# Consultation Paper on "Providing Better Investment Solutions for MPF Members" by FSTB and MPFA

## Response by Invesco Hong Kong Limited

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

No.

- Invesco is in support of the idea to enhance the regulation of default funds in the MPF system to better protect the interests of those members who do not, or do not want to make an investment choice.
- However, the terminology of "core fund" is misleading. It gives the impression that the fund is the "endorsed fund" by MPFA / the Government under the MPF system and a "must have" investment choice by the members.
- In our opinion, there is ***no single fund*** that can fit all members' needs as each member will have different risk/return appetite, personal financial situation etc. The core fund concept also contradicts the potential "life cycle" or "target date" approach as put forward in sub-paragraph (b), under which different or combination of CFs may be required over time.
- We however agree that the investment approach should be one that balances long-term risks and returns in a manner appropriate for retirement savings and that represents good value to members. Good value nevertheless is not equivalent to "low fee" as emphasized throughout the consultation paper. Good value needs to be considered on a holistic perspective, including but not limited to product design, risk/return (after fees) relationship, services, administration, governance etc.
- In summary, we are in support of more consistent default fund arrangements for all members to choose from, but against the "core fund" concept. In our opinion, a term "default investment option" will be more appropriate to avoid any misinterpretation by members.

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

No.

- In our opinion, the default fund does not have to be the same across schemes.
- We however support the idea of having some level of consistency or a preferred investment structure for the default funds to facilitate better comparison and benchmarking across schemes.
- There is certainly more than one way of achieving the investment objective of reducing exposure to risky asset as a member approaches retirement, whether by way of an array of target date funds or by rebalancing various life cycle funds over a member's working career.

- To capitalize on the existing MPF system, we recommend MPFA and the Government consider adopting an approach similar to that adopted by the pension systems in Australia (MySuper), the UK (work-based DC pension schemes) and the US (401k plans) where those regulatory authorities regulate by way of guidelines and criteria for default fund arrangement. The MPF industry practitioners should have the flexibility to arrive at a fund design best optimizing their existing scheme/product structure within the laid down framework, for scale building and cost effectiveness purposes.
- The suggestion of a general framework will also increase the level of flexibility and speed in handling any required future changes or enhancements to the default fund arrangement as compared to a prescribed or mandated approach.

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

No.

- As set out in our response to Q1, the position adopted by MPFA / the Government in the Consultation Paper on a standardized default fund will give the impression that the fund is the "endorsed fund" and a "must have" fund option and will likely herd the members into this option. This will discourage members from taking an active interest in their retirement savings and hence learning how to make investment decisions based on one's own personal circumstances over their working career. We hence have great reservation in the suggestion set out in paragraph 75 of the Consultation Paper that "MPF scheme disclosure documents should also make it clear that members are entitled to make an investment choice if they wish but they are not obliged to do so".
- As elaborated in our response to Q2, there are different ways in achieving the same investment objective of balancing long-term risks and returns in a manner appropriate for retirement savings. It is therefore not appropriate to standardize the default funds. A general framework with guidelines and criteria specified by MPFA / the Government is the preferred approach which will give the providers the flexibility to arrive at a fund design best optimizing their existing scheme/product structure.

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?

No.

- For investors who not want to make an investment choice or cannot make an investment choice (i.e. those who end up in the default arrangement), Invesco agrees with the suggested investment approach to automatically reducing risk over time as members get closer to age 65, as members will have less time to recoup any potential investment losses.
- However, we do not believe that investors should be encouraged to "not to make any investment choice". The de-risking approach based on age alone fails to take into account of

other important factors such as personal financial situation, risk appetite etc. which may shape a member's risk/return profile at different points in time. We strongly believe that appropriate investor education is the right way to address the root course of the issue.

- In addition, we would like to draw the attention of MPFA and FSTB to the fact that retirement planning does not stop at age 65 when an individual reaches the MPF system's statutory normal retirement age. In reality, retirement planning goes beyond age 65.
- With the improved life expectancy in Hong Kong, the retirees are expected to live for at least another 15 to 20 years. It is desirable to reduce risks and hence the equity content of a member's investment portfolio as he approaches age 65 but it will be unnecessary for the portfolio to completely de-risk by age 65; otherwise the retiree may lose the inflation protection in his post retirement period.

