



Valuation Investment Strategy (VIS) for the DB Section

The Trustee's approach to DB investment strategy

1. Context for investment strategy

The Trustee's primary objective (and legal duty) with respect to the DB Section of the Scheme is to ensure that the existing benefits that have been accrued by members can be paid in full. In other words, it is 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 section aims to achieve an appropriate balance between generating returns and managing risks, while maintaining consistency with the DB section's Integrated Risk Management Framework (IRMF) and the Trustee's risk appetite. This balance between returns and risk is reviewed in detail at each triennial actuarial valuation and regularly monitored by the Trustee's Investment Committee.

2. What is the Valuation Investment Strategy (VIS)?

The Trustee's broad investment strategy is set out as a theoretical, but investible, asset allocation across equities, property, gilts and other fixed income assets, including liability driven investments (LDI), corporate and emerging market bonds.

This theoretical asset allocation is what we call the Valuation Investment Strategy (VIS), which is the investment strategy developed for the most recent actuarial valuation and will be adjusted from time to time to retain consistency with the IRMF and risk appetite.

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.

It should be noted that the VIS is not intended to be the actual implemented investment strategy, but it does serve as a guide to the construction of the implemented portfolio. The implemented portfolio can differ from the VIS (within limits), as USS Investment Management finds opportunities in the financial markets to use its discretion to add value and improve risk-adjusted returns. The implemented portfolio operates within the same risk and return envelope as the VIS. It is monitored and controlled within USS Investment Management and overseen by the Investment Committee via a wide array of reporting metrics.

3. 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 IRMF. These risk-return characteristics were compared against the Scheme's funding objectives and the Trustee's risk appetite.

In developing the VIS, the Trustee also considered:

- Advice from USS Investment Management and from external advisors, principally the Scheme Actuary and Mercer (the external investment advisor for the DB section), both of whom were closely involved throughout the process.
- The views of stakeholders which were solicited and taken into account. For example, feedback was received from employers that the allocation to growth assets should not be reduced. This feedback was taken on board by the Trustee.



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 Section, 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.

4. The components of the VIS

Generating investment returns is important to the Scheme to help pay existing DB benefits (it also helps 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 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 hedging assets;
- The overall portfolio is well diversified.

An 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 effectively involves specific investments that mimic a collateralised (i.e., secured) form of "borrowing" within the investment portfolio using different financial instruments. 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.

The Trustee considers that an appropriately balanced investment strategy involves three broad components or building blocks:

- Growth assets
- Hedging assets
- Leverage

The asset allocation corresponding to the VIS and the implemented portfolio can be found on the USS website [here](#).

5. The growth component

Growth assets are assets with high expected investment returns, such as equity and property (real estate). They 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. 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.

6. The 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, i.e., the interest rate and inflation risk of the liabilities. That's because these two elements are important factors in determining the price of the benefits promised to members. In the absence of hedging, these liability-related risks dominate the risks associated with the allocation to growth assets.

To illustrate this, at 30 September 2021, around two-thirds of the total financial risk in the self-sufficiency deficit was driven by liability-related risks (i.e., the risks that interest rates fall and/or inflation increases) and around only one-third was driven by the risk associated with growth assets (i.e., that future investment returns are lower than expected). This large imbalance prevailed despite 34% of the interest rate risk and 28% of the inflation risk having being hedged at that time.¹

So hedging is a key component of the investment strategy because of its role in helping to keep the Scheme within risk appetite and its risk profile well-balanced.

However, while increasing hedging reduces the liability-related risks, it is limited in scope and does not remove them completely. There remain significant unhedged risks related to the accrued self-sufficiency liability. At 30 September 2021, 66% of the interest rate risk and 72% of the inflation risk associated with the (accrued) self-sufficiency liability remained unhedged. Moreover, 100% of the risks associated with the future service liability were unhedged. This will change over time as further hedging takes place.

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.

7. The leverage component

The primary purpose of leverage is to facilitate efficient risk management in relation to the investment strategy. It also facilitates efficient deployment of the Scheme's capital.

Like many UK DB schemes, leverage is an important building block of the USS investment strategy and 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 increased leverage in the VIS (relative to the level of leverage used prior to 2020) 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 using leverage, the Trustee does so on a collateralised basis, meaning the Trustee posts and receives collateral (e.g., gilts and/or cash) when managing leverage. This provides protection to both the lender and the Scheme, and as a result reduces the cost of leverage significantly.

¹ These hedge ratios of 34% and 28% are calculated relative to the self-sufficiency liability.

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.

In managing leverage, the Trustee uses a variety of different controls to address the associated risks. These include:

- Leverage monitor – are we staying within allowed leverage bands?
- Liquidity monitor – could we run out cash?
- Counterparty risk monitor – are we diversifying across counterparties? Is counterparty creditworthiness acceptable? Is the counterparty exposure within the specified limits?
- Limits on repo processes – to reduce risk associated with the rolling of repos.
- Stress testing collateral demand – could we run out of collateral?

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

Glossary

Financial Management Plan (FMP): The plan for managing the Scheme following an actuarial valuation. It sets out the funding and investment strategy, including how risks will be managed in light of the covenant provided to the Scheme by the sponsoring employers, and the financial position of the Scheme established at the valuation date.

Integrated Risk Management Framework (IRMF): The IRMF defines the Trustees approach to identifying, managing and monitoring risks that can affect the funding objectives for the DB section of the Scheme.

Monitoring & Actions Framework: This is the approach to monitoring and managing the development of the Scheme against the FMP following an actuarial valuation. It is intended to assist the Trustee in determining whether or not the Scheme’s financial position is progressing as expected and whether it is appropriate to continue to fund the Scheme on the basis of the actuarial valuation.

Self-sufficiency: This refers to the level of assets and a low risk investment strategy that together provide a high probability (c. 95%) of paying all accrued benefits and maintaining a high funding level, without the need for additional contributions. The self-sufficiency liability is the level of assets the Trustee would actually target in the absence of an employer covenant.