MSCI

MSCI's Response to the Hong Kong MPFA Public Consultation Paper: Providing Better Investment Solutions for MPF Members

September 2014

Executive Summary

MSCI[1] welcomes and supports the MPFA's Core Fund Proposal particularly in relation to the offering of broad, well-diversified, lower cost, index-based solutions to its members. We also support the consideration to broaden retirement solutions with outcome-oriented investment funds. We think that such enhancements, if implemented, will bring meaningful and lasting benefits to its participants.

As a leading equity benchmark provider, MSCI has been serving the investment needs of investors for more than 40 years. The globalization of equity portfolios has been a preeminent theme over this period and the industry has witnessed a continued and structural reduction of home-bias in long term portfolios, whether in Defined Benefit or Defined Contributions schemes.

It is therefore MSCI's belief, and conviction, that the equity component of any MPFA Core Fund should be based on a broad and well diversified global opportunity set rather than a narrow subset of Hong Kong listed equities. The introduction of a Core Fund presents an ideal opportunity to address the current home-bias, and more generally, it is also an opportunity to bring the more advanced Defined Benefit know-how to participants in the HK MPF schemes. The MSCI MPF ACWI Index, which contains 2,242 securities across 35 countries, presents an ideal benchmark for the equity component of the proposed Core Fund. Our analysis clearly shows how such an Index reduces investment risk, either in terms of maximum drawdown or volatility.

We believe that the current home bias in the equity MPF portfolios goes against the intention to provide well-diversified investment solutions to its members who already have an embedded exposure to the Hong Kong economy in many other facets of their wealth creation and preservation.

In addition, and building on the point above, MSCI wishes to put forward a few suggestions for MFPA's consideration;

a) The first area for consideration would be to review the 30% Hong Kong dollar exposure requirement. Whereas this requirement applies to the Total Portfolio, it has in practice, had the undesirable consequence of transferring this home-bias constraint into the MPF Equity funds.

b) The second suggestion would be to review the list of permissible countries and exchanges. We estimate that the current restrictions have negatively impacted the long term performance by about 30bps in the past 14 years. The global capital market landscape is constantly evolving. Over the past decades, we have seen many new markets become fully recognized by international investors and added to the MSCI global equity indexes. MSCI's market classification framework centers on a number of transparent criteria and is followed by USD 9.0 trillion of assets from market participants around the world. We suggest that the MPFA considers the use of the MSCI market classification framework as a reference in determining the permissible countries and exchanges.

[1] MSCI Inc. is a leading provider of investment decision support tools to investors globally. MSCI products and services include indexes, portfolio risk and performance analytics, and ESG data and research. As of June 30 2014, an estimated USD 9 trillion AUM is benchmarked to MSCI indexes. In 2013, MSCI launched its MPF series which reflect MPFA Investment restrictions and guidelines

c) The third area for consideration is to expand the investment opportunity set to include China-A shares. Whereas most investors around the world face certain restriction in accessing this important share class and thus making it premature to include in a core portfolio, Hong Kong based investors - particularly if the Shanghai-HK Connect succeeds - face less access issues. For this reason, it could well serve the MPF scheme participants to further expand and diversify their Equity portfolios by including China A-Shares in the Core Fund

d) A final area for consideration is the integration of Environment, Social and Governance principles (ESG) in the investment process. These principles are being adopted by many investors as a means to reduce long term sustainability risk to their investment portfolios and also to normalize sustainable behavior from Corporates. In many other jurisdictions, codes to this effect have been established to promote sustainable investing disciplines and practices, such as the MySuper disclosure requirements in Australia and the Stewardship code in Japan.

To close, we want to share some views on Target Date and Life Cycle funds that have become so central to many DC schemes around the world. Broadly speaking, these funds follow a pre-determined Asset Allocation path based on changing investor profiles, investment needs and risk considerations. Because in essence these funds delegate the outcome responsibility to professional investors, they represent a very attractive solution to many participants, particularly those that may not have the necessary investment skill or interest. In configuring these funds, we suggest that an encouragement is made to use the recent innovations in "factor" based investment. These indexed solutions provide a cost effective tool to tilt portfolios (to lower risk for example), while maintaining a higher than otherwise exposure to Equities - and thus retaining the potential for superior returns. For example, we could well see that a typical "at retirement" portfolio includes Equities, but with a tilt toward lower volatility and higher dividend yielding stocks (using for example, the MSCI ACWI Minimum Volatility + MSCI ACWI High Dividends Yield as reference components).

