MPF Investment Solutions Consultation

Mandatory Provident Fund Schemes Authority
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Summary

Morningstar supports the introduction of a core fund based on a standardised default fund. The core fund should not only act as a default for members not making a choice, but it should also be made available as a standalone option for all members to choose given the likely scale benefits that will attach to these options.

We believe guidelines governing the construction of core funds will assist to achieve greater consistency than that which exists today, but it is also important for such guidelines to provide some flexibility and scope for differentiation between the core funds. In addition to fostering product innovation flexibility will also make it easier for global best practice to be adopted at a lower fee to members.

Morningstar recognises the impact of management costs on long-term returns and agrees that the core fund should represent good value for MPF members. Importantly though, "good value" is not just about cost but the delivery of a solution that is valued by MPF members and delivers strong net (post-fee) returns.

Morningstar supports the use of target-date funds as core strategies as they offer a lower-cost way for plan providers to provide appropriate asset class diversification to their participants in a prudent manner. As an average investor's overall economic situation evolves and as investors move from accumulation into drawdown, the asset allocations evolve throughout their lifetime. Target date funds help to track this path.

While supporting the introduction of a cap on investment fees we believe 0.75% may be too aggressive a target in the short term given the MPF's current assets. Such a cap may lead to undesirable practices in the construction of core fund portfolios, limiting the sort of asset classes used in and the style of management. Targeting an asset-weighted average fee of 0.75% is a reasonable initial target but a cap of 1.00% per annum may be more appropriate. Rather than mandated caps, Morningstar favours better disclosure and competition as drivers of better outcomes for investors in the long term.

While indexing can be a useful strategy in running a portfolio, Morningstar does not believe it should be a mandated requirement in a fund. The manager running the fund should be free to make an informed decision about whether to use indexing based on an assessment of future returns and the overall fee budget at any given point.

Finally, the transition to the new arrangements should be conducted over a specificed time period and not on one date. Equally, the transition arrangements should allow for current providers to make existing default options compliant with the new guidelines.

Question 1: Introducing of the Core Fund

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

Y ☒ N ☐

Comments:

At Morningstar, we acknowledge that the lack of structural guidelines has led to a wide range of default funds being offered to members of different MPF schemes, resulting in vast risk and return differences for MPF members over long periods. When also taking into consideration that a large number of MPF members do not make an active investment choice, we support the introduction of a core fund that is specifically designed to achieve the retirement objectives of MPF members.

In terms of the key elements, we believe that it is sensible for the core fund to be based on a standardised default fund. Not only does this provide an appealing default option for MPF members who do not make an investment choice, the sheer volume of members belonging to this group should also provide meaningful scale for the core fund. Nevertheless, although it makes sense for the core funds to share the same structural framework, we also believe it is important to provide some flexibility and scope for differentiation between the core funds. This can foster product innovation and offer global asset managers the potential to introduce proven strategies that have achieved sufficient scale in other pension markets, potentially allowing members to benefit through lower fees and costs.

Second, we agree that a long-term investment approach is a vital element in allowing MPF members to build robust savings pools for retirement. We also believe that a target-date approach is appropriate for the core fund as it offers a lower-cost way for MPF providers to provide appropriate asset class diversification and a one-stop solution for members in a prudent manner.

Third, as a strong advocate of after-fee returns, Morningstar recognises the impact of management costs on long-term returns. Thus, we agree that the core fund should represent good value for MPF members. We believe "good value" is not just about cost but the delivery of a solution that is valued by MPF members and delivers strong net (post-fee) returns.

Question 2: Default Fund

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

Y ☒ N ☐

Comments:

At Morningstar, we agree with all the issues outlined in paragraph 33 of the consultation paper. To save for retirement, we concur that it requires a strategic, long-term approach that offers good value for scheme members. For members invested in the default fund, either explicitly (through choice) or implicitly (by default), we believe that their investment outcomes should not vary greatly simply because of structural differences in investment approach. Rather, we believe it is best for MPF schemes to differentiate by factors such as the diversity of product offering, investor experience, transparency, disclosure and ultimately investment performance.

From a structural standpoint, we agree that the default funds should be substantially the same. By having default funds that utilise a structurally similar investment approach, it removes the inconsistency between schemes and provides the scope for easier benchmarking, especially in terms of performance and fees.

