

UNIVERSITIES SUPERANNUATION SCHEME LIMITED

STATEMENT OF INVESTMENT PRINCIPLES

1 Introduction

- 1.1 This statement has been prepared by Universities Superannuation Scheme Limited, the trustee company of Universities Superannuation Scheme. Its purpose is to outline the broad principles governing the investment policy of the trustee company and to satisfy the requirements of the Pensions Act 1995 (as amended by the Pensions Act 2004 and the Occupational Pension Schemes (Investment) Regulations 2005). It also provides information on various other aspects of the investment of the fund's assets.
- 1.2 The statement has been agreed by the board of the trustee company on written advice from the investment committee (a sub-committee of the board) working with the internal investment team, the scheme's external investment consultants and the scheme actuary and has followed consultation with the participating employers.
- 1.3 The board reviews the statement at least every three years and without delay if there are any significant changes in investment policy or where the trustee company considers that a review is needed for other reasons. The investment committee monitors compliance with this statement at least annually and obtains confirmation from the investment managers that they have exercised their powers of investment with a view to giving effect to the principles contained herein as far as reasonably practicable.
- 1.4 The fund's investment arrangements, based on the principles set out in this statement, are detailed in the Investment Policy Implementation Document ("IPID"). This is a working document which is updated on a regular basis and which is available to participating employers and scheme members on request.

2 Investment principles

- 2.1 *The trustee company will act in the best financial interests of all classes of scheme member, seeking to ensure that the assets are invested in a way most likely to secure the benefits offered by the scheme.* The managers are instructed to give primary consideration to the financial prospects of any investment they hold or consider holding.
- 2.2 *The trustee company's investment objective is to achieve returns over the long-term that will meet the liabilities with a stable contribution rate.* Regard is had to the scheme's relative immaturity, strong positive cash flow, the scheme's statutory funding objective, the covenant of the employer, the wishes of the employers and the board to minimise the risk of higher contributions at some time in the future and the need to ensure that the risk of deterioration of the funding level, to such an extent as to lead to the need to implement a recovery plan under The Occupational Pensions Schemes (Scheme Funding) Regulations 2005, is

acceptable. Assessment of the USS employer covenant is carried out internally by the chief financial officer and his staff and is based primarily on information from the UK funding councils, Dun & Bradstreet and other publicly available information on the financial health of the sector. The board considers the employer covenant at each of its meetings.

- 2.3 *The trustee company takes a long-term view on investment given the scheme's strong positive cash flow and ongoing flow of new entrants, and the strength of covenant of the employers. Some short-term volatility of returns can be tolerated, as the scheme does not need to realise investments to meet liabilities, although the trustee company is mindful of the desirability of keeping the funding level on the scheme's technical provisions close to or above 100% thereby minimizing the risk of the introduction of deficit contributions. The actuary has confirmed that the scheme's cash flow is likely to remain positive for the next ten years or more.*
- 2.4 *The trustee company seeks to manage investment risk through a diversified portfolio and with regard to the risk appetite of its stakeholders. Further information on risk is given in sections 3 and 4 below.*
- 2.5 *The trustee company believes that over the long-term equity investment and investment in selected alternative asset classes will provide superior returns to other investment classes. Further information on the trustee company's beliefs about investment returns and its investment benchmark and management structure are given in section 5 below.*
- 2.6 *The trustee company seeks to be an active and responsible long-term investor believing that this will protect and enhance the value of the fund's investments in the long-term. Further information on responsible investment is given in section 6 below.*

3 **Risk**

- 3.1 The trustee company recognises that it would be theoretically possible to select investments producing income flows broadly similar to the estimated liability cash flows. With a fund of this size, it is impractical and presently very expensive to match the bulk of the scheme's liabilities. Therefore, in order to meet the long-term funding objective to pay the scheme benefits as they fall due whilst managing the level of contributions, the trustee company needs to take on a degree of investment risk relative to the liabilities. This taking of investment risk seeks to target a greater return than the liability matching assets would provide whilst maintaining a prudent approach to meeting the fund's liabilities.
- 3.2 Before deciding what degree of investment risk to take relative to the liabilities, the trustee company receives advice from the internal investment team, the investment consultant and the scheme actuary, and considers the views of the employers. In particular, it considers carefully the following possible consequences:

- The assets might not achieve the excess return relative to the liabilities expected over the long-term. If the value of assets increased at a lower rate than the value of the liabilities, this would result in deterioration in the fund's financial position and consequently, given the USS rules regarding contribution rates, the need for higher contributions from the employers than currently expected.
 - The relative value of the assets versus the liabilities will be more volatile over the short term than if investment risk had not been taken. This will increase the potential size of any shortfall of assets relative to the liabilities at the date of the scheme's triennial valuation, which may result, given the USS rules regarding contribution rates, in a requirement to impose deficit contributions on the employers, or in the event of the discontinuance of the fund.
- 3.3 The trustee company's willingness to take investment risk is dependent on the continuing financial strength of the employers and their willingness to contribute appropriately to the fund, the financial health of the fund and the fund's liability profile. The trustee company monitors these factors regularly with a view to altering the investment objectives, risk tolerance and/or return target should there be any significant change in any of the factors.
- 3.4 Having regard to the above, and after taking advice from the internal investment team, the investment consultant and scheme actuary, the trustee company has adopted investment arrangements that it believes offer an acceptable trade-off between risk and return.

