Opinion on "Providing Better Investment Solutions for MPF Members" – Consultation Paper (hereafter referred as the Paper) issued by the Mandatory Provident Fund Schemes Authority (hereafter referred as the MPFSA) in June, 2014

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The main proposal of the Paper is to set up a default / core fund -- a standardized, low-fee investment product for retirement savings. The core fund is to adopt a life cycle or target date approach to reduce exposure to risky asset as investors' age approaching 65, while the fee shall be kept at or under 0.75% through passive investment strategies.

The Paper stresses that MPF members are particularly at risk from investment shocks in the years immediately preceding retirement (paragraph 43), therefore reducing exposure to risky assets (stock) as a member gets close to age 65 is the preferred investment approach. The Paper proposes the two approaches: target date and life cycle funds.

The Paper is certainly with good intent. But it is not able to address the fundamental problems of existing MPF schemes:

1) Low return.
2) High fee.
3) How to educate MPF members to make choice.

COMMENTS ON THE PAPER

LOW RETURN

The target fund / life cycle approach is certainly not an investment vehicle for higher return because it is basically a balanced fund concept, mixing up bond and equity in a portfolio. A balanced fund by design is never targeting at absolute return or even relative higher return than the stock index benchmark. Over the past five years, leading 2030 target date funds in the U.S. had an average annual return of 15%, lagging behind 19% return of the SP500.

INVESTMENT RISK

The target fund / life cycle approach as described in the Paper is more a design on reducing risk rather than enhancing return. One crucial point missing is that the target fund / life cycle approach may reduce principle risk through increasing the bond weighting, but it may not reduce investment risk; it may even increase investment risk by mandatory shifting into bond or stock not according to market condition but purely on the age of MPF members. Investment cycle has its own life, it does not care about individual's age. Automatically shifting more into bond when one's age is near 65 may coincide with an interest rate up cycle which will reduce the value of one's bond holding. At the same time, increasing exposure to equity when one is young does not necessarily mean it will yield a good result. A Japanese youth in his 20 started investing in stock market from 1990 onward, may find its stock investment deeply in the red after 24 years. A 30 or 40 year old investor with 70/80% stocks exposure in 2000 or 2008, despite his/her relatively young age, is having a higher risk profile than he / she may equip to handle and will create a high investment hurdle to recover.

HIGH FEE

Target date funds are implicit "buy and hold" portfolios. It is simply not justified to charge a 0.75% fee to "manage" a buy and hold portfolio. There is no reason for a target fund to charge a much higher fee (0.75% or even 0.5%) compared with a low fee index fund. Vanguard, one of the three main players of target date funds in the U.S. other than T. Rowe Price and Fidelity, only charges around 0.15% fee for its target date funds. [1]

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[1] Bary, Andrew, "Target-Date Funds Take Over", Barron's, July 5, 2014.
http://online.barrons.com/news/articles/SB50001424053111904544004579651134019266274?mod=BOL_archive_twm_ls

DECISION PROBLEM

Passive investing is a misnomer. It makes investing sounds easy. The problem is passive investors must decide how to allocate their assets and choose which index to track. How a tracking manager track an index also affects return. Is it fully replication? Can the manger trade around index reconstitutions? Or the manager is sampling? It is more complicated than the word passive has implied.[2]

Target date funds are not designed the same. Equity/bond portion may be different among funds, the allocation to domestic stock is one issue, allowance to invest in alternate investment and commodity is another issue. The mixing of the life cycle fund is not an easy choice either. How to choose different combinations of constituent funds is a tactical asset allocation problem, besides the indexing problem – which index to choose as the benchmark.

The fact is, asking a layman to choose among hundreds of constituent funds is no easy task, asking a layman is choose 5 to 10 core funds is still no easy task. The Paper has no solution or suggestion to tackle this inherent problem of investment choice.

PROBLEMS OF HIDDEN ASSUMPTION

The Paper is using a lot of hidden assumptions of the Modern Portfolio Theory and Efficient Market Hypothesis to construct its proposal. The MPFSA has all along refused to involve the government in the investment management business, which is a reasonable position. But by proposing the target date / life cycle approach for the core fund, the MPFSA has implicitly chosen for the MPF members an investment position, which may outperform or underperform the market in the future by a great extent.

The Paper adheres to concepts of Modern Portfolio Theory and Efficient Market Hypothesis (EMH) like the ideas of risk, return, and long run. These theories basically say most investors should be overweight stocks as a long term investment because variance in stocks is reduced over time. That conclusion is closely related

[2] Rudden, Patrick, "The Myth of the Passive Investor", CONTEXT, the AllianceBerstein Blog on Investing, July 24, 2014. http://blog.alliancebernstein.com/index.php/2014/07/24/the-myth-of-the-passive-investor/

with the concept of standard deviation which is very debatable as actual facts have shown.

One major issue of the Paper is the lack of discussion on the merits and demerits of target / life cycle funds. The public and MPF members are not advised of the problem inherent in the target / life cycle funds like one-size-fits-all regardless of individual risk tolerance and retirement needs, and various sorts of rebalancing problems.

ALTERNATIVE PROPOSAL

PREMISES

1) The MPFSA should not decide for its members the design of the core fund or to set up core fund at all, as they are no guarantee for good performance.
2) The MPFSA should rather cooperate with other government departments and private organizations to promote personal finance management knowledge.
3) The MPFSA should not mix up the issue of fee and return. Lower fee is one matter, high return is another. The desire to attain lower fee AND high return in one strike is a wish hard to come true. The fact is there is no free lunch in investing management.

LOW FEE ROUTE

Best way is attain lowest fee is via promoting Exchange Traded Fund (ETF) investing. ETF is similar to a fund but less the fund management fee. The expense ratio of the SPDR S&P 500 ETF (SPY) is only 0.095%. The expense ratio of the Tracker Fund of Hong Kong (2800) is 0.15%. If passive investing is the preferred approach, instead of setting core fund with high fee, ETF may be a viable alternative. The MPFSA may sort out a group of investable ETF based on market capitalization, liquidity, geographical representation, and expense ratio as constituent funds, allowing MPF members to choose from.

HIGH RETURN + LOW FEE ROUTE – COLLECTIVE POOL

a) The MFPSA should let the members have a choice to join in a pool and group in those members who do not make a choice on constituent funds into that pool.
b) The MFPSA will open tender to fund houses for the management of that pool.
c) The MFPSA will set the benchmark for the performance assessment and determine the hiring and firing of the investment managers.
d) The pool is simplified to invest in the following assets in the beginning: i) HK stock, ii) China stock, iii) international stock, iv) US stocks, v) short term bond, and vi) long term bond.

Advantages of the collective pool proposal:

1) The large pool will attract good managers to bid on the investment contract with LOW fee. Instead of relying on individual MPF members to join a fund, which is then large enough to achieve economic of scale to lower fee, the large pool can gain institutional size from the right beginning.
2) The MFPSA is not managing the pool, nor responsible for the performance of the pool. MFPSA is just an agent of the pool.
3) The MFPSA is in a much better position to assess the past records and performance of the investment managers, and decide which one to be hired and fired.
4) Individual investors have the inertia and may not possess knowledge to switch underperforming managers, while the MFPSA can help to enhance investment performance through terminating underperforming managers.
5) Simplifying the asset choice to 6 categories, MPF members need only to allocate their contribution among them.

FINANCIAL EDUCATION

The government should promote basic financial management course in secondary schools, introducing basic financial concepts and investment products, preparing future MPF members to make investment decision for themselves.