Customized Investment Solutions
December 2023

CASH FLOW-DRIVEN INVESTING

Moving beyond a corporate defined-benefit solution

Cash flow-driven investing (CDI) is just as the name would suggest, an investment approach focused on delivering a consistent, reliable stream of income to meet the obligations of an organization. CDI is growing in popularity and is most commonly presented as an investment solution for corporate defined-benefit plans that must make regular benefit payments. But corporate defined-benefit plans do not stand alone in this challenge. Public, multi-employer and healthcare plans, as well as foundations and endowments have regular cash flow requirements. The same can be said for insurance companies. Although each organization's cash payments may serve a different purpose, the need is the same: a programmatic and systematic approach to meet current and future liabilities.

C stands for customized

Cash flow-driven investing is an option for a wide variety of investor types because it is highly customized. No two organizations look the same; therefore, no two CDI portfolios should be identical. Each CDI portfolio can be tailored to an organization's specific circumstances, taking into consideration cash-flow predictability, expected contributions, risk tolerance, liquidity needs, tax considerations and the overall objective of the portfolio. Each of these factors contributes to the development of a customized investment solution (Exhibit 1).

Exhibit 1: Components of a CDI solution

Asset mix: Cash flows, comprised of principal and income, are typically generated by investing in a combination of investment grade-rated corporate bonds, high-quality structured finance, short-duration high yield corporates and emerging market (EM) debt. Additional yield can be sought through higher allocations to asset classes with a higher risk/return profile such as to high yield corporates and EM debt, bank loans and even distressed debt.

Curve positioning: Where traditional liability-driven investment strategies focus on investing further out on the yield curve to match long liabilities, a CDI portfolio focuses on investing on the front end of the yield curve where credit risk may be more appealing. Research analysts often have more transparency into the short-term viability of a potential investment and therefore, have stronger conviction in their credit recommendations.

Time horizon: A CDI portfolio can be constructed for a preset time horizon or it can be rolled forward as contributions are added on a periodic basis. Annual contributions create additional flexibility in portfolio construction and offer an opportunity to buy further out on the yield curve, which potentially translates to higher yields, spreads and total returns.

AEGON Asset Management

Different cash flow needs require tailored cash flow solutions

Public and multi-employer defined benefit plans

Scenario: Asset allocations vary significantly among defined-benefit plans based on their respective funded status. Because a majority of these plans are still heavily invested in equities and alternatives, the fixed income allocation is a potential source of diversification and is often invested in a Barclay's Aggregate-like core bond portfolio.

Why Now? We see many defined benefit plans are already cash-flow negative or heading there soon. This phenomenon forces investment committees, advisors and consultants to spend a significant amount of time finding creative ways to make benefit payments. Often, plans are forced to sell assets to make payments. This could be an inefficient use of resources and an ineffective way to make investment decisions. For example, selling equities during a turbulent market period or following a major correction may not be a prudent approach.

Solution: Implementing a programmatic and systematic approach to managing short-term obligations equips investment committees with a solution designed to prevent the need to sell assets to satisfy cash-raising responsibilities. Using a CDI portfolio promotes the goal of funding obligations with a predefined set of asset flows. As shown in **Exhibit 2**, a CDI portfolio can provide similar diversification to a Bloomberg Aggregate portfolio but can be positioned with the goal of generating higher yields. For plans or trusts with an asset allocation that favors equity risk, having a CDI portfolio may help to hedge the portfolio during a market downturn.

Endowments and foundations

Scenario: Endowments and foundations, similar to pension plans, have a need to invest for the short and long term. The asset allocation mix is typically a blend of return-seeking growth assets and diversified, preservation-oriented assets with the goal of supporting today's expenses and tomorrow's growth.

Why Now? Endowments and foundations rely heavily on fundraising to remain sustainable, which can be unpredictable. If current year fundraising is needed to meet the current year's spending budget and goals are not met, organizations could be forced to liquidate assets and are left with no new money to invest for future growth. The likelihood of a fundraising shortfall is increased during economic slowdowns, when asset prices are also more likely to be depressed.

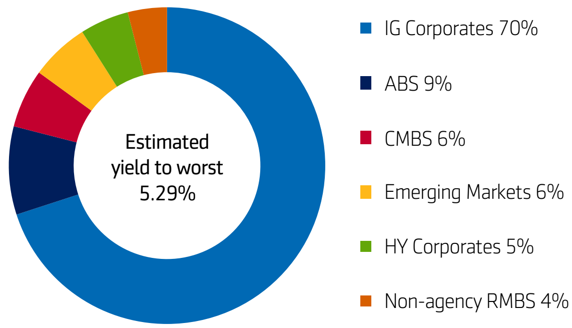
Solution: A CDI portfolio can be designed with the goal of creating a cash-flow stream to account for a portion or all of a fund's annual budget needs. Using a strategy that doesn't rely on current year fundraising to meet the projected cash flows, relieves some of the pressure for fundraising. This also gives the investment committee freedom to use the annual fundraising as they best see fit—whether that is in new long-term investments or further investment in their CDI portfolio. Either way, with short-term concerns planned for, it allows for a more dynamic and flexible approach to the remaining asset allocation of the fund.