4 **Diversification of risk**

- 4.1 The overall investment risk to the fund is diversified across a range of different investment types, which are expected to provide excess return over time, commensurate with risk.
- 4.2 The fund may invest in a wide range of assets and strategies, including quoted equity, government and non-government debt (including inflation-linked), currencies, money market instruments, property and alternative assets and strategies including private equity and debt, infrastructure, commodities and absolute return strategies. Investment may be undertaken directly, indirectly (e.g. via funds), in physical assets or derivatives.
- 4.3 The trustee company also monitors, analyses and responds to other risks such as regulatory risk, administrative risk, custody risk, concentration, currency, liquidity and counterparty risk and political and country risk.
- 4.4 The investment portfolio has been constructed to be consistent with the investment objective, risk tolerance and excess return target of the trustee company.

5 Strategic investment benchmark and investment management structure

- 5.1 The trustee company believes that, over the long-term, equity investment and investment in selected alternative asset classes will provide superior returns to other investment classes. The management structure and targets set are designed to give the fund a major exposure to equities through portfolios that are diversified both geographically and by sector. The trustee company also believes that a portfolio of alternative assets can provide similar returns to equities whilst reducing risk through greater diversification.
- 5.2 The fund's strategic investment benchmark is reviewed periodically to ensure that it is appropriate for the circumstances and objectives of the scheme. Full details of the fund's current benchmark and divergence limits are set out in the IPID, but the following table provides a summary in broad terms as set at 31 December 2009. The target allocation for alternatives is presently set at 20% with a corresponding reduction in the allocation to quoted equities. The alternatives allocation will build up progressively, driven particularly by the drawing of existing and new investment commitments to private equity and infrastructure and by new investment to hedge funds or absolute return strategies.

	<i>31 December 2009</i>
Equities	68
Alternatives	9.5
Fixed interest (including index-linked)	12.5
Property	10

- 5.3 It is the trustee company's intention to diversify the asset allocation exposures geographically, by asset class and across active management strategies. It also aims gradually to increase the allocation to risk reducing assets (such as government bonds and index-linked gilts) and other risk-hedging instruments as the scheme's funding level improves, whilst being mindful of the desire of the employers to minimise the likelihood of an increase in the scheme contribution rate. The allocation to risk reducing assets would primarily be drawn from the allocation to quoted equities. The market-related triggers for incremental allocations will be driven by improvements in the scheme funding level.
- 5.4 The above distributions have been agreed on the recommendation of the investment committee based on its belief that, over the long-term, a reasonable estimate of the real annual rates of return of each asset class would typically be:

Equities	5%
Alternative assets	5%
Property	3.75%
Fixed interest	2%
Index-linked	1.75%

- 5.5 The trustee company's policy is to hedge back to sterling an appropriate proportion of the developed market currency exposure.
- 5.6 The majority of the fund's investments are currently managed in-house. This is generally supported by the in-house managers' longer-term investment orientation and incentives, lower costs and greater transparency, as well as the absence of marketing or commercial demands. External managers are appointed (and may be dismissed) as appropriate, given our assessment of their skill and expected net returns versus relevant benchmarks. They can enable the scheme to diversify market and fund manager risks and to achieve access to a wider range of opportunities and styles than we could deliver, economically and competitively, in-house. Index tracking is used as appropriate to reduce investment risk relative to benchmark and investment management costs. The IPID, as periodically updated, gives details of each investment manager's mandate as set out in their respective investment management agreements.
- 5.7 The alternative asset programme is managed in-house, substantially through subcontracting some management functions to specialists or through direct investment.
- 5.8 The overall property portfolio is managed in-house with advice received from external specialists. External managers or funds are used as appropriate.
- 5.9 The assumptions and beliefs concerning investment risk and returns, on which the trustee company's benchmark and management structure are based, are reviewed regularly by the investment committee and the board.
- 5.10 The external managers are remunerated through a combination of ad valorem fees and performance-related fees. The fee arrangements in each case are considered by the trustee company to be the best way of encouraging outperformance while ensuring value for money.
- 5.11 The investment management structure is subject to a formal review at least every five years. The appointment of any manager can be reviewed at any time if, for example, changes to its investment management process, personnel or business management lead to a loss of confidence in the manager's ability to outperform its benchmark over a full market cycle or result in the manager no longer being suitable for the mandate for which it was appointed.

