Valuation Investment Strategy (VIS)

Stakeholder engagement programme

This document summarises the stakeholder engagement programme ("the programme") of the Valuation Investment Strategy (VIS) from the 2023 valuation for the Universities Superannuation Scheme (USS).

It covers the engagement carried out up to March 2024, prior to the consultation on the Statement of Investment Principles (SIP), which is currently planned for 25 March to 29 April 2024.

We have structured this document into four main sections, which includes:

1. An introduction
2. The objectives of the programme
3. The review of investment strategy
4. The feedback received

1. An introduction

From November 2023 to early March 2024, the trustee ran an engagement programme with stakeholders on the Valuation Investment Strategy (VIS). This programme included two phases.

The first phase predominantly in November – December 2023 involved:

a. An initial meeting with Universities UK (UUK) and its advisor, Aon
b. Initial meetings with individual employers
c. Russell Group Finance Directors (FDs)
d. Attendance at the Stability Working Group (SWG)

The second phase in January – March 2024 involved further meetings with:

a. Individual employers and
b. Stakeholder representative bodies, in particular:

   i. UUK and its advisor, Aon
   ii. University and College Union (UCU)
   iii. Russell Group Finance Directors (FDs)
   iv. The Trustee's Employer Investment Discussion Forum (EIDF)
   v. The Stability Working Group (SWG)
   vi. UUK's Employer's Pension Forum (EPF)

c. A webinar with employers, the recording and presentation of which are available on our investment related documents and briefings page.

A third phase of stakeholder engagement is planned between April and May 2024, following the consultation on the Statement of Investment Principles (SIP).

2. The objectives of the engagement programme

The objectives of the first phase of the engagement programme were to:

a. Solicit initial feedback on what was important to employers in the context of investment strategy for the 2023 valuation
b. Explore what stability meant to stakeholders in the context of the 2023 valuation
c. Seek informal feedback on stakeholder risk appetite

The objectives of the second phase of this programme were to:

a. Share the trustee's latest thinking on the potential range of investment strategy for the 2023 valuation.
b. Improve stakeholders' understanding of the potential investment strategies for the 2023 valuation.
c. Seek informal feedback on the types of metrics that could be used by the trustee when assessing different investment strategies for the 2023 valuation.
d. Seek informal feedback on the different potential investment strategies.

3. The review of investment strategy

The trustee would ordinarily review the investment strategy annually, when there's a valuation or following material market moves. The scheme's Technical Provisions (TP) funding level and risk position has improved materially since 2020.

As at 31 March 2023, 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%.

The required level of contribution rates to the scheme is driven by the:

a. Funding/contribution strategy: The level and margins in contributions and the spreading of deficit/surplus.
b. Benefit strategy: The level of guarantees and the split between Defined Benefit (DB) and Defined Contribution (DC).
c. Investment strategy: The balance between return seeking and matching assets.

The first two drivers were agreed as part of the 2023 valuation, which was finalised in December 2023. The third driver is the subject of this engagement programme.

a. Employers were increasingly focused on the stability of contribution rates as the 2023 valuation progressed. As a result we focused on the following points as part of the engagement process: It's not possible to guarantee fixed levels of benefits and contributions.
b. However, our funding and investment strategy could help to achieve an appropriate balance of stability in benefits and contributions.
c. The range of options available are bounded by the prevailing regulatory framework and the trustee's risk appetite.

d. We explored a range of investment strategies that could give the best chance of delivering the desired outcome.

In setting the investment strategy from the March 2023 valuation, the trustee has a wider range of plausible options to choose from. This is because the scheme is further from its risk limits than it was previously, as a result of being in surplus (on a TP basis), instead of deficit (as it was in the 2020 valuation). As a result, the trustee has more flexibility to reflect stakeholder views when it comes to selecting a VIS from the 2023 valuation.

The trustee has a requirement to consult with employers on the SIP. However, as above, the trustee was eager to engage with stakeholders more widely on investment strategy.

4. The feedback received

As part of the engagement programme, the trustee actively solicited and received feedback from stakeholders on the VIS and investment strategy more generally. This was received mostly orally in the meetings.

In the first phase of engagement, we carried out individual meetings with a range of different types of employers, covering approximately 38% of the scheme's active membership. In the second phase we carried out follow up employer meetings, in addition to the other meetings with stakeholder representative bodies above.

The sections we cover here are:

a. General views
b. Employer risk appetite
c. The meaning of stability in the context of the 2023 valuation
d. The provisional range of strategies agreed by the trustee
e. The use of metrics for trustee decision-making on the VIS
f. Preferred types of investment strategies

In the sections below, we provide more detail from each key area noted above.

a. General views

We received a wide range of feedback from employers on USS and the 2023 valuation.