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?

As mentioned in our response to Q2, Invesco is in support of the idea of having some level of consistency to facilitate better comparison and benchmarking across schemes. We recommend MPFA / the Government lay down the general framework and desired outcome by way of guidelines and criteria such that the industry practitioners may arrive at a design best optimizing their scheme/product structure, taking into consideration of scale building and cost effectiveness.

**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;**

- Target date fund approach will require having a series of CFs in the scheme each targeting a different retirement year and result in proliferation of funds.
- Life cycle approach could avoid set up of new CFs but require rebalancing between existing risky and less risky assets in the scheme by the trustee & administrator as member ages.
- We strongly believe that the decision on the preferred approach will be best handled by the product providers. Each provider has different strengths and investment / operation structure; they will be in the best position to determine which approach works best for them and for their members.

**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;**

- We need to emphasize again that target date fund approach will require having a series of CFs in the scheme each targeting a different retirement year and result in proliferation of funds. However, if MPFA is going to prescribe the target date CFs as the only means of providing the default arrangement, then we feel that 5-year to 10-year intervals are reasonable intervals. It will be administratively expensive if the intervals are shortened to less than 5 years. On the

other hand, it might be too long to go beyond 10 years as it will cover 2 or more market cycles and defeating the objective of protecting the aging members from extreme market volatility.

**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;**

- As suggested in our response to a) above, the asset classes to be used as the building blocks should be left to the respective providers. Different providers have different strengths. By prescribing the building blocks, MPFA may force the providers to adopt sub-optimal investment solutions and result in inferior or more costly products.

**d) which investment building blocks are more appropriately managed in a passive manner;**

- In theory, any asset class can be managed passively. However, a passively managed portfolio does not necessarily provide the members with the best possible return or the most desired risk/return profile.
- In addition, many currently available Index Tracking Collective Investment Schemes (ITCIS) do not meet MPFA's investment restrictions (e.g. no stock lending, restriction on the use of derivatives). Hence the number of cost effective ITCIS is very limited.
- We suggest leave the decision with the MPF providers.

**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;**

- There is no right or wrong time to de-risk. The real question is the desired outcome.
- To be in line with MPFA's original position on having the MPF system as a privately run programme, the MPFA should provide guidance on the desired risk/return profile at maturity and leave the decision on the design with the managers.
- This can be done by (a) prescribing the desired risk-return profile at maturity and allowing the providers to achieve the desired result by capitalizing on their strengths and best available products; or (b) providing age-related check points (e.g. at age 40, 50 and 60) with a recommended range of equity/fixed income allocation (e.g. an equity exposure between x% to y% at age 40; an equity exposure between u% to v% at age 50). The providers will maximize the return for scheme members by adopting tactical asset allocation calls within the recommended range of equity/fixed income allocation as they see fit; or (c) providing a specific age range where de-risking will need to take place and the investment managers will determine the speed and approach in which the de-risking will take place.
- We note that MPFA wishes to address comparability. This can be achieved by (1) using a hypothetical investor approach (i.e. assume the same investor, Joe Smith, investing in different MPF products until retirement and compare Joe Smith's return in different MPF default option arrangements at different ages at a common valuation date such as 31 March); and (2) calculating returns of the recommended range of equity/fixed income allocation by MPFA at all relevant age-related check points ("Central Glide Path"). Members can compare their own returns against those of the Central Glide Path and of the hypothetical investor.

**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; and**

- As mentioned in our response to Q4, retirement planning goes beyond 65 and it will be unwise for a member to completely de-risk at 65 as it will render the retiree vulnerable to post retirement inflation risk. Some equity exposure at and post retirement is recommended.

**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 recommended above, MPFA should provide guidance on the desired risk/return profile at retirement but the means to achieve this desired "end-game" should be left to the provider.

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

No.

