# STATEMENT OF INVESTMENT PRINCIPLES

## Introduction

The Pensions Act 1995 requires trustees to prepare and keep up-to-date a written statement recording the investment policy of the scheme. The purpose of this document is not only to satisfy the requirements of the Act but also to outline the broad principles governing the investment policy of the scheme.

The statement has been agreed by the management committee of Universities Superannuation Scheme (USS) on written advice from the investment committee (a sub-committee of the management committee), the scheme's external investment consultants and the scheme actuary following consultation with the participating employers or their appointed representatives.

The management committee reviews the statement at least every three years. The investment committee monitors compliance with this statement at least annually and obtains confirmation from the investment managers that they have exercised their powers of investment with a view to giving effect to the principles contained herein as far as reasonably practicable.

The investment committee is established under the articles of association of the trustee company, Universities Superannuation Scheme Limited (USS Ltd), and under the rules of the scheme, to advise the trustee company on all questions relating to the investment of the assets of the fund. It consists of between three and eight people of whom at least one must be a member of the management committee. Additionally, up to five may be persons other than directors whom the management committee may decide to appoint because they have special skills or are able to give competent advice to the trustee company on the policy to be adopted from time to time for investment of the fund.

The management committee, as the governing body of the trustee company, retains the overall power of investment in relation to the fund but can delegate to the investment committee the power to decide the investment policy of the fund. In practice, the investment committee will generally make recommendations to the management committee, rather than decisions, on matters of strategy. This would encompass, for example, changes in the fund's investment objective, the appointment and remit of external managers, investment in new asset classes and decisions on whether to participate in new investment activities. In making its recommendations, the investment committee receives advice from its external investment consultants. All stock selection decisions are made by the individual investment managers (either internal or external) within constraints recommended by the investment committee and agreed by the management committee, although the chief investment officer and the investment committee monitor their activity. The internal fund managers make recommendations for the continuance or amendment of their fund’s asset allocation policy on a half yearly basis for the approval of the investment committee. The investment committee also determines the appropriate allocation of cash (new money) between the different managers on a quarterly basis. The management committee believes that this structure, together with the range of expertise of its in-house staff, committee members and external managers and advisers enables the trustee company to make effective investment decisions.

## Investment objective and strategy

The trustee's duty is to act in the best financial interests of all classes of scheme member and accordingly to ensure that the assets are invested to secure the benefits under the scheme. The managers are therefore instructed to give primary consideration to the financial prospects of any investment they hold or consider holding.

The fund's investment objective is to maximise the long-term investment return on the assets having regard to the liabilities of the scheme and the desirability of maintaining stable contribution rates. Regard is had to the scheme's relative immaturity**,** the minimum funding requirement of the Pensions Act 1995 and the wish of the employers and the management committee to minimise the risk of higher contributions at some time in the future. At the last triennial valuation as at 31 March 2002 the scheme's funding level exceeded its minimum funding requirement level. The aim is to maintain an adequate funding cushion so that the risk of deterioration of the MFR ratio to below 100% is at an acceptable level.

## Investment management structure

The securities investments of the fund are currently managed by a number of discretionary specialist managers and index tracking (and enhanced index tracking) managers. The reason for using a number of different managers is to spread the investment risk of the scheme. The property portfolio is managed internally.

The management structure is subject to review, generally every five years, by the investment committee and the management committee.

The external managers are remunerated through performance-related fees and the enhanced index tracking managers are remunerated either through ad valorem fees or performance-related fees. The fee arrangements in each case are considered by the trustee company to be the most cost efficient way of remunerating the managers.

## Investment strategy and asset mix

The management committee believes that over the longer term equity investment will provide superior returns to other investment classes. The management structure and targets set are designed to give the USS fund a greater than average weighting in equities compared to the weighting generally held by other funds through portfolios that are diversified both geographically and by sector.

The management committee has determined the appropriate asset distribution, and permitted deviations, for the fund as:

| | % | Divergence limits |
|---|---|---|
| UK equities | 40 | -10% to +10% |
| Overseas equities | 40 | -10% to + 10% |
| Fixed interest | 10 | -5% to + 2.5% |
| Property | 10 | -5% to + 2.5% |

This distribution has been agreed on the recommendation of the investment committee based on its belief that, over the longer-term, the real rates of return of each asset class will be of the order of:

| | |
|---|---|
| Equities | 4.5% |
| Index-linked | 2% |
| Fixed interest | 2.5% |
| Property | 3% |

External specialist managers have been appointed to manage, or advise on the management of, approximately 45% of the fund:

| | |
|---|---|
| UK equities (active) | 5% |
| UK equities (index/enhanced index) | 15% |
| Global equities | 20% |
| Non-government bonds | 5% |

The asset distribution of the internally managed fund is used, to the extent necessary, to balance the asset distribution of the total fund to ensure that it remains within the agreed divergence limits. The indices against which the managers are measured have been agreed with them and the managers are expected to add value by selection against the indices and by asset and sector allocation. They have been informed that USS is a risk-tolerant fund due to its funding level and to the fact that it is relatively immature.

The objective of the index tracking fund is to match the return on the FTSE All-Share Index. This fund is managed by the internal manager acting on external advice. The objective of the enhanced index tracking funds is to exceed the return on the FTSE All-Share Index by 0.5% pa.

The investment objective for direct property investments is to exceed the return of the Investment Property Databank (IPD) universe by 0.5% pa over rolling five-year periods.

