Review of Statement of Investment Principles

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AON

Introduction

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Why bring you this report?

Following the 31 March 2023 valuation, the Trustee of the Universities Superannuation Scheme (the 'Scheme') carried out a review of the Scheme's investment strategy. This has led to a review of the Valuation Investment Strategy (VIS) and an update to the Scheme's Statement of Investment Principles (SIP). The Trustee is required by regulation to consult with (but not gain the agreement of) all participating Employers (the 'Employers') on the planned changes to the SIP.

To help Employers consider their response to the consultation, Aon has been asked by Universities UK to complete a review of planned changes to the SIP and the VIS, the outcome of which is set out here. We have also commented on the USS Investment Beliefs, which were also shared and updated. The investment strategy of the Scheme is important to the Employers as it directly impacts the stability of the Scheme and also the cost of providing future benefits to members.

This paper should be read in conjunction with the various documents and briefings provided for Employers on the USS website: https://www.uss.co.uk/for-employers/investment-related-documents-and-briefings which were provided as part of the consultation. Aon has given permission for this document to be shared with the Employers of the USS on a non-reliance basis.

How is this report set out?

- After this introductory section, we have our 'At a glance…' section. The aim of this is to provide a quick executive summary of the main points in this report.
- The first section of the main report then summarises the planned changes to the VIS along with Aon's views.
- As an increase to the interest rate and inflation hedge ratios is the main change planned to the VIS, we then look at Liability Driven Investment (LDI) and hedge ratios in more detail in the next section.
- Next we look at the SIP, covering Aon's views on the changes the Trustee proposes to make to the draft SIP that is being consulted on.
- We then touch briefly on the changes the Trustee proposes to make to the Investment Beliefs document that was also circulated as part of the consultation.
- Finally, we set out our main conclusions.
- In each section we highlight key areas Employers may wish to provide feedback on as part of the consultation.

Next steps

The Employers should:

- Review our advice, alongside the draft updated SIP and the other documents supplied as part of the consultation.
- Consider whether to feedback any suggestions or concerns to the Trustee as part of the consultation.

At a glance…

This section is an executive summary of the main points in this report.

Our main comments on the draft SIP and other documents supplied as part of the consultation are:

- Our understanding is that the only material change the Trustee intends to make to the VIS is to increase the target interest rate and inflation hedge ratios from 40% to 50%.
- The allocation to growth assets remains unchanged at 60%.
- While the allocation to credit has reduced from 25% to 20% and LDI has increased from 15% to 20%, this is mainly due to moving the US Treasury Inflation-Protected Securities (US TIPS) allocation from credit to the LDI portfolio so is not changing the VIS, just how the constituents are reported.
- The increase to hedge ratios seems sensible to us, given the improved funding position. We would not normally include US TIPS as part of an LDI portfolio, but recognise that this does not really change anything since the US TIPS (and other credit assets) were already being included in the hedge ratios.
- We see these changes as important, but incremental changes to the overall investment strategy. We would not expect the changes to materially impact the expected return of the Scheme, which is used by the Scheme Actuary for funding purposes.
- Given the improved funding position, it could be there is scope for further de-risking from the current position and Employers could consider how this approach fits with their desired risk/return parameters, noting that reducing the expected return can impact future service costs.
- We believe that the draft SIP, as updated, correctly reflects the proposed new strategy and complies with the legislation.
- The changes proposed to the SIP are modest. We have highlighted the more material ones in this report and set out some areas where the Employers might want to ask for further information, but we saw nothing that caused us concern.

Review of the VIS

This section comments on the review of VIS and gives our views.

Current VIS

Following the 2023 valuation the Trustee has reviewed its investment strategy as set out in the VIS. The VIS consists of an allocation to growth assets, an allocation to LDI assets (for hedging interest rate and inflation risk) and an allocation to credit assets. The VIS allows for the use of leverage in order to provide a greater degree of interest rate and inflation hedging. We comment in more detail on liability driven investment and hedge ratios in the next section.

At a high level, the current VIS is as follows:

Growth	60%
Credit	25%
LDI (net of leverage)	15%
Total	100%
Interest rate hedge ratio	40%
Inflation hedge ratio	40%

The hedge ratios apply to the value of the liabilities on a self-sufficiency basis. Note that, to the extent that the Credit assets have interest rate and inflation sensitivity, they are included in the hedge ratios.

Consultation

As set out in the “VIS Stakeholder Engagement Programme” the Trustee ran an engagement programme with stakeholders on the VIS.

As at 31 March 2023, we understand that the Scheme had a surplus on the Trustee’s technical provisions (TP) basis of £7.4bn and a funding level of 111% funded. This is quite different to the position as at 31 March 2020, where the Scheme reported a TP deficit of £14.1bn and a TP funding level of 83%. Hence the decision to review the VIS.