We sincerely appreciate your consideration and stand ready to answer any further questions you may have.

Theodore Niggli

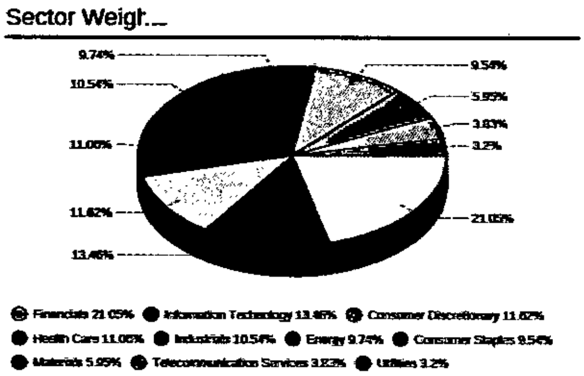
Managing Director, MSCI Index Business, Asia Pacific

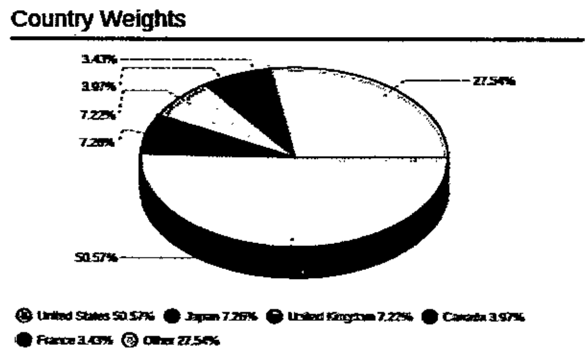
The Equity portion of a Core Default fund should be based on a broad, diversified and investable Index, representing the global opportunity set

We use this section to provide our response to the Consultation Question 1-3, and 6-8.

We believe that the Equity component of the cost effective Core Fund should be indexed, and based on a globally diversified portfolio, representing the full investible opportunity set. A good example of such an index is the MSCI MPF ACWI Index (see Exhibit 1). This index covers 23 Developed markets and 12[2] Emerging Markets, for a total of about 2,242 securities, across all sectors. For reference, the MSCI ACWI[3] index family is one of the most followed indexes in the MSCI family; with about $2.3T benchmarked assets, including a large pool of managers that have been offering cost-effective Indexed Funds for many years.

Exhibit 1: MSCI MPF ACWI Index (HKD, data as of August 29, 2014)





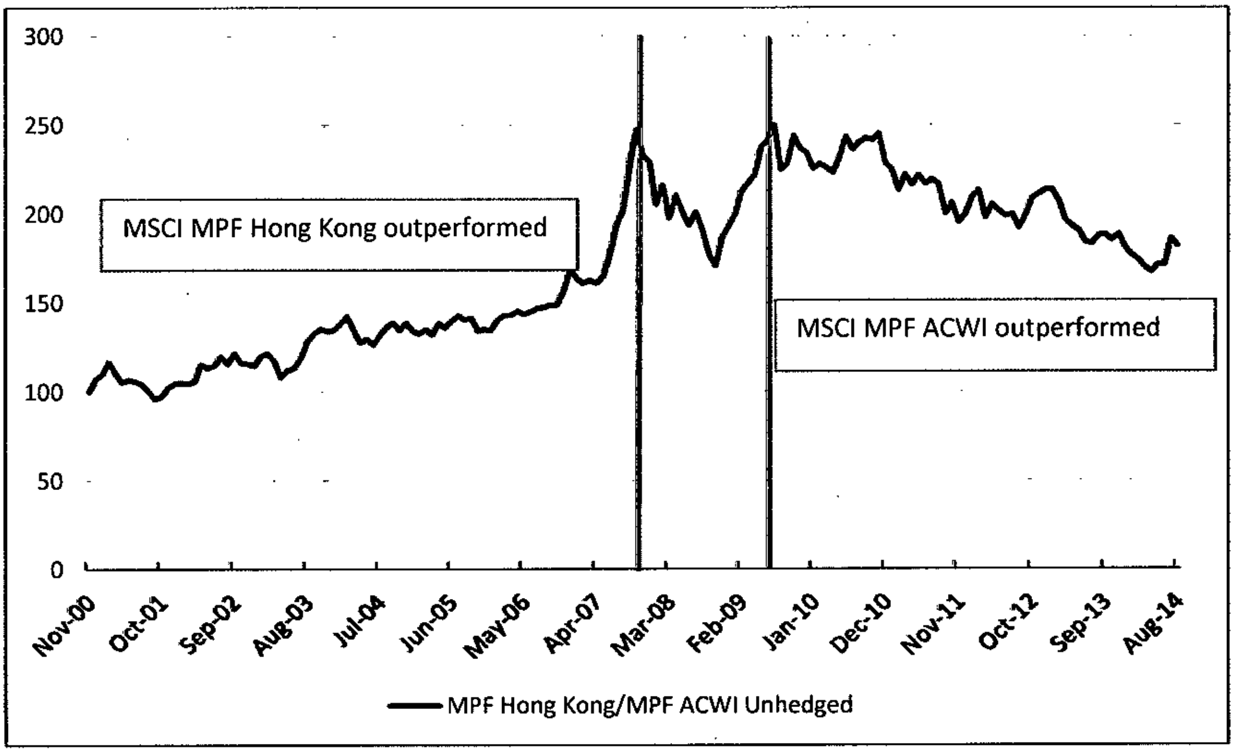
Our research and on-going working experience with a large number of the world's top pension plans, and other long term investors, have supported the structural shift to fully globalized Equity portfolios. The ideal candidate to benchmark, or replicate this opportunity set, is a global equity index with no bias to specific countries or sectors, with a strong emphasis in investibility and replicability, and offering a choice of managers, whether active or indexed.

