Consultation Paper on

"Providing Better Investment Solutions for MPF Members"

Response from:

Date: 30 September 2014

Consultation Paper on "Providing Better Investment Solutions for MPF Members"

Q1. Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) above?

Comments:

supports the direction to standardize the default fund arrangement. However, we have significant concerns on the name of "core fund" (核心基金). The naming convention implies that the core fund is the recommended investment option, which would be highly misleading for members.

A consistent approach to default arrangement across all MPF schemes could be achieved through guiding principles and it is crucial to allow flexibility to MPF service providers to implement the approach that best fits its operational efficiency. Among the two approaches, the target date approach is more preferred than the life cycle approach with rationale below.

"Life cycle" approach

The life cycle approach could be implemented with a pre-determined switching mechanism among a few CFs in order to achieve the target mix of equities and fixed income instruments upon members reaching different ages. However, the major drawback of switching among CFs is that it involves redemption and subscription of funds. Such pre-determined redemptions could arise during unfavorable market conditions resulting in significant investment losses for members, especially relating to the equity allocation.

In addition, once members make a fund switch, the automatic re-allocation among the CFs should be discontinued. Members may not understand this mechanism and thus may not be aware that the automatic re-allocation of their portfolio has been discontinued and therefore may be unaware of their actual exposure to market volatility.

"Target date" approach

Under the target date approach, the adjustment to the target mix of equities and fixed income instruments would be carried out within each CF. It is therefore seamless to members as it does not involve redemption and subscription of funds. This approach is easy to understand, straightforward and flexible. Also, a typical glide path allows the adjustment of asset allocation within a range of equities and fixed income instruments. The greatest advantage of the target date funds is that investment managers may exercise a degree of discretion based on their professional endeavor to protect members' interest if market conditions are unfavorable.

Q2. Do you agree that the CF that is the default fund should be substantially the same in all MPF schemes?

Comments:

supports the approach to standardize the default fund arrangement, but the extent of "substantially the same" should only reference the investment mix between equities and fixed income instruments in the broadest sense. However, the investment outcome will necessarily be different.

The default fund could be governed by guiding principles specifying the range of equities and fixed income instruments at different age ranges of members or over the investment horizon of the CFs. The default funds among different MPF service providers would then maintain a degree of consistency based on such guiding principles while enabling differentiation and flexibility for investment managers to act in the best interest of members.

Q3. Do you agree that it is appropriate that the core fund be based on a standardized default fund?

Comments:

As stated in our comment to Q1 above, we have significant concerns that the concept/name of "core fund" would be misleading.

Caution is required in managing member expectations when positioning the default fund concept. It should not be promoted as necessarily a suitable investment choice for members as the default fund would only consider the age of members in its design. Other factors, such as individual financial or personal circumstances and risk appetite, have not been taken into account. Preferably, members should review their own retirement planning and needs when choosing suitable CFs, including the option to choose a new default fund(s).

Q4. 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?

Comments:

supports the general view to reduce risk over time when members approach their retirement ages. Given the limitation that the most relevant personal data in the records of MPF service providers is the age of members, the default fund, which automatically reduces risk over time as members approach age 65, would be a practicable investment approach. However, it is not necessarily the most suitable investment approach for members as it has not taken into account factors other than age (such as individual financial or personal circumstances and risk appetite). It has also assumed that members aim to retire at age 65.

To echo the objectives of implementing a consistent default fund arrangement across all MPF schemes, our view is that a glide path could be set out as the guiding principle. However, it is crucial that the range of equities and fixed income instruments at different ranges of ages should be broad enough to enable investment managers to exercise their professional judgment. If the band is narrowly defined, forced rebalancings may become inevitable, resulting in suboptimal performance results for members.

Q5. 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:

- 48(a): "whether the preferred approach is a series of target date CFs that adjust risk in each target date CF over time or a life cycle approach that varies the member's holdings of different CFs over time"

  Although both the target date CF and life cycle approaches could possibly achieve the risk adjustment objective over time, the life cycle approach inevitably involves redemption and subscription of funds and such forced redemptions could arise during unfavorable market conditions. The target date CF approach would be more flexible in terms of protecting members' interest as investment managers could exercise their discretion to adjust the portfolios and avoid forced redemption of securities if, for example, they foresee recovery in the market.

- 48(b): "if a series of target date CFs is the preferred approach, how many funds are needed: is one fund every 5 years adequate or are more or less funds preferred, taking into account the establishment and maintenance costs of new funds"

  One fund every 5 years would provide a better matching closer to the retirement year of individual members.

- 48(c): "what types of assets should be the investment building blocks at the underlying fund level: more sophisticated design might require more asset types, however, this will involve greater complexity and costs"

  The investment building blocks at the underlying fund level could follow the current legislative restrictions and it is not necessary to specify further guidelines or restrictions for the default fund. This would allow MPF service providers to make use of their existing underlying APIFs to achieve better economies of scale.

- 48(d): "which investment building blocks are more appropriately managed in a passive manner"

  We strongly recommend that the MPF service providers exercise their professional judgment as to the adoption of an active or passive approach and the allocation to each, taking into account their views as to how performance may best be achieved for members as well as the existing underlying investment platform, for efficiency purposes.

