Our guest: USS

USS (Universities Superannuation Scheme) is the pension fund for 224,000 academics and senior university staff. It is the second largest pension fund in the UK, with assets under management of approximately $53 billion. Created in 1974, the fund is relatively young and consequently has strong positive cash inflows of approximately $1.5 billion a year. Investment management is split between the in-house team managing 75 percent of total assets, and the balance by a number of external specialist investment management firms. 80 percent of the fund is invested in equities. The internally managed American equities account for $3.9 billion of the total. The USS investment philosophy is to take a long-term view.

Jason Fletcher

Jason Fletcher is head of a three person Americas team. He has been at USS since 1995. Jason worked for British Airways Pension Fund between 1990 and 1995 where he followed Asian markets such as Indonesia and Thailand. In 1995 he moved to USS as the head of Asian equities (ex Japan) and in 1998 he moved to the US desk. Matt Clark and Tushna Ghadially are the other Americas fund managers.

What are the differences between managing money in-house and managing money for third parties?

Third Party fund managers probably spend half their time marketing whereas we've got one board to market to so it's not quite as onerous as seeing say 50 institutions a year to keep the business going. 90% of our time is spent picking stocks and sectors. Second, we are not constrained by a house view or onerous restrictions on portfolio weightings. If we underperform it's our fault. In addition, our costs are lower – about a quarter of traditional fund managers.

How do you measure your performance?

Our performance is measured against the MSCI Americas index like many of our competitors. We're playing the same game; we've got the same targets. The American team outperformed the MSCI Americas by 2.47% in 2005. However, more importance is attached to long-term performance at USS. Over 5 years we have outperformed by 1.45% annualized. We have given up some of this performance in 2006.

Why do so few pension funds manage overseas equities in-house?

A lot of people think that you've got to be running a certain amount of money to make it worthwhile. For overseas portfolios it also depends on the relative cost of managing money in the UK or in the local market. Others believe you need fund managers close to the market. In my view, having a bit of distance between you and the market allows you to take a longer-term view in choosing investments.

USS has been criticized for having too much equity exposure, can you explain why your equity exposure is so high?

It hasn't done us any harm this year, last year or the year before but we suffered in 2000, 2001 and 2002. The reason we have high equity exposure is that we look longer term. In the long run we think equities will outperform. USS is an immature fund with liabilities that are due 15 years in the future. 70% of members are active and deferred. Total membership grew 5% last year. However, like other funds we have been considering alternative assets as a way of potentially getting equity like returns but lowering the risk of the fund.

Do you have any investment constraints?

Yes, we have broad guidelines set by the trustees. The trustees also set out-performance targets. In the US alone there are 1,500 companies with a market cap above $1 billion. That gives us enough to look at. Liquidity can be a constraint when you get below $1 billion in market cap. We own about 60 stocks in North America. A holding has to be at least $39 million to have an impact on the fund.

What's the biggest position you can take?

The US team, takes the out-performance targets set by the trustees and sets appropriate levels of risk against the index that should deliver that out-performance. We evaluate risk on individual companies relative to the index weighting. Three hundred basis points at risk is our maximum on an individual company. So for example, if GE is 2.7% of the market, the maximum weighting we could have in GE would be 5.7% and the minimum would be zero.

What's the average length of your holdings?

Two to five years typically. Some stocks in cyclical areas like semiconductors and airlines tend to be held for shorter periods. When you buy something, you've got some idea of where you think it's going to go either relative to the market or in absolute terms. When it gets to that level, you then need to decide whether to hold it or sell it. If it hits that level in two days, you'd call me short term but I'd argue I'm just taking a value decision here.

What is your investment style?

We don't have a specific style. We just keep searching for the style that works. Different styles are appropriate for different markets and different economic environments. We just try to hunt out ways to outperform the market.

Favored sectors?

Our top weighting at the moment is in US banks. We are also slightly overweight in consumer cyclicals and telecoms. Our key underweights are oil and basic materials and we are slightly underweight technology.

Any fund managers you admire?

Not really – the biggest danger of idolizing other fund managers is if you copy them, you are bound to under-perform. I think it is a mistake to tie yourself to one particular style.

How many US companies do you see each year?

There are three of us on the US team and we each try to travel to the US for up to four weeks a year. During a week we might see 20 companies but we also see analysts if we're in New York, Boston or San Francisco. Companies also come to see us in London. In total we probably have 200 company meetings a year.

Given that there are three of you on the US desk, do you specialize in certain sectors?

No, on the American desk we prefer the collegiate approach. I find this encourages internal debate on companies and sectors that we wouldn't have if we were pigeon holed as sector specialists. Hopefully this improves sector and stock selection. However it's important that you work in a team that's keen to share ideas and willing to challenge (or be challenged) by other team members on decisions. Matt and Tushna do a great job keeping me on my toes.

