A matter of time

Sam Roberts explains the importance of knowing your investment time horizon

All defined benefit pension scheme trustees should now be familiar with the concept of a flight/journey plan. It's a fairly complex calculation based on lots of assumptions to estimate how many years it could take for that scheme to no longer have to rely on either extra contributions from the sponsoring employer or achieving risky investment returns.

The flight plan is one way to think about how long trustees have to achieve their key objective of paying all members' benefits in full. Or, in other words, the trustees' investment time horizon.

Often the flight plan will be between five and 15 years. Most trustees might tweak it slightly and then accept it, but what else should be considered and what are the implications of a longer or shorter investment time horizon?

• Don't accept the first number calculated. Can the flight plan be shortened without increasing the overall investment risk, eg by using LDI or diversifying the growth assets more? Is the investment strategy's risk/return trade off really as good as it could be? The investment options available are much better and more cost effective than they used to be, especially for smaller schemes.

• The strength of the employer covenant. The stronger the covenant, the longer the investment time horizon can be. Can the covenant be strengthened to give more time for investment returns to be achieved? As we unfortunately see from time-to-time, covenant strength can weaken quickly without much warning (or is assumed to be stronger than it really is). Monitor regularly and be ready to move quickly if things change to help to protect members' benefits. If the employer becomes insolvent, the trustees' investment time horizon effectively goes to zero. Please don't fall into the trap of investing as if you have a long investment time horizon when you don't – a pension scheme is not automatically a long-term investor just because it is a pension scheme.

• The maturity of the scheme. How cashflow negative will the scheme be over the next few years and where will this cash come from? Try to avoid potentially having to sell equities just after they have crashed. A more mature scheme (eg one with more pensioners) will have a shorter investment time horizon than a less mature scheme as more cash will need to be disinvested and paid out sooner.

• Taking more investment risk means that the investment time horizon is less certain. So you might get there much quicker than you expect (or not)!

• Try to avoid stretching your investment time horizon to the maximum limit in normal market conditions. Give yourself a bit of a contingency margin – you may find you need it.

• Are there any likely future events that could change the investment time horizon? Eg extra cash available from the employer, more cash equivalent transfer values, or more early retirements than assumed?

The longer the trustees' investment time horizon the more they should/can consider:

• Defining a better long-term solvency target. This is likely to be lower than the immediate solvency premium estimated by the scheme actuary as some of the insurer's margins can be stripped out, although competition in the insurance market could change.

• Thinking harder about the potential impact of longer term risk factors, eg taking advantage of future asset volatility through triggers and/or being more aware of environmental, social and corporate governance issues.

• Choosing growth assets that focus more on the long term and take less notice of a benchmark index, eg active global equity and emerging market multi-asset funds. After all, it is more important for the growth assets to outperform the liability value over the trustees' investment time horizon than outperform a particular index.

• Including more exposure to less liquid assets, eg property, infrastructure or private equity.

So, what's your scheme's investment time horizon and how does it affect your investment strategy?

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