

Talking Points

MPF Core Fund Proposal a Big Step Forward

As its next step in reforming the MPF system, the MPFA has proposed to introduce a "core fund" as laid out in its June 2014 consultation paper, Providing Better Investment Solutions for MPF Members. Under the proposal, the "core fund" essentially is a standardised, low-fee product that is well placed to serve as the default option for those who have not specified their investment choice in their MPF portfolios (although MPF members can actively choose to invest in the core fund as well). We think this is a great initiative and outline our thoughts here.

The current lack of regulatory guidelines has led to a wide range of default funds being offered, resulting in vast risk and return differences for MPF members over the long term. Adding the fact that a large number of MPF members do not make active investment choices, we support the introduction of a core fund specifically designed to achieve the retirement objectives of MPF members.

Morningstar supports the introduction of a core fund based on a standardised default fund. The core fund should act not only as a default for members who do not make a choice but it also should be made available as a standalone option for all members to choose given the likely scale benefits these funds would achieve.

We believe guidelines governing the construction of core funds will help achieve greater consistency than currently exists 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, this would 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.

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.

We support the use of target-date funds as core strategies as they offer a lower-cost way for plan providers to make appropriate asset class diversification available 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 lifetimes. Target-date funds can help track this path (Figure 1).

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 system'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 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 superior outcomes for investors in the long term.

To put more context around fee levels, we have examined data from the July 2014 Morningstar Target-Date Series Research Paper. Looking specifically at U.S. target-date funds, the average asset-weighted expense ratio in 2013 was 0.84%, a 7 basis point drop from 0.91% in 2012. The U.S. target-date mutual fund industry stands at more than US\$600 billion today, whereas MPF assets are less than US\$100 billion, or roughly the size of the U.S. target-date market in 2005 (Figure 2).

Although 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.

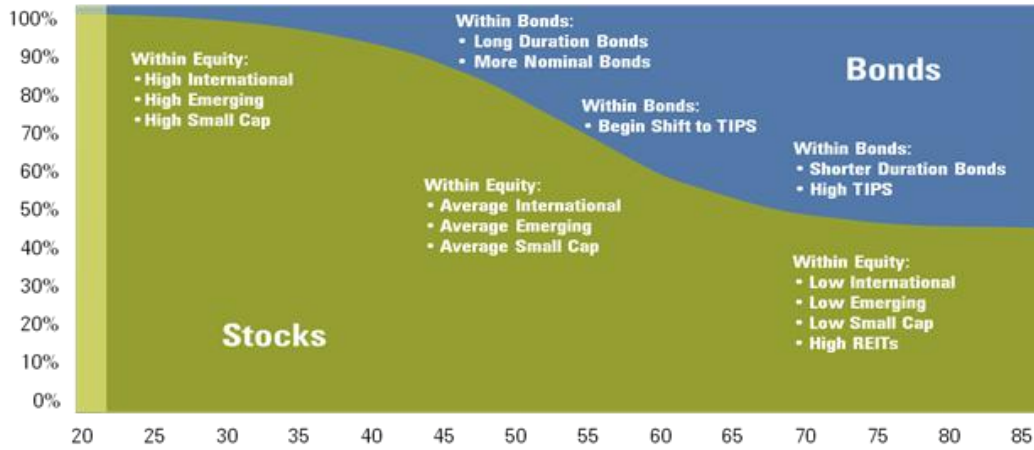
Finally, the transition to the new arrangements should be conducted over a specified period and not on one date. Equally, the transition arrangements should allow for current providers to make existing default options comply with the new guidelines.

All-in-all, we believe the introduction of a core fund is a big step towards better fulfilling MPF members' retirement needs. While we are encouraged by the MPFA's ongoing efforts to develop Hong Kong's retirement program, we believe members can further benefit from greater transparency and disclosure of MPF products and enhancements in product diversity and investor experience.

For our full response on the consultation paper, please click [here](#). ■■

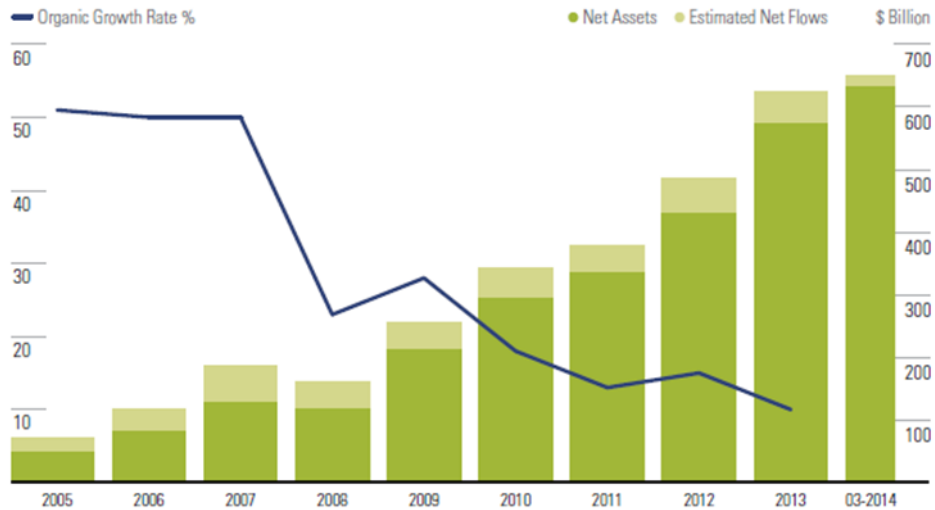
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Figure 1: Asset Allocations for Target-Date Funds Over an Investor's Life



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

Figure 2: Net Assets, Estimated Net Flow and Organic Growth of U.S. Target Date Mutual Funds 2005-31 Mar 2014



Source: Morningstar, Inc.