Providing Better Investment Solutions for MPF Members

Consultation Paper – June 2014

Towers Watson Investment Services Hong Kong Limited

30 September 2014

TOWERS WATSON

Introduction

- In response to the Consultation Paper for Providing Better Investment Solutions for MPF members issued in June 2014, Towers Watson Investment Services Hong Kong Limited (Towers Watson or We) hereby provide our thoughts on the possible introduction of a core fund to the MPF system.
- The contact person for this consultation submission is set out below:-

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- This paper serves to respond to the questions set out in the Consultation Paper.
- In general, Towers Watson has the following comments:-
  - We support the idea of exploring a better approach for the default strategy. It is believed that the terminology core fund could be misleading to the general public. As such, throughout this paper, we will use the terminology “default fund” in lieu of “core fund”.
  - With the current diverse default arrangement, we encourage the creation of a standardised principle / framework for the default fund, but the design and operational aspects should be delegated to the service provider.
  - Some elements of the default fund should be left to the discretion of the service providers so that they can retain a competitive edge.
  - We have concerns about the fee cap and worry that there will be no room for further reduction. That said, we believe a cost effective default fund is essential given the public’s focus on fees.
  - A risk reduction type of investment strategy which investment risks reduce according to age / years to retirement is more appropriate, i.e., a target date or life cycle strategy is preferred.
- The next several pages summarise our detailed responses to the Consultation Paper.

Questions 1 and 2

- The table below sets out our responses for Questions 1 and 2 of the Consultation Paper:-

Question 1 Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) above?	Towers Watson agrees that the default fund should be standardised, balancing long-term risks and returns, of good value, and available to all MPF scheme members. That said, it is important to have agreed on the definition of "standardised" in paragraph 36(a).
Question 2 Do you agree that the CF that is the default fund should be substantially the same in all MPF schemes?	It depends on what "substantially the same" means.

Question 3

- The table below sets out our responses for Question 3 of the Consultation Paper:-

Question 3 Do you agree that it is appropriate that the core fund be based on a standardised default fund?	Similar to Question 2, it depends on what “standardised default fund” means. Towers Watson believe that the default fund should be standardised in principle. If the default fund is a standardised fund which refers to all default funds within the MPF schemes adopt the same design, strategies and investment arrangements, e.g., all default funds have to adopt a passive approach, Towers Watson has the following concerns (1) Who is responsible for the design of the default fund? (2) Service providers would not have the incentive to be creative. They will lack a sense of ownership for this product (3) If the design of the default fund is heavily regulated with prescribed approach, would the investment guidelines be possibly further restricted?

Questions 4 and 5

- The table below sets out our responses for Questions 4 and 5 of the Consultation Paper:-

Question 4 Do you agree that the appropriate investment approach of the core fund is one of the automatically reduces risk over time as the member gets closer to age 65? If not, what other option would you propose?	In principle, Towers Watson agrees that the default fund uses a risk reduction strategy over time. It is important that the default fund focuses on the time horizon as the life journey in that it does not end at age 65, but the end of life span. That said, this does not mean that the cash exposure is 100% at age 65. This is because, in general, the post retirement period could be 20 years or more. Hence, this imposes an important consideration for the appropriate investment strategy during the later journey of the MPF members' investment horizon.
Question 5 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 in all schemes or can some elements be left to the decision of individual product providers?	Towers Watson believes that service providers should have the discretion in the design of the default fund. Otherwise, there will not be any healthy competition in the market and service providers will not have any incentive to be creative about the effectiveness of the offering. Ultimately, it will be the MPF members who will suffer.

- The next four pages set out Towers Watson's views on the issues relating to paragraph 48 (a) to (g).

Question 5 – paragraphs 48 (a) and (b)

- The table below sets out our responses for paragraphs 48 (a) and (b) (Question 5) of the Consultation Paper:-

Paragraph (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	Towers Watson believes that both target date and life cycle have their pros and cons. For target date fund approach, the investment strategy changes gradually throughout a members' investment horizon; however, the methods used might not be easily understood by MPF members. In addition, it might take some time before some service providers can benefit from the economy of scale for offering these target date funds. Furthermore, in order to cover all MPF members, a large number of Target Date funds will need to be introduced. For life cycle fund approach, this will require fewer funds to manage. Service providers can utilise their existing products to build such strategy. However, there could be an exposure to market risk when there is a change of fund over time.
Paragraph (b) If a series of target date CFs is the preferred approach, how many funds are need: 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	Towers Watson believes that five years seems reasonable.

Question 5 – paragraphs 48 (c) and (d)

- The table below sets out our responses for paragraphs 48 (c) and (d) (Question 5) of the Consultation Paper:-

Paragraph (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	Towers Watson believes that current asset classes such as equities and bonds are the essential building blocks. That said, the default fund should be as diversified as possible with daily liquidity. Daily liquidity is essential because MPF members may conduct switching based on their desire and this requirement matches the flexibility of daily switching.
Paragraph (d) Which investment building blocks are more appropriately managed in a passive manner	In general, Towers Watson believes equities could be passively managed especially those markets with sizable market cap and high volume trading. Furthermore, we believe smart beta ideas should be considered because typical passive mandate assumes market capitalisation is good, which is not always the case.