6 **Responsible investment**

- 6.1 As an institutional investor that takes its fiduciary obligations to its members seriously, the trustee company aims to be an active and responsible long-term investor in the assets and markets in which it invests. By encouraging responsible corporate behaviour, the trustee company expects to protect and enhance the value of the fund's investments in the long-term.
- 6.2 The trustee company therefore requires its fund managers to pay appropriate regard to relevant extra-financial factors including corporate governance, social,

ethical and environmental considerations in the selection, retention and realisation of all fund investments. The trustee company expects this to be done in a manner which is consistent with the trustee company's investment objectives and legal duties.

- 6.3 Specifically, the trustee company has instructed its internal fund managers and called on its external managers to use influence as major institutional investors to promote good practice by investee companies and by markets to which the fund is particularly exposed.
- 6.4 The trustee company also expects the scheme's fund managers, both internal and external, to undertake appropriate monitoring of the policies and practices on material corporate governance and social, ethical and environmental issues of current and potential investee companies so that these extra-financial factors can, where material, be taken into account when making investment decisions.
- 6.5 The aim of such monitoring should be to identify problems at an early stage, and enable engagement with management to seek appropriate resolution of such problems. The trustee company uses voting rights as part of its engagement work to ensure that voting is undertaken in a prioritised, value-adding and informed manner. Where collaboration is likely to be the most effective mechanism for encouraging company management to address these issues appropriately, the trustee company expects its fund managers to participate in joint action with other institutional investors as permitted by relevant legal and regulatory codes.
- 6.6 The investment committee monitors this engagement on an on-going basis with the aim of maximising its impact and effectiveness. The trustee company's governance, social, ethical and environmental policies are also reviewed regularly by the board and updated as appropriate to ensure that they are in line with good practice.

7 Additional Voluntary Contribution assets

Additional voluntary contributions (AVCs) from members to purchase additional benefits on a money purchase basis are invested separately from the other assets of the fund and are managed and administered externally. They, do, however form part of the fund. The appointment of AVC providers is subject to review by the board and their investment performance is monitored by the investment committee.

8 Governance

- 8.1 The board, as the governing body of the trustee company, retains the overall power over investment of the fund's assets. It delegates some aspects of the fund's investment arrangements to the investment committee and the internal investment team, but retains direct responsibility for setting investment objectives, establishing risk and return targets and setting the fund's strategic benchmark and investment manager structure. It makes decisions on these matters after considering recommendations from the investment committee.

- 8.2 The trustee company established the investment committee under its articles of association, and under the rules of the scheme, to advise it on all questions relating to the investment of the assets of the fund. It consists of between three and nine people of whom at least one must be a member of the board and up to five may be persons other than directors whom the board may decide to appoint because of their knowledge of and expertise in investment matters. In making its recommendations to the board, the investment committee works with the internal investment team and receives advice from its external investment consultants whenever it considers it appropriate. The investment committee implements the board's decisions under delegated powers by retaining and monitoring investment managers, performance measurers, custodians and other service providers.
- 8.3 The investment managers (internal and external) are responsible for day-to-day management of the fund's assets in accordance with guidelines agreed with the trustee company. The investment managers have discretion to buy, sell or retain individual securities in accordance with these guidelines. The chief investment officer monitors and reports on the performance and activities of the managers to the investment committee each quarter. The investment managers also report direct to the investment committee from time to time.
- 8.4 The internal fund managers make recommendations for the continuance or amendment of their fund's asset allocation policy for the approval of the investment committee. The investment committee also oversees the appropriate allocation of cash (new money) between the different managers on a quarterly basis.
- 8.5 The trustee company has appointed performance measurers independent of the investment managers to calculate and analyse the performance of each investment manager's portfolio and of the total fund.
- 8.6 The trustee company has appointed external custodians who are responsible for the safekeeping of the fund's assets and for performing the associated administrative duties such as trade settlements, dividend collection, corporate actions, tax reclamation and proxy voting. The custodians also act as agents for the fund's stock lending programme (although third party agents can also be appointed).
- 8.7 The scheme actuary performs a valuation of the fund at least every three years, in accordance with regulatory requirements. The main purpose of the actuarial valuation is to assess the extent to which the assets cover the accrued liabilities and agree an appropriate funding strategy.
- 8.8 An asset liability modelling study was carried out in 2008 and will be carried out regularly to seek to ensure that the fund's asset distribution remains appropriate given the liability profile of the fund and the trustee company's risk tolerance.
- 8.9 The fund's governance arrangements are described in more detail in the IPID.

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