ALLIANCEBERNSTEIN

30 September 2014

Dear Sir,

AllianceBernstein Consultation Response:
Providing a Better Investment Solution for MPF Members

We are delighted to have the opportunity to respond to this consultation paper.

At AllianceBernstein we have considerable experience of the issues faced in the construction, design, governance and communication of defined contribution plans. We are a leading provider of customised default investment strategies in the US, UK and Japanese markets, managing over £15 billion in such assets belonging to in excess of two million members of workplace arrangements.

In our experience, default strategies are not only where the majority of savers in such arrangements will end up, but also where they are most likely to achieve the best retirement outcome at an affordable cost.

However, we believe this can only be the case where they are subject to governance oversight which is aligned with the needs of both current and (equally importantly) former members enrolled in that arrangement.

Given the starting position of the MPF arrangements, our key recommendations would be:

1. Avoid an overly prescriptive design requirement but rather concentrate on establishing a clear governance process for the oversight of the core fund and the principles to which it should be designed. This process should entail clear separation of the responsibilities of investment solution provision from that of the independent governance oversight provider.
2. That target date funds provide the most appropriate vehicle for the delivery of the core fund.
3. That a cost cap should initially be avoided and reviewed at a future date to see whether the improvement of the governance process has the desired impact. This should be supported with transparent cost disclosure of what is spent on the investment solution and what is spent on over services of the pension provider (such as record keeping, communications etc.).
4. Constraining the proliferation of incomprehensible and poorly governed core strategies by:
   a. Ensuring that there is a simplified system for describing the high level fund objectives so as core funds from different providers can be easily bucketed together for comparison purposes and members can understand what is being done for them – our experience is that the number of such high level objectives is relatively limited and hence a providers ability to proliferate their offering is also limited;
   b. That there is a focus on transparency of the performance of any core fund (with a requirement to publish monthly returns for all core funds in operation) such that independent external comparisons can be made across core funds and providers are not encouraged to proliferate to obfuscate poor performance.

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We understand that over the short-run, the target date fund solution may result in a meaningful increase in the number of funds at the constituent fund level across different schemes. However, over the long-run, with greater transparency and comparability of fund options across the platform, the adoption of core funds are likely to improve participant choice and lead toward a simplification of scheme menus as providers recognize that a more simplified investment menu can lead to better participant decision making and value for money.

It is our firm belief that where poor design and value for money exists in DC pensions today these are symptoms of poor governance oversight. We do not believe, and little substantial evidence exists to substantiate it either, that overly prescriptive design or cost models will be beneficial in the long-term to DC savers.

We attach our detailed response.

I trust that our response to the Consultation is useful and naturally we would be delighted to discuss our response further, and expand on the observations made, if this would be helpful within the consultation project.

Yours faithfully,

Ajai Kaul
CEO, Asia Pacific
AllianceBernstein

Appendix: Full Response

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

NO

We are in agreement with statements "b", "c" and "d" in paragraph 36.

Our experience is that good regulation of the core fund should concentrate on the governance and design principles around which it is built.

Whilst standardisation can initially lead to cost reductions and greater member understanding of what the core fund is, we do not agree with implication in statement "a" that an overly prescriptive approach should be followed for the following reasons:

1. **Limits competition to the detriment of future product innovation and market efficiency gains** – Evidence shows that in any market where there has been over standardisation of investment solutions there tends to be an undue focus on short term cost competition to the detriment of future efficiency gains and positive product innovation. The result is long term poor value for money for members as a result of both poor investment performance and larger long-term cost savings being sacrificed for more limited short-term cost savings.

2. **The creation of unwanted Systemic risk in the system** – Over Standardisation of the investment solutions can lead to a strong likelihood that the retirement system as a whole fails all members at the same time. This can have considerable consequences for both the local labour market, members views of the regulators competence (if they have essentially designed the strategy) and the strain on State benefits.

3. **Lack of homogeneity of members** – Members, and employer workforces, do not necessarily share the same investment objectives and beliefs and a one size fits all core find may not be appropriate. For example:

    a. Some groups of members (often on lower incomes and likely to be mainly dependent on State Income in retirement) the objective may be to fund for a lump sum at retirement whereas other groups (often on higher incomes) may need to fund for an income in retirement. Providers should be required to assess the likely needs of their members at least at an overall employee level and customise the core fund to be appropriate to them.

    b. Beliefs about active management and whether it can deliver vary by provider/members additionally beliefs around areas such as ESG can also differ considerably and the core fund should encapsulate this.

We believe that an appropriate balance can be achieved by establishing a robust governance regime for core funds - where the design and cost of the investment solution is overseen on the members behalf in line with established principles.