Question 5 – paragraphs 48 (e) and (f)

- The table below sets out our responses for paragraphs 48 (e) and (f) (Question 5) of the Consultation Paper:-

Paragraph (e) What would be the approach for reducing risk over time (i.e., the glide path)I should de-risking start 20 or more years away from retirement or should it only happen in the 10 years immediately preceding age 65	Towers Watson believes that 10 years prior to age 65 is a reasonable period for de-risking. The reduction should be gradual and service providers should be given the flexibility in reducing risk. A balance between innovation and preservation using underlying investments can help differentiate between providers. Otherwise, all default funds will be the same.
Paragraph (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	Generally, equity-type investments post retirement is still needed for growth as means to longevity protection. However, this has to be carefully balanced depending on each individual's financial status and the need for safety.

Question 5 – paragraph 48 (g)

- The table below sets out our responses for paragraph 48 (g) (Question 5) of the Consultation Paper:-

Paragraph (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	Towers Watson encourages that some elements should be left to service providers to retain competitive advantage, but under a common framework. We would like to emphasise that the concept of default fund in principle is good for the industry, but its success will hinge on the motivations of different stakeholders, i.e., service providers and MPF members. From a service provider perspective, they would be the key to develop appropriate and competitive offerings whilst MPF members should provide feedback to service providers from a user perspective. If this is the right approach for the majority of members, then we would like to see members being steered towards that. But if the funds composition are imposed upon the providers, or worse, centrally run outside of the current MPF industry with little or no benefit to existing providers, then there will be a disincentive for providers to promote the initiative. Also if there is no freedom for provider design or nor room for value-added decisions, then the funds may be seen to be the responsibility of some other party – likely the MPFA. Should the fund not perform up to expectation, the blame will be put on the "designer". Ultimately, this will result in bad publicity. On the other hand, if the funds are competitively run but with a high degree of commonality, then there would be more effort to strive for differentiation and outperformance by providers.

Questions 6 and 7

- The table below sets out our responses for Questions 6 and 7 of the Consultation Paper:-

Question 6 Do you agree that keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach?	Towers Watson believes that a fee cap imposed on the default fund would ultimately become the floor and there will be no room for further reduction. There needs to be concerted efforts in better communication, more transparent explanation on the composition of the fees for the default funds so that members can make appropriate comparisons. We believe it is informative to various parties about the coverage of 0.75% as the fee cap. Is this just referred to the investment management fee? It is not clear whether this proposal includes the transaction and trading costs. In addition, what is basis of setting the fee cap at 0.75%.
Question 7 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?	Please see the response as per Question 6. Considering the proposed FER being set at 1.0% and the current average FER for a mixed assets fund is 1.84% (as at 29 August 2014), how exactly the managers build a default fund within this cap? Would simply using passive approach be feasible? What is medium term in this context?

Questions 8 and 9

- The table below sets out our responses for Questions 8 and 9 of the Consultation Paper:-

Question 8 Do you agree that passive, index based, investment strategies should be the predominant investment approach in the MPF core fund?	Towers Watson agrees that passive strategies should be considered for the default fund investments. It is viewed as simple to understand and matches the governance of individual MPF members, which is low. That said, if there is a case for active management for underlying mandates, some of them could be managed actively. Investment managers / service providers should evaluate how the underlying asset classes to be managed. In other words, what should be the investment approach for efficient markets such as US equities? For Asian equities, should they be active managed to capture the alpha given the possible opportunities?
Question 9 Are there particular asset classes which you think would not appropriately be invested on a passive, index based approach?	Towers Watson believes that passive, index based approach is probably not ideal when investing in inefficient markets, although providers may prefer to use an active approach for some of the inefficient markets. That said, we believe MPF should be evolving with the market development over time. Other type of strategies, such as smart beta, should also be considered.

Questions 10 and 11

- The table below sets out our responses for Questions 10 and 11 of the Consultation Paper:-

Question 10 Do you agree that 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?	Towers Watson agrees that the name of the core fund should be standardised across schemes. We believe that MPF Default Investment Fund is appropriate because it reinforces the primary purpose of the fund which focuses on the default investment strategy.
Question 11 Do you agree with the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79?	In principle, the existing defaulters' investments should be transferred to the new default arrangement. However, this needs to be addressed from a legal perspective if such arrangement would violate the regulation. One option may be to offer a grace period of, say 12 months, to MPF members that they have the right to switch out from the existing default fund. If such decision is not made at the end of the grace period, their investment under the existing default fund will be automatically transferred to the new default fund. Towers Watson believes that it is more practical to seek input from the administrator of the MPF schemes to formulate the most efficient transition process.

Question 12

- The table below sets out our responses for Question 12 of the Consultation Paper:-

Question 12 Do you agree with the proposal in paragraph 81 as to how to deal with the transition for existing MPF members of default funds??	Towers Watson believes that it is more practical to seek input from the administrator of the MPF schemes to formulate the most efficient transition process.

Other comments

- With the current diverse default arrangement, a standardised default approach is essential and will help MPF members to align their risk and return profile. In other words, MPF members will not be too conservative during the early part of the accumulation phase or too aggressive when they are closed to age 65.
- That said, Towers Watson believes that it is extremely important to communicate clearly the purpose of the default fund to the public to manage their expectation of such fund. Currently, MPF members could view the default fund as a product which provides stable return over time. However, if a risk reduction type of default fund is being designed, the fund could experience volatile return when the equity content is high for the younger members.

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About Towers Watson Investment

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