MORNINGSTAR®

LC Paper No. CB(1)396/15-16(08)
(English version only)

Morningstar Investment Management Asia Limited
Unit 6809, The Center
99 Queen's Road Central
Hong Kong

5 January 2016

Hon TAM Yiu-chung
Chairman of the Bills Committee on Mandatory Provident Fund Schemes
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Sir,

RE: Morningstar's Response to the Invitation for Submission to Bills Committee on MPF Schemes

We are writing in response to the invitation for submission to the Bills Committee on Mandatory Provident Fund Schemes (Amendment) Bill 2015, dated 18 December 2015.

We are pleased to be able to take part in the previous round of consultation, and now contribute our views to the Bills Committee. Morningstar Investment Management is a world-class organization built on a foundation of Morningstar's proprietary research, data and analytics that strive to create better investing outcomes for investors. As such, we support the introduction of the Default Investment Strategy and have enclosed our feedback below.

We look forward to the outcome of the review. Please feel free to contact us if you wish to further discuss our responses.

Yours sincerely,

Wing Chan
Director of Manager Research, Asia

Morningstar's Response to the Invitation for Submission to Bills Committee on MPF Schemes

Morningstar supports mandating each trustee to provide a standardized, fee-controlled Default Investment Strategy (DIS) in every MPF scheme. We agree that the previous 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 scheme 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 DIS that is specifically designed to achieve the retirement objectives of MPF members. In addition, the sheer volume of members belonging to this group should also provide meaningful scale for the DIS.

We believe the investment principles that have been laid out are sensible. By having a DIS that utilizes a structurally similar investment approach, it removes inconsistencies between default funds and provides the scope for easier benchmarking, especially in terms of performance and fees. However, it is also important to provide some flexibility and scope for differentiation between the DISs. We believe that the manager running the DIS should be free to make an informed decision about whether to use a particular (or a mixture of) investment approach on different asset classes, based on an assessment of future returns and the overall fee budget at any given point. Examples of flexibility are varied asset allocation ranges, the scope to choose between active or passive investment approaches, and the introduction of new asset classes. 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.

De-risking Mechanism

Morningstar supports the de-risking mechanism based on age. That said, we believe there is room for improvement. We view that the allocation of the Core Accumulation Fund (40% lower risk investments and 60% higher risk investments) is too conservative and the de-risking process begins too late (at 50 years of age). Based on international experience, life-cycle portfolios often start with a more aggressive allocation (10% lower risk investments and 90% higher risk investments in some cases) for the younger workforce given their longer investment horizon, and therefore, higher risk tolerance.

We also view that the allocation of the Age 65 Plus Fund (80% lower risk investments and 20% higher risk investments) is too conservative. Given the life expectancies of 75.3 and 86.9 years for males and females in Hong Kong respectively, the average scheme member has more than 10 years of post-retirement life to invest through. Taking the longevity risk into consideration, the proposed allocation is too conservative to satisfy their retirement needs. Based on international experience, allocations of life-cycle portfolios at investors' 65 often contain more than 40% of equities.

As the MPF system is designed to help the workforce save for retirement, the DIS should load up sufficient risks to achieve this primary objective. Having over-conservative DIS arrangements would instead increase scheme members' shortfall risk. With a more aggressive initial allocation, it is important to have the de-risking process start earlier in the investors' accumulation phase. The proposed de-risking process begins when investors reach 50, which is rather close to the drawdown phase.

As the DIS is designed for scheme members who do not want to, or do not know how to make a choice for their MPF investments, it is vital to have the DIS load up sufficient risks for their retirement, and also de-risk in a timely manner as their risk tolerance decreases with age.

Statutory Fee Control Mechanism

Morningstar supports any move that will assist investors achieve their investment outcomes. We acknowledge that the introduction of a statutory fee cap is an appropriate initial move, but we view that a 0.75% cap may be too aggressive a target for the short term given the MPF's current asset base. This is apparent when we compare the proposed fee cap of 0.75% to the weighted average FER of 1.88%, 0.98% and 1.50% for actively-managed MPF equity funds, passively-managed MPF equity funds and MPF bond funds, respectively, as illustrated in the consultation paper we previously provided to the MPFA. A fee cap that is too low may lead to undesirable practices in the construction of the Core Accumulation Fund and the Age 65 Plus Fund portfolios, limiting the sort of asset classes used and the style of management.

We reiterate our view that a cap of 1.00% may be more appropriate at this stage given the MPF's FUM scale and existence, as well as when comparing to the fee levels in other countries (please refer to our response to MPFA's consultation paper). In the longer run, we hope the economy of scale and competition from the DIS could help drive down fees and costs for members. We also encourage better disclosure which could be one of the drivers of better outcomes for investors in the longer term.

Investment and Transitional Arrangements

Morningstar supports the proposal to make the DIS and its constituent funds available to all scheme members. We believe the flexible arrangement provides greater choice for members, especially in lower cost offerings. In addition, 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 DIS and its constituent funds.

Finally, we support the transitional arrangements proposed in the Bill. Based on international experience, the majority of people in a default strategy are those who 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 opt-out notification. Therefore, it makes sense to transfer the accrued benefits of the remainder into the DIS after the opt-out period. We also welcome the provision for trustees to issue opt-out notifications over a six month period, as this lengthy period would allow the industry to spread out the implementation timetable and associated resources, potentially minimising costs.

About Morningstar