- In our opinion, keeping the total fee at or under 0.75% is ***not*** a reasonable initial approach.
- The MPF system is a mandated pension system privately run by commercial providers who require adequate incentives for ongoing delivery of competitive products to members. It is important to note that there are many cost drivers affecting the level of the fee charges of a Fund (including but not limited to administration complexity / reporting requirements / level of client servicing / means of investment etc). Different providers are affected by different cost drivers depending on their investment and operation model. It is therefore not reasonable to cap the total fee without looking at the cost drivers relevant to specific providers.
- Since the publication of the 2 E&Y studies on the MPF system in year 2012, the industry has been working closely with MPFA to address a number of identified cost drivers so as to help lower the fee charges of the CF(s). The weighted average FER has come down from 1.74% in 2012 to 1.69% in May 2014. We trust that further reduction can be achieved once the suggested cost saving measures by E&Y are fully implemented, and we believe that a little bit more time is required as scale of the system is one of the crucial contributors to costs reduction.
- Recently MPFA issues a “Low Fee Funds List” to help members identify funds with fees at or under 1.0% or total expenses at or under 1.3%, which has been widely accepted by the public as indicators of low fee funds. The proposed fee cap at 0.75% and FER cap at 1% in Q7 represent 25% + further reduction which is quite a drastic reduction. It will be helpful if MPFA can share with the industry how the proposed caps are derived.

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 refer to our response to Q6.
- Besides, it is also worth noting that the FER measure does not reflect any rebate of bonus units to members which can be a substantial discount from the management fees as set out in the prospectus.

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

No.

- As mentioned in our response to Q5, passive / index based strategy may not necessarily give rise to MPFA's desired risk / return profile at retirement.
- There is no specific reason to believe that passive / index approach will be less expensive than an active strategy. If we compare the fees of the ITCIS in the market with those of the active strategies, we note that some of them are comparable if not more expensive.
- Although less expensive index or passive investment products are available in the market, a lot of them do not meet MPFA's investment restrictions (e.g. no stock lending, restriction on the use of derivatives). Hence the number of cost effective ITCIS is very limited.
- Furthermore, a lot of the MPF providers in the market are active managers. Prescribing passive or index based investment strategies as the predominant investment approach may result in sub-optimal investment solutions by many providers.
- We recommend leave the decision with the providers.

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

No.

- Please refer to our response to Q5 d).

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?

No.

Please refer to our response to Q1. As stated above, if a “common marker” is to be used, our preferred one is “MPF Default Investment Option”.

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

No.

- We disagree to some of the implementation and transitional arrangement suggestions as set out in paragraph 79 (see our second and third last bullet points below).
- Nevertheless, we agree that for existing members who have previously made clear of their investment choice(s), the new default option launch should not affect how their accrued balance and new contributions be invested.
- We also agree that for the existing MPF members, a fresh opportunity of funds (with the new default option being one of the options) election should be offered so that they can decide if they want to switch over to the new default option.
- The fund option election form should clearly indicate that if members don't take action nor make a new election, then their existing investment(s) will remain as is(are). Members are required to submit an instruction to re-direct their existing investment(s) to a new investment choice(s) ("member consent"). All MPF members should be made well aware of the new default option and the election exercise via advertising and educational campaigns organized by the MPFA, the industry and employers.
- We do not agree that any members who fail to make a new choice of fund(s) are forced into the new default option. We should respect the members' decision to "exercise their right to choose" or "not to exercise their right to choose".
- Compulsory switch over of assets from the existing CF(s) to the new default option will have various negative impacts on the remaining members in those CF(s) – fund price may come down significantly due to large sell offs; FER is expected to go up as the scale goes away; members investing in the guaranteed funds will break their guaranteed conditions and lose the guarantee etc.
- To mitigate the impact to the market and to members, and to minimize the administrative burden and costs, we suggest that the new default option should only be automatically applied to newly enrolled scheme members who fail to make a choice.

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?

No.

- We do not agree with the transition proposal in paragraph 81 for members who currently wholly invest their contributions into the existing default CF(s). Please also see our response in Q11.
- Advertising and educational campaigns by the MPFA, the industry, and employers prior to the launch of the new default option will certainly help promote members' awareness so that they can decide if they want to switch over to the new default option.
- The fund option election form should clearly indicate that if members don't take action/make a new election, then their existing investment(s) will remain as is(are).
- We do not agree that any members who fail to make a new choice of fund(s) are forced into the new default option. We should respect the members' decision to "exercise their right to choose" or "not to exercise their right to choose".

- Compulsory redirection of assets from the existing default CF(s) to the new default option will have various negative impacts on the remaining members in those funds as highlighted in our response to Q11.

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