While under the same structural framework, we believe it is important to provide some flexibility and scope for differentiation between default funds. Examples of flexibility can include asset allocation ranges and the introduction of new asset classes. Rather than having to develop a tailored solution for the Hong Kong market, flexibility may allow global asset managers to leverage global expertise and introduce proven strategies that have achieved sufficient scale in other pension markets. And by leveraging funds that already have an economy of scale, potentially members can benefit from lower fees and costs. The flexibility would also provide the scope for future industry innovations, which otherwise would be more difficult to achieve with a highly prescriptive approach.

Finally, the availability of default options to all members is very much welcomed. Not only does it provide greater choice for members, the increased scale associated with a higher level of participation may also result in lower fees and costs, which would be beneficial for all members invested in the default funds.

Question 3: Fund Base

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

Y ☒ N ☐

Comments:

We agree that the MPF core fund should be based on a standardised default fund. First, we believe it is a great initiative to introduce a low-cost core fund for MPF members. At Morningstar, we are strong advocates of after-fee returns. Generally speaking, investors are better served by investing in low-cost funds, either active or passive, as it provides them a better chance of achieving higher after-fee returns. Therefore, the introduction of a low-cost core fund should lead to better investor outcomes, especially over long periods.

In addition, we agree with the issues and points outlined in paragraphs 37-40 of the consultation paper. Considering the disparity in the types of default funds offered in MPF schemes today and the resultant differences in return and risks over long periods, the existing approach of allowing scheme providers full autonomy in the design and structuring of default funds does not appear to be an ideal solution for members.

Considering the issues identified in the current default funds and the continual effort to lower the fee burden for members, we believe it is appropriate for a MPF core fund to be based on a standardised default fund. Given that there is a meaningful percentage of members who have not chosen an investment option, or do not wish to choose one, they can provide the much-needed scale for the core fund while also benefitting from the core fund's standardised long-term approach and lower fees. With the core fund open to all MPF members, providing it further scale, it can better achieve its objective of offering members good value.

Question 4: Investment Approach

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?

Y ☒ N ☐

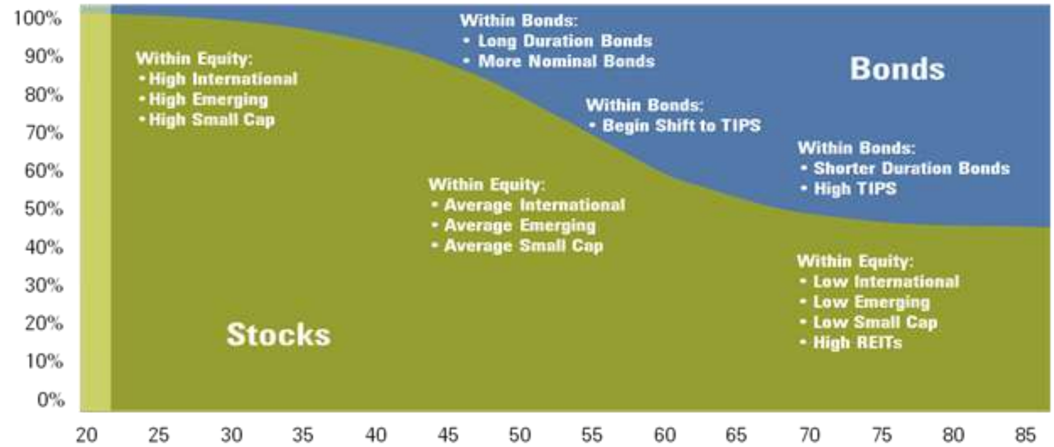
Comments:

We believe the future of target-date funds is bright. They offer a lower-cost way for plan providers to provide appropriate asset class diversification to their participants in a prudent manner. For example, some of the asset classes in the target-date fund may not be feasible as stand-alone options.

Morningstar has published many academic research papers on retirement and provides thought leadership on retirement investment solutions. Morningstar's investment philosophy and objective of creating a target-date glide path is best described as a holistic needs-based glide path that evolves with the average investor's total economic situation (including an evolving picture of their financial capital, human capital and retirement income liability). It attempts to maximise investors' total financial health by investing their financial capital in such a way that it brings their total wealth closest to Modern Portfolio Theory's optimal portfolio (adjusted for risk preferences) while considering the nature of investors' liabilities.

Our research paper, "Lifetime Asset Allocations: Methodologies for Target Maturity Funds", provides a blueprint for combining numerous best practices and academic theories into a real world methodology for creating custom glide paths.

