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26 September 2014

Investment Regulation Department
Mandatory Provident Fund Schemes Authority ("**MPFA**")
Units 1501A and 1508, Level 15
International Commerce Centre
1 Austin Road West, Kowloon
Hong Kong
Attention: Consultation on Providing Better Investment Solutions for MPF Members
(By email only: mpfinvest@mpfa.org.hk)

Vanguard's Comments on the Consultation Paper ("Consultation Paper") on "Providing Better Investment Solutions for MPF Members" ("Consultation")

Dear Sir/Madam,

We are grateful for this opportunity to provide our feedback on the Consultation and appreciate that several of our previous comments have been considered by the MPFA. Based on the proposals set out in the Consultation Paper, we have responded to each of the consultation questions in Appendix A to this letter.

Vanguard is happy to be listed as a respondent to the consultation.

The Vanguard Group, Inc. ("**VGI**") is the world's largest mutual fund provider and the third largest exchange-traded funds provider. VGI is also a major 401(k) plan provider in the United States. Globally, VGI and its associated companies (collectively, "**Vanguard**") manage over USD

3 trillion[1] in mutual funds, separately managed accounts and exchange-traded fund ("**ETF**") assets.

Vanguard Investments Hong Kong Limited ("**VIHK**") was established in Hong Kong in 2011 and has launched four HK-domiciled ETFs – one in 2013 and three in mid-2014. VIHK is very keen to help facilitate the reforms proposed in the Consultation Paper by sharing with the MPFA our experience.

Vanguard is happy to provide the MPFA with our further thoughts, so please do not hesitate to contact us should the MPFA have any follow-up questions.

Yours sincerely,

Lora Yip
Deputy Head of Legal and Compliance, Greater China

[1] *Figure as of 31 August 2014*

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Appendix A – Vanguard's Responses to the Consultation Questions

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

(Response to Q1)

Yes, Vanguard fully supports the direction of introducing a core fund in the manner set out in paragraph 36, that: -

(a) the core fund is based on standardized default funds;
(b) as a default fund, the investment approach of the core fund balances long-term risks and returns in a manner appropriate for retirement savings;
(c) the core fund is good value; and
(d) the core fund is available to all MPF scheme members to choose.

Elaborating on our comments on point (c) of paragraph 36, Vanguard advocates that the core fund be good value to scheme members. We believe a core fund of good value provides the best chance of meeting the overall objectives of retirement savings. Whilst investment returns will inevitably be affected by market fluctuations, it is certain that the accumulative cost effect brought by a fund with higher cost will have a significant adverse effect on the long-term investment return. As such, Vanguard agrees that the investment cost for the core fund should be as low as reasonably possible.

On point (d) of paragraph 36, Vanguard supports that the standardized default be available as an investment choice to all members. Members who actively select the Constituent Funds ("CF") should also have the right to benefit from the core fund.

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

(Response to Q2)

Yes, Vanguard agrees that core funds should be substantially the same across all MPF schemes. One of the main reasons for setting up the core funds is to safeguard the interests of the members who struggle to make, or do not wish to make, investment decisions with a level of consistency. The core fund can provide them with the best chance of meeting their retirement objectives if those members do not make an investment decision. It would be difficult to justify why certain members have substantially different investment outcomes when they have essentially made the same investment decision (i.e., by making no investment decision) because their employers happened to enroll them into different schemes.

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

(Response to Q3)

Yes, Vanguard agrees that the core fund should be based on a standardized default fund. Standardization across all core funds is required to help members of different schemes to achieve the overall objectives for their retirement savings.

Vanguard recognizes the importance of transparent comparisons across different schemes and funds. We appreciate that the MPFA has recently enhanced and standardized disclosure, and developed and made tools available for members to compare schemes and funds. We think benchmarking and comparing investment performance and fees for core funds will be more meaningful (hence more competitive and better value across different MPF schemes) if all the core funds are standardized.

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?

(Response to Q4)

Vanguard agrees that an appropriate investment approach of the core fund is one that automatically reduces risk over time for two reasons: (i) historical market data shows there are significant potential rewards for taking market risk; and (ii) younger members are more capable of withstanding such risk than older members. A larger percentage of younger members' total wealth is in "human capital" compared to their financial holdings. An individual's total net worth consists of both their current financial holdings and their future work earnings. For younger members, the majority of their ultimate retirement wealth is in the form of what they will earn in the future, their "human capital". Therefore, a large commitment to stocks in a younger member's portfolio may be appropriate to balance and diversify risk exposure to work-related earnings.

