

# Universities Superannuation Scheme (“USS”)

## Investment Process

### 1. Introduction

1.1 The USS Investment Committee sets an **asset allocation benchmark** based on advice from both its external and internal advisers. This is designed to provide excess return over the liabilities in the longer term. In setting the benchmark, the Investment Committee has regard to risk relative to the liabilities. The London Investment Office (LIO) is responsible for management of the assets relative to this benchmark using mainly internal investment management teams. Here we describe the investment philosophy and process employed by the LIO to achieve superior benchmark performance.

### 2. USS – Competitive Advantage

2.1 All studies show that **average active management** is more expensive than, but no better than, **index tracking management** in most markets. To outperform in the fiercely competitive investment market, it is necessary to have competitive advantage. For those organisations which embark on active management it is important for them to identify their competitive advantage and adhere to its basic trends.

2.2 There are three aspects of USS which singles it out from most other final salary schemes:

- Unlike many schemes, USS is open to new members and is a relatively **immature** fund– its timeframe is longer than many.
- USS is one of the largest pension funds in the UK. This provides no competitive advantage against commercial active managers (many of whom will have much greater scale), but it does allow the scheme to pursue strategies not open to smaller schemes (e.g. direct property investment, direct **alternatives investment**, etc.) The size of the fund, combined with the university connection, also allows the trustees to attract an Investment Committee with members who are of a much higher standard (in terms of investment sophistication) than most schemes. Such a group should be less likely to fall victim to investment fashion and more tolerant of longer term strategies.
- The LIO’s sole role is to manage the USS assets on a “not-for-profit” basis. Its interests are thus very much aligned with those of the trustee and as it is not either chasing new business nor desperately seeking to retain existing business, it is not driven by a need to perform well in the short term.

2.3 These differences define the LIO's competitive advantage and justify the use of active management. In particular the LIO:

- may adopt a long term approach to investment and so harvest both the liquidity and **volatility premia** available in many asset classes and stocks
- can avoid any investment fashion it wishes to avoid, unlike many of its commercial peers
- should be able to attract high class professionals through offering an environment where staff need not feel that their investment decision making is being driven by short term commercial needs.

At the heart of these competitive advantages is the ability to be long term. This is not to say that no shorter term strategies can add value but rather that USS should not compete in the "short term" because in that space it has, if anything, competitive disadvantage.

N.B. The existence of liquidity and volatility premia is based on the assumption that because the majority of investors are relatively short term in their outlook, investments which are either illiquid or volatile will tend to be priced less attractively than those which are not. Those who are tolerant of volatility and liquidity should therefore be able to buy these investments at a price below their long term value.

### 3. **The LIO Investment Process**

3.1 At every stage, the LIO's process takes into account long term financial, political, economic and extra financial drivers of investment performance. The scheme can thus benefit from long term thematic shifts in stock, sector and country performance over the next 5 to 10 years. There are two key elements to the investment process, namely **asset allocation** relative to the benchmark and stock selection within the various asset classes.

#### 3.2 **Asset Allocation**

Asset allocation (i.e. deviations from the Investment Committee's benchmark) is discussed at formal monthly meetings of the Asset Allocation Committee which comprises the heads of each investment area. More frequent meetings are held if market conditions dictate. The committee is chaired by the Chief Investment Officer ("CIO") who makes the asset allocation decisions based committee on input.

Discussions are based on the long-term view of political and economic conditions, including environmental and social factors. The emphasis is on finding potential mispricing relative to these views and on identifying short term trends in markets driven by fashion rather than fundamentals (so that these may be avoided). This leads to a view which may be contrarian, but not just for the sake of it.

As assessment of the credit environment, stockmarket valuations and expectations is married up with sentiment and long term technical indicators to determine the likely direction of individual stock and bond markets over the medium to long term. This analysis allows the LIO to make judgements on the risk premium factored into the equity, bond, property and alternatives markets against their expectations. This relative judgement will determine the asset allocation.

As the LIO's level of conviction falls and/or the evidence of mispricing diminishes the over and under weightings will become smaller.

### 3.3 **Stock Selection**

The portfolio managers at the LIO are divided into a number of teams each of which is responsible for a particular investment area. In order to achieve worthwhile diversification and to provide a working environment which will attract and motivate good people, each investment team has considerable discretion in the way in which it manages its investments. Most third party fund management organisations are compelled to operate an over-rigid approach as many clients and consultants demand "consistency" across asset classes. The dangers of a rigid investment process are:

- It does not allow the portfolio managers to adopt a process which reflects the nuances of each underlying market.
- It introduces risk in that the money is all being run in exactly the same way.

While the individual LIO teams manage assets in their area in a way which is appropriate to that market, all the teams invest money on a long term basis. In particular:

- Taking a long term approach using fundamental analysis and taking into account extra financial factors enables all the teams to identify those stocks and sectors that will benefit from the long term trends and themes within global economies and politics identified at the asset allocation phase.
- In addition, by using a longer timescale than the majority of investors, the LIO can invest in stocks and sectors that fund managers constrained by short term performance criteria may need to forego.

As with asset allocation, the long term timescale may mean that from time to time a contrarian view is taken. It also allows a team to stick with a position which goes out of favour for psychological rather than fundamental reasons. The extent to which a team takes a contrarian position will depend on the degree of conviction which the team has about the underlying view.

Apart from the long term focus, the other investment belief which pervades all investment teams is the belief that the performance of companies is determined to large extent by the quality of management and the corporate governance processes. This is an area to which much research time is devoted.

If the LIO's process had to be labelled it would be GARP ("Growth at a Reasonable Price") but unlike the majority of managers, the LIO looks for growth over a 5 to 20 year timescale not the one to two year timescales used by most external managers.

### 3.4 **Culture and Communication**

An important but intangible aspect of any successful fund management organisation is in culture and ability to share knowledge. The LIO, through using a small number of small investment teams, promotes communication and cross-team working. Each team is encouraged to invest money in the way which suits its market best and all are encouraged to communicate with each other.

### 3.5 **Repeatability**

It is important that the process, and the conditions under which it may or may not work for a period of time, are fully understood and that it is repeatable over the longer term. The Investment Committee looks to obtain independent verification of the LIO processes to ensure that they reflect the agreed investment beliefs and processes.

## 4. **Summary**

The LIO's quest for good relative performance is underpinned by three aspects of competitive advantage:

- Most critically, the existence of a sophisticated investment committee allied with the lack of short term pressure enables the LIO to take a long term view and thus benefit from harvesting liquidity and volatility premia. USS can afford to be more tolerant of short term volatility than most other investors.
- The lack of short term commercial pressure allows the LIO to build a working environment and culture which should attract, retain and motivate good long term investors despite the fact that it cannot offer all the financial benefits available at a high quality boutique.
- The relatively small size of the organisation facilitates good communication and knowledge sharing with the committee based approach providing structure.