AMP CAPITAL

Consultation Paper on Core Funds

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

When MPF was implemented in 2000, the MPF Office at that time considered the MPF Conservative Fund as the safest option and hence logically could be the default fund for members who are familiar with choosing investment options. In fact, a lot of schemes had chosen the MPF Conservative Fund to be the default fund at that time. Over the years, different schemes have started to change the default fund to different products as members become more familiar with MPF.

The concept of a core fund is essentially a default fund although it's named differently in the consultation paper. It is expected that once the core fund concept is implemented, there will be no need for default fund except in the circumstances where employer may still prefer their choice of default fund for accrued benefits attributable to employer voluntary contributions when members have not made their own choice.

For the introduction of core fund to be successful, it is critical for MPFA to keep the system simple and easy to understand. We believe standardizing fund names is an effective means to minimize confusion to members. We agree that it would make it easier for members to understand if core fund appropriate to certain types of members have similar names and similar asset allocation range. This will avoid the situation when a balanced fund with one MPF scheme is 50% equity whereas another balanced fund is 70% invested in equity.

We support that the Core Fund shall be made available to all MPF members. As each MPF scheme may have more than one core fund, the trustee of the MPF scheme shall regularly review the product range to minimize possible overlap of core funds with existing fund choices and to avoid an excessive number of funds in the scheme.

While both MPFA and the industry continue to streamline the operation workflows to enhance the value to members, we are confident that the total expense ratio of the constituent funds will come down. <u>However, we do not support the quantification of good value for a core fund.</u> The indicative benchmark of 1% of total fund expense ratio is an arbitrary number. One member may perceive good value as 1% while another may think otherwise. We believe that whether a fund offers good value of members differ from individual to individual. To ease the comparison, we strongly urge the MPFA to enforce standardization on disclosure of all-in fees. Currently, different schemes charge different types of fees and many disclose the various fees in different places in the offering document. We believe it will be very helpful to members if MPFA could standardize the types of fees and the format of disclosure so that it will help members to gauge the fees among different funds and schemes.

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

   Firstly, there may be different core funds for different members. However, we agree that the risk profile of core funds for group of members with similar characteristics shall be similar enough. The key for ensuring similarity shall cover naming convention, volatility, and expected return over the long term. However, we would like to point out that it does not necessarily point to similar asset allocation range. The investment outcome is more important to members rather the asset allocation. For example, if a market neutral strategy could deliver stable return over the deposit rate on a long term basis, it shall be more appropriate for investors approaching retirement.

   The investment guideline for MPF constituent funds and pooled investment funds were written more than 15 years ago. Due to its mandatory nature, the Authority took a conservative stance in drafting the regulation. Currently, only equities, bonds and cash are allowable investments. If we look internationally, many countries have allocated part of the pension assets in alternative investments, be it private equity, infrastructure, real estate, hedge fund strategies etc. Diversification into different asset classes will not only enhance the return but more importantly decreases the correlation of investment returns to general market conditions, thereby providing pension members with more stable and consistent return over the medium term.

   The MPF system has been implemented for 15 years. Looking at the experience of Australia and the US, we believe this is an opportune time to review the investment guidelines and restrictions. Members will certainly appreciate the Authority taking a forward looking stance.

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

   Again, a core fund may not only be one fund. Even if we set an allocation range, the fund managers may still deviate from the neutral allocation depending on their market views. What we shall focus in pension investing is the outcome i.e. goals of the investment choice. Asset allocation is one of the means to arrive at the outcome. However, there are other approaches or combination of approaches to achieve similar outcome.

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?

   As we approach retirement, naturally we shall consider lowering the risk in our nest of eggs. How much risk each member is willing to tolerate will depend on their level of sophistication, level of wealth etc. For those who do not bother to make an investment choice, they will be defaulted to the core fund. We believe that two points shall be noted in dialling down the risk when members approach retirement:

   (a) Age or years to retirement are <u>NOT</u> the only ways to determine members' risk tolerance. There are other factors that the fund managers shall look at such as assess their risk tolerance? Measures that are more "outcome oriented" may be downside volatility, maximum drawdown over the number of years to retirement etc.

It is worth sharing with the MPFA that Australia has just completed a similar regulatory review in late 2013. As a result of the study, My Super, a simple and cost effective default superannuation product was introduced. We would like to refer you to the following website for details.

http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2013/Better-regulation-and-governance

(b) Providers shall also be conscious of over-reducing the risk. This is particularly true that many people may enjoy a post-retirement life of 15-20 years. Bringing the portfolio to almost 100% fixed income instruments will constrain the growth potential of the savings for the members.

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?

