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USS looks at high yield and emerging market bonds

By Andrea Venturini | Published: 20 February 2012

With government bond portfolios at the centre of the sovereign debt storm, the £33bn Universities Superannuation Scheme is looking at high yield and emerging market debt to add value to its strategic asset allocation. The scheme's deputy CIO and head of European equities Elizabeth Fernando talks about the two asset classes and the best way to enter them.

The UK's second largest private pension scheme is considering outsourcing its first high yield and emerging market bond mandates to external asset managers.

Speaking to *MandateWire* at the second annual Organisation for Economic Cooperation and Development World Pensions & Investments Forum, organised jointly by the OECD and the World Pensions Council in Paris, Ms Fernando says that if the Universities Superannuation Scheme (USS) decides to invest in these assets, it would probably choose active managers.

"But that decision has not been taken yet," she says. "We will decide if we want to be in those asset classes and then we'll decide how best to access them."

Fixed income

The fund has already introduced some changes to its fixed income portfolio, hiring BlueBay Asset Management, Legal & General Investment Management and Royal London Asset Management to run active investment grade bond portfolios in the first half of 2011.

> “Credit may not be a long-term strategy”

"We don't have an in-house credit team and the number of people we would need to hire to make it a sensible and valuable business is too large. Also, credit may not be a long-term strategy," she says.
Across 2010 and 2011 the scheme also upped its allocation to UK gilts and decreased its global bonds portfolio. Until 2011 the fund employed Capital International as its only external manager, handling active global equities.

At March 31 2011, USS's asset allocation stood at 57.8 per cent equities (including 51 per cent developed market and 6.8 per cent emerging market equities), 10 per cent global government bonds, 4.5 per cent liability hedging assets, 1.9 per cent credits, 10 per cent property and 15.9 per cent alternatives, comprising infrastructure, hedge funds, private equity and timberland.

Private equity investments are managed through an internal fund of funds, while for hedge funds the scheme hired UBS Fund Services to provide an administrative platform.

"The UBS platform has given us better visibility over what our managers are doing. We like having managed accounts, we like having visibility over the assets, we have ownership of the assets," Ms Fernando comments.

The scheme invests through about 60 private equity funds and hedge funds and one timberland fund. Investments in infrastructure are made both via global funds and direct partnerships, including a long-standing relationship with Australian manager CPG Capital Partners.

“We like having visibility over the assets”

USS is also considering participating in the UK Infrastructure Project, the government’s programme aimed at driving the country’s growth with the help of institutional investors. Ms Fernando says the fund might take part in the initiative but insists the benefit for members have to come before the moral implications of investing in the plan.

“We are going to participate if we find the returns attractive. We will not do something simply because it is a good thing to do. We are quite pragmatic about that,” she insists.

USS recently signed off an investment strategy review, the results of which are yet to be made public. The study followed the scheme’s actuarial valuation as at March 31 2011, which showed a £2.9bn deficit, Ms Fernando reveals.

Despite this, the fund is not arranging a recovery plan but has simply increased contributions for both members and funding institutions.

Funding gap

“When we did this exercise [the actuarial valuation] three years ago, the future asset growth we anticipated was sufficient to close the deficit within the time horizon that the regulator was comfortable with. So we didn’t need extra contributions going in,” Ms Fernando says.

“And we also increased contribution rates for both institutions and members last year. It is not directly because the regulators asked us to do it. We looked at the cost of providing the benefits and we think that that was a sensible thing to do,” she adds.

The valuation results have only partially influenced the new strategic asset allocation, while the situation in the markets has also influenced the discussions.

“[Changes in the asset allocation] were partly reflecting the valuation’s results but also reflecting where we felt the market values had moved. Derisking is a theme that is being pushed on all pension funds at the moment,” Ms Fernando says.

“We used to be able to say the tipping point was 20 years away and it is probably now 12 years away. You cannot run a portfolio that is 80 per cent equities and alternatives. As you get closer to that tipping point you need to start moving towards matching your liabilities but then you run into these problems I alluded to: what do you invest in that is going to meet that objective? So it is a combination of all those factors that resulted in the strategic asset allocation.”

The fund is closed to new members but is still open to future accrual and Ms Fernando says she hopes it will remain this way.

“The pension fund is very important to the overall proposition for higher education and its ability to attract and retain the kind of staff that they need and deserve to have, so I think they will try very hard to keep that scheme open,” she says.