Our guest: Universities Superannuation Scheme

Very few UK pension funds manage overseas equities in-house. The six largest are: British Airways; BAe Systems; BP; BT (Hermes); National Grid (Aerion) and USS (Universities Superannuation Scheme). These six pension funds account for approximately $300 billion of assets. USS is the second largest pension fund in the UK and has $60 billion in total assets. It was created in 1974 and is the pension fund for 224,000 academics and senior university staff. The fund is relatively young and has strong positive cash inflows of approximately $1.5 billion a year. Investment management is split between the in-house team, managing 75% of total assets and the balance by a number of external specialist investment management firms. 80% of the fund is invested in equities.

Elizabeth Fernando is head of European equities at USS. She is responsible for the $5.6 billion European (ex UK) portfolio which she runs with Warren Low. Elizabeth joined USS in 1995 and before that she worked for Lloyds Investment Managers (which became Hill Samuel, later taken over by Scottish Widows).

Talking about the differences between running third party money and running an in-house fund, Fernando says "as an in-house fund manager your priorities are different - you've got one fund and one client; the whole team's bonus is linked to the performance of that one fund so it encourages a better team environment – sharing ideas both within teams and across regions which results in improved performance is rewarded. You are measured and judged on performance alone. New funds won or accounts retained which might be objectives in third party asset managers play no part. I think there is an unfair perception in the market that in-house managers are less able than their external peers – in my experience that is simply untrue – there is huge pride in outperforming our external managers particularly as we have far fewer resources at our disposal."

Talking about USS's investment style, Fernando builds the portfolio very much on a bottom up basis – she is looking for high quality companies who deliver consistent and improving returns for their shareholders. Collins Stewart's Quest model is a useful tool to find stocks that fit certain criteria. For example, she can ask for companies that are growing sales at >4%, who have been improving their return on capital over recent years and who have a high dividend yield. Fernando says "you can basically stick any criteria you want into it and it provides a list of names on which I then undertake further fundamental research before deciding which if any to invest in." While USS doesn't impose any official market cap restrictions, from a practical point of view, it tends to stick to the larger names. "We really need stocks we can invest or divest half a per cent of the European portfolio without impacting the price within a reasonable time frame. As a broad guideline we look at stocks with a free float above $1 billon" says Fernando.

Guidelines have been agreed with the trustees such as maximum and minimum overweights but they are suitably wide so that they don't actually constrain anything fund managers would want to do. Generally, the European team has a lot of freedom. Incredibly, back at the end of the '90's, 13% of the fund was invested in one name. The 13% position was Nokia and it was "a very high conviction call – things were going very well for them at that point and analyst expectations were lagging the commercial reality", says Fernando. It turned out to be "a really good year" for the European portfolio. USS doesn't have anything as extreme as that at the moment – its biggest bet is currently about 3.5% of the fund. The European team aims to maintain sector weightings in a band of 2.5 – 3% underweight or overweight but this is not rigidly adhered to if a strong opinion is held. For example, for a few years USS was zero weighted in utilities yet it is roughly 6% of the index.

There are no sectors USS won't invest in but Fernando does not favour airlines. She finds them very volatile and feels it is difficult to argue that they are long term value creators, which is what she looks for. She acknowledges that a few of the low cost carriers now do have sensible business models and are generating good returns but still regards the old national flag carriers as "pretty awful". Biotech companies also are often too small to invest in. There are no geographic constraints either as the fund is run very much on a sector basis. The country weightings are the result of where fund managers find the stocks.

Therefore a fund manager won't buy a French company simply to increase the exposure to France or a sell a Spanish company simply to get the weighting down in Spain. The only exception is emerging markets as Fernando does maintain a focus on the emerging markets exposure versus the index due to their greater volatility.

As well as being a "bottom up stock picker", Fernando also "has a bias to quality which last year didn't do us any favours. However, we are investing for the long term and for that you need to be confident that you are investing in businesses with clear strategies and sound finances which are able to deliver good results in the long term." The average length of a holding is between two and three years.

The European desk's responsibilities are split loosely by sector but being a team of three, all members of the European team need to be able to have a view on all areas. For example, although Warren Low has primary responsibility for telcos, Fernando needs to know why he has taken the decision he has so that she knows his views well enough to take a decision in his absence. The team is not split by geography either but Fernando tends to focus more on emerging markets than her colleagues given that she has more experience in this region.

Talking about the outlook for European markets more generally, Fernando is "pretty optimistic" while conceding that "all markets are a bit extended at present." She believes Europe has a very strong secular story behind it. She points out "it had been lagging on economic growth" but says "that now is quite clearly improving in a number of the large economies." She also feels the restructuring which has been going on behind the scenes for a very long time is beginning to show through in margins and profitability. Her optimistic view on Europe is backed up by the asset allocation figures - Europe is one of USS's overweight markets, ranking second behind Asia (ex Japan) in weighting at the moment.

The European portfolio is currently very overweight capital goods. Fernando is "still pretty relaxed on economic growth". She acknowledges that this is "probably a bit non-consensual" but adds "analysts have been forecasting peak earnings and peak margins for the last three years and it's turned out not to be true. Order books remain very strong and all the companies I am talking to are saying demand remains robust. I also feel analysts underestimate the improvement years of restructuring will yield in terms of margins and return on invested capital". She also has big exposure to the auto sector because of restructuring stories.