There is no perfect solution for some of the questions raised in paragraph 48. Whether it is a series of target date constituent funds or a life cycle approach that varies the member's holdings of different constituent funds over time, the outcome to investors are effectively the same. From a member education point of view, having different target date funds for members will be easier to understand. Most Western pension systems adopt an interval of about 5 years in target date funds. We believe a five to ten years intervals are reasonable.

We hope the MPFA would take this opportunity to review the allowable investments for constituent funds and to allow more diversity in asset classes. For example, asset classes that provide consistent income will help to cushion fluctuation and this shall be weighed against their liquidity. Australian is one of the pioneers in allowing investment in illiquid assets such as real estate and infrastructure in the Australian superannuation system. While pension investments are long term and MPF members may not withdraw their mandatory balance before retirement (or other unfortunate circumstances), concern over illiquidity may give way to consistency of returns and income. Experience in other countries strongly supports investment in alternative assets in pension fund for both return and diversification purposes. We strongly support MPFA reviewing their investment guidelines and regulations to refresh them.

The consultation paper has displayed a bias towards passive strategy on the assumption that they are cheaper than actively managed funds. Do passive funds really have lower risk than actively managed funds? Or was it because negative returns of passive funds could be more easily explained? We believe that a default fund (core fund) does not necessarily have to be passive. Fund managers shall have the discretion to charge different fees, asset allocation and to decide when and how they will dial down the risk.

Academic research indicates that there is no conclusive evidence that passive investment will generate better risk adjusted returns to investors. We believe that active managers add value at both the security and asset allocation levels which tend to work at different phases of the market cycle.

Given that members may still have 10-20 years post-retirement life, we would strongly object to bringing down the risk as far as possible upon retirement. We think there shall still be around 20-30% invested in risky assets. Perhaps a study on volatility and drawdown of funds with different asset allocation shall be conducted to provide us with insight on the extent of risk to be left in the fund when members approach retirement.

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

   We feel strongly against putting a fee cap put on core fund. Hong Kong has always been a freely competitive market. We shall let individual fund manager determine their fees. If they are too high, members will join other schemes through Employee Choice Arrangement.

   We believe investors shall focus on the risk adjusted return instead of fee cap. It's also worthwhile sharing with the MPFA that one of the key reasons that Australia did not adopt the fee cap approach is the concern on possible moral hazard it may create, i.e. fund managers may undercut fee to win scale. With these considerations, Australia has chosen the path of disclosure by specifying what the managers can charge, what they need to disclose and remove the possibility of hidden fees.

   Another consideration is that the difference in cost of doing business in different markets. Similarly, differences in regulatory approach may also drive up the operating costs of pension funds. Hence, we do not believe MPF shall impose a single cap without analysing the cost of doing business and margin to providers before implementing a single fee cap with no flexibility.

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?

   Please refer to answer in question 6.

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

   We are not clear of the rationale behind MPFA's support of passive funds. Among the index linked investment funds, Hong Kong equities index funds are substantially cheaper than other passive funds. In some cases, an ITCIS (index tracking collective investment scheme) could carry more fees than an actively managed fund. We believe as a regulator, MPFA shall be neutral between active and passive funds, especially when a cap is already imposed.

   Please also note that under the current available list of ITCIS, there is a lack of available vehicles for some segments of the market and asset classes.

   If passive strategy is encouraged, essentially all core funds will be the same. In that case, the fees could be further brought down if we aggregate the funds to a single portfolio rather than having them sit in various schemes.

   In many other countries like Australia or US, there is diversity on the type of default fund and not all of them are passive. It's perhaps a bit hard for Hong Kong to justify why should the default fund be passively managed.

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

   As we do not agree that core fund shall be passively managed, this question is not relevant. However, we would like to point out that in other countries, default funds may include many asset classes that are currently not allowable under the MPF regulation, e.g. direct real estate, listed real estate, direct infrastructure and listed infrastructure. These asset classes help to generate stable source of income and provide attractive capital gains in the long run.

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?

    We support standardizing the name of default and core funds to minimize confusion. In addition, if a scheme has more than one core funds, the industry shall help to develop standard naming convention such as year of retirement.

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

    Implementation of core fund recommendation shall look beyond mandatory contribution to cover voluntary contribution made in MPF scheme as well. Otherwise, there may be inconsistency between mandatory and voluntary contributions and create more confusion to members. MPFA shall also look to eliminate the name of default fund once the core fund approach has been implemented.

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?

    The consultation paper focuses on mandatory contribution. Although historically MPFA has not focused on voluntary contribution, we believe it deserves looking into it in more details. If we make a decision on mandatory contribution only without providing guidance on the voluntary contribution part, it may confuse members and cause misunderstandings.