Form for Responding to Consultation Questions

1. Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) above?

☒Yes ☐ No

Comments:

<u>Pension market context is important</u>
We think it is important to set in context the aspiration of the MPFA's consultation with the evolution and growth of the global pensions market. At the end of 2013, 47% of global pension assets were invested in Defined Contribution ("DC") structures, according to the Towers Watson Global Pension Assets study, published February 2014. The study found that DC assets in the largest seven pension markets (Australia, Canada, Japan, Netherlands, Switzerland, the UK and the U.S.) have historically been growing by 8.8% per year for the last ten years against 5.5% per annum growth in the Defined Benefit ("DB") pensions market. Hong Kong has also demonstrated strong pension assets' growth of 12.1% CAGR when measured in U.S. dollar terms over that time horizon.

This is significant as it highlights the imperative for MPFA to get right any decisions and design outcomes arising from this consultation.

<u>Transition</u>
We note that a number of MPF Schemes already offer default, or core funds, within their fund ranges. It will be necessary to consider how these existing arrangements will sit alongside the new Core Fund, including whether participants in those existing default funds would be required to transition to the new Core Fund, over what time frame and the extent to which they would be expected to bear any set-up or transition costs.

<u>Performance must be considered alongside costs</u>
It is important to finely balance the stated objective of capping total fees with the need to deliver consistent and superior investment risk-adjusted returns net of fees for participants. We support the MPFA's desire to manage costs to participants, but this should not be at the expense of generating returns either inclusive or exclusive of fees. Whilst a passive-only Core Fund structure may be likely to meet the low cost objective, it may not deliver the superior returns that exposure to certain actively-managed strategies may be able to achieve. We do not believe that superior performance and low cost

are mutually exclusive.

In our responses to this consultation, we explain why we support the inclusion of private equity as an investment option within the Core Fund. We believe that private equity can generate valuable outperformance that can make a meaningful difference to the ultimate retirement outcomes for pensioners.

We strongly advise against a default to a 'good enough' investment design for the Core Fund, which might be the outcome if the construction is driven only by the aspiration to achieve low costs while performance is less prioritised. A number of research papers and articles have commented on the underperformance of actively-managed equity target date funds relative to mutual funds and this should provide an important caution when designing the Core Fund.

Furthermore, individuals often demonstrate bad market timing, switching out of equities and into cash at market lows, reinforcing the need for a well-diversified performing portfolio in which participants have confidence. Boston-based market tracking firm, Dalbar, found that over the past 20-years, investors in mutual funds performed 3.96% worse than the mutual funds themselves, because of their bad timing. Data collected by the U.S. Investment Company Institute shows a low tendency for withdrawals from target date funds, which is encouraging, given the often under-appreciated costs of switching and redemption that can apply.

Target Date Funds should be the preferred structure

In regard to the structural options, from the experience of the defined contribution market in the U.S., it is clear that over the last five years or so there has been a significant shift to adopt Target Date Funds (TDFs) as the default option for investors. A report from Cerulli Associates in March 2014 (*Cerulli Projects that Target-Date Strategies will Capture Nearly 65% of 401(k) Contributions in 2018, The Cerulli Edge - Retirement Edition, 1Q 2014 Issue, March 2014, Boston*) found that 36.4% of U.S. 401(k) contributions went into TDFs in 2013, while TDFs accounted for 16.7% of all 401(k) assets. By 2018, Cerulli expects these figures to have increased to 63.4% and 35% respectively.