The Trustee is responsible for determining the investment strategy, but put forward three potential scenarios to a sample of Employers as part of its consultation. These were as follows:

A. Less growth assets and more liability hedging.
B. Similar growth assets and the same/more liability hedging.
C. More growth assets and less liability hedging.

According to the paper, there were Employers in favour of each of these options, but Scenario B received the most support.

Proposed VIS

Note that the paper “Composition of the Valuation Investment Strategy” has recently been updated, following feedback from Aon. If Employers

downloaded this before 28 March 2024, they should check they have the latest version.

At a high level the proposed VIS is as follows:

Growth	60%
Credit	20%
LDI (net of leverage)	20%
Total	100%
Interest rate hedge ratio	50%
Inflation hedge ratio	50%

Our understanding of the proposed VIS is as follows:

- The only material change the Trustee intends to make to the VIS is to increase the target interest rate and inflation hedge ratios from 40% to 50%.
- The allocation to growth assets remains unchanged at 60%.
- While the allocation to credit has reduced from 25% to 20% and LDI has increased from 15% to 20%, this is mainly due to moving the US TIPS allocation from credit to the LDI portfolio. As such, this is not changing the VIS, just how the constituents are reported.

Aon’s view on the proposed VIS

Our views are as follows:

- The increase to hedge ratios seems sensible to us, given the improved funding position. We comment in more detail on liability driven investment and hedge ratios in the next section.
- We would not normally include US TIPS as part of an LDI portfolio, but recognise that this does not really change anything since the US TIPS (and other credit assets) were already being included in the hedge ratios.
- The Scheme is materially better funded now than in 2022, potentially giving scope to reduce risk in the VIS.
- Given the improved funding position, it could be there is scope for further de-risking from the current position and Employers could consider how this approach fits with their desired risk/return parameters, noting that reducing the expected return can impact future service costs.

Interaction with the Implemented Portfolio

The Implemented Portfolio (IP) corresponds to the actual investments held in the Defined Benefit (DB) part of the Scheme. As described in the current SIP, the IP can differ from the VIS.

At a high level the IP at 31 March 2023 was: 57.7% growth, 22.9% credit, 19.4% LDI (net of leverage). The hedge ratios were higher than in the VIS. The interest rate hedge ratio was 45.4% and the inflation hedge ratio was 43.2%.

We note that this arrangement gives the Employers less visibility on the actual assets held. The Employers could ask for:

- Information on what changes to the IP are intended on the back of this exercise, alongside the expected impact of these changes.
- More detail on the interaction over time between the VIS and the IP.

Liability Driven Investment

Our previous paper "Review of Statement of Investment Principles" dated 19 April 2022 went into considerable detail on the mechanics of LDI and hedge ratios. For ease of reference we have summarised some of the key points here and also provide our latest views.

What is LDI and how does it work?

As interest rates fall or inflation increases, the value of the liabilities determined by the Trustee increase. LDI is about investing in assets that match the Scheme's liabilities, using assets that match the interest rate and inflation sensitivity of the liabilities.

Pension payments are a series of regular cashflows that may be linked to inflation. As such, the cashflow stream is similar to that of a bond. LDI looks to invest in low risk assets that behave in a similar way to the liabilities – typically these assets would be government bonds.

LDI helps reduce volatility versus the liabilities, providing more certainty to the Scheme.

Use of leverage

It is not unusual for leverage to be used within an LDI portfolio. Leverage allows an investment to be made without fully funding it. Therefore, as opposed to investing in £100m of bonds to provide a £100m of protection, a scheme could invest in £50m in bonds, giving £100m liability coverage with the remaining £50m being used to invest in growth assets.

There are risks associated with using leverage including collateral and counterparty risks but for most schemes these considerations are taken into account by the trustee and underlying fund managers. Following the gilt crisis in September 2022, regulatory guidance has meant that LDI portfolios need to be better capitalised with access to sufficient liquidity should the portfolio need to be recapitalised. The Trustee will be taking this into account when making a decision on changing the level of hedging.

- The Employers could consider asking the Trustee for further detail on how the level of leverage and collateral is managed and monitored.

Comments on the increase to hedging

Does the nature of the Scheme mean such approaches are less appropriate?

Most of our clients have taken the view that interest rate and inflation risk is not something they expect to be rewarded for taking. As such, most have hedged at least as much of this risk as is proposed in the VIS. Our view is that these risks should be hedged as far as possible.

The Universities Superannuation Scheme is a unique pension scheme. It is one of an increasingly small number of open schemes. Conceptually, it is

possible to run an open scheme in a very different way to a closed scheme, and the case for hedging interest rates and inflation can be less clear-cut.

However, the funding strategy (for determining cash contributions) is determined by the Trustee, acting on the advice of the Scheme Actuary, and in consultation with Universities UK. (Additionally the Investment strategy is set by the Trustee in consultation with the Employers.)