We have listed some of the key themes we discussed below:

i. Affordability of contribution rates

There was anxiety among some employers about the level of contribution rates rising again. It takes several years to adjust university finances and it is challenging to manage short-term shocks to contribution rates. However, there was also some nervousness about the contribution rate (now) being too low and whether the current surplus means that employers are paying or have paid too much.

ii. Industrial relations

There was a keenness to avoid disputes with the union in future and there was an understanding that the stability of both benefits and contributions was important. However, it was acknowledged that the benefits and contributions rates currently offered by USS were likely to be much better than what was available elsewhere in the public and private sector.

iii. The deficit re-emerging

Employers wanted us to avoid the risk of a deficit re-emerging and to try to protect the current surplus. That meant trying to avoid a repeat of the 2020 problems if real interest rates fell back down.

iv. Time horizon

The sector should have a long-term view on pensions because if we de-risk the assets, we could miss an opportunity. We shouldn't de-risk under the guise of stability and instead we should focus on the optimal growth/hedging balance given the scheme is still open with a strong covenant.

v. Regulatory concerns/questions

There was some interest as to whether the regulator had more risk tolerance to large, open schemes with strong covenants, like USS.

vi. Valuation methodology

There was an appetite for a more stable valuation methodology. Ideally a new methodology could help to stabilise the liabilities and avoid lurching between deficit and surplus.

vii. Use of LDI/leverage

The benefits of using liability hedging (and leverage) to protect the volatility of the funding level were acknowledged. However, employers also asked us to be wary about the use of leverage, particularly following the recent LDI crisis.

viii. Cost of living

Inflation was mentioned as being challenging for both employers and employees. For employers, higher outgoings with fixed incomings were difficult, without having higher pensions costs (resulting from high inflation) as well.

We fed all of these views back to the trustee at its meetings in November and December 2023.

b. Risk appetite

The trustee's risk appetite is driven by:

i. The trustee's legal duty (to secure the accrued benefits of its members)
ii. The prevailing regulatory framework
iii. The covenant of the employers and the reliance the trustee is willing to place on it
iv. The benefit structure

We asked employers to comment on their risk appetite to funding the scheme:

i. Some employers expressed a higher risk appetite, which meant that:

- They were willing (or able) to accept more short-term funding level and contribution rate volatility, in order to achieve potentially lower long-term contributions on average.
- As such they were focussed on holding a higher level of growth assets.

ii. Other employers expressed a lower risk appetite, which meant that:

- They were willing (or able) to accept less short-term funding level and contribution rate volatility.
- As such they were more willing to pay slightly higher cash contributions over the long-term to have more stable contributions.
- This might mean holding less growth assets.

iii. In practice, many employers were in between these two viewpoints and were looking for an appropriate balance of contribution rate volatility over the short-term and cash contributions over the long-term.

We fed this range of views on risk appetite back to the trustee at its meetings in November and December 2023. The actual risk taken by the trustee will reflect the range of employer views and can be less than the trustee's risk appetite, but it cannot be more.

c. The meaning of stability

As above, we heard that stability was important to stakeholders. The key part of our first phase of engagement was trying to understand better what employers meant by 'stability'.

We proposed three different meanings of stability relating to contribution rates. There were a range of views across the employers we met with (which included UUK), as well as there being a range of views within each employer.

We found that all three of the meanings of stability that we provided resonated with at least some of our employers. However, more employers tended to agree with the first two meanings of stability, than the third meaning:

i. Minimising the risk of a deficit re-emerging and requiring Deficit Recovery Contributions.
ii. Generate surplus to maintain an acceptable overall contribution rate, for a given benefit structure.
iii. Minimising long-term contribution requirements at the expense of short-term volatility.

Furthermore, some employers agreed with more than one meaning of stability.

d. The provisional ranges of strategies

Prior to approving a single investment strategy on the VIS, in December 2023 the trustee approved provisional ranges of strategies which could then be used for further engagement with stakeholders and further modelling.

The descriptions of these ranges compared to the VIS agreed from the 2020 valuation. This investment strategy consisted of the following high-level components (or building-blocks):

i. 60% growth assets
ii. 25% credit assets
iii. 40% liability hedging ratios (on a self-sufficiency basis)

In the second phase of engagement, we discussed the provisional ranges of strategies with stakeholders, using the following high-level components (or building-blocks) of the VIS (as above).

These ranges were reasonably wide around the VIS agreed from the 2020 valuation. They reflected both the wide range of plausible strategies the trustee could consider (as a result of the improved funding and risk position), but also the wide range of views received from stakeholders in the first phase of engagement. The ranges were:

i. **Growth assets between 45% – 65%**

Directionally, we did not believe there was much appetite to significantly increase growth assets from the current allocation (60%). However, we felt there may have been more willingness to reduce growth assets to reduce some short-term funding level (and hence contribution rate) volatility.

ii. **Liability hedging ratios (on a self-sufficiency basis) between 35% – 60%**

Given the strong starting surplus (on a Technical Provisions basis), the trustee was much further from its risk limits and could theoretically adopt lower hedge ratios. However, we did not believe there was much appetite for a significant reduction in liability hedging. Conversely, we felt there may have been more willingness for additional liability hedging to reduce some of the short-term funding level (and hence contribution rate) volatility.

iii. **A credit allocation between 20% – 30%**

In our analysis, credit was included for diversification purposes (it improves most risk and return metrics, but also impacts the scheme's collateral adequacy, under our assumptions). The range for credit was symmetrical around the allocation agreed from the 2020 valuation (as above).