As an average investor's overall economic situation evolves and as investors move from accumulation into drawdown, the asset allocations evolve throughout their lifetime. Overall, as investors age, we believe asset allocations should have a more pronounced home country bias to help pay for their home currency denominated retirement income liability (e.g. a real inflation adjusted income in retirement). Additionally, real return asset classes, such as inflation-linked investments, commodities and real estate, typically play an increasing role as human capital provides less and less inflation protection as the investor ages. Finally, intra-bond allocations should shift gradually from high-return, long-duration, nominal-bond oriented asset allocations towards a less volatile, shorter-duration, real-return oriented asset allocation. This is depicted in the chart below:



Source: Ibbotson Associates- "Lifetime Asset Allocations: Methodologies for Target Maturity Funds".

Question 5: Technical Issues

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?

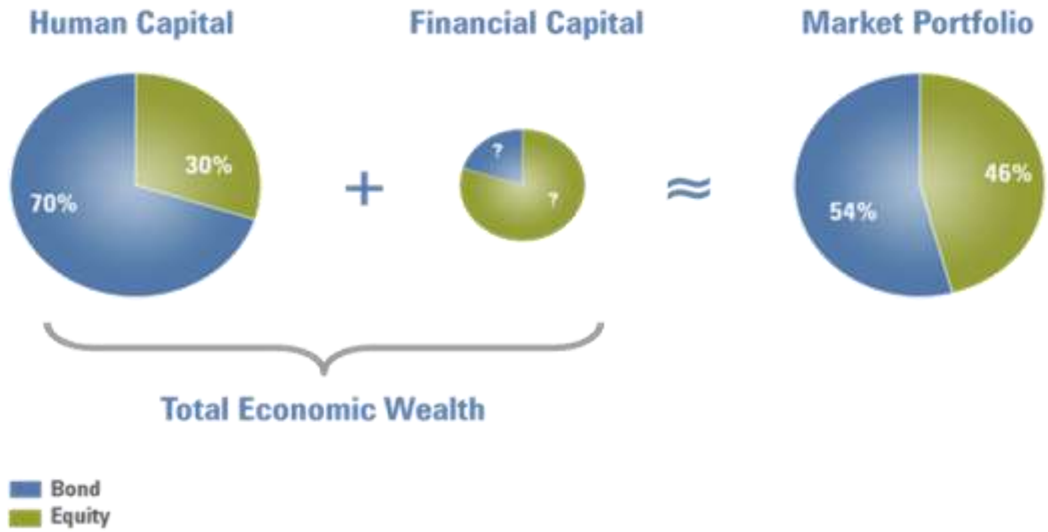
Comments:

Morningstar believes that while default members should be exposed to a structurally consistent investment framework, individual product providers should be provided with scope for product differentiation and innovation, which ultimately should benefit members as a result of competition. In Morningstar's view, the guiding principal in dealing with the technical issues set out in paragraph 48 should be to keep both complexity and fee levels low.

Decisions on which asset classes are managed in a passive manner should be made by the provider in accordance with its fee and risk budget. This should not be mandated by the MPFA. This approach should contribute to the potential for differentiation and innovation among the schemes, within the constraints of the structural framework.

If target-date funds are selected as the preferred approach, Morningstar would recommend consideration of one fund for every 10 years to keep establishment and maintenance costs low. If there are no meaningful cost minimisation benefits to investors, one fund for every five years should be implemented given the better matching between investors and optimal asset allocation.

In regards to broad asset allocation, given increasing life expectancy and the need to fund a longer retirement period, equity exposure will need to be maintained at and beyond age 65. Morningstar incorporates the 'human capital' concept into the lifetime financial planning process, which provides a framework to determine the equity/bond split within an investor's portfolio at any point in their lifecycle. Essentially, an investor's total economic wealth consists of financial capital and human capital. Anyone's total economic wealth should be like a market portfolio or most optimal portfolio on an efficient frontier, which has about 46/54 equity fixed income split. To optimise the financial capital portion, we need to quantify the human capital portion. We quantify human capital based on the demographic data we collect from various official sources.



Source: Ibbotson Associates- "Lifetime Asset Allocations: Methodologies for Target Maturity Funds".

As per Morningstar's response to Question 4, an average investor's overall economic situation evolves and as investor participants move from accumulation into drawdown, the asset allocations also evolve throughout their lifetime.