Further, as passive members take little action or do not take action at all for their MPF investment, they are unlikely to adjust their own portfolio on an on-going basis. The core fund should balance long-term risks and returns in a corresponding manner for these members.

Considering that members are particularly at risk from investment shocks in the years immediately preceding retirement, the core fund should adopt an investment approach that balances long-term risks and return for these investors by automatically reducing risk as members get closer to retirement age.

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?

(Response to Q5, for MPFA's ease of reference, the responses below address the technical issues set out in paragraph 48 one by one)

Regarding point (a) of paragraph 48:

Vanguard prefers a series of target date CFs – or CFs that invest in approved pooled investment funds ("**APIFs**") with target date features – to a life cycle approach that varies the member's holdings of different CFs over time. The main reason is that if the target date approach is adopted, adjustments will only be made at the CFs or the target date APIFs level only. Members would only need to choose a target date fund by determining which year they would retire.

Unlike the members of a CF with target date features, not all members of CFs covered by a life cycle approach initially invest for gradual risk adjustment. When the relevant portion of members' contribution is adjusted across different CFs, the investment return for the other investors may face unnecessary fluctuation as a result of switching, redemption or subscription.

In order for a life cycle approach to be sufficiently diversified, the scheme may need to have appropriate types of CFs that serve as components. This requirement makes the life cycle approach less feasible for smaller or start-up scheme providers. Current average fund expense ratios ("**FER**") of CFs are relatively high. This may not allow the core fund to be good value. On the other hand, the target date approach is more feasible as diversification can be easily achieved when the target date CFs invest into different APIFs or when the CFs invest into APIFs with target date features.

With a life cycle approach, performance measurement and comparison of core funds across different schemes is difficult. Performance of core funds becomes a mere collection of default members' accounts, making it less transparent than the performance reporting of CF and APIF currently used by members.

Regarding point (b) of paragraph 48:

The number of target date funds offered by each scheme should largely depend on the size and market share of each scheme. For target date CFs with a smaller size, a fund may opt to have a number of funds in 10-year increments to lower administrative costs. Later, the scheme provider can increase to funds in five-year increments, if needed.

Regarding point (c) of paragraph 48:

Vanguard thinks that investment grade bonds and equities are appropriate building blocks at the underlying fund level. In particular, we recommend exposure to a broadly-diversified mix of equities and bonds.

Regarding point (d) of paragraph 48:

Vanguard believes that equities and investment-grade bonds can be managed in a passive manner. A passive approach provides members a broadly-diversified portfolio, and delivers investment returns that are consistent with market returns. Passive investing, as compared with active management, incurs lower management fees and investment costs. Lower FERs contribute to creating a better value core fund and can help meet the MPFA objective that the core fund be good value.

Regarding point (e) of paragraph 48:

In light of the life expectancy for members, and the fact that a preponderance of members exercise their option to withdraw their assets entirely upon reaching the retirement age of 65, Vanguard believes that de-risking should start 25 years prior to the retirement age of 65. A significant level of equity exposure is maintained up to age 40 because one's "human capital" remains dominant over small balances in financial capital during the early stages of asset accumulation. After age 40, the equity allocation should continue to decline up to the retirement age, compensating for the shifting balance between human and financial capital.

Regarding point (f) of paragraph 48:

Vanguard suggests the terminal risk profile at age 65 should be maintained, and that around 30% equity exposure be maintained at and beyond age 65. This allocation to equities recognizes that most pre-retirees and recent retirees still have the ability to alter their retirement plans – though far less than younger members – if absolutely necessary. Modest exposure to equities can diversify their portfolios and help them realize their long-term goals.

Regarding point (g) of paragraph 48:

While we believe core funds should be passively-managed and largely standardized in relation to the above aspects, some elements – such as the design of the glide path and the number of target date funds offered by each scheme – should be left to individual product providers to decide.

That said, in general we believe that the flexibility given to individual product providers should be limited so the benefits brought by the core funds' standardized risk adjustment approach remain. In order to meaningfully standardize the core fund, it is important to create some consistency in the general design of the glide paths for all core funds. Since asset allocation is one of the most important factors to long-term investment outcomes, if the glide paths across individual product providers are substantially different, the key objective of standardizing default fund outcomes will likely be defeated. We suggest standardizing the general design of the glide paths by setting the upper and lower boundaries or the limits of tolerance of equity/bond allocation.

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

(Response to Q6)

We believe that the fee cap of 0.75% is feasible.

