

USS RESPONSIBLE INVESTMENT FIVE YEAR REVIEW 2006

USS made a policy decision in November 1999 to strengthen its approach to dealing with the environmental, social and governance implications of business behaviour. The strategy devised to do this had the following phases:

- A conceptualisation phase, in which USS's approach to responsible investing was formulated;
- An initiation phase in which detailed policies and processes were defined and communicated to stakeholders;
- An experimentation phase in which USS explored how it could embed the principles of responsible investment (RI) into different aspects of its mainstream approach, and
- A five-year consolidation phase during which these experiments were expected to be fully integrated into USS's investment and wider organisational approach and culture.

The Scheme's original RI strategy was based on an iterative learning approach, which included scheduled comprehensive reviews of the RI programme. These reviews were designed to be facilitated by reviewers not directly connected with responsible investment in USS. This is the second such review, carried out this time as last by the USS internal audit function in conjunction with an external consultant¹

The aim of this review was to:

- Analyse and assess the scheme's achievements and successes in the first five years of the implementation of the fund's responsible investing strategy;
- To understand the less successful elements of the strategy; to learn from experience; and, above all,
- To create a solid foundation for the formulation of the next five-year strategy.

METHODOLOGY

In order to ensure that the findings in this review were evidence-based, the review selected three representative projects undertaken by the RI team. These were: The Enhanced Analytics Initiative (EAI), Pharma Futures, and US Corporate Governance (see below). These projects were chosen according to the likelihood that they would facilitate an exploration of the totality of issues in the review.

- a. The Enhanced Analytics Initiative or EAI – a project designed to encourage sell-side broker company research analysts to make extra-financial factors an integral part of their research and stock recommendations.²
- b. Pharma Futures – a scenario planning exercise, designed to bring together major global investors and leading pharmaceutical company executives and other informed commentators to analyse the industry's long-term opportunities and threats.³

¹ JOL consulting <http://www.jolconsulting.com/>

² <http://www.enhancedanalytics.com/>

³ <http://www.pharmafutures.org/>

- c. US Corporate Governance – a coordinated effort on behalf of the scheme to engage with companies, regulators and trade associations in the US to improve corporate governance.⁴

The Review was undertaken using an interview process conducted by authors independent of the investment operation at USS. The interviewees included experts in their respective fields and interested parties both inside and outside USS. In addition, a survey of individuals likely to have a view on RI at USS was carried out.

Specific Objectives of the Review

The specific objectives of this review were to:

1. Assess the validity of the RI team’s work against the framework and principles that were agreed for the implementation of the policy in 2000.
 - 1a. Consider the success or otherwise of the RI team’s strategy in effecting market changes.
 - 2b. Consider the success or otherwise of the RI team’s project methods.
3. Assess the degree to which the scheme has fulfilled its ambition to integrate the principles of responsible investing into the internal and external management of its funds.

Current Strategy

In order to ensure that the fund’s RI activities are maximally effective, it was agreed in the original strategy and subsequent updates that the RI team’s activities should focus on some issues in depth, rather than attempting to cover the entire spectrum of issues raised by having a portfolio of 1500 listed on stock markets throughout the world, as well as a range of other assets. .

The scheme’s original RI strategy also comprised three overarching themes:

1. *Corporate behaviour*: The RI team sought to influence corporate behaviour with respect to the management of environmental, social and governance factors through engagement with corporate managers and boards of directors.
2. *Integration*: The RI team sought to enhance fund returns through stock selection, portfolio construction and risk management by helping to ensure that consideration of extra-financial factors which were likely to play a role in corporate success and failure and, therefore, in the determination of stock prices, were integrated into the investment decisions of the scheme’s internal fund managers.
3. *Market returns and contextual benefits*: Largely working in collaboration with other investors, the RI team sought to improve market returns by raising standards of investor and corporate behaviour and hence by improving the allocation of capital within the financial system. It also sought to protect the living standards of its members and beneficiaries over the long term in terms of, for example, quality of life in retirement issues –(in the belief that behaviour of the investee companies can have significant environmental and social effects).

⁴ See for example, <http://www.unpri.org/clearinghouse/uss.php>

SUMMARY OF FINDINGS

The review found clear evidence that USS has a high profile in the projects in which it engages. The capital that the scheme brings to bear through its collaborative work with other investors is a significant multiple of USS's own funds and tangible outcomes in the shape of permanent new market institutions and changes in the behaviour of market participants are also in evidence.

Each of the projects reviewed appeared to protect and enhance USS's reputation and influence amongst internal and external stakeholders and in the wider pension fund and investment community. The review noted that:

- Respondents to the review contended that USS has taken a leading position in the projects under consideration and applauded the quality and impact of the RI team's project; work
- Each member of the team is well regarded in the RI field;
- Concerns were expressed as to the level at which extra financial issues were actually being integrated into investment decisions, and how actively the fund was engaging with companies on certain issues.

