fund or product mentioned or outlined in this document may not be suitable for you and may not be available in your jurisdiction. It is your responsibility to ensure that any service, security, investment, fund or product outlined is available in your jurisdiction before any approach is made to Fidelity International. This document may not be reproduced or circulated without prior permission and must not be passed to private investors. Past performance is not a reliable indicator of future results. Unless otherwise stated all products are provided by Fidelity International, and all views expressed are those of Fidelity International.