

Universities Superannuation Scheme (“USS”)

Investment Beliefs and Guiding Principles

These investment beliefs are shared by the USS Board, investment committee and executive. They inform how we address investment and risk management for the Scheme. These beliefs, the resulting investment policy and implementation process will evolve over time, along with the Scheme’s circumstances and experience. This document addresses USS’ investment objectives, the trade-offs between return and risk, alignment of managers and cost-effective implementation.

About USS

USS is an open defined benefit pension scheme serving the higher education sector in the UK. The Scheme has a strong covenant, liabilities stretching to the end of this century and positive net cash-flow from investment income and contributions. These features characterise USS as a long-term investor.

USS is the second largest pension fund in the UK. Its size supports the governance and management resources to invest across a wide range of traditional and alternative assets and strategies. The bulk of the Scheme’s assets are managed internally, but external managers are used when it is not cost-effective or feasible for USS to provide the requisite standard or range of investment activities.

Aims

Our focus is on risk-adjusted returns after costs. We aim to:

- generate sufficient real returns to meet the Scheme’s liabilities with an affordable contribution rate
- limit and diversify investment risk, to maintain reasonably stable contribution rates.

These aims must be balanced against each other. A degree of mismatching between assets and liabilities is unavoidable as we balance affordability of the Scheme against stability in the contribution rate. This asset-liability risk should be scaled to the Scheme’s changing circumstances and objectives, and should be reviewed as financial market valuations, return and risk prospects change.

Sources of returns and risk

Investment returns and risks can be split conceptually between those that are systematic (relating to structural properties of markets) and those that come from active management or ‘idiosyncratic’ returns.

Systematic risk and returns ('beta'):

Risky and/or less liquid assets are normally priced so as to provide expected returns above those on risk-free assets – thus compensating investors for the danger of loss and inflexibility over particular periods. Accepting short-term volatility in returns or illiquidity can, therefore, help to achieve higher long-term returns.

The chief source of systematic investment returns is participation in economic growth, via equity markets or otherwise. In the long run, we expect equities to deliver an 'equity risk premium', materially outperforming cash and inflation. Other long-term sources of risk premia include credit, value, illiquidity, volatility and the provision of insurance. Bearing inflation or interest rate (duration) risk relative to liabilities may also be rewarded under certain circumstances – for example, when there is an imbalance between the supply and demand for long-dated inflation-linked bonds or for other liability hedging assets.

Skill-based returns ('alpha'):

No investment market is efficient all the time, with the levels of efficiency varying across markets and time periods. Active management can therefore add incremental value. We aim to provide our active managers with appropriate flexibility to generate outperformance within suitable risk controls. Certain mandates may allow scope for leverage or short positions.

Financial markets, however, bring together the views and knowledge all investors and traders – and beating the 'field' consistently is very hard. Over the long-term, success in investing requires building, sustaining and adhering to your competitive advantages – whether they are based on investment horizon, superior information and analysis, or portfolio construction. Active trading costs and fees erode the benefits of superior insight. Where it is particularly difficult or expensive to gain an 'edge', passive management may be the most cost-effective approach.

We believe asset prices and returns are driven ultimately by fundamentals, with asset prices tending eventually towards fair value. While the fundamentals themselves are not easy to understand or predict, large mispricing can occur in the context of market failures, investor sentiment and flows. Prospective returns from any asset are thus sensitive to current valuation levels. The ability to increase/reduce exposure to under/over-valued assets can be rewarding and reduce the risk of lasting underperformance.

USS as long-term investor: scope and constraints

As a long-term investor with the capacity to bear shorter-term underperformance, USS is relatively well placed to:

- harvest equity, credit, illiquidity and other systematic risk premia
- position exposures according to its assessments of valuation across or within markets, avoiding or capitalising on short-term investment 'fads'.

In general, the probability of success in this endeavour increases with the investment time horizon: longer-term investors have more time to make money back if they suffer short-term losses. That said, it is not always easy to remain focused on the long term when the short term moves against you. It takes a good investment case, courage and a well-balanced approach to scaling risk exposures.

Moreover, shorter-term considerations cannot be ignored. The continuing support of sponsors, beneficiaries and regulators is required to sustain a long-term investment strategy. The risk-taking capacity of the Scheme is thus limited by prudential considerations, stakeholder concerns and regulatory pressures related to Scheme funding and periodic valuations. The fundamentals underlying risk-taking capacity include the strength of the funding ratio and covenant, the duration of liabilities, the maturity of the Scheme, the scope for risk-sharing across beneficiaries and contributors, and the regulatory environment. The Scheme monitors changes across these factors to ensure that its investment policy remains appropriate.