Automatic enrolment has had a dramatic impact on retirement saving in the leading pension fund markets. In the U.S., the Plan Sponsor Council of America reports that approximately 47% of 401(k) plans use automatic enrolment and of that number, TDFs are the default option for more than 73%. It added that new plan participants are also most likely to choose TDFs even when they are not automatically enrolled. In the UK, automatic enrolment is a recent innovation. To facilitate its introduction, UK pension scheme employers may meet their new duties of automatic enrolment through an independently delivered option, known as NEST, which offers a default pension structure as one plan option. It reported recently that 99.8% of NEST members use the default structure which is composed of 47 single-year TDFs, risk managed for each year of retirement. Other plan options are also available, and offer the same low charges as the default fund. NEST likes the TDF structure because it can manage volatility through the lifetime of a fund; and it takes a dynamic approach to fund management for the same reasons. From these experiences, we conclude that TDFs are the logical structure to employ for the MPFA's Core Fund.

The reason for the popularity of TDFs is that sponsors are able to translate the disciplines of running money in their Defined Benefit (DB) plans to benefit Defined Contribution (DC) participants: the investment horizon is long term and the asset allocation, manager selection, rebalancing and so on, are professionalised for the participants, in this format. The objective is essentially the same as in the DB world: to manage the risk/return profile of the participants' investments and to generate as much value as possible and to help them to retire with sufficient funds. This is borne out by Cerulli Associates, which found in its March 2014 report that the surveyed investment managers identified asset allocation and risk management as the most important drivers of TDF growth.

For participants, the simplicity of a TDF is the key driver for adoption. The TDF structure addresses key hurdles to increasing retirement saving, namely:

- Participants being daunted by complexity
- Too much choice
- Natural risk-aversion
- Unfamiliarity with pension and investment matters
- Fear of making the wrong choices
- Pensions are regarded as dull and so discourage engagement
- Inertia

Therefore, any default TDF should be simple, and limit the choices and decisions participants need to make. We believe that participants in any MPFA Core Fund should be given the option to invest in one fund right through to retirement via a default fund which automatically adjusts as they progress towards their identified retirement date.

<u>Design of the Core Fund should incorporate an alpha-generating component</u>

However, as with any investment product, not all TDFs are created equal. We believe that the MPFA's principal objective should be to construct its Core Fund based on the needs of the majority of participants in that fund, taking into consideration the investment knowledge of participants, and that it should follow the following design principles:

- The Core Fund should be age-appropriate, i.e. it should be designed as a series of single-year TDFs reflecting a participant's retirement year
- It should be professionally-managed
- It should offer a diversified investment strategy to generate growth and manage volatility
- It should be equity-focused in the early years and gradually adjust the asset allocation to reduce risk as the glide path towards retirement progresses
- The number of funds (investment options) within the Core Fund should be no more than the number needed to construct a sensibly diversified portfolio
- These investment options should have clearly-stated investment objectives and be easily differentiated from one another
- Make available a custom model for more investment-savvy participants.

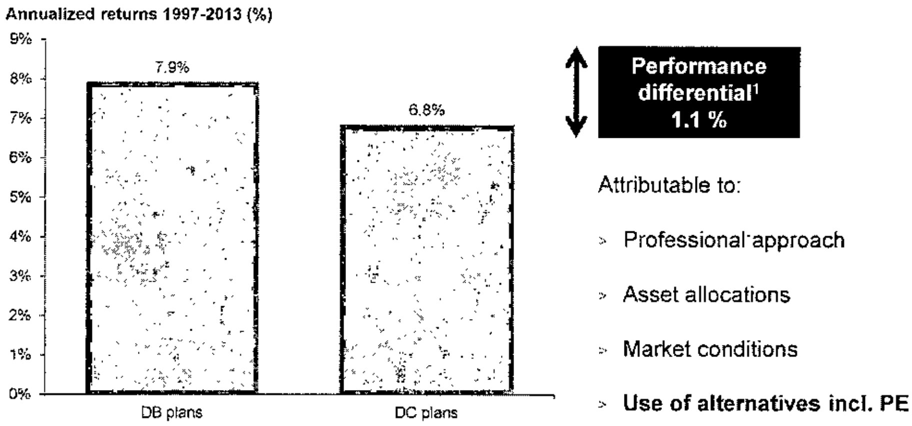
We believe the final point above should not be discounted from consideration by MPFA, and that it could be accommodated within the Core Fund structure. In terms of the optimum number of funds or investment options within the Core Fund, we note the average number of Constituent Funds currently offered by MPF Schemes is 12. This is lower than the 18.4 average number of fund choices in a U.S. 401(k) plan (when a TDF is counted as a single option) according to research conducted by Vanguard ("How America Saves, 2013"). The same research discovered than on average, there are eight investment options or funds with a single TDF.