From a practical point of view, to limit the exposure of the Employers (and the employees, under cost-sharing) to additional contributions due to the assets and liabilities moving out of sync, we can see merit in hedging interest rate and inflation risk in the Scheme – despite it being open to accruals. The argument is analogous to other UK schemes, at least for the post-retirement liabilities.

We are supportive of increased hedging

As such, we support the direction of travel here, with the VIS leading to greater hedging than is currently the case. Given the size of the Scheme, any significant increase in hedging will take time to implement and we would expect any increase to be managed by looking at available liquidity and transaction costs, although the increase planned is relatively modest.

Is now a sensible time to make such a change?

The change is a strategic move to higher levels of hedging rather than a tactical position and therefore it is not necessarily trying to time the market. Given the large size of the Scheme, it will naturally take some time to build up the hedge ratios to the new strategic levels. We regard current market levels as reasonable for making the relatively modest increase that is planned under the VIS.

What are the advantages and disadvantages of this from the Employers' point of view?

Hedging provides greater certainty on the past service funding position from changes in interest rates and expected inflation. The key advantage is that reduced funding level volatility will provide greater certainty into the levels of potential deficit repair contributions required by the Employers. This increased certainty may help avoid or reduce conversations on contributions and benefit negotiations.

The disadvantages from the Employers' perspective are that the Scheme may be purchasing liability hedging assets at a time when they are at expensive levels (albeit real yields are significantly higher now than they have been in recent history). In addition, the use of leverage (although commonplace now), does add additional risks on counterparty and collateral management.

Incorporation of credit and US TIPS

We understand that the interest rate and inflation sensitivity of the credit portfolio and US TIPS are included in the calculation of the hedge ratio. In our experience, where schemes hold credit, it is typical for this to be factored into the hedge ratios.

US TIPS will be sensitive to US interest rates and inflation and, as such, would not normally be included in an LDI portfolio or factored into an assessment of hedge ratios for a pension scheme with UK liabilities. We

also understand that the allocation to US TIPS is expected to increase slightly, to 5% (from 4%). We do accept that the size of the Scheme means that alternative forms of hedging are needed, but the Employers should note that US TIPS will only ever be an approximate form of hedging.

How well hedged is the Scheme?

The intention is to increase the target interest rate and inflation hedge ratios from 40% to 50% on the self-sufficiency basis. However, potentially of greater interest to the Employers is how well hedged the Technical Provisions are – since it is the Technical Provisions that primarily drive the cash contributions required following an actuarial valuation.

Given the assumptions involved in setting the Technical Provisions, it is impossible to directly translate self-sufficiency hedging to a corresponding hedge experience on a Technical Provisions basis. Based on a range of different assumptions, we understand that the Trustee has estimated that a self-sufficiency liability hedge ratio broadly in the range of 50% - 65% could lead to a fully hedged experience on a Technical Provisions basis. You could infer from that, that the Trustee does not reasonably expect the proposed self-sufficiency hedge ratio to lead a greater than 100% hedge on a Technical Provisions basis under most market conditions. Based on this, we regard the planned increase as reasonable.

Statement of Investment Principles

The aim of this section is to describe the legislative requirements of the SIP and give Aon's comments on the updated SIP as drafted by the Trustee

Legislative requirements

The main areas of legislation directly affecting the contents of a SIP are:

- The Pensions Act 1995.
- The Pensions Act 2004.
- The Occupational Pension Schemes (Investment) Regulations 2005.

Note that the provisions of sections 35 and 36 of the Pensions Act 1995 which deal with SIPs and choosing investments were modified by sections 244 (which replaced section 35) and 245 (which amended section 36) of the Pensions Act 2004. The prescribed regulations referred to in these sections of the Pensions Act 2004 are those contained in the Occupational Pension Schemes (Investment) Regulations 2005.

Note also that while these are the main areas of legislation, the requirements of the SIP have also been amended by other regulations, in particular:

- The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018.
- The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019.

Aon's comments on the draft SIP's compliance

We believe the SIP covers everything required by the legislation noted above and indeed goes beyond the requirements in some areas. We also believe that the SIP, as amended, continues to correctly reflect the investment strategy.

Please note that while we are comfortable the SIP covers everything required from a regulatory point of view, we are unable to offer a legal opinion on the SIP's compliance with the legislation, which should be obtained separately if required.

Aon's broader comments on the SIP

As mentioned above, we have no concerns from a compliance point of view. The changes proposed to the SIP are modest. We have highlighted the more material ones below and set out some areas where the

Employers might want to ask for further information, but we saw nothing that caused us concern.

We did raise comments on the existing SIP when it was reviewed in 2022 and most of the comments raised then remain valid, but given the current SIP was accepted, we do not repeat those comments here. As such, our comments below are based solely on the proposed changes to the SIP.