In context of the current system we would suggest that the first step, rather than being overly prescriptive over the design of the core fund, would be to ensure good and clear transparency is in place regarding the core fund. This could be achieved as follows:

1. That someone independent of the provider of the core fund, is responsible for setting its objectives and overseeing its performance and has the ability to hire and fire the core fund manager.

2. That the fee for the core fund is separately identifiable from the other services provided by the pension provider.

3. That principle based standards are established for the manner in which objectives are set and the appointment and performance of the manager is overseen, some potential principles are as follows:

    a. **Principle 1**: Alignment of responsibility, control and competence – Those involved in the oversight and management of the default fund should only take responsibility for decisions where they have appropriate experience and over which they are able to exert control in the future.

       Example: In a contract-based arrangement, unless the employer has absolute authority to amend the investment strategy of the default fund without reference to either members or provider, then the only decision they should be responsible for is choosing the provider of the default fund.

    b. **Principle 2**: Robust design – The objectives and design of the default fund should take into account the range of circumstances of savers likely to use it. In particular, it should take into account the range of contribution, employment, wealth and retirement profiles of those savers.

       Example: Relatively few savers retire on the date they either select or defaulted to when they start saving for a pension. They may have to retire earlier or later for reasons often outside their own direct control – for instance, due to ill-health or redundancy. The default fund should be able to cope robustly with these possibilities.

    c. **Principle 3**: Future proof - Inertia is a powerful force in savings. The implementation of the default fund should therefore be flexible enough to ensure that inertia does not harm the outcomes of those invested in it.

       Example: The objectives and management of the default should recognise the need to adjust to changes in investment thinking, manager competence, regulatory regimes and member behaviour.

    d. **Principle 4**: Independence of oversight – The default fund should not rely upon its own savers to provide independent oversight. The main oversight role should be performed by a body free of conflicts of interests, which means it cannot be provided by anyone directly involved in the management of the default fund.

       Example: Those setting the objectives of the default fund and overseeing their delivery should not be directly responsible for taking investment management decisions within the default fund.

e. **Principle 5**: A single default fund – Providers should not try to abdicate their responsibility by providing a range of default options, while leaving the individual to decide which one is suitable for them at any given moment.

   Example: A series of 'risk-graded' options is more likely to confuse investors and leave them in an unsuitable savings vehicle than a single default fund that automatically adjusts to suit their circumstances.

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

NO

Please see our answer to question 1. We believe that they should be subject to similar principles and governance requirements but that it would not be desirable for this to be overly prescriptive. Again whilst we agree that this may drive down costs in the short-term and aid member understanding this will be to their considerable detriment in the long term.

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

NO

Please see our answer to question 1. We believe that they should be subject to similar principles and governance requirements but that it would not be desirable for this to be overly prescriptive. Again whilst we agree that this may drive down costs in the short-term and aid member understanding this will be to their considerable detriment in the long term.

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?

YES

Although we would caution that if a significant amount of freedom is allowed in glidepath design, which may justified given the potential differing objectives of different groups of members, a clear and simple labelling system is established to ensure that people understand what the objectives of the fund are and the likely riskiness of the asset allocation would be at retirement.

Additionally as this is a default strategy, to retain future flexibility to make changes in the future without the need to engage with members who have not engaged so far, we would recommend that the target date is not fixed at a stated retirement age but rather referenced to the age at which state benefits commence (although certain categories of members may have a target of state pension age plus or minus a number of years based on the likely experience of when they are going to take their money).

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?

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"

We would strongly urge the MPFA to adopt a target date fund and would caution against lifestyle/lifecycle approaches. This is because target date funds provide the following substantial benefits to members and regulators:

1. **Simplifies communication to members** – our research has consistently shown that the understanding of target date funds is considerably higher than lifestyle/lifecycle approaches (with the fund objectives in the fund name rather than buried in the detail)

2. **Reduced cost of making future changes to the investment strategy** – With changes made within a single fund rather than across numerous individual member accounts, the inevitable future changes in design that will be necessary given the long term nature of pension savings, will be far cheaper and easier to perform in a target date fund structure.

3. **Reduced risks and costs of administration and auditing** – the administration of the investment process must be done accurately on a range of funds rather than on every single member account – we refer the MPFA to the numerous and well documented failures of lifestyling in the UK market where failure to comply with the process was not picked up for many years and has been costly to rectify.

4. **Improved transparency** – As a single fund a target date fund approach provides a more easily comparable performance track record across the market than a collection of individual funds assembled on the individual member account under lifestyling.

5. **Improved oversight of performance by fiduciaries** - Our experience is that target date funds better focus both the investment manager and the fiduciary on member outcomes than lifestyling where the concentration is often focused on overall performance of the strategy individual components but ignoring the bigger picture.