The 0.75% fee cap should be an all-in fee that includes all on-going fees (for trustee, administration and distribution, investment management and custody) both at the CF level and at any underlying APIF or index fund level.

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?

(Response to Q7)

Vanguard agrees with the proposed 1.0% FER over the medium term. FER includes expenses deducted from a CF plus any underlying APIF, which indirectly affects a member's return. From a long-term perspective, the diminishing effect brought to members' return by a higher FER is substantial.

By setting the maximum FER at 1.0%, the CF has incentive to choose more low-cost underlying APIFs, whereby the cost outcome brought by the multi-tier investment structure of MPF schemes can also be alleviated.

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

(Response to Q8)

Index-based, investment strategies should be the predominant investment approach for the core fund. The main objective of the MPF scheme - especially the core fund – is to help members capture the returns available from the global capital markets with the least friction due to investment fees and expenses. To achieve this objective, low-cost index-based investing is the key.

There are also studies that show FER is the most reliable predictor of future performance. FER serves as a valuable guide to members as it is one of the few characteristics known in advance.

Vanguard acknowledges that there are factors other than cost that contribute to the success of passive investment strategies when saving for retirement. Economies of scale and an efficient and risk-controlled portfolio-management process can help an index fund to deliver consistent returns relative to the targeted benchmark over time.

On the other hand, actively managed funds usually incur higher expenses because of the research process required to identify potential outperformers and the generally higher turnover associated with the attempt to outperform a benchmark.

While it is true that there are a minority of active funds that might be able to outperform the benchmarks they target over a short period of time, in the long term, it is difficult for active managers to consistently produce excess return over the fifty or more years involved in retirement investing. Figure 1 shows the relative performance of actively managed mutual funds when evaluated against the funds' benchmarks (as identified in each firm's fund prospectus) over the 1, 3, 5, 10, and 15 years through 31 December 2012. For each period we show three results:

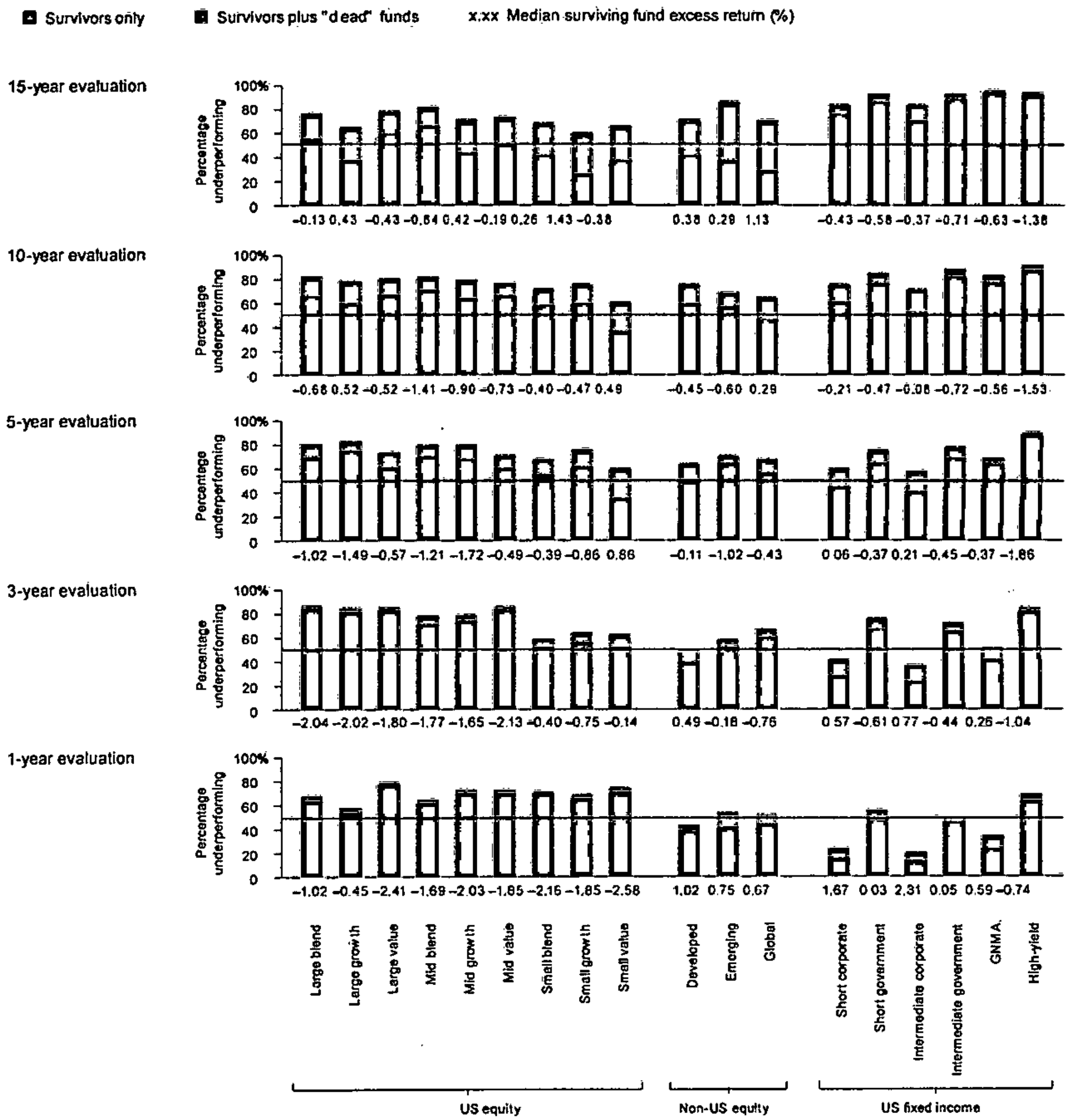
1. The percentage of funds in each category that survived the time period but underperformed their benchmarks and were unadjusted for "survivorship bias" (results do not reflect those funds that dropped out over time).