That being the case, the need for superior returns is paramount and the selection of Constituent Funds is therefore critical. Small amounts of alpha compounded over the working life of a plan participant can make a significant difference to their retirement income.

In their search for better returns, many DC sponsors have started to look at how to translate their positive experience of alternatives, such as Private Equity (PE), in their DB plans into their DC offerings. In February this year, BlackRock became the latest major scale DC fund provider to incorporate alternative funds within its TDF range. It joined a number of established TDF managers, including Russell Investments and Franklin Templeton, that incorporate alternative funds within their TDF design.

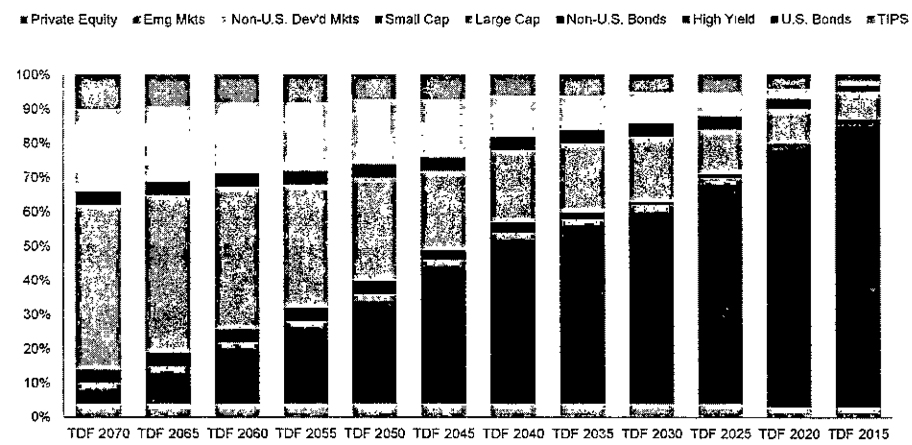
The chart below shows the historic performance of DB versus DC plans. This shows that for the 17-year period from 1997-2013 DB plans outperformed DC plans on a total return basis, delivering 1.1% of outperformance over that period.

Clear added value



[1]17 years ending 2013. Returns are the compound average of annual averages. There were 3.037 U.S. DB plan and 2,020 U.S. DC plan observations. Source: CEM Benchmarking Inc. Past performance is not necessarily indicative of future results.

We noted earlier that the TDF structure offers many of the characteristics of a DB approach to managing assets. We, therefore, believe it is a natural home for alternative investments as part of the asset mix. In order to add value, we would anticipate that an allocation in a TDF to Private Equity ("PE") in the form of a sleeve would start at somewhere in the range of 8% of the overall fund and that this would trend towards 3% of the fund at the maturity date. We show below an indicative glide path of the asset mix of a retirement year TDF that incorporates PE to illustrate this point:



Model portfolio for illustrative purposes only.

As part of the overall asset mix, the sleeve is shielded to some extent from participants' contributions and redemptions and is subject to the rebalancing requirements of the TDF which take place from time to time. Whilst investments in private equity are generally illiquid in nature, we believe that a daily liquidity requirement for the TDF is therefore less of a concern but nonetheless there is a need to provide a daily valuation for the sleeve so that participants can be confident that their trades in the TDF reflect the fair value of the PE assets at all times. As noted above, TDFs experience consistently low withdrawals so the requirement for liquidity would seem to indeed be manageable even when less liquid investment options are included as part of the Core Fund. The U.S. Investment Company Institute reported that only 1.3% of DC plan participants took withdrawals in Q1 2014, the same percentage as Q1 2013 (ICI, *Defined Contribution Plan Participants' Activities, First Quarter 2014*).

