Dimensional Responses to Consultation Questions

Providing Better Investment Solutions for MPF Members
September 29, 2014

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

Yes.

Comments: Dimensional supports the introduction of a core fund as set out in paragraph 36.

We believe the use of Core funds as the standardized default option for MPF members is a better investment option to balance long-term risks in a manner appropriate for retirement.

<u>Target Date/Life Cycle and Target Retirement Income Approaches</u>

In reference to (b), we agree a core fund solution is well suited to balance long-term risks and returns in a manner appropriate for retirement. Target date and life cycle solutions are reasonable first generation core offerings because they provide a sensible diversified investment option for non-engaging members. Target date and life cycle funds broadly allocate the portfolio across different asset classes thus taking advantage of the diversification benefits over a long term investment horizon. In addition, target date and life cycle solutions consider the underlying rationale that younger investors are able to take on more risk than older investors by reducing the amount of portfolio return risk as a member ages. This reduction of risk in target date approaches is achieved by implementing a "glide-path" that specifies the amount of equity allocations over different ages.

Dimensional believes that a core fund design could improve upon the typical target date and life cycle approaches. Retirement income depends on both the accumulated assets and the interest rate at which those assets can be invested in retirement. Dimensional therefore believes the core fund's risk should be measured by a member's retirement income risk and not by asset risk as in the current target date and standard life cycle approaches. We believe the goal for the core fund is to help MPF members (especially non-engaging members) accumulate assets in early life stages and as MPF members get closer to retirement, consider income risk management. Unlike current target date and standard life cycle approaches, Dimensional believes a member's retirement income risk should be considered and the MPF balance should be managed using a liability driven investing approach (LDI). Therefore, a LDI approach should also be used in constructing the core fund to reduce income risk.

We also agree that for core funds, a reduction of income risk as a member approaches retirement is appropriate. In this scenario, we define risk as the uncertainty of the member realizing their retirement income goal; unlike target date approaches who define risk as asset return volatility. Although asset return risk is an important consideration, a more relevant risk measure for MPF members is retirement income risk. This concept of retirement income risk is not new and has been widely used. For example, for defined-benefit pension plans, the risk of not funding the sustainable retirement income levels for its members (measured by actuary funding ratio) is the most relevant and most important risk, not the asset return volatility. Although current offerings in other countries like the U.S. often follow a target date or life cycle approach, we believe MPF should explore an approach that explicitly manages retirement income risk. We refer to this approach as the “Dimensional retirement solution” approach or “DRS” in this response.

The benefits of a DRS approach and framework is its ability to link the core fund construction with the management of retirement income risk in a manner that is easily implemented with no more additional effort than a target date approach. Current target date approaches only take into consideration a member’s age and ignore other important considerations such as a member’s account balance and future contributions. MPFA and MPF providers or plan sponsors can incorporate this information into the profiles of representative MPF members by surveying other sources of information from currently available information sources.

For example DRS’s glide-path, or more specifically the models asset allocations over time, not only considers age but also variables that are critical in reaching the retirement income goal such as the funding ratio which is defined as the current account balance plus future contributions (assets) divided by the retirement income goal (liability). For MPF members with relatively large future contributions who can endure a higher amount of retirement income uncertainty, they may maintain relatively higher risky-asset allocations and will also have higher expected amount of retirement income. Members whose current retirement income accumulation is close to what is needed for a good retirement may reduce their risk exposures significantly to preserve that income. By taking these other variables into consideration, DRS should produce more reliable retirement income results than approaches that rely primarily on age.

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

Yes.

Comments: Dimensional believes there are advantages of applying a similar default fund structure among all MPF schemes. However, we would suggest allowing for flexibility in the implementation of the CF to account for different circumstances that may exist among the schemes and member demographics. Dimensional also believes that flexibility in the implementation of the CF will encourage the continued adoption of new research findings and further enhance the CF.

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

Yes.

Comment: As discussed earlier, if the term “fund” refers to a combination of funds or a series of funds that meet consumer needs based on both age and the ability of achieving their retirement income goal, then yes.

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 options would you propose?

Yes, but age should not be the only factor considered when reducing risk over time.

Comments:

As we discussed in the response to Q1, the goal of the core fund is to help MPF members fund a secure income goal throughout retirement.

Dimensional believes a retirement income goal should be viewed like a pension liability and can be funded with current balances, future contributions, as well as other sources of retirement income. This type of investment approach would apply liability-driven investment techniques to manage retirement income risk. It creates a retirement account balance sheet by integrating known retirement assets of a member including: account balances, expected future contributions and any other known pension benefits and compares them to the retirement income goal. Such liability-driven investing techniques are well-understood, market-proven and widely applied in defined-benefit retirement fund investment management.

An investment approach should also incorporate expected future contributions (“human capital”) by treating the present value of the member’s estimated future contributions as a fixed-income asset. Taking into consideration future contributions provides a more accurate depiction of a member’s asset-liability representation. For younger members, the value of their projected future contributions tends to be large relative to their current balance so they can afford to have a higher allocation to risky assets. For older members, with fewer working years before retirement, the importance of their projected future contributions tends to be smaller. Once the total value of retirement assets is determined, it is compared to the estimated value of the future income liability, the retirement income goal. This ratio is the same measure as the funded ratio used in pension plans.