2. The percentage of funds in each category that started the given period but either underperformed or dropped out of the sample (removing "dead" funds from a performance database).

3. The annualized excess return for the median surviving fund.

The figure's major finding is that active fund managers as a group underperform their stated benchmarks across most of the fund categories and time periods considered. For example, 69% of US large-cap value equity funds underperformed their benchmarks over the ten years ended 31 December 2012. The case for indexing is also strong over shorter horizons, although shorter sample periods tend to produce slightly more erratic results.

Figure 1



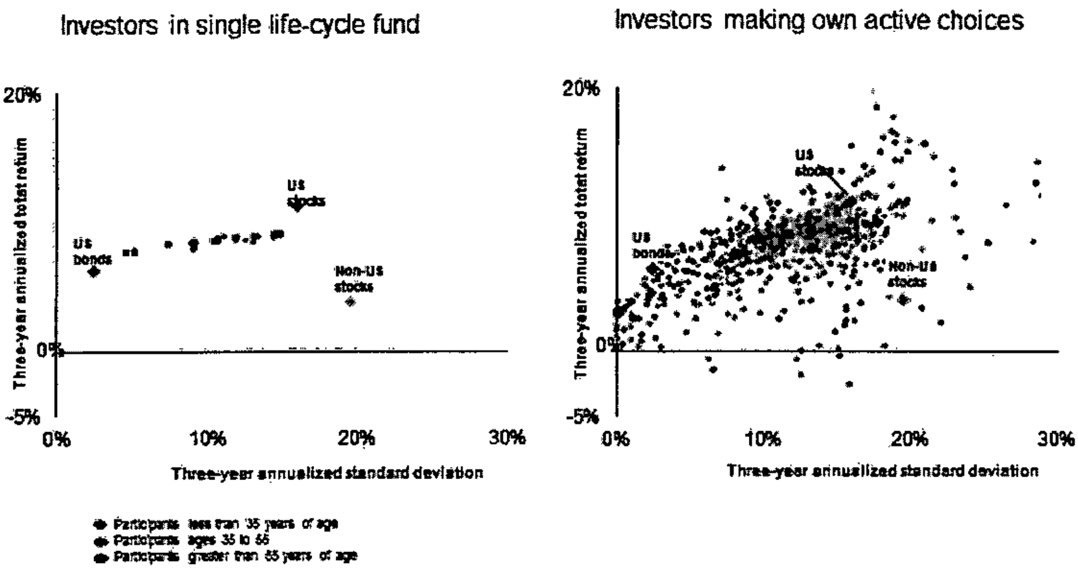
Note: Data reflect periods ended 31 December 2012. Sources: Vanguard calculations, using data from Morningstar, Inc. Fund classifications provided by Morningstar; benchmarks reflect those identified in each fund's prospectus.