[2] To be in compliant with MPFA's guideline on permissible stock exchange, the MSCI MPF ACWI Index includes only EM countries such as: Brazil, China, Greece, India, Korea, Malaysia, Mexico, Perú (3 listed in NYSE) Russia (5 listed in LSE and NYSE), South Africa, Taiwan and Thailand. In addition, to be compliant with MPFA's investment guideline, this index includes the 10% issuer capping. Data as of August 29, 2014.

[3] MSCI ACWI includes 2,446 securities and covers 23 Developed markets and 23 Emerging markets as of August 29, 2014. The index covers approximately 85% of the global investable opportunity set.

Exhibit 2 summarizes the cumulative relative performance of the MSCI MPF Hong Kong Index relative to the MSCI MPF ACWI[4] since the inception of the Hong Kong MPFA scheme. The analysis shows that the MSCI MPF Hong Kong outperformed the broader MSCI MPF ACWI Index from year 2000 to mid-2007 but underperform since 2009. However, the MPF Hong Kong Index exhibited significant higher risk and maximum drawdowns during the two periods compared to the broadly diversified MSCI MPF ACWI Index highlighting the risk of a concentrated Hong Kong equity portfolio.

Exhibit 2.Historical Performance of MSCI MPF Hong Kong vs. MSCI MPF ACWI Index (Cumulative Relative Performance in HKD)



	11/30/2000 to 12/31/2008		12/31/2008 to 08/29/2014	
Historical Gross Return, HKD	MPF ACWI	MPF Hong Kong	MPF ACWI	MPF Hong Kong
Return* (%)	-0.74%	7.68%	15.13%	13.91%
Stdev *(%)	16.94%	25.37%	15.94%	21.09%
Maximum drawdown	-53.81%	-69.32%	-26.50%	-35.43%
No. of Constituents (8/29/2014)			2242	179

