

7th Anniversary: Itch or Glitch?

MPF improvements depend on all stakeholders

By Philip Tso



TO PROTECT THE AGED was the reason for introducing the Mandatory Provident Fund (MPF) system in 2000. Is it heading in the right direction? What else should be done?

The last seven years have witnessed significant developments in various aspects of the MPF.

Firstly, the market has grown beyond expectations, with assets having reached more than HK\$220 billion and continuing to build at a steady pace. This translates to an average MPF balance of \$HK100,000 per member. The public has started to focus on the concept of retirement savings.

Secondly, MPF service providers continue to expand their product offerings to include specialist and multi-manager funds. Members now have more choice than when the system was formed.

Thirdly, the Government remains proactive in refining the system. For instance, it has refined providers' disclosure requirements and consulted market participants about the content of

annual benefit statements. This ensures members are able to understand the information disclosed.

These are all positive developments; the MPF system is on track to achieve its goals, but there is room for further improvement. This requires continued effort from the Government, service providers, employers and employees to jointly review issues and develop the system. Below are some key issues and potential enhancements for consideration.

Fee Structure

Recently, a few MPF service providers announced fee reductions, most of which are applicable to capital preservation funds. The public views this positively, but is simply reducing fees enough?

The average annual fee charged on an MPF portfolio fund is 2% of asset value, of which half is attributable to administration. With significant growth in assets the administration fee structure should be changed.

Seven years ago, there were no assets.

At the same time service providers were required to perform extensive administration duties. As MPF assets have now exceeded \$HK220 billion, some economies of scale should have been achieved. In addition, there is no clear relationship between the assets and the administration required. This suggests service providers should consider charging administration fees on a fixed dollar per member basis. This approach is more appropriate than percentage-of-assets arrangement because:

- it is easy to understand;
- it encourages members to consolidate preserved accounts and enjoy economies of scale;
- it is consistent with global standards where defined contribution schemes in the US, UK and Australia do charge fees on a per member basis;
- the larger the MPF balance, the smaller administration fees are proportionately;
- MPF benefits should improve over a long term as net of fees as returns are higher.

The drawback to this approach is that it is relatively expensive for those with smaller MPF balances.

The second area to consider is the investment of funds. Most MPF portfolios are managed on an active basis relying on the investment manager to generate out-performance. Few MPF products incorporate passive investment. Passive investment provides market returns, charges low fees and takes less risk. The MPF Authority has, in fact, approved more than 90 index tracking funds. Service providers can use these vehicles as underlying investments. Given little effort is required from an investment management perspective and its lower cost, a combination of active and passive approaches allows service providers to manage assets in a more efficient and cost-effective manner. The key is to spend investment management fees appropriately: less fees spent on generating market returns, and more on managers who can reliably generate out-performance.

Better Investment Education

As average MPF balance has reached over HK\$100,000, members' accrued benefits have become more significant and this has drawn attention to managing them in a more sophisticated manner. In order to make informed investment decisions, members need to be educated to understand retirement investment concepts.

This is no doubt different from personal investing. Understanding risk tolerance and investment horizons is key. Some workers who have a long investment horizon may choose conservative investment options, whilst those who are a few years away from retirement may choose high-risk funds such as a Hong Kong equity vehicle.

The potential consequence of this is members either lose the opportunity to maximize their benefit levels or the decreased accrued capital due to volatile equity markets. The key focus in the short term is to educate members about retirement investing such as when

to switch, how to choose appropriate investment options, and how to monitor their MPF portfolios.

Investment education is the key to success for a defined contribution arrangement. Members are required to choose appropriate investment funds. Making incorrect investment decisions can be costly and leave members without enough savings for their retirement.

In addition to the fee reduction in MPF funds, another potential development of the system is allowing members to choose their preferred service providers. In general, this is a positive development because:

- it creates healthy competition – recent fee reductions are a good example;
- funds could deliver higher net of fee returns due to price competition;
- it increases public awareness as members can further control their MPF benefits.

However, this could also confuse members and lead them to make inappropriate investment decisions by either chasing performance, over-diversifying through the division of accrued benefits among different providers, or buying brand name products rather than seeking out quality.

To ensure that introducing personal choice of MPF service providers is a success, it is important that members fully understand product features and choose an investment that fits their profile. Fees are one of the differentiators, but should not be the only one.

Employers should provide assistance to members by conducting investment education seminars to ensure members make informed choices.

The current form of investment education is too generic. Therefore, employers should proactively seek members' information about their investment knowledge and understanding of product features. Then both employers and providers can address members' concerns.

More Choice is Better?

Employers and MPF service providers could consider segmenting member

profiles based on time commitment, financial literacy and investment horizon. One solution does not fit all – profiling members can personalize education. This will encourage them to think seriously about their investment strategy and, hopefully, make informed investment decisions for their future.

The market view is the more choices, the better the arrangement. But, how financially literate is the average employee? Are they able to make the right choice? If a wide range of investment options confuses members, a lifecycle option would address the issue.

A lifecycle fund alters the exposure to growth (mainly through equities but possibly through other capital growth asset classes) and safety (mainly bonds and cash) in accordance with investment horizons.

The exposure of growth assets is directly proportional to an individual's investment horizon – the longer it is, the larger the exposure to growth assets. For those who are close to retirement, the fund will increase exposure to safety investments.

This lifecycle option will ensure the investor is exposed to the appropriate level of investment risk. In particular, members with little financial literacy will benefit by focusing only on investment decision at the outset, and not throughout their accumulation stage. There is less opportunity to make wrong decisions.

The MPF has celebrated its 7th anniversary, let us work together to achieve its founding goal – to protect the aged **W**



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