The securities assets of the fund are therefore allocated between the managers in an approximate ratio of :

| | % |
|---|---|
| Internally managed balanced fund | 55 |
| Index tracking/enhanced index tracking funds | 15 |
| Externally managed specialist funds | 30 |

This ratio will fluctuate due to stock market movements and cash allocation.

The allocation of cash is reviewed and approved by the investment committee on a quarterly basis.

The asset distribution of the fund is reported to the investment committee and the management committee on a quarterly basis to ensure that the asset distribution remains within the agreed limits. If limits are breached the chairman of the investment committee, after consultation with the investment specialists on the investment committee, will agree with the chairman of the trustee company the appropriate action to be taken.

No more than 4% of the total fund by market value can be invested in one company except for very large UK companies in which managers are allowed a maximum overweight position of 50% of the FTSE All-Share Index weighting with an overall cap of 10% of their part of the fund. No more than 10% of the market capitalisation of any one company (excluding collective investment schemes and companies established by the trustee company to aid the efficient administration of fund investments subject to appropriate controls) may be held without prior authority from the chairman of the investment committee. In both cases, the constraints apply as at the date of purchase.

The chief investment officer monitors the portfolios of all the managers to ensure that an adequate spread of investments is maintained and reports on this to the investment committee.

The external managers may not, as a rule, invest in securities not quoted on a recognised or designated investment exchange. Investment in private equity and other unquoted securities or funds by the internally managed fund is allowed up to a maximum of 2.5% of the total fund. Any such investments are reported to the following investment committee.

Additional assets

Additional voluntary contributions from members to purchase additional benefits on a money purchase basis are invested separately and managed and administered externally. The appointment of AVC providers is subject to review by the management committee.

Monitoring performance

The performance of the fund and of each investment manager is measured quarterly by HSBC against the relevant indices. The performance of the investment managers and the fund is reported quarterly to the investment committee.

The performance of the property portfolio is also separately measured against the customised IPD universe. The IPD performance data is incorporated within the data provided to HSBC by USS Ltd for measurement of the performance of the whole fund against its benchmark.

The internal auditor and chief investment officer visit the external investment managers to check the quality and effectiveness of procedures on a regular basis. The internal auditor monitors the internal manager to check the quality and effectiveness of procedures on a regular basis.

Transaction costs

Each of the securities managers is required to provide a report annually to the trustee company on transaction costs incurred which provides, as a minimum, the information required by the IMA/NAPF Pension Fund Cost Disclosure Code. The external managers are not permitted to use soft commissions in respect of their transactions on behalf of the fund but the investment committee has agreed that the use of soft commissions by the internally managed fund is appropriate and in the best interests of the scheme.

Level of scheme maturity

Although nearly 40% of the liabilities as at the 2002 valuation were in respect of pensions in payment, the scheme is cash flow positive and does not need to realise investments to meet liabilities. The actuary has confirmed that this is likely to remain the case for the next ten years or more.

Stock lending

The trustee company is authorised by the scheme rules to participate in stock lending and has done so since 1998. It has concluded that the risks associated with stock lending in accordance with those lending programmes in which it participates, which incorporate a high level of risk mitigation, are not intrinsically different from those of other market operations and are justified in the light of the return to the scheme in terms of the annual stock lending fees capable of generation.

Any stock lending programme in which the fund participates must provide for all loans to be fully pre-collateralised and be approved by the investment committee acting on legal advice.

Responsible investment

As an institutional investor that takes seriously its fiduciary obligations to its members, the trustee company aims to be an active and responsible long-term shareholder of companies and markets in which it invests. The trustee company pursues this policy in order to protect and enhance the value of the fund's investments by encouraging responsible corporate behaviour.

The trustee company therefore requires its fund managers to pay appropriate regard to relevant corporate governance, social, ethical and environmental considerations in the selection, retention and realisation of all fund investments. The management committee expects this to be done in a manner which is consistent with the trustee company's investment objectives and legal duties.

The management committee has instructed its internal fund managers and called on its external managers to focus their effort on the engagement option, and thus seeks to use its influence as a major institutional investor to promote good practice by investee companies and by markets to which the fund is particularly exposed.

The management committee expects the scheme's fund managers to undertake appropriate monitoring of the policies and practices on material corporate governance and social, ethical and environmental issues of current and potential investee companies.

The aim of such monitoring should be to identify problems at an early stage, and enable engagement with management to see appropriate resolution of such problems. The trustee company will use voting rights as part of this engagement strategy, where voting should be undertaken in a prioritised, value-adding and informed manner. Where collaboration is likely to be the most effective mechanism for encouraging company management to address these issues appropriately, the trustee company expects its fund managers to participate in joint action with other institutional investors.

The investment committee monitors this engagement on an on-going basis with the aim of maximising its impact and effectiveness. The trustee company's governance, social, ethical and environmental policies are also reviewed regularly by the management committee and, where appropriate, updated to ensure that they are in line with good practice for pension funds in particular, and institutional investors in general.

Derivatives

Each of the managers is permitted to use derivatives within limitations specified by the investment committee. The current limit is 5% of funds under their management although the limit for the internally managed fund can be increased to up to 10% with the prior approval of the chairman of the investment committee. In connection with transitional arrangements for a reorganisation of the fund's management, the management committee may approve a higher percentage for that limit, which will then apply in that connection for such period as that committee shall have specified. The use of derivatives is to be solely for the efficient management of the portfolio.

Underwriting

The managers are permitted to underwrite issues provided they are prepared to hold all the stock which they underwrite.