The USS team tries to see all its holdings at least once a year. (It currently has about 65 holdings). The team sees companies when they come through on road shows as well as visiting management in their home markets. Not surprisingly given in-house pension funds' low visibility, corporate access can be a problem. This is partly because USS is not high profile as a fund and partly because everything is held via a nominee account so USS's name doesn't always appear on the share register. However, once companies understand who USS is, how big it is and how much stock it owns; there's rarely a problem. Fernando insists her team prepare thoroughly for meetings - "if the management are taking the time to meet with you, you should do them the courtesy of being well prepared". Also, once the team has met a company it tries to stay in pretty regular contact with them. The other problem is if a company does a road show with a broker USS doesn't talk to. USS can get overlooked when brokers allocate one-on-ones given that it is not a huge client (as it doesn't trade stocks!). This is ironic given that USS is likely to be just the kind of institution companies would rather have on their share register.

Fernando dislikes the fact "one-on-ones always go to the likes of Capital, Fidelity and the big usual suspects." Her advice for how companies might increase their European shareholder base would be to offer houses like USS small shared meetings. She is happy to share with other similar institutions. This way the company gets to see three or four times as many people and the deterioration in the quality of meeting is not significant (unlike going from a one-on-one to a group lunch of 40 people, for example). She's not sure that this will happen, however, given that brokers don't like organising small groups as they get votes from houses for providing one-on-ones. She concludes that the difference between having a one-on-one and having a small shared meeting (provided you don't have one fund manager dominating) isn't enormous. She feels "you can go from three to 10 or 15 in a room but once the numbers get larger, your inclination to ask questions goes down and companies' inclination to answer questions fully also goes down. The whole experience is less rewarding."

In terms of which nationalities are best at IR, USS finds the Swiss are typically very well informed. Who USS wants to see from a company depends upon what the team wants to know. For example, Fernando believes "if you want to talk about strategic direction and really understand how management see their business then you do need to see the management as IR is just too removed from the Board room debate and there is the danger that you get IR's view on what they think the story is rather than what management would tell you if they were sitting there. On the contrary if you want a trading update or you are just getting to know a particular business then instead of going off to see the head of each division, IR has a very good role to play there." She rates Sergio Marchionne, current

CEO of Fiat, as being particularly rewarding to meet. She's seen him in numerous CEO roles and commends him for being "very clear on his targets and vision and he is very outspoken". CRH, the Irish building materials company is also singled out for praise. "They always do a fantastic job. They are very good and well prepared. As a complete package, they would be one of my top IR choices."

USS will invest in a company if they've not met management but likes to see them fairly soon afterwards. If USS has had no contact with a company it would try and make sure it saw management next time they were coming through on a road show or it might get a broker to set up a trip to see them. USS uses around 12 brokers and, as might be expected, the service varies greatly from country to country. In some markets USS uses a local broker – for example in Switzerland, Ireland and Scandinavia. It also makes extensive use of independent research houses. USS uses Independent Minds on Holland which it rates very highly. It also uses Drug Analyst for the pharma sector. USS is happy to pay for research as it is "completely unbundled." This is another major difference between an internal and external fund manager as USS has only one client so it doesn't matter how the expenses get taken. Under the traditional bundled approach the client pays for the cost of third party research in commission. In an unbundled world a much lower rate of commission is paid on transactions with research paid for separately by cheque. For an external fund manager which has a variety of clients, unless it can persuade those clients to reimburse it for research paid for by cheque those costs will come directly out of the fund manager's P&L and will therefore dent profitability whereas if the cost is all buried into commission, the client pays for it.

It is not clear why relatively few UK pension funds manage overseas equities in-house but Fernando feels "there's probably an issue of scale - as fund sizes tend to be smaller and you still need a reasonably sized team to run the money effectively. The cost advantage of being in-house versus external is much lower." While the European portfolio at USS is substantially smaller than the UK portfolio ($5.6 billion versus the UK's $12.4 billion), Fernando points out that the European desk still has the same number, if not more, companies to look at. Also, it is set more demanding performance targets so it arguably requires a similarly sized if not larger investment team. The obvious disadvantage of working in-house therefore is "resource". While Fernando has a team of three on the European desk currently, historically it's been as small as a team of one yet it covers 20 markets. USS competes against external fund managers who might have a team of five, six or seven and they may very well have in-house analysts. USS doesn't have any in-house analysts - all fund managers do their own research.

Asked if there's less pressure managing money in-house, Fernando responds "I think it's a different pressure. You don't have the marketing department pressure, you don't have to slavishly look at weekly or monthly numbers and there's not someone standing over you wanting to know why you've done this and why you've done that but on the other hand given our smaller team there are times when there are simply not enough hours in the day to stay on top of the volume of information getting thrown at you. I think any fund manager wants to do as well as they can as ultimately your performance shows your skill and is your reputation".

So how does USS's performance stack up against the competition? Fernando acknowledges "it has been very volatile." This is partly because it has emerging markets within the fund and partly because Fernando prefers running a more concentrated style of portfolio which means "when you get it right you get it incredibly right and when you get it wrong you tend to get it very wrong." USS benchmarks its European portfolio against the MSCI All Countries Europe ex UK. They had a very good year in 2005 and were 2.4% ahead of the index. However, in 2006, the performance, like many others, was pretty poor – 3.1% behind. Fernando explains "in 2005 we had very good stock selection on both the big overweights and the big underweights. In 2006, our big overweights and underweights did give us a positive contribution but it was far smaller and ultimately was insufficient to offset the substantial mid cap out performance we saw last year. In addition we were hurt by the focus on takeover speculation – we didn't have a single stock bid for last year."

In spite of being in a minority, Elizabeth believes the outlook for in-house teams managing overseas equities is "pretty good." Partly because over the longer term internal pension funds have performed at least as well as their external counterparts and partly because more assets are coming out of the UK into overseas markets which means pension funds can afford to resource their overseas desk to the degree that they need to be resourced.

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