

## **Review and outlook of the MPF – from the fund industry prospective**

MPF was introduced in December 2000 and it has now become an integral part of the life of the Hong Kong working population. As at the end of March 2004, MPF covers over two million employees and self-employed persons, representing a compliance rate of 96% and 80% respectively. Monthly contributions are around HK\$2 billion and total assets amounted to close to HK\$100 billion.

### Market Review

In 2001 and 2002, due to the global stock markets downturn, most equity funds and other growth-oriented funds witnessed negative returns. However, with the recovery in the global economy since the second quarter of 2003, many MPF funds registered robust gains in 2003. Underpinned by strong economic growth, the stock markets continued to rally in the early part of 2004. However, this upward trend has been arrested in the second quarter due to concerns about U.S. interest rates hikes, the impact of the austerity measures adopted by the Mainland Government, geopolitical tensions, as well as record high oil prices.

On a since-launch basis, MPF funds (up to July 2, 2004), registered an average return of 1.11% (asset-weighted).

<u>Year</u>	<u>Annual return (asset-weighted)</u>
2001	-8.67%
2002	-7.01%
2003	19.35%
Jan. to July 2, 2004	-0.09%

(Source: Lipper/HKIFA)

Out of the 289 MPF funds covered in the HKIFA survey, over 60% registered positive returns on a since-launch basis. Amongst the various fund categories, Japanese equity funds came first by registering an average gain of 27.61% on a since launch basis. Other Asian sectors also posted positive returns. However, the US and