Diversification

Diversification across traditional and alternative assets and strategies helps to maintain investment returns while mitigating risk – supporting the objectives both for affordability (limiting required contributions by sustaining expected investment returns) and for safety (limiting potential increases in required contributions under adverse return scenarios).

The Scheme has substantial diversification across geographies, asset classes and strategies. It allocates beyond global equities into fixed income, property and alternative assets and strategies, including private equity and debt, infrastructure, timber and absolute return funds.

The scope to diversify risk, however, has limits. Correlations across assets may rise over periods of time (particularly in difficult periods) and thus reduce the benefits of diversification. Furthermore, even a long-term investor must decide how much tolerance it has for the illiquidity that is inherent in some diversifying investments.

Hedging of asset-liability risk

In addition to risk mitigation via diversification, certain large exposures may be hedged, when this is possible at reasonable cost. For example, the Scheme has a strategic hedging programme to reduce currency mismatches between its assets and liabilities. Furthermore, while no asset class perfectly matches the Scheme's evolving liabilities, part of the Scheme's asset allocation is to 'liability-hedging' or risk-reducing assets (inflation-linked gilts and government bonds).

Alignment and Use of Managers

The fund must manage its principal/agent issues through mutual understanding and the setting of aligned and appropriate incentives. These goals will often be supported within long-term relationships – which also serve to lower turnover and associated costs, as well as to enable managers to access illiquidity, value and other factors when these are expected to deliver excess returns over time.

The in-house management team is particularly well placed to deliver these requirements. It offers long-term commitment, continuity and comprehensive understanding of the Scheme. It acts both as adviser to the Scheme and as the 'preferred provider' of investment management in areas where this is cost-effective. It is not distracted or conflicted by asset-gathering or other commercial interests. It operates within the broad policies set and overseen by the Board, its committees and independent advisers.

Performance incentives for the in-house team (and where possible for external managers) focus on long time-frames against specified objectives. This approach captures time-windows that are more meaningful for the Scheme and is more likely to reward skill rather than short-lived luck.

While in-house management will often be less costly, 'right-cost' is more important than 'low-cost' to secure the required quality of investment management and operations. External managers are accessed as required, where specialised expertise is unavailable, uneconomic or cannot be developed in time internally. We take care to address agency issues as much as possible, to ensure alignment with the Scheme's long-term objectives. In Alternatives, particularly, we have developed our resources and skills in evaluating managers and have constructed a diversified programme of externally managed investments to meet our requirements, rather than building up the considerable resources needed for a direct investment programme.

Excessive turnover of managers or staff is costly in terms of time, expenses and portfolio transitions. Switching managers is viewed on a forward-looking basis, incorporating transition costs. We favour a model of 'managers for the long-term', with incentives aligned appropriately (where possible, on a risk-adjusted, after-costs and longer-term basis). Shorter-term monitoring of performance and activity focuses more on assessing the quality of the investment process than on immediate outcomes.

Responsible investment and stewardship

Across all asset classes, we seek to ensure that long-term opportunities and risks are identified and appropriately managed – including environmental, social and governance (ESG) factors. These factors should be integrated into the investment process for most effective implementation. ESG practices within investment vehicles or investee companies can be important influences on long-term returns and risks. Over the long-term, well managed companies should generate higher returns with less risk.

USS monitors and, when appropriate, engages and seeks to improve the governance of investment vehicles or investee companies. USS aims to ensure that they are run in the long-term interests of their investors or owners and that the full range of risk factors is considered. We seek similar vigilance and application in our external managers – their governance and stewardship activities are considered when their suitability for USS is assessed.

Risk Budgeting and Control

A risk budgeting approach is applied when allocating assets across managers and when setting scope for their discretion. This takes account of their different styles, skills and opportunity set. We aim to provide our active managers with appropriate flexibility to generate outperformance within suitable risk controls. Risk and performance are then monitored for consistency with targets or expectations.

Beyond asset allocation and active investment management risk, the Scheme is exposed to a number of operational risks. These are covered in a risk register, covering all classes of risk to which the Scheme is exposed and setting out the risk owners and mitigation policies for each risk item.