Question 6: Fee

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

Y ☐ N ☒

Comments:

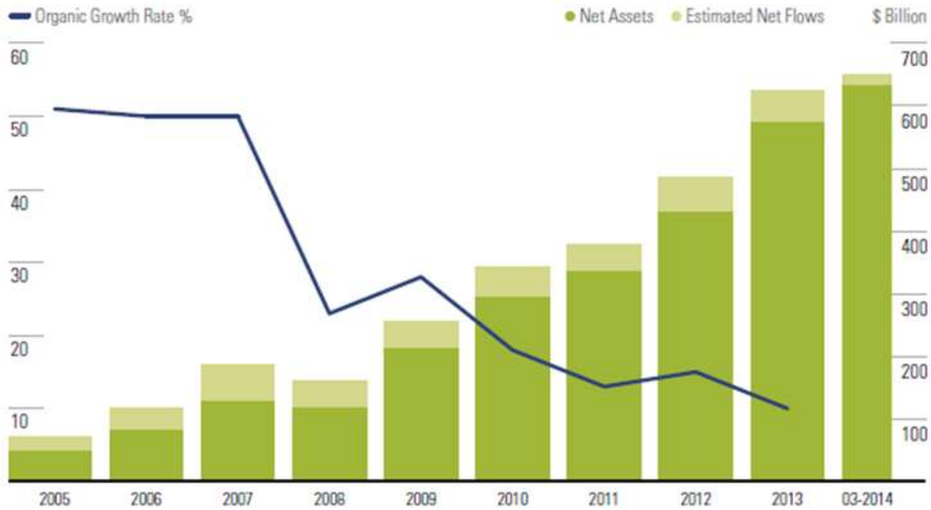
Morningstar supports any move that will assist investors achieve their investment outcomes. We have produced numerous studies that show the reduction of fees paid by investors is a key driver of outcomes but we believe 0.75% may be too aggressive a target in the short term that may lead to undesirable practices in the construction of core fund portfolios. Targeting an asset-weighted average fee of 0.75% is a reasonable initial target but a cap of this amount may unnecessarily limit the sort of asset classes used in portfolios and the style of management. A cap imposed at a level of 1.00% per annum may be more appropriate at this stage of the MPFs' FUM scale and existence.

Morningstar favours better disclosure and competition as drivers of better outcomes for investors in the long term. We acknowledge a cap of some form for default options is appropriate as investors should not be asked to subsidise fund companies while they build the necessary scale to offer more competitive offerings. To put some more context around fee levels, we have examined data from a number of Morningstar sources below.

In the July 2014 Morningstar Target-Date Series Research Paper, Morningstar research shows that the typical US open-end mutual fund investor paid 0.71% annually in 2013, down from 0.78% three years earlier. Looking specifically at target-date funds' the average asset-weighted expense dropped 7 basis points to 0.84% from 0.91% from 2012 to 2013. At the end of 2010, the average was 1.02%. Fund expenses have been coming down as a rising market triggered breakpoints in management fees and also spread funds' fixed costs over a larger pool of assets. Target-date funds (which are under consideration for use as Core fund strategies) are currently more expensive than average mutual funds but the growth in this sector is seeing fees drop at a faster rate.

In reviewing these figures, it is important to note that the US target-date mutual fund industry stands at more than US$600 billion today whereas the MPF assets are less than US$100 billion, or roughly the size of the US target-date market in 2005.

Exhibit 1 Net Assets, Estimated Net Flow, and Organic Growth Rates of U.S. Target-Date Mutual Funds, 2005-March 31, 2014



Source: Morningstar, Inc.

In addition, while the target-date funds' average asset-weighted expense stands at 0.84%, there is a significant range around this, as seen in the chart below. Fees range from under 0.25% per annum to close to 1.25% per annum. As might be expected, funds employing a largely passive strategy are some of the cheapest but this approach does not always result in the lowest cost nor best net outcomes for investors.

Exhibit 29 Target-Date Series' Market Share and Average Expense Ratio

Source: Morningstar, Inc. as of 12/31/2013

The Australian superannuation (or pension) industry is also a large and developed market. Of the approximately 3,000 superannuation fund options listed on the Morningstar Australian database, less than 15% would have an ongoing fee less than the proposed 0.75% cap. This universe includes a range of legacy options that we would not suggest the MPF benchmark to, but it does provide some context to the proposed cap.

In recent years the Australian Government has put in place new default fund arrangements to, among other things, help reduce costs for investors. There are currently 120 products authorised by the Australian Regulation Prudential Authority (APRA) as MySuper default options. The average fee for these products sits above the 0.75% level. Equally, the fees charged by some of the largest MySuper default options (in excess of US$10b each) are in the order of 0.6% to 0.9%. Importantly these are options typically run by not-for-profit organisations focused on member outcomes. While they have the capacity to produce an investment option at a far lower cost, the fiduciaries are choosing to spend investment fees at these levels to ensure suitable portfolio diversification and access to managers who can help maximise net returns. While this may change over time, it is useful to consider in setting the MPF guidelines.