Please note, these ranges couldn't be applied in isolation (for example, a strategy with 65% growth assets, 60% liability hedging, and 30% credit assets is very unlikely to be implementable from a collateral perspective).

e. The use of metrics for decision-making on the VIS

The next part of our engagement sought informal feedback from stakeholders on which type of metrics might be the most important to them when considering the different types of investment strategies (within the ranges described above).

We therefore asked each employer, to feedback on their most important metrics, from a shortlist of five key metrics.

We selected the shortlist to provide a manageable number to consider, while also providing a range of different:

- Perspectives (e.g. the potential impact on returns, risks, funding levels and/or contribution rates).
- Time horizons (e.g. from the next valuation to a 30 year period).
- Modelling assumptions (e.g. using our stochastic model and also deterministic stresses).

- Possible outcomes (e.g. we showed both upside, best-estimate and downside scenarios).

The metrics we shared included:

i. **The 30-year expected real return of the scheme's assets (% per annum)**
The annualised best estimate return an investment strategy is expected to generate over a 30-year period, over inflation.

ii. **The 25th and 75th percentile TP funding position in three valuations time (i.e. March 2032 (in £bn))**
The projected funding position on a Technical Provisions (TP) basis, assuming a 1 in 4 downside scenario and a 1 in 4 upside scenario in 2032.

iii. **The probability of Actual Reliance[1] exceeding Affordable Risk Capacity (AfRC[2]) by next valuation (i.e., March 2026).**
The likelihood of Actual Reliance[1] (the self-sufficiency funding position net of transition risk) exceeding AfRC[2] by 2026.

[1]Actual Reliance is calculated as self-sufficiency liabilities + transition risk – assets, where transition risk measures the risk exposure of moving the assets from the current VIS to a self-sufficiency investment strategy over time, as well as the exposure to demographic risk (notably mortality).
[2]AfRC is calculated as the present value of 10% of payroll over 30 years.

iv. **The probability of the total contribution requirement being greater than 26% by the next valuation (i.e. March 2026)**
The likelihood of needing to pay a total contribution rate that is greater than an "acceptable" rate of 26% (allowing full use of surplus), by 2026.

v. **Stress-tests**
To measure the potential impact of a concurrent 1% real rates fall and 15% equities fall (based on fixed / dynamic TP pre-retirement discount rate) on the:

  - Total contribution rate (versus 20.6%)
  - Funding position (£)

The informal feedback we heard from individual employers was that:

- There were broad levels of support across all of the metrics. However, metric iii. was seen as being potentially more useful to the trustee, than employers.
- Metric i. was seen as being useful to understand the long-term expected return implications of different types of strategies and metric ii was useful to see the potential range of projected future funding levels.
- Employers found metrics iv. and v. helpful to describe the potential impact on future total contribution requirements, with metric iv. being most popular overall.

Please note, employers typically expressed a preference for 2 or 3 of these metrics (without ranking them).

f. Investment strategies

We also sought informal feedback from stakeholders on what type of investment strategy they might like to see the trustee consider.

For this exercise, we provided three indicative groups of strategies within the provisional ranges (outlined in section d above). The descriptions of these groups were relative to the current VIS (also outlined in section d above) and included:

A. **Less growth assets and more liability hedging**
   Strategies that may exhibit less short-term funding level volatility (owing to less growth assets and more liability hedging), but could lead to higher long-term contribution rates, on average (owing to less growth assets and therefore a lower expected return on assets). Less growth assets may also provide the trustee with less ability to manage Future Service Contributions (FSCs) going forward.

B. **Similar growth assets and the same/more liability hedging**
   Strategies that may exhibit the same / less short-term funding level volatility (owing to the same / more liability hedging), but could lead to similar long-term contribution rates, on average (owing to having similar growth assets and therefore a similar expected return on assets).

C. **More growth assets and less liability hedging**
   Strategies that may exhibit more short-term funding level volatility (owing to having more growth assets and less liability hedging), but could lead to lower long-term contribution rates, on average (owing to having more growth assets and therefore a higher expected return on assets). More growth assets may also provide the trustee with more ability to manage Future Service Contributions (FSCs) going forward.

For each of these groups, we also provided an example strategy for which we showed the outputs of the five metrics shown in the previous section. This helped stakeholders to determine whether the groups of strategies that they were interested in provided characteristics that they felt were appropriate or desirable.

The informal feedback we heard from individual employers was that:

i. There was some support across each of the three potential groups of investment strategies above.
ii. Within some employers, there was support for each of the different groups of strategies.
iii. However, in aggregate, we received most support for group B, which includes investment strategies with similar levels of growth assets (as the current VIS) and the same/more liability hedging.

While there are a range of different (and justifiable) views on investment strategy, we worked with the trustee to consider which options best reflected their collective investment beliefs and risk appetites. The proposed VIS from the 2023 valuation is included on our investment related documents and briefings page.