Valuation Investment Strategy (VIS) for the DB part of the scheme

The trustee's approach to DB investment strategy

Context for investment strategy

The trustee has a legal duty with respect to the DB part of the scheme to ensure that the existing benefits that have been accrued by members can be paid (i.e., to ensure that the scheme is sufficiently well funded to secure benefits due under the rules of the scheme and to make these payments now and in the future).

The investment strategy for the DB part aims to achieve an appropriate balance between generating returns and managing risks, while maintaining consistency with the trustee's risk appetite. This balance between returns and risk is reviewed in detail at each actuarial valuation and regularly monitored by the Investment Committee.

What is the Valuation Investment Strategy (VIS)?

The trustee's broad investment strategy is set out as a theoretical, but investible, asset allocation across three key components: growth assets, credit assets and liability hedging. Liability hedging is expressed through interest rate and inflation hedge ratios on a self-sufficiency basis.

Growth assets are made up of equities and property; credit assets are made up of corporate and emerging markets bonds; and the liability hedge ratios include the interest rate and inflation exposure from gilts and other fixed income assets, including liability driven investments.

This theoretical asset allocation is what we call the Valuation Investment Strategy (VIS). The VIS is the investment strategy developed from the most recent actuarial valuation. It will be adjusted from time to time to retain consistency with the trustee's risk appetite and to balance the DB part's objectives for returns and risk tolerance.

In addition to supporting the outcome of the valuation, the VIS feeds into the scheme's Financial Management Plan (FMP) and is used to monitor progress against the valuation projections via the Monitoring & Actions Framework.

The VIS does not define the actual assets in which USSIM may invest; it is a hypothetical investment strategy which is expected to deliver appropriate long-term returns underlying the valuation at an acceptable level of risk. The actual implemented investment portfolio can differ from the VIS (within limits set by the trustee), as USSIM finds opportunities in the financial markets to use its discretion to add value and improve risk-adjusted returns. USSIM is set risk and return objectives by the trustee in respect of the implemented portfolio which pay regard to the level of risk and expected return associated with the VIS.

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How has the VIS been developed?

The VIS was developed based on a comprehensive and holistic analysis of the risk and return characteristics of different investment strategies, taking account of the Integrated Risk Management Framework (IRMF). These risk-return characteristics were compared against the scheme's funding objectives and the trustee's risk appetite and investment beliefs.

In developing the VIS, the trustee also considered:

- Advice from USS Investment Management and Mercer (the external investment advisor for the DB part).
- The views of stakeholders from a range of engagement activities. Please see the summary of our VIS stakeholder engagement programme.

As allowed for in the IRMF, the strength of the employers' covenant informs the trustee's view of how much risk it can reasonably take in delivering the DB benefits and managing the appropriate long-term strategy for the scheme's investments. The trustee monitors the employer covenant and will adjust its risk tolerance as appropriate. A number of other factors may affect the trustee's appetite for risk, including the funding position of the DB part, its cash-flow profile and its liability profile. The trustee monitors these factors regularly and may alter its investment objectives and/or risk tolerance in the event of any significant changes.

The components of the VIS

Generating investment returns is important to the scheme to help pay existing DB benefits (investment returns can also help to keep future contributions lower than they otherwise would be). To this end, the trustee seeks to maintain an appropriately high allocation to higher-return (but also higher risk) growth assets, such as equities and property, provided that the overall level of risk remains within risk appetite.

Keeping the overall level of risk within appetite involves focusing on the funding position and, in particular, managing the risks between assets and liabilities.

This is achieved by ensuring that:

- The allocation to growth assets is appropriately sized and diversified.
- The risks associated with liabilities, in particular interest rate and inflation risks, are appropriately sized through the use of liability hedging (by an allocation to liability hedging assets).
- The overall portfolio is well diversified, which credit assets can help with.

Another important element in helping to achieve an appropriate balance between generating returns and managing risk is the use of leverage within the investment strategy. Leverage means that the economic value of the total asset exposure will exceed the net assets of the scheme. The level and sources of leverage need to be carefully monitored and managed because of the requirement to post collateral and the additional risks associated with it.