* Annualized in HKD

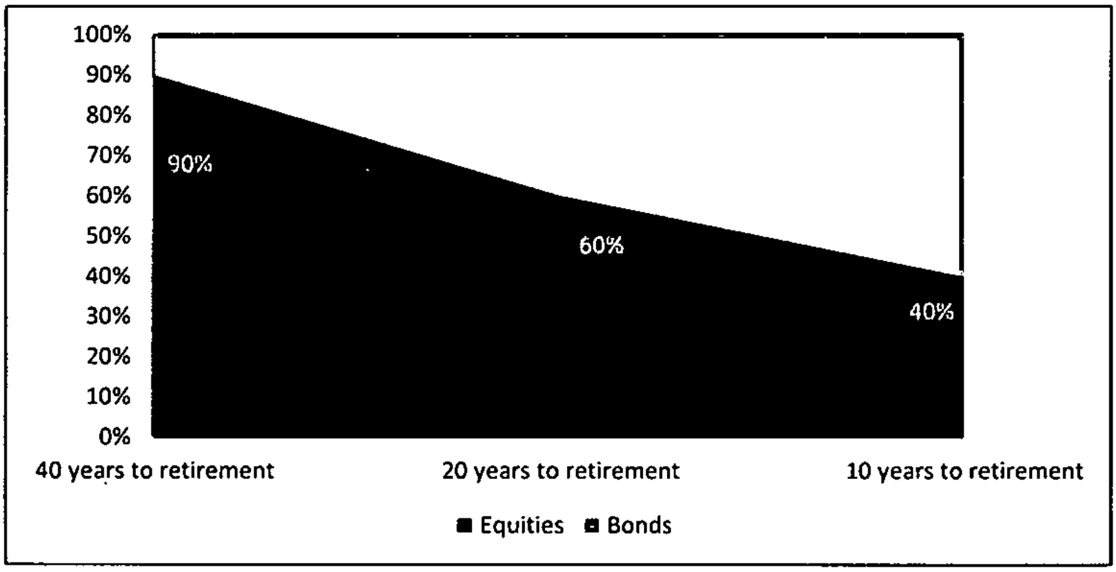
[4] For fair comparison, this is the unhedged to HKD version of the MSCI MPF ACWI

Low cost and transparent rule-based factor tilted Indexes may provide another de-risking option in the life cycle fund

We use this section to provide our response to the Consultation Question 4-5.

We have seen Target Date funds or Life Cycle funds widely adopted by Defined Contribution retirement systems worldwide. Such funds typically decrease the equity exposure, based on the remaining investment horizon, as the main means of de-risking a diversified multi-asset portfolio. With the significant innovation brought by Factor Investing, this de-risking step could now be potentially achieved without a significant reduction in the exposure to the Equity Risk Premia, and while keeping the portfolio management and turnover costs reasonably low.

Exhibit 3 Example of the glide path of a life cycle fund



In Exhibit 3, we plot 3 stages of a typical life cycle fund as an example[5] to illustrate the potential benefit of using an indexed factor portfolio to de-risk the total portfolio while maintaining a certain level of equity exposure. For simplicity, we assume an equities/bonds split prescribed in the original glide path for each 3 stage of 90/10, 60/40, and 40/60, respectively. Using historical information, we find that the total portfolio risk for each of the 3 stage was 15%, 10.9% and 8.4% respectively. By replacing the MSCI MPF ACWI Index allocation in the Second Phase (20 Years to Retirement) with a portfolio of low risk, high quality and value companies, as defined by the ACWI Quality Mix Index, the same level of equity allocation helped lower the risk of the portfolio to 9.3%[6] and at the same time achieved a better performance. Similarly, in the Third Phase (10 Years to Retirement), we replace the

[5] We have used the MSCI ACWI factor indexes for illustration purpose. Past performance is no indication or guarantee of future performance.

[6] We have included the market assumptions and historical statistics used in this calculation in Appendix

MSCI MPF ACWI Index with a portfolio of lower volatility and higher dividend paying stocks, as defined by the MSCI ACWI Minimum Volatility Index and the MSCI ACWI High Dividend Yield Index. In this case, keeping the same level of equity allocation but switching to the MSCI ACWI Minimum Volatility Index and the MSCI ACWI High Dividend Yield Index, the overall risk of the portfolio would have been lower from 8.4% to 7.2% and at the same time achieved a better performance.

The example has shown that at the end of the life cycle fund, by using factor index, it allows the investors to tilt/mix portfolios to lower risk in a cost efficient way, while keeping an exposure to Equities for the potential superior returns.

Appendix

Historical risk measure and market assumption for the reverse calculation of the glide path

	MSCI ACWI# Index	MSCI ACWI Quality Mix## Index	MSCI ACWI Min Vol + HDY###	Bonds
Total Return* (%)	4.6	7.1	8.3	-
Total Risk* (%)	16.4	13.7	13.2	5.5**

* Gross returns annualized in USD for the 05/31/2000 to 08/29/2014 period

** Assume the volatility of the bonds is 1/3 of the MSCI MPF ACWI equities and the correlations between the bonds and these 3 equity indexes are all 0.4

We use MSCI ACWI as a proxy of MSCI MPF ACWI (Unhedged) to demonstrate the de-risking by factor indexes

MSCI ACWI Quality Mix Index is a composite index by equally weighted of the MSCI ACWI Minimum Volatility Index, MSCI ACWI Value Index and MSCI ACWI Quality Index