The investment objective of a PE sleeve would be to generate excess returns over publicly-traded indices (targeting 2-3% per annum net of all fees) by investing in high-quality private equity assets. The PE sleeve would seek to generate its returns primarily through capital appreciation, with some contribution from investment income. The exposure to private equity assets would be achieved through primary commitments to, or secondary purchases of, private equity fund interests, although other strategies (such as co-investments alongside private equity funds into individual companies) would also be pursued.

The targeted composition of the PE sleeve under normal circumstances would be expected to comprise a 70% weight to high quality private equity investments and a 30% weight to ETFs that are designed to provide exposure to the performance of a diversified group of large companies by tracking indices such as the S&P 500 Index. The PE sleeve's investments in ETFs would be selected to replicate the beta component of private equity returns.

The PE sleeve would initially invest in private equity secondary investments. The PE sleeve would therefore be invested at a faster pace than would be the case for primary investments and since these investments are more mature, they would typically be ready to make distributions to investors. The sleeve would then use these distributions to re-invest in primaries.

The percentage of the PE sleeve's assets invested in private equity investments would vary according to some key factors:

1. The Core Fund's overall portfolio composition at any given point in time, in particular, the maturity profile of the underlying private equity investments
2. The expected additional contributions and withdrawals by participating plans
3. The proximity of the TDF to its maturity date

The Core Fund would also invest in cash or an equivalent but this cash position would normally be a small proportion of the sleeve's assets.

We believe that the ability to gain access to PE in its traditional form will help to add considerable value to DC participants' savings over the long term. We noted earlier the underperformance of actively-managed equity funds within TDFs relative to mutual funds, which points to the urgent need for improved investment options, including those with the potential to generate alpha, such as private equity.

Clearly any PE constituent fund would need to be managed by an appropriately qualified and experienced private equity manager, such as

2. Do you agree that it is appropriate that the core fund be based on a standardized default fund?

☒ Yes ☐ No

Comments:

We have concentrated the majority of our comments in our response to Q1. Our responses to the subsequent questions are commensurately shorter.

The over-riding objective of the Core Fund is to achieve superior risk-adjusted returns at a low cost for participants within a simple design. There does not appear to be advantage to adding unnecessary choice, not least given that a number of MPF Schemes already offer default fund options to their participants. That being said, it may be that there will be a number of MPF Schemes with established relationships, or even contracts, with existing investment managers which may necessitate some flexibility with the design while allowing the Core Fund to be substantially the same across all MPF schemes. It will also be important to avoid concentrating risk within too narrow a range of investment options and/or investment managers. We have noted above, however, that consideration could be given to offer a custom model for more investment-savvy participants, but this may not be appropriate in every MPF Scheme, subject to the mix of participants.

3. Do you agree that it is appropriate that the core fund be based on a standardized default fund?

☒ Yes ☐ No

Comments:

To address the issues of complexity and fear of making the wrong choice, it seems important that the design of the Core Fund should be common or standardised as much as possible in order to build familiarity, trust and encourage take-up.

As per our response in Q1, we believe that a Core Fund set up as a TDF makes sense because the investment horizon is long term and the asset allocation, manager selection, rebalancing and so on, are professionalised to manage the headline risks for the participants as well add value over the long term. However, the way that the asset allocation of a TDF is managed and the quality of the managers employed over the long term will lead to different performance outcomes and we would argue that adding a well-managed PE sleeve to the mix can support positive outcomes for participants. Standardising the asset allocation design of the Core Fund will also help to mitigate those differing performance outcomes, but they will not be eliminated, particularly if the Core Fund permits wide choice of constituent funds or investment managers across different MPF Schemes.