About us

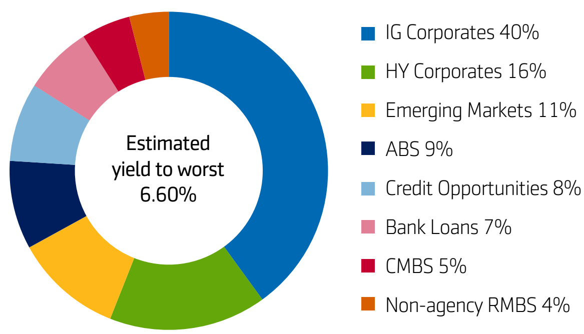
We are active global investors. In a complex world we think and act across traditional boundaries. We organize our teams globally by asset class, to bring the breadth and depth of our investment and research capabilities together for clients across the world. We call it investing beyond borders.

Exhibit 2: Diversification of a CDI, CDI Plus and Core Aggregate portfolio

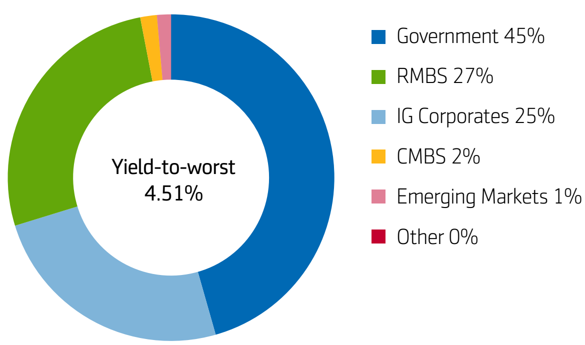
CDI hypothetical portfolio



CDI Plus hypothetical portfolio*



Bloomberg US Aggregate Index



Past performance is not indicative of future results. Sources: Bloomberg, Credit Suisse and Aegon AM US as of December 31, 2023. *Enhanced version of a CDI portfolio through allocations to asset classes with a higher risk/return profile. **Hypothetical examples for illustrative purposes only.** Individual accounts may vary based on restrictions, substitutions, cash flows and other factors. Yield to worst should not be interpreted as performance. As such, the hypothetical examples shown do not reflect the deduction of investment management fees and other expenses. It should not be assumed that a client's portfolio will mirror the characteristics shown or any of the holdings listed were or will be profitable. As with any investment strategy, there is potential for profit as well as the possibility of loss. There is no assurance that the intended benefits stated above will be achieved. Refer to disclosures for important information regarding the estimated yield-to-worst calculations.

Explore your options with a trusted service provider

Aegon Asset Management specializes in multi-sector, fixed income investing, an expertise built over decades of working closely with insurance company clients. Having evolved from the customized benchmarking and asset-liability management approach used by life insurance companies, we have adapted skills and developed infrastructure to help match asset cash flows with anticipated liabilities. Our highly customized approach to finding relative value at each part of the yield curve is born from the strategy life insurance companies utilize to match their highly complex, unique liability streams.

We combine the full complement of our deep, fundamental, bottom-up research culture, our global top-down house view process, and our risk management systems, to provide customized solutions for all types of clients.

Although the investment approach is consistently applied, the collaboration between clients, advisors, actuaries, investment consultants and investment professionals is essential to developing and implementing a customized investment solution that meets the unique needs of each investor.

Disclosure

Unless otherwise noted, the information in this document has been derived from sources believed to be accurate at the time of publication.

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Diversification does not ensure a profit nor guarantee against loss.

The hypothetical portfolio shown is based on Aegon AM US' investment process and assessment of the market and reflects a portfolio of securities similar to one which the team would construct today if they were awarded a mandate of similar market value to the portfolio shown. The portfolio is based on sample guidelines and the credits selected are reflective of similarly managed portfolios, but do not reflect an actual portfolio currently being managed by Aegon AM US.

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The estimated yield calculations shown for the CDI and CDI plus hypothetical fixed income allocations were calculated using the following market indices as proxies for asset class allocations. All yields used in the calculations are as of quarter end. The yields for each asset class were weighted by the allocation weighting to calculate an estimated yield for each investment strategy. Yields for the ABS and non-agency RMBS allocations have been supplemented with an additional spread component to better reflect potential portfolio holdings. Spreads used to supplement the ABS and non-agency RMBS yields reflect spreads from the ABS and non-agency RMBS sleeves of the Core Aggregate Fixed Income and Core Plus Fixed Income composites.

IG Corporates: Bloomberg US Intermediate Credit Index

Emerging Markets: Bloomberg Emerging Markets USD Aggregate 3-5 Year Index

CMBS: Bloomberg CMBS 1-3.5 Year IG Index

ABS: Bloomberg ABS Index

HY Corporates: Bloomberg US High Yield Ba/B 1-5 Year Index

Non-agency RMBS: Bloomberg US Treasury 1-3 Year Index

Credit Opportunities: Bloomberg US High Yield CCC Only Index

Bank Loans: Credit Suisse Leveraged Loan Index

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