An appropriately balanced investment strategy involves three broad components or building blocks:

- Growth assets
- Credit assets
- Liability hedging (which we express through hedge ratios on a self-sufficiency basis).

The asset allocation corresponding to the VIS and the implemented portfolio can be found on our investment related documents and briefings page.

The growth component

Growth assets (such as equity and property) can offer the potential for higher long-term returns than other asset classes, but with higher risk, particularly relative to liabilities.

The trustee believes that exposure to the risks associated with growth assets is rewarded over the long term but may not be always rewarded over the short-to-medium term (and has no certainty of being reward over any time horizon). For this reason, the trustee seeks to maintain an allocation to growth assets that is at an appropriate level, such that we can take advantage of these higher expected returns without placing the scheme outside the trustee's risk appetite.

The trustee regularly monitors the scheme's exposure to growth assets.

The credit component

Credit assets can provide diversification benefits, additional return versus government bonds and reduce the scheme's overall portfolio risk. Credit assets are typically expected to generate lower but more stable returns compared to growth assets. However, the allocation to credit also provides interest rate sensitivity, which can help to manage liability risks.

The liability hedging component

In addition to the requirement that the total risk associated with the investment strategy falls within the trustee's risk appetite, the profile of different risks must also be well-balanced. In other words, the exposure to different individual risks should be manageable and, if possible, commensurate with the associated expected returns.

A category of risks that are particularly large and of concern to the trustee relates to the financial risks associated with the liabilities, mainly the interest rate and inflation risk. That's because these two elements are important factors in determining the price of the benefits promised to members. Liability hedging is therefore important because of its role in helping to keep the investment strategy within the trustee's risk appetite and its risk profile well-balanced. Some examples of liability hedging assets include bonds such as UK gilts (including inflation linked), US Treasury Inflation-Protected Securities (US TIPS) and related derivatives.

While liability hedging can reduce liability related risks (both in terms of interest rate and inflation risk), there remain significant unhedged risks related to the accrued self-sufficiency liability. Based on the VIS

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approved at the 2020 valuation, 60% of the interest rate and inflation risk associated with the (accrued) self-sufficiency liability remained unhedged (owing to the self-sufficiency liability hedge ratios being 40%).

The expected cost of hedging is factored into the expected return of the VIS and this cost is considered in the round against the amount of risk reduction provided. It is important to strike an appropriate balance between the cost of hedging and the risk it is intended to manage.

Leverage, liquidity, collateral and counterparty considerations

The primary purpose of leverage is to facilitate efficient risk management in relation to the investment strategy.

Like many UK DB schemes, leverage is an important aspect of the scheme's investment strategy and it has been for some years. It enables separate decisions (rather than a single, interlinked decision) to be taken about the management of liability hedges and the exposure to growth assets. This allows us to pursue higher risk-adjusted returns.

The leverage in the VIS is deployed in a way that reduces the impact of adverse changes in interest rates and inflation on the funding position, whilst maintaining an expected return that is higher than it might otherwise be.

Additionally, when managing leverage, USSIM does so on a collateralised basis, meaning USSIM posts and receives collateral (e.g., gilts and/or cash). This provides protection to both the lender and the scheme, and as a result reduces the cost of leverage significantly.

The amount of collateral posted at any point in time is a function of the overall level of leverage, its associated risk, and the outstanding unrealised profit/loss. The level of leverage is constrained by this collateral requirement, as well as by certain operational and regulatory limits. It is, therefore, important to closely monitor and control the management of collateral when considering the level of leverage that can be supported. The trustee reviewed its collateral management framework following the gilts crisis in 2022, to ensure that these risks are being managed appropriately.

The risks and costs associated with leverage are monitored and managed by USSIM (under delegation from the trustee) using various controls for managing cash, collateral and counterparty risks. This delegation includes limits, which relate to:

- Liquidity – could we run out of cash?
- Collateral adequacy – are we holding sufficient collateral?
- Collateral replenishment – could we replenish collateral if need be?
- Counterparty risk – are we diversifying across counterparties? Is counterparty creditworthiness acceptable? Is the counterparty exposure within the specified limits?

USSIM uses a diversified set of instruments as sources of leverage, including repurchase agreements (repos), swaps, futures and other financial derivative contracts.