Would you ever consider working for an investment management firm?

I'm very happy where I am. What I enjoy doing is investing money. The marketing side is something I don't know a lot about and I'm wary of it. The reason why I'm in this business is I enjoy the challenge of trying to outperform the market.

Who do you want to see from a US company?

It depends on the level of understanding you have of the company. If it is a first meeting with a company, the IR director can be helpful. I particularly like IR people who that have been hired internally from operations. In the US we rarely see the CEO other than at small companies. Everyone assumes the CFO is the right person as we are financial analysts but for me it's important to understand what the drivers of a company are. That's why I favor operational people. It depends on the company. The CFO of a restaurant or media company is the right person to meet as he hopefully holds the purse strings!

Any tips for US companies when meeting European investors?

US companies can be a little over confident.
It's a cultural thing. A bit of humility can lead to trust. US companies typically prefer not to talk about the parts of a business that are not performing well. They can talk for an hour about a division that is going fantastically well and when you get back to your desk, you realize it's only 10% of the business. I do respect a company that will open up about things that are not working well. Preparation for meetings is very important if you want to get the most out of them. wI see being armed with 10-15 relevant questions as essential.

Which companies do best in telling it how it is?

In the last six months the best meetings I have had have been with Dow Chemical, Beacon Roofing, CME and Boeing. Jeff Immelt struck me as someone who does a good job of presenting his company.

What about corporate access?

I believe corporate access is important for fund managers. We see around a 100 companies a year in the US and a similar number come to visit us in London through brokers and independent investor relations companies like Phoenix-IR. As we only speak to a small number of brokers some companies don't come to see us in the UK. We try to focus on those companies when we travel.

USS has been something of a pioneer in its approach to unbundling, can you talk about that?

The new disclosure rules that came in on July 1, 2006 aimed to improve the transparency between fund managers and beneficiaries. Essentially this is about opening up what trading commission is paying for. Most third party fund managers decided to simply state the proportion of commission paid for each service. For example, they pay $1 million in commission and disclose to their clients it is split 50/50 between research and trading. We took a stronger line separating it out completely, identifying what we would pay for research and other services. The in-house fund management arm at USS is wholly owned by the trustee company. I'm a member of the USS plan as are most people here. Therefore we are all aligned. We have no incentive to understate costs. From the perspective of the fund manager we are looking to get better value for money. By bundling commissions you are fudging the issue. Ideally, we should be dealing with the best dealers, speaking to the best sales people and getting research from the best analysts. If they are not at the same firm, just divide them up and pay them separately. From our point of view, we've had to think about how much research is worth in a lot more detail. We use 4TEUS software to decide how much we pay each broker. This allows us to value the input of individual analysts.

What do brokers think about your stance on unbundling?

Initially they were very wary of any change in commission structure. Now because of this 4TEUS system, we can tell them how much value we put on their analysts. We give the analysts scores. So, to some extent they can work out how much they are getting paid for each analyst, which I think they quite like, as brokers constantly have to review their analysts. I don't think the II (Institutional Investor) survey is a terribly good way of paying analysts so if they can get a fund manager to give them direct information about who really is adding value it would be more useful.

What are the downsides to your approach?

The key risk to our approach is that brokers decide that the payments are not sufficient and reduce the quality of their service to USS. With other fund managers not fully unbundling we need to be careful that we are paying brokers sufficiently well to get the right level of service. We need to monitor this closely in the future. In a bundled world brokers only earn commissions when we put on trades. These payments can be lumpy and very un-predictable. With unbundling they get regular payments for research whether we trade or not. So it should promote long-term relationships with brokers.

How do you see the unbundling issue evolving?

It's too early to say. The uncertainty on tax treatment could slow any move towards full unbundling. Trading commission in the past did not attract VAT. Government, given the legislation, is clearly keen on unbundling. But if investors have to pay 17.5% VAT on research when trading commission is VAT free, that is a lot of money and a potential reason not to do it. However highlighting the pitfalls of unbundling hides the fact that the old system was far from perfect. Fund mangers ended up paying high commission rates and did not always get value for money. There is some friction in the industry as unbundling has been seen as a commission cut but commission rates have been falling anyway. Ultimately it is the client (trustees and beneficiaries) that will choose whether unbundling occurs. I'm not aware of anyone else that is doing it as clearly as us. A lot of people are using commission sharing agreements (CSAs). Some are forcing the smaller brokers to unbundle but not the bigger brokers, which seems odd to me. The assumption is that dealing is better by the big houses but I don't know if that is really the case.