4. Do you agree that the appropriate investment approach of the core fund is one that automatically reduces risk over time as the member gets closer to age 65? If not, what other option would you propose? ☐Yes ☐No Comments:
5. Do you have any preliminary views on the technical issues set out in paragraph 48, in particular whether consistency is required on all aspects of default fund design in all schemes or can some elements be left to the decision of individual product providers? Comments:
6. Do you agree that keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach? ☐Yes ☐No Comments: Having a fee cap at 0.75% seems to be a reasonable initial approach. It is important to prioritise the overall objective of generating strong returns for DC participants and so the fee cap should not preclude the use of alternative asset classes like PE, which are relatively expensive to invest in. However, as highlighted in our response to Q1, we would expect a target objective for the PE sleeve to consistently outperform listed markets by 2-3% per annum net of all fees. Participants should be aware that investing in a PE sleeve is likely to incur total fees and expenses in the range of 1.5-2.0% per annum. At the TDF level, it would be possible to combine allocations to low cost investments in the listed capital markets with allocations to PE so that the combined fee load did not exceed the stipulated fee cap.

7. Do you agree that keeping total expense impact (i.e. FER) for the core fund at or under 1.0% over the medium term is a reasonable approach?

☐Yes ☐No

Comments:

As highlighted in our response to Q6, the fee cap at 0.75% initially seems reasonable and the FER could be kept at or under 1.0% in the future, depending on the needs of participants and the results generated by existing ongoing investments. Our suggested approach under Q6 of combining low cost investments such as index-tracking funds with PE investments would provide a viable approach to managing costs under or to the stipulated caps.

Fees and expenses are major concern in all of the big DC markets and this is certainly the case in the U.S. where sponsors and regulators are keen to ensure that participants receive value for their money. However, high quality PE remains an attractive asset class for many investors because of a proven historical track record for generating superior investment returns.

8. Do you agree that passive, index based, investment strategies should be the predominant investment approach in the MPF core fund?

☐Yes ☐No

Comments:

9. Are there particular asset classes which you think would not appropriately be invested on a passive, index based approach?

Comments:

Certain assets do not lend themselves to passive management. These include private equity investments. We believe that it is possible to combine passive and active management to achieve the outcomes the MPFA seeks of a Core Fund, and that this should be the preferred design structure. This would allow for the low cost aspiration to be achieved alongside the opportunity for superior investment returns. We encourage the MPFA to follow the UK's NEST in adopting a dynamic approach for the management of its default fund rather than to rely upon passive management to deliver optimum retirement outcomes for participants.

There are, of course, other components which will help to underpin costs beyond reliance on passive management: building scale and encouraging automation are two of them. Scale is most likely to be achieved if the design of the Core Fund is right (please see our responses to Q1 in this regard) as this will help to encourage participation. NEST's early success in attracting 99.8% of its members to its default structure is an inspiring example of how attention to and implementation of a good design can deliver results.

10. Do you agree that the name of the core fund should be standardized across schemes? If so, do you have any preference amongst the possibilities set out in paragraph 77 above?

☐Yes ☐No

Your preference:

☐"MPF Core Fund" (having regard to its use as a core investment approach for retirement savings)

☐"MPF Basic Investment Fund" (emphasizing its design as a basic investment approach for retirement savings)

☐"MPF Simple Investment Fund" (emphasizing its design as a simple investment process for retirement savings)

☐"MPF Default Investment Fund" (reinforcing that its primary design is built around the default investment strategy for those who do not, or do not want to make an investment choice in saving for retirement)

☐"MPF "A" Investment Fund" (or some other term which removes any implications about the nature of the strategy)

Comments:

11. Do you agree with the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79?

☐Yes ☐No

Comments:

12. Do you agree with the proposal in paragraph 81 as to how to deal with the transition for existing MPF members of default funds?

☐Yes ☐No

Comments:

Information of Respondent

(Please refer to the Personal Information Collection Statement on pages 47 and 48 of this Consultation Paper)

Name (optional):

Organization (where applicable, optional):

Address (optional):