Unlike active fund management, index-based investment strategies are able to mitigate the risk associated with specific securities and remove a component of return volatility by holding a broad range of securities to accurately track the targeted benchmark. Passive strategies produce more consistency in terms of investment style. By attempting to closely track an index, an index fund has a consistent allocation and is not susceptible to manager-specific risks and fluctuating risk-and-return characteristics. For trustees and the MPFA, the observation on passive defaults can lead to a better understanding of the risk/reward characteristics actually assumed by default investors.

While we think an active investment approach is appropriate under certain circumstances, for example when such approach is offered at bottom-quartile fee levels, a passive investment approach would be more appropriate for the MPF system. The MPF system is designed as a minimum floor for retirement protection. Given this social insurance element, taking active risk would not be socially desirable for Hong Kong people's retirement planning. Over time, if managed properly, a member's accumulated contributions in the MPF system can serve as a significant source of funding for his or her retirement. On the other hand, for members who want to pursue active risk, they can always opt into active MPF CFs and/or funds outside the MPF system with their personal saving.

Figure 2 shows a comparison between the investment returns of a single target date fund which adopts a passive investment approach and the average investment returns from investors who actively make their own investment choices. As the left chart illustrates, scheme members in a target date fund have a more consistent investment outcome than the right chart, where scheme members make their own fund choices.

Figure 2



Source: Vanguard, 2013.
Note: Includes 1,000 random participant accounts drawn from respective samples for single life-cycle fund, managed account, and all other participants.
Excludes 1/2% top and 1/2% bottom outliers for both risk and return, for a net sample of 980 observations.
U.S. bonds=Barclays U.S. Aggregate Bond Index; U.S. stocks=MSCI US Broad Market Index; non-U.S. stocks=MSCI AC World Index ex U.S.
Past performance is no guarantee of future results.

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

(Response to Q9)

While equity and investment-grade bond securities can be appropriate for a passive, index-based approach, as mentioned in the Consultation Paper, asset classes like local money market exposure may be less appropriate for such an investment approach.

<u>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?</u>

(Response to Q10)

Vanguard agrees that the name of the core fund should be standardized across schemes. Among all the names suggested in the Consultation Paper, Vanguard thinks that "MPF Core Fund" is the most direct and appropriate name.

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

(Response to Q11)

Vanguard agrees with the general principle stated in paragraphs 78 and 79. We agree that all existing MPF members – not just existing investors of the current default funds – should be made aware of the new core fund arrangement upon the launch of the core fund. We also agree that members who have not previously made a choice of CF should have their accrued benefits and future contributions invested into the new core fund, unless they opt to invest into some other CFs after being notified of the new arrangements.

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?

(Response to Q12)

Vanguard agrees with the proposal in paragraph 81 in principle. While we acknowledge that it might be difficult for trustees to identify members who have not previously made a choice of CF, Vanguard proposes that all MPF members be given the opportunity to make a new fund choice – including members who do not invest their contributions into the existing default funds. A right to opt in or opt out allows members to revisit their investment allocation and have due consideration about the new core funds. The MPFA can also take this opportunity to highlight the benefits of long-term target date funds to all MPFA members. The difference in arrangement is that members of existing default funds can be given the right to opt out. If they do not opt out, their assets in the existing default funds would be automatically transferred to the new core funds. For members of other CFs, a right to (partially or fully) opt in would be brought to their attention by notice.

Vanguard's other comments regarding the 30% HKD Currency Requirement

Under the MPF regulation, there is a requirement that at least 30% of a CF must be held in Hong Kong dollar currency investments, as measured by the effective currency exposure.

For the design of a glide path, it is important to ensure that it exhibits a "global" approach to equities and fixed income outside Hong Kong. In the fixed income sector, our analysis shows that Hong Kong has a very small portion of the global bond market (<1%) with approximately 85% in corporate debt, which is heavily weighted to the financial and industrial sectors. In equities, there is a significant overweight to financials and a significant underweight to IT, health care, consumer staples and energy. The issuer concentration is three times (53% weighted in top ten securities in Hong Kong) higher than the US market.

Vanguard sees the merits of a glide path that exhibits a broad diversification of allocations to global fixed income and equities from a long-term investment perspective. It is also an important risk management tool as diversification will ensure that investments will not be overly concentrated in any one asset, industry, market or geographic region. However, for the purpose of compliance with the 30% Hong Kong dollar currency exposure requirement, it becomes inevitable that hedging by using USD/HKD forward contracts needs to be an option. This will impose additional costs that will vary according to market conditions. Because compliance with this requirement increases the core fund's operating costs, Vanguard recommends that the 30% Hong Kong dollar currency exposure be removed or reduced from 30% to 10% in terms of the threshold.