Changes to paragraph 1.2.1:

- Wording has been added to the SIP to reference the new RI beliefs and ambitions statement. It first gets referenced here, but is also referenced elsewhere.
- We have looked at this RI statement, which sets out the Trustee's three main beliefs. Our only area of note relates to the belief that the Scheme is a Universal Owner. It states "As a Universal owner, we can't diversify our way out of large systemic risks, nor can we stock pick our way around them". We comment on this further in the next section.

Changes to paragraph 1.3.3:

- This introduces a holistic framework for monitoring risk, which seems reasonable. There is a similar change to 1.5.5.
- The Employers could ask for greater detail on how this holistic framework will work in practice.

Changes to paragraph 1.4.3:

- This introduces the Universal Ownership concept. See our comments on this above and in the next section.

Changes to paragraph 1.5.7:

- This widens the reviews to cover all managers, not just public markets managers. This is a positive move, although in practice we expect there is limited scope for changes in private markets.

Changes to paragraph 2.1.3:

- This removes the references to a journey plan and the dual discount rate. We understand that the valuation continues to have a dual discount rate but there is not an explicit journey plan. We understand these amendments have been made to reflect the 2023 Actuarial Valuation.
- The Employers could ask for the reasons behind these changes and ask for details on the long term journey plan for the Scheme.

Changes to paragraph 2.1.4:

- This adds a reference to the Employers' risk appetite – as now required to comply with the General Code. A similar reference has also been added to paragraph 2.3.1.

Changes to paragraph 2.2.2:

- The new wording is an improvement and more in line with the VIS.
- However, note that the VIS is not set out in the SIP and the assets can be out of line with the VIS as mentioned previously in this report.

Investment Beliefs

The aim of this section is to give Aon's comments on the Trustee's investment beliefs

Introduction

The Trustee has provided an Investment Beliefs document which is referred to in the Statement of Investment Principles. Although we have reviewed the document, the Trustee does not require consultation with the Employers on this apart from the extent to which they interact with the SIP.

Clearly, the Trustee is entitled to believe as it chooses and producing such a document is a useful guide when making decisions. We did raise comments on the existing beliefs when they were reviewed in 2022 and most of the comments raised then remain valid, but we do not repeat those comments here. As such, our comments below are based solely on the proposed changes to the beliefs.

Aon's comments on the beliefs

The changes are relatively minor, the more material ones are as follows:

- The new wording at the start mentions a new document: RI beliefs and ambitions statement. It also claims that the Trustee is a Universal Owner. See our comments on the changes to SIP paragraph 1.2.1 above and our comments on Universal Ownership below.
- Part A, paragraph 4 has been amended to reference shorter time frames as a consideration as well as longer time frames, which we regard as reasonable.
- Part A, new paragraph 5 explicitly makes the point that longer time frames give greater opportunity for riskier assets to deliver better returns than low risk investments, which we would agree with.
- The changes to Part B are consistent with Part A and seem minor.

Universal Ownership

The updated beliefs and SIP have both been changed to state that the Scheme is a universal owner.

The Institute and Faculty of Actuaries states that "Universal Owners are institutional asset owners (pension funds, mutual funds, insurance companies, sovereign wealth funds) that own such a representative slice of the economy as to find it impossible to diversify away from large system wide risks".

The Scheme is certainly very large and understand USS believe it fulfils the UNEP FI definition of universal ownership. However, the Employers could ask why the belief is being expressed now and what the practical implications are.

Further details on the Trustee’s approach to responsible investment, ESG and net zero can be found on the webpage. The Employers should consider whether they are receiving sufficient information in this area.

Conclusions

The aim of this section is to set out our high level conclusions

Our main comments on the draft SIP and other documents supplied as part of the consultation are:

- Our understanding is that the only material change the Trustee intends to make to the VIS is to increase the target interest rate and inflation hedge ratios from 40% to 50%.
- The allocation to growth assets remains unchanged at 60%.
- While the allocation to credit has reduced from 25% to 20% and LDI has increased from 15% to 20%, this is mainly due to moving the US TIPS allocation from credit to the LDI portfolio so is not changing the VIS, just how the constituents are reported.
- The increase to hedge ratios seems sensible to us, given the improved funding position. We would not normally include US TIPS as part of an LDI portfolio, but recognise that this does not really change anything since the US TIPS (and other credit assets) were already being included in the hedge ratios.
- Given the improved funding position, it could be there is scope for further de-risking from the current position and Employers could consider how this approach fits with their desired risk/return parameters, noting that reducing the expected return can impact future service costs.
- We believe that the draft SIP, as updated, correctly reflects the proposed new strategy and complies with the legislation.
- The changes proposed to the SIP are modest. We have highlighted the more material ones in this report and set out some areas where the Employers might want to ask for further information, but we saw nothing that caused us concern.

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