Mr Bill Galvin
Group Chief Executive Officer
USS

Email: bgalvin@uss.co.uk

21 February 2022

Dear Bill

We are writing to express our concerns on the proposals you have shared with regard to the USS investment strategy.

In recent presentations on your plans for the future Investment Strategy you have outlined a number of significant proposed changes to the current strategy within your Integrated Risk Management Framework. These include:-

- Maintaining the allocation of assets to growth assets at approximately 60%[i]
- Increasing the investment in the LDI portfolio (primarily inflation-linked bonds) from 35% to 52%
- Increasing leverage from the current 17% to 37% by borrowing against specific scheme assets

We understand that your thoughts are still developing and that you will undertake a formal consultation process on the recommended Statement of Investment Proposals soon. We welcome the proposal to maintain the level of growth assets at 60% but we are very concerned about the significant expansion of the inflation-linked bond portfolio – and especially using short term debt to fund the expansion.

Our concerns fall into three categories:

- Undue focus on the “gap to self-sufficiency risk metric”, which appears to be driving the investment strategy, in isolation of other risk measures is inappropriate for this scheme
- The level and type of leverage proposed would import significant risks into the scheme
- The timing of any increase in inflation-linked bond purchases is poor and out of step with the work to review aspects of the USS Scheme

Gap to self-sufficiency metric

We believe the proposed strategy is driven largely by a desire to reduce the volatility in the "gap to self-sufficiency" metric which is particularly affected by changes in real (i.e. after inflation) interest rates. (Buying large amounts of inflation-linked bonds reduces the volatility of the metric as, if real interest rates decline further, the value of index-linked bonds increases at the same time as the liability measure increases.) However, in an open scheme with a long time horizon and a strong covenant, there should be no need for USS to move to self-sufficiency, and a premature focus on the purchase of low return assets is likely to lead the scheme to have lower asset levels and less resilience in the future. A risk metric that focussed more directly on USS' ability to pay benefits as they fall due in adverse circumstances would be a better and more useful approach.

Risk through leverage

We consider that the funding of an increase in the LDI portfolio through short-term floating rate debt secured on assets imports significant risks into the portfolio. Inflation-linked bond values may be particularly volatile over the next few years as central bank policy moves away from quantitative easing and towards controlling inflation. As an example, an increase from 2021 real rates to 1% positive real interest rates (still low by historic standards) would more than halve the value of a 25 year inflation-linked government bond. Very volatile values can cause big calls for collateral from USS which, if they can't be met, can cause USS to become a forced seller of assets at the worst time in the market. Furthermore, the cost of the debt used to purchase these assets could increase significantly if short term interest rates are increased to suppress inflation. This would leave USS paying higher short-term rates on its borrowings just as the value of the assets purchased collapses.

Poor timing

Given that Central Banks are turning from a focus of supporting economies to combatting inflation, there is a very real risk that interest rates rise significantly from their current very low levels. Certainly, it seems much more likely that real interest rates will rise over the next few years than continue to fall. As such, there is a significant expected cost to the proposed strategy. USS calculates the expected cost as a 25 bp reduction in expected return. This translates into an expected loss of several billion pounds over time. We believe there may be other – lower cost – ways of addressing the risk of high inflation that have not been considered by USS.

For example, the strategy could recognise that other assets over the long run are "real assets", e.g. equities, property, and that it is not necessary to achieve self-sufficiency to manage inflation. Alternatively, liabilities could be managed e.g. offering the ability for people who don't really value the DB benefits to transfer to DC. This could well encompass people with only a few years of accrual who are not in the UK and would prefer a transfer to their home jurisdiction or people with large DB pots who see the value in swapping some for a DC pot which should in most circumstances deliver a higher return as suggested by Professors Miles and Sefton at Imperial College Business School.

Furthermore, with the further work streams underway to review aspects of the USS scheme – on Governance, flexible options and conditional indexation – there is a strong case for leaving the investment strategy as it is until the implications of these changes are clear.

Issues to be addressed in the consultation

In the formal consultation we would ask that USS clarify a number of key questions:

- On what basis has USS determined that the current portfolio allocation leaves the scheme with too much risk?
- Can USS illustrate how the balance of risks and stability changes with alternative investment strategies in a quantified way?
- Have the assessments of available and affordable risk capacity been reviewed in the light of the now agreed covenant support framework, and why have these changed (or not) from the estimates in the consultation on the Technical Provisions in August 2020?
- What other options were considered to address the risks identified?
- What analysis has been performed on the ability to manage 37% leverage in highly volatile markets? Please provide specific scenario analysis.
- Is there a compelling need to enact this approach in the short term given the changing Central Bank policies and the investigation of scheme redesign?

In summary, we do not believe that the case for further purchase of inflation-linked bonds has been made and we believe the increase in leverage may introduce potentially significant risks into the scheme in a period of high market volatility. In the consultation, USS will need to demonstrate with quantified evidence why such proposed changes in the investment strategy are necessary at this time, particularly with the unprecedented covenant strengthening measures and significant reductions in benefits that have already been agreed as part of the 2020 valuation and the work beginning on options for scheme redesign. The evidence provided by USS needs to go to the scheme's ability to pay pensions as they fall due rather than just its (wholly theoretical) ability to switch instantaneously to a self-sufficiency portfolio. We would of course be pleased to discuss these issues with you as part of the consultation and explore alternative options which we hope would take our feedback into consideration.

Yours sincerely

Professor Louise Richardson
Vice-Chancellor University of Oxford

Professor Stephen Toope
Vice-Chancellor University of Cambridge

Professor Alice P. Gast
President Imperial College London

---

[i] This represents c44% of total assets due to the leverage

cc:
Dame Kate Barker – Chair of USS
Russell Picot – Chair of the USS Investment Committee
Simon Pilcher – Chief Executive Officer of USS Investment Management

–