- 48(e): "what should be the approach for reducing risk over time (i.e. the glide path): should de-risking start 20 or more years away from retirement or should it only happen in the 10 years immediately preceding age 65"

  The de-risking could start from around 20 years preceding the maturity of the target date funds. Any guiding principles on the distribution of assets among equities and fixed income instruments should be broad enough to allow investment managers the flexibility to adjust the distribution of assets taking into consideration the market situation at that time. The equity portion at the early stage of de-risking should remain a significant portion of investments in order to address inflation expectations and to generate growth to support about 15 to as much as 35 years of retiring living of members following retirement.

- 48(f): "what should be the terminal risk profile of the approach at age 65: should risk be reduced as far as possible, or given that members will still need investment exposure post retirement, should some equity exposure be maintained at and beyond age 65"

  Our analysis suggests that retirement longevity within Hong Kong can range between 15 to 35 years for those retiring at age 65. Thus, the post-retirement investment strategy requires a balance between risk and return. We suggest that certain exposure in equities with the remaining in fixed income instruments after maturity would help to provide better growth opportunities to members to support their retirement living.

- 48(g): "whether consistency is required on all of these aspects across all defaults in all schemes or can some elements be left to the decision of individual product providers"

  Guiding principles given by the MPFA would be sufficient for the purpose of maintaining consistency. Such guiding principles should be kept at a broad level in order to allow sufficient flexibility for MPF service providers to structure their funds, including the objectives, investment strategies, underlying investments, etc.

Q6. Do you agree that keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach?

Comments:

In line with the views of the industry, we have substantial reservations on whether the suggested level of 0.75% per annum is realistic.

One of the core elements in running an MPF scheme is the investment management fees and expenses. Taking the passively managed approved ITCIS as an example, except for the two Hang Seng Index related ITCIS and some US equity market related ITCIS, the FER of other equity markets related ITCIS ranges from 34 bps to 149 bps. Thus, it is impracticable to construct a geographically diversified portfolio using ITCIS as the underlying building blocks to achieve all-in management fees of 0.75% per annum and FER of 1.0%.

Moreover, comparing to the pension systems in other countries, Hong Kong's MPF system is still at the developing stage and the amount of accumulated assets within the MPF system is strikingly low compared to OECD averages. We believe that as the MPF system becomes more mature over time, the management fees will be gradually adjusted by market force.

Q7. 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?

Comments:

Please see comments to Q6 above.

Q8. Do you agree that passive, index based, investment strategies should be the predominant investment approach in the MPF core fund?

Comments:

Both active and passive investment strategies have their advantages and disadvantages. Although the findings from the study conducted by the Polytechnic University of Hong Kong indicated that the actively managed MPF funds did not deliver better returns than corresponding passive index tracking funds, it is important to appreciate that at different points of time there would be differences between actively and passively managed funds. The flexibility for investment managers to exercise their skills and decisions for the interest of members is therefore worth to be taken into consideration apart from aiming to achieve lower fees and lower FER. A mix of active and passive investment strategies/portfolios may help to strike a balance between flexibility and costs. To do so, more room should be given on the management fees and FER and then leave the fees to be driven by market force.

Q9. Are there particular asset classes which you think would not appropriately be invested on a passive, index based approach?

Comments:

Most of the asset classes could be managed by active or passive strategies.

In addition, currently the MPF legislation sets out investment guidelines and restrictions in detail. The default fund, which is CF, would be subject to such investment guidelines and restrictions and thus it is not necessary to further define any particular asset classes which could be or could not be invested in. This could enable MPF service providers to utilize their existing underlying APIFs as the building blocks for establishing the default fund. Investment managers should continue to exercise their skills to ensure any investments should be consistent with the investment objectives and at appropriate level of the total assets of the CFs.

Q.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?

Comments:

suggests that there should be some flexibility on the naming convention while maintaining certain consistency. Some of the MPF service providers may establish new CFs as the default fund while some may make use of their existing CFs as the default fund if those existing funds are able to meet the requirements of the default fund. In the latter case, renaming existing CFs may cause confusion to existing members who are investing in such CFs. We suggest to allow the default fund to be named by MPF service providers as usual and quoting "(Default Fund)" next to the name of the relevant CFs.

Q11. Do you agree with the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79?

Comments:

We agree with paragraph 78 that all members should be made aware of the new default fund arrangement and be promoted to manage their MPF investments actively, both accrued benefits and contributions in the future.

With regard to paragraph 79, existing members who have not previously made a choice of CF would have been brought to attention about their existing default fund arrangement when they enrolled in the MPF scheme and some may have been receiving annual benefit statements for a number of years. These members may be comfortable with the default fund arrangement and thus they did not take any further action. In addition, applying the new default fund arrangement to the accrued benefits of these existing members would inevitably involve redemption and subscription of CFs. It could result in a realization of gains or losses, depending on the individual situation of their MPF accounts. If the existing default fund is a guaranteed fund or low risk fund (such as MPF Conservative Fund), members may lose the guarantee or their investments may be exposed to higher risk. In addition, as mentioned in the consultation paper, some of the trustees or administrators are unable to identify those members who are investing in the default funds due to investment choice not being made. It is more practicable to inform existing members about the availability of the new default funds and leave the choice of taking any actions or not to the existing members.

Contributions of new members who do not make any election of CFs would be invested in the new default funds.

Q12. Do you agree with the proposal in paragraph 81 as to how to deal with the transition for existing MPF members of default funds?

Comments:

With the concerns mentioned in the comments under Q11, we do not agree with moving existing members' accrued benefits and future contributions into the core fund without an active instruction from the members within the notice period. The choice of taking any action or not on the investment allocation of accrued benefits and future contributions should be left to the existing members.