6. **Avoids product proliferation** – The greater complexity of producing many different types of target date funds compared to lots of differing lifecycles, once the administration systems have been produces, will reduce the temptation for product proliferation that we have witnessed in other markets that primarily use a lifecycle approach (see the UK where consultants produce a different lifecycle for every employer to the detriment of cost, transparency of performance and simplicity for members)

7. **More efficient investment approach** – as the target date fund could potentially invest in asset classes (typically illiquid ones) a lifestyle strategy could not because of the need to provide individual liquidity for all underlying components at the individual account level.

8. **Better risk management** – In a target date fund a portfolio manager is directly aligned with the risk and return objectives of the core fund than a lifestyle approach where funds are put together by an administrator and not subject to this oversight

9. **Better governance** – With a target date fund a clear dividing line can be made between those who are responsible for making asset allocation decisions (the target date fund investment manager) and those who are overseeing them. This is not possible in a lifestyle approach where often the critical asset allocation decisions will be made by the same individuals as are setting the objectives of the core fund and overseeing the performance

10. **Lower transaction costs** – the aggregation of all transactions now happens at a target date fund level and can be minimised rather than being undertaken on each individual account.

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"

The gaps will depend on the likely shape of the glidepath. For example in the US, where typically target date funds invest to provide a balanced fund at retirement for provision of income throughout retirement, 5 year or even 10 year intervals can be used as the glidepath is relatively shallow. However in markets such as the UK where the objective has been traditionally to provide either a cash lump sum or an income via an annuity a steeper glidepath necessitates smaller gaps of maybe 3 years or less.

We would recommend that providers are provided with a certain degree of freedom to define what the best balance of risk and cost is for their desired investment solution.

As a further point we have discovered that a naming convention that refers to a target retirement window of say state pension age plus or minus two years (or the 2040-2044 fund) is easier to align with the uncertain needs of the members, addresses the irrational fear of a member whose desired target year is not in the fund name and is more consistent with modern working patterns than specifying an exact date. It also better communicates that the investment of a member's savings for retirement is far from an exact science.

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"

We believe this should be left to the respective providers (in setting their investment beliefs and objectives – including a cost budget for the core fund on its own) and the core funds investment manager and not be prescribed for the reasons set out in our answer to question 1.

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

The debate of active versus passive is far from being as simplistic as many commentators believe. Most asset classes that are likely to be included in the core fund could be managed passively either by reference to some form of index or through buy and hold.

It is highly subjective within any asset class as to what index is chosen or individual assets bought and held. As a result even a manager that chooses to pursue some form of a passive approach must make some significant active decisions which are likely in our experience to dominate the member outcome.

For this reasons we believe even where passive management is used there should be a clear split in responsibilities between those who set the objective and oversee the investment management of the core fund and the investment manager who makes these decisions.

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"

We believe it is the job of the group that is providing the oversight of the core fund on behalf od the member to specify the appropriate risk profile for the membership in setting the de-risking glidepath via reference to the likely risk capacity of the member and how it varies with age and the likely outcome objective for the fund (to provide income in retirement or a retirement lump sum).

However experience from the US tells us that it is important that these objectives are clearly communicated to the members and that the MPFA should take a role in setting these standards for how the objectives of the core fund are set and communicated.

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"

Given there are a considerable number of uncertainties in play, when the individual will actually retire and how they will choose to access the money in retirement we would recommend that whilst providers are encourages to look at their membership characteristics to determine an appropriate terminal risk profile, that it should inherently embed this uncertainty by being a prudent hedge between retaining a growth objective and achieving income or cash stability. Given the likelihood that members may remain invested beyond the target date it may also remain appropriate for the investment strategy to continue to develop beyond that time – experience of the UK system has ended up with considerable difficulties where overly spurious assumptions made about individual members have led to asset allocations at retirement that are far from robust top the uncertainties those members actually face.

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"

As mentioned previously the MPFA should establish a robust governance framework and set of principles of the delivery of the default strategy but avoid an overly prescriptive approach which could have considerable risks associated with it.

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

NO

Markets subject to price caps do not typically lead to a positive consumer experience as a result of:

- Stifling of innovation – no future efficiency gains
- Stifling of competition – provides barriers to entry for new providers
- Demotes efficient buying behaviour – focus solely on cost
- Lack of focus on quality features within the product – poor outcomes

We believe a better process is focusing on governance, to enhance the quality of the buying process (initial and ongoing) and quality features that should be demanded on the member's behalf. As a start we would recommend that prior establishing a need for a charge cap that the following two actions are taken:

- The cost of the investment solution should be distinct and separate from other services provided– where a cost cap has been introduced in markets such as the UK clear evidence shows this has been to the detriment of the investment solution and expected member outcomes (as the pension provider has sought to retain its margin by reducing the quality of the investment solution offered)
- The cost paid for the investment solution should be established in its investment objectives and subject to independent oversight

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?

