USS

Prudence – a note to employers (21 May 2021)

Employers have been fielding questions from members on expected investment returns and prudence. Mirko Cardinale, Head of Investment Strategy and Advice at USS Investment Management, addresses some misconceptions on these points in more detail here. We also touched on this issue in our latest member webinar, and we have also published a separate technical briefing note on the different factors that influence prudence.

There are a few points worthy of note.

Asset values and forecasts for future returns do not move in isolation. As noted in our 21 May update, covering experience since 31 March 2020, the former clearly influences the latter.

It is not about speculating on the biggest return. To the extent we plan to rely on investment returns to pay the pensions employers are promising to USS members, we need to have confidence in the returns we can achieve. While we expect equities to perform substantially better than bonds over the next decade, that's a 'best estimate' with a substantial margin of error. Expected returns are highly uncertain and, in general, historical returns are a very poor forecast of future returns.

In fact, the only long-term 'guarantee' offered by the market today is a loss (relative to inflation). This is thanks to the relentless decline over the past decade in the prospective returns offered by 'risk-free' assets like government bonds. It is reflected in the price of annuities provided by insurance companies: the cost of buying a £7,500 annual lifetime income for a 65-year man has increased from £100,000 in April 2008 to £150,000 in March 2021 – a 50% increase over the past 13 years.

Our job as Trustee is to identify the cost of securing the benefits already promised to our members, and of continuing to offer the same secure benefits in future. So, we must look at a broad, diversified range of asset classes. Here, the potential highs of equities and the fixed lows of bonds balance each other out.

Central forecasts for expected investment returns are fundamentally different from prudent funding plans. The inherent uncertainty of the former is reflected in the latter. But even under Scenario 3 of the Trustee Update – the prudent basis on which we've initially 'priced' the options in UUK's consultation – we're expecting above-inflation investment returns. This assumes average prudent future returns in the pricing of future service benefits that are nearly 2% better than the 'risk-free' rate and 0.5% above inflation.

Finally, the value of our assets is only part of the picture. In particular, the 'low-risk' or 'self-sufficiency' cost of securing members' pensions at 31 March 2018 was £20.8bn more than the value of our assets at that time. At 31 March 2020, it was around £35bn more. A year later, it stands at more than £30bn – even *after* the recent recovery in asset values. Despite being slightly lower than at the 2020 valuation date, the current self-sufficiency deficit is still much bigger than it was in 2018, and very large relative to the size of the HE sector. The distance from self-sufficiency is central to the long-term funding objective[1] proposed by the Joint Expert Panel. It is also one of The Pensions Regulator's concerns around the amount of risk being taken in our funding plan (relative to the size of the HE sector) and is reflected in its position on prudence. It shows how dependent we already are on employers' balance sheets and uncertain future investment returns. And it explains why we are reluctant to rely to an even greater extent on the latter without greater confidence in having long-term access to the former.

---

[1] *"USS aims to be fully funded on a Technical Provisions basis where Technical Provisions are valued on a low-risk self-sufficiency basis for post-retirement years and on a prudent on-going basis for the pre-retirement years. The Scheme will also ensure that, at all times, the proximity to full self-sufficiency assessed on a low-risk basis can be supported by employers over an appropriate time frame if the Scheme were to be closed to future accruals."*