Question 7: Total Expense Impact

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?

Y ☐ N ☐

Comments:

Please refer to question 6 for our discussion on fees. While we believe a 0.75% cap may be too aggressive, the resultant impact on an FER is more difficult to comment on. The additional costs that would contribute to an FER are unlikely to be asset-based, therefore the percentage will depend greatly on the level of assets within the scheme.

We note that paragraph 58 references establishment costs as a contributor to the FER but would question whether such costs should be incorporated. The manager running the scheme should cover establishment costs out of the stated annual fee charged to the fund. To the extent establishment costs are higher than this in the first year is a capital cost to the manager and should not be paid by the investors.

Question 8: Investment Strategies

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

Y ☐ N ☒

Comments:

Indexing can be a useful strategy in running a portfolio but Morningstar does not believe it should be a mandated requirement in a fund. The manager running the fund should be free to make an informed decision about whether to use indexing based on an assessment of future returns and the overall fee budget at any given point.

Morningstar, and many other research providers have published numerous research studies that demonstrate that, on average, actively managed funds underperform passively managed funds on an after-fees basis. The lower cost nature of passively managed investment strategies (as illustrated in paragraph 71 in the Consultation Paper, the average FER for passively managed equity fund was 0.90 percentage points below that of actively managed equity funds), could assist accomplish one of the objectives – that the core fund should be "good value".

On the other hand, research has shown that active management risk-adjusted outperformance can persist. In fact, researchers Harlow and Brown[1] found in 2006 that consistently identifying top-performing managers — in terms of risk-adjusted performance — could boost average annual returns by as much as 1.5 percentage points, with a study period over 1979-2003.

We believe that both index managers and active managers can add value to a portfolio. In an ideal world, we prefer to work with an opportunity set of funds that includes both passive and active investment managers. Such a line-up would enable us to spend our active risk budget as wisely as possible by using index managers when appropriate so that we could spend larger amounts of the active risk budget on the managers with the best-expected alphas.

With the above merits, the difficult exercise then is to consistently identify the top-performing active investment managers and weight the expected performance against the fees levied by the managers and the costs involved in selecting the manager, not to mention quality of the manager selection.

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[1] Harlow, W. V. and Brown, K. C. "The Right Answer to the Wrong Question: Identifying Superior Active Portfolio Management" Journal of Investment Management, Vol. 4, No. 4, 2006

With passive investment strategies, while utilising a low-cost vehicle (e.g. an ETF) by an MPF constituent fund may help reduce overall costs, analysing the cost aspect of using passively managed investment strategies further, it is suggested that one of the key drivers for the current cost of an index tracking MPF is not just the cost of the underlying vehicle/approach but rather the other expenses charged by the MPF constituent fund. It has been found that MPFs investing in ITCISs tracking the Hang Seng Index underperformed ETFs tracking the Hang Seng Index by 84 to 154bps on an annualised basis for the one-, three-, five- and 10-year periods. This level of deviation is similar to the sum of the weighted average cost to trustees of administration of MPF funds (0.75%) and the other costs such as distribution (0.40%) illustrated in paragraph 55 of the consultation paper.

Annualised Total Return (%)	**1-Year**	**3-Year**	**5-Year**	**10-Year**
MPF (Tracking the Hang Seng Index)	13.89	3.70	6.79	8.37
ETF (Tracking the Hang Seng Index, within the ITCIS)	14.84	4.54	7.94	9.91
Hang Seng Index (Total Return)	15.39	4.88	8.34	10.23

Comparison of Annalised Total Return (%)	**1-Year**	**3-Year**	**5-Year**	**10-Year**
MPF vs ETF	-0.95	-0.84	-1.15	-1.54
MPF vs Index	-1.50	-1.18	-1.55	-1.85
ETF vs Index	-0.55	-0.34	-0.40	-0.32

Source: Morningstar Direct, Morningstar Research (asset-weighted data, as of end-June 2014)

We would recommend the Authority and the MPF trustees explore ways to reduce the overall fees of the MPF constituent funds. In general, we believe fees charged by funds are one of the best predictors of future returns. In addition, as the scale of the schemes grows, economies of scale should 'kick-in' to help reduce costs.