Validity against Agreed Strategy

The Review found that the RI team's work was consistent with the principles and strategy established in the initial policy, and with the strategy that evolved and was approved from time to time by the fund's Investment Committee.

The review noted that the RI team's work to improve portfolio and market returns is in keeping with the scheme's Statement of Investment Principles. In addition, the Review found that the scheme's objective to improve market returns is consistent with USS's position in the investment industry; that the RI team's work in this regard is performed to a high professional standard, and that the majority of the implementation of the strategy has been highly successful.

A survey of USS members carried out previously and surveys of USS employees and interested investment professionals carried out as part of this review endorses USS's approach to RI and the work of the RI team. The overall results of the interviews carried out as part of this review are also very supportive.

PRINCIPAL FINDINGS

The principle findings of the review focused on the scheme's three themes of influencing corporate behaviour; of improving fund returns; and of improving market returns.

Corporate Behaviour

Projects have helped to protect against value destroying behaviour as a result of poor extra-financial risk management in the companies in which the scheme invests, especially in 'high-impact' sectors.

- The EAI has been designed to influence corporate behaviour via the signals that investors send to corporate managers through the setting of stock prices. The consultancy⁵ employed by the Initiative to review and rate investment research has found continuous improvement in the quality of EAI-inspired research and an increasing degree of integration of RI principles into equity valuations and into stock recommendations.
- The Pharma Futures project was undertaken because of the scheme's relative inability to influence, through portfolio positioning, the behaviour of pharmaceutical corporate executives in a sector that is vital to the long-term financial interests of USS pensioners and to their future living standards. The review found that the project elicited contributions from highly influential people, recognised for their understanding of and experience in the pharmaceutical industry, forming a powerful group which commanded respect and attention.
- The review found that the scheme's US corporate governance work is forming coalitions of investors in a country where few previously existed. It is providing leadership on RI where, until recently, there was a vacuum and it is helping to expand the audience for the subject in a country where, until recently, few end beneficiaries took notice of it.

Ambition for Integration

Integration means that extra-financial factors are taken into account in individual investment decisions – “in the selection, retention and realisation of all fund investments.”⁶ To the extent that the stock market misprices the role that extra-financial factors such as innovation and the environmental and social consequences of corporate activity play in the determination of stock prices, the authors of this review agree that it is possible for the scheme to gain an investment advantage and to improve the performance of its funds. Several interviewees and the majority of respondents to the review's questionnaire expressed concern however concerning the extent to which RI principles are integrated into the wider practices of the scheme.

Internal integration

The review found particular instances in which long-term considerations did appear to form a significant input into investment decisions for certain internal fund managers. It also believes that the RI team has made a meaningful contribution to the evolution of the scheme's investment culture, as it pertains to long-term investing.

The behaviour of the scheme's internal fund managers appears to be influenced by the scheme's philosophy of long-termism, by individual investment beliefs that coincide with long-termism and by the scheme's adopted RI strategy. However, there is little evidence that this behaviour is augmented or aided by use of the outputs from specific RI projects and the review concludes that the scheme's integration ambition has not yet been realised. It believes however that persistence in this endeavour is justified and can provide a unique advantage to the internal investment team.

Integration amongst the broader investment sector

⁵ onValues <http://www.onvalues.ch/>

⁶ USS Statement of Investment Principles www.usshq.co.uk

The review did uncover evidence that the scheme's RI strategy has altered belief systems, investment processes and the type of data that industry analysts and fund managers pay attention to amongst fund managers outside USS.

Market Returns and Contextual Benefits

The rationale for RI projects is provided by the following premises:

- Universal owner: the consequences of market failure cannot be avoided by a large investor who must necessarily own a substantial proportion of available stocks.
- Economic returns: adoption of responsible principles increases economic returns to companies and markets.
- Contextual benefits: externalities have the potential to impact on the standard of living of USS beneficiaries.
- Responsible ownership: market and company behaviour incompatible with the owners' interests should be addressed by owners of the stature and capability of USS.

Given these premises, there is clear evidence that the projects chosen by the RI team are successful in their own terms - providing tangible evidence of, for example, improvements in corporate governance. In this way, the review notes that, in accordance with agreed objectives, projects should improve the market returns that underpin the performance of USS equity and other portfolios.

Strategy

The review noted that the RI strategy was consistent with the principles and policies established when it was initially implemented, with the fund's Statement of Investment Principles, and with the strategy as it evolved and was agreed from time to time by the USS Investment Committee.

However, feedback from certain parties, including a member group, suggest a degree of concern in respect of the fact that the scheme's responsible investment strategy does not fully address their desire for engagement with individual companies. On this point, the fund informed the reviewers that the weighting given to various RI themes, including corporate behaviour, by the RI team varied dependent on perceived value and effectiveness at protecting and enhancing the long term value of the fund.

The Reviewers noted that an increased resource to be applied to RI matters as part of the next five-year strategy will imply a greater allocation of time to individual companies.