NO

Please see our answer to the previous question. However where possible all expenses should be made transparent to the member and independent oversight provider in respect of the investment solution.

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

NO

This will be determined by the cost budget the oversight provider sets for the core fund and its own investment beliefs. We believe that in an efficient market there should be a broad array of combinations of passive and active components and that if one or other becomes predominant that it is likely to be an indication of a market failure, where the concentration has shifted away from value for money and best member outcomes to either cost minimisation or profit maximisation for providers.

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

First and foremost the asset allocation strategy and the choice of indices used can-not be done on a passive basis and this in itself will be a key determinant of the short and long term risk and return outcomes of the fund.

There are many arguments for various asset classes that should or not be managed on a passive basis, but this will largely come down to appropriate index construction which may be easier in some asset classes than others.

Q10. Do you agree that the name of the core fund should be standardised across schemes? If so, do you have any preference amongst the possibilities set out in paragraph 77 above?

YES – The MPF Core Fund

We believe that so long as appropriate standards of governance and principles of design are in place it is a helpful for members to provide a simple to recognise stamp that this meets them.

We believe MPF core fund best encapsulates the objectives of the fund of the choices provided.

Importantly our research shows that the core fund may for many investors actually be the best place for them to be invested as it:

1. Keeps costs low – as everybody bulk buys the same investment services
2. Manages behavioural bias – typically inexperienced investors are recklessly prudent when young given their investment horizon and complacently aggressive when they are old, a core fund is likely to better manage these risks. In addition the tendency for such investors to buy high and sell low is best managed by a core fund.
3. Uses investor inertia to their benefit – this is an investment behaviour that many investors exhibit once they have enrolled in a scheme. That is they never change their investment choice, whereby the core fund will automatically be kept up to date for changes in best thinking, markets and legislation.
4. Improves member engagement – as less time and effort is spent on complex investment related issues and more on the benefits of saving more and what the outcome might be.

As such we would avoid any connotations in the naming of this fund that are negative.

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

Yes, but a better approach is available

For new members, auto-enrolment in the new core default fund is appropriate and standard practice in most DC markets. However, for current members, the process described is an acceptable one but is a conservative implementation approach. It assumes that scheme members who made a clear choice of a core fund made an educated selection appropriate for their life stage. Our experience in the US and other major defined contribution markets is that even members who made an affirmative selection did so on imperfect knowledge or on the advice of friends and relatives. The great majority of members we describe as "Accidental Investors" who would much prefer knowledgeable plan trustees and investment professionals to guide them to an appropriate selection. Target date funds, appropriately constructed, represent embedded advice for the typical plan member. Our research indicates that most scheme members value having this choice made for them.

Even if scheme records indicate that a member made a clear choice of a non-core fund options, it may not have been a good choice. In one target date implementation case study in the US, only 29% of scheme members who had previously selected their own investment options were found to have an age appropriate asset allocation (defined as a 10% band around the newly constructed target date glide path). Of the 71% of members judged to have a poor allocation, approximately two-thirds were young members who were under exposed to equity markets while the remaining one-third were older and retired members who were taking too much market risk for their age. Given the effort being taken through this consultation to improve outcomes for MPF members, a maximum effort should be placed on getting as many members enrolled in the new target date core funds as possible.

We believe the implementation approach outlined in Paragraph 81 is a better one which should be used broadly for all MPF members.

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?

Yes, but the approach should be expanded to all member investments in all schemes.

Instead of limiting this "negative consent" approach only to schemes with deficiencies in member selection records, we would advocate expanding investment re-election to all members in all schemes – whether in core default funds or not and even if records indicate affirmative selection of other investment options – to maximize adoption of the new target date funds while maintaining the flexibility for members with strongly held investment beliefs to opt-out and manage their own mix of funds.

Ideally this investment re-election process would apply to all MPF members when the new target date core funds are introduced:

- All members (including those who had made previous selections) would be made aware of the new target date funds as well as other investment options, and the opportunity to select or re-select fund options
- They would be also be notified that they need not act. If they like the concept of the target date core funds, existing benefits and future contributions would be automatically be invested in an age appropriate portfolio
- As of a certain date, the fund transfers are automatically made and recorded in each member's account.

In the US experience with this process, 70-80% of member assets will be transferred into newly introduced target date portfolios, either through affirmative selection or inaction. At the same time, members with strong investment knowledge or unique situations can opt-out and select funds appropriate for their needs. Despite concerns of trustees, this approach has been well received by members and generates very few complaints.