The above can be implemented in a number of ways. One way is by constructing DRS portfolios corresponding to different representative cohorts of MPF members. Members can be defaulted into a core fund based on their retirement account data, which may include salary, contributions, account balances and age. This requires little to no input from members, either in terms of providing information or portfolio choice.

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?

Comment: Dimensional believes having a consistent framework across all defaults in all schemes has many benefits; however, scheme members may benefit by allowing some design decisions to be made by individual product providers. For example, members in one scheme may face a unique risk or have access to additional benefits not available to members in another scheme. Creating solutions tailored to the circumstances and balance sheets of the scheme members has the potential to provide better outcomes. Within reason, decisions about the specific equity and fixed income allocation, the detailed asset class allocation within equities/fixed income; and the underlying fund managers may be better left up to the individual product providers.

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

Yes.

Comment: Dimensional strongly believes in low and transparent fee structures and recognizes that costs matters. An emphasis on lower, more transparent plan costs benefits members by achieving better financial outcomes. Access to cost-efficient solutions provides plan sponsors with another component for better plan design since costs can have a significant impact on investor success over time. Dimensional believes transparency and providing members with information about fees is important, and all solutions should be designed as a low-cost option.

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?

Comment: We agree that the impact of new fee requirements need to be considered and properly designed to minimize unnecessary disruptions to members. As a benchmark we believe that fund management expenses could be as low as 0.5% (50 basis points). In the United States, 91% of total plan fees are paid by the member, with investment management fees comprising 84% and recordkeeping and administrative costs representing 16%. Smaller plans in the U.S. pay significantly higher fees than larger plans for administering a DC plan. Median fees for all services range from over 1.40% for plans with assets under $1 million to just under 0.40% for plans with assets over $1 billion. Based on the current size and expected future growth of the MPF system, we would expect that fund management (not total plan) fees could be less than 50 basis points. Therefore, it could make sense for MPF to select low-cost investment solutions within both the core fund and stand-alone fund options.

Dimensional has a long and successful track record of applying a research-driven approach to managing defined contribution members' investment solutions globally. As the MPFA evaluates and improves the overall MPF system and its diversified multi-pillar retirement model, we look forward to sharing our unique research and corresponding implementation insights regarding:

- Overall MPF plan design
- Retirement income goal setting
- Member savings rates
- Impact of fees vs. fee disclosure
- Multi-factor default solutions
- Construction of optimal retirement income portfolios
- Optimal member withdrawal rates
- Longevity risk and management

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

The MPF core fund should emphasize investment strategies that are broadly diversified, low cost, fee transparent, and scalable. It is important to note that passive, index-based strategies are not the only approach that offers these benefits. While Dimensional does not believe that a traditional stock-picking approach can consistently create enough value to warrant the additional idiosyncratic risk and higher costs associated with these strategies and be scalable, there is significant empirical evidence—as well as a theoretical foundation— that indicates it is possible to provide superior performance to that of a pure market-cap weighted index. Standard index funds are constructed to track an index and confine trading to very limited reconstitution periods—prioritizing lower tracking error over higher returns. Over long periods of time, this can be a significant drag on performance.

In contrast, decades of academic and empirical research indicate that in public stock and bond markets where there is adequate liquidity and price transparency, it is possible to use market prices and fundamental characteristics to systematically identify differences in expected returns among securities. Dimensional uses a process-driven, low-cost, and scalable investment approach to build broadly diversified portfolios and pursue enhanced returns through thoughtful portfolio design and skillful implementation, trading when it adds value rather than following a commercial benchmark.

Dimensional would suggest that a structured approach which is well-diversified and not reliant on individual stock-picking should provide higher expected returns over time, and would be suitable in addition to or in lieu of a passive index-based approach.

Because the goal for the core fund is retirement income, the majority of its fixed-income components should typically be invested in maturities consistent with the long term nature of the member's retirement income requirements. Therefore short-maturity fixed income investments, which are appropriate for preserving capital value in the short term but are risky with respect to preserving long term income, are typically less desirable.

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

There is little academic or empirical evidence to suggest that a traditional stock-picking or interest-rate-timing approach can consistently add value even in smaller, more specialized asset classes. However, the weaknesses of a passive index-based approach are present regardless of asset class, and may even be magnified in markets or asset classes with higher frictional costs (less liquidity, higher trading costs, etc.).

Again, Dimensional believes that over the long term, a structured, low-cost approach is more likely to provide superior results.

Q10. 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

Comment: We believe it is beneficial to have a standard framework and criterion to construct and monitor the core funds. Dimensional believes scheme members may benefit from allowing some decisions to be made by individual product providers. For example, members in one scheme may face a unique risk or have access to additional benefits not available to members in another scheme. Creating solutions tailored to the circumstances and balance sheets of the scheme members has the potential to provide better outcomes. Within reason, decisions about the specific equity and fixed income allocation, the detailed asset class allocation within equities/fixed income; and the underlying fund managers may better be left up to the individual product providers.

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

Yes

Comment: N/A

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.

Comment: Dimensional believes that the introduction of new core funds is fairly significant and could prompt all MPF members to re-evaluate their investment choices. An alternative approach to be considered is to re-enroll every member by giving them the option to re-select their investment options with the default being to enroll in the new core default fund.

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