Question 9: Asset Classes

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

Comments:

Similar to our response to Question 8, we believe the manager running the fund should have the ability and be free to make an informed decision about using a particular (or a mixture of) investment approach on different asset classes.

It is worth noting that choosing (or not choosing) an asset class and deciding on the allocation of that particular asset class within a portfolio, by definition, is an active investment decision. Here, we raise another question: In the context of a core fund, who will be the decision-maker in putting the allocation at work between different asset classes, albeit utilising active or passive approach, and what is the cost and quality involved in making this asset allocation decision? The cost perspective of this question, once again, rings the bell of one of the key objectives of the core fund — it should be good value.

To help improve the chances of successful outcomes for the participants, the asset classes offered should be time-tested, able to withstand a variety of market conditions and predominantly core in nature. The investment options should complement each other when combined in a portfolio setting.

In general, if a certain asset class is illiquid and less efficient — e.g. micro-cap stocks, some frontier markets — the illiquid underlying securities could result in wider bid/ask spreads on the passive investment vehicle, such as an ETF. Such wider bid/ask spreads for a passively managed fund could cut into investor returns. In this case, investors are advised to exercise caution and perform additional analysis before investing (although, in fact, active managers face the same cost considerations). This may prove to be a harder exercise for MPF members.

Similar to some concentrated active funds, narrowly focused passive investments tend to be more volatile and could experience large return fluctuations. This is not favourable to buy-and-hold investors such as MPF members who are looking for steady and long-term portfolio growth.

When selecting asset classes for a retirement scheme, Morningstar does not attempt to predict which specific investment categories will outperform over short periods. Within the broad asset class of stocks or bonds there are always short-term leaders and laggards across investment categories. Instead, by providing a broad level of diversification across investment categories and adhering to long-term targets, category line-ups should be designed to avoid the short-term volatility that can occur in less diversified selections or those constructed based on the hot-performing segments of the market.

Question 10: Naming the Core Fund

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?

Y ☒ N ☐

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:

No comments

Question 11: Transitional Issues

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

Y ☒ N ☐

Comments:

We agree with the approach outlined in paragraphs 78 and 79 but suggest the following points be considered in finalising the transition arrangements.

Stipulating a time period over which the transition should be made is preferential to a single date. A time period approach would enable providers to incorporate communication of the changes into existing communication timetables if desirable. More significantly, a staggered approach would let the industry spread the implementation timetable and associated resources. Put another way, having a single implementation date for such a large project may result in an extreme load on existing industry infrastructure, driving up the costs of implementation and increasing the chance of error.

The transition arrangements should allow for the possibility that the MPF manager may choose to make its existing default option compliant with the new requirements, similar to what has occurred with the introduction of MySuper in Australia. Members would still require communication about the change but account balances would not necessarily be required to transfer. The longer the transition time, the more likely that this approach may be utilised by plan providers.

Question 12: Transition from Default Fund

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?

Y ☒ N ☐

Comments:

This approach makes sense as, based on international experience, the majority of people in a default strategy are there because they have not made a choice, do not want to make a choice, or do not feel equipped to make a choice. Members who do not fit into these categories are the ones who will most likely respond to the proposed communication, leaving the remainder to move into the new core fund.

About Morningstar

Morningstar Investment Management Asia, which is part of the Morningstar Investment Management group, is authorised and regulated by Hong Kong's Securities and Futures Commission to provide non-discretionary investment consulting services and discretionary investment management services to financial institutions.

The Morningstar Investment Management group, part of Morningstar, Inc., creates custom investment solutions that combine award-winning research and global resources with proprietary Morningstar data. With approximately $169 billion in assets under advisement and management as of June 30, 2014, the Morningstar Investment Management group provides comprehensive retirement, investment advisory, and portfolio management services for financial institutions, plans sponsors, and financial advisors around the world. The Morningstar Investment Management group includes Morningstar's 11 registered investment advisory and licensed advisory entities. In Hong Kong, these services are provided by Morningstar Investment Management Asia Limited.

Morningstar, Inc. is a leading provider of independent investment research in North America, Europe, Australia, and Asia. The company offers an extensive line of products and services for individual investors, financial advisors, asset managers, and retirement plan providers and sponsors. Morningstar provides data on approximately 456,000 investment offerings, including stocks, mutual funds, and similar vehicles, along with real-time global market data on more than 12 million equities, indexes, futures, options, commodities, and precious metals, in addition to foreign exchange and Treasury markets. Morningstar also offers investment management services through its registered investment advisor subsidiaries. The company has operations in 27 countries.