MSCI ACWI Min Vol + HDY is a custom composite index by equally weighted of the MSCI ACWI Minimum Volatility Index and MSCI ACWI High Dividend Yield Index

Client Service Information is Available 24 Hours a Day

clientservice@msci.com

Americas

Americas	1.888.588.4567 (toll free)
Atlanta	+ 1.404.551.3212
Boston	+ 1.617.532.0920
Chicago	+ 1.312.675.0545
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Europe, Middle East & Africa

Cape Town	+ 27.21.673.0100
Frankfurt	+ 49.69.133.859.00
Geneva	+ 41.22.817.9777
London	+ 44.20.7618.2222
Milan	+ 39.02.5849.0415
Paris	0800.91.59.17 (toll free)

Asia Pacific

China North	10800.852.1032 (toll free)
China South	10800.152.1032 (toll free)
Hong Kong	+ 852.2844.9333
Seoul	00798.8521.3392 (toll free)
Singapore	800.852.3749 (toll free)
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The company's flagship product offerings are: the MSCI indexes with over USD 9 trillion estimated to be benchmarked to them on a worldwide basis1; Barra multi-asset clas factor models, portfolio risk and performance analytics; RiskMetrics multi-asset class market and credit risk analytics; IPD real estate information, indexes and analytics; MSC ESG (environmental, social and governance) Research screening, analysis and ratings; and FEA valuation models and risk management software for the energy and commoditie markets. MSCI is headquartered in New York, with research and commercial offices around the world.

[1] *As of March 31, 2014, as reported on June 25, 2014, by eVestment, Lipper and Bloomberg*

September 2014

Form for Responding to Consultation Questions

Q1. Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) above? ☐ Yes ☐ No Comments: We've provided our response on page 4-5.
Q2. Do you agree that the CF that is the default fund should be substantially the same in all MPF schemes? ☐ Yes ☐ No Comments: We've provided our response on page 4-5.
Q3. Do you agree that it is appropriate that the core fund be based on a standardized default fund? ☐ Yes ☐ No Comments: We've provided our response on page 4-5.
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 ☐ No Comments: We've answered Q4-5 on page 6.

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? Comments: We've included our responce on page 6.
Q6. Do you agree that keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach? ☐ Yes ☐ No Comments: We've included our responce on page 4-5
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? ☐ Yes ☐ No Comments: We've provided our response on page 4-5
Q8. Do you agree that passive, index based, investment strategies should be the predominant investment approach in the MPF core fund? ☒ Yes ☐ No Comments:

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

Comments:

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 ☐ No

Your preference:

☐ "MPF Core Fund" (having regard to its use as a core investment approach for retirement savings)

☐ "MPF Basic Investment Fund" (emphasizing its design as a basic investment approach for retirement savings)

☐ "MPF Simple Investment Fund" (emphasizing its design as a simple investment process for retirement savings)

☒ "MPF Default Investment Fund" (reinforcing that its primary design is built around the default investment strategy for those who do not, or do not want to make an investment choice in saving for retirement)

☐ "MPF "A" Investment Fund" (or some other term which removes any implications about the nature of the strategy)

Comments:

Q11. Do you agree with the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79? ☐ Yes ☐ No Comments:
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 ☐ No Comments:

Information of Respondent

(Please refer to the Personal Information Collection Statement on pages 47 and 48 of this Consultation Paper)

MSCI 明晟 MSCI Barra RiskMetrics

Theodore Niggli
Managing Director

Suite D, 16F, Mirae Asset Tower,
No.166 Lu Jia Zui Ring Road,
Shanghai, 200120, China
MSCI Barra Financial Information Consultancy (Shanghai) Ltd

T: +86.21.6132.6638
M: +86.13651751483
F: +86.21.6159.0218

theodore.niggli@msci.com

MSCI Hong Kong
12th Floor
Nexxus Building
41 Connaught Road, Central
Hong Kong

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MSCI 明晟 MSCI Barra RiskMetrics

Theodore Niggli
Managing Director

Suite D, 16F, Mirae Asset Tower,
No.166 Lu Jia Zui Ring Road,
Shanghai, 200120, China
MSCI Barra Financial Information Consultancy (Shanghai) Ltd.

MSCI Hong Kong
12th Floor
Nexxus Building
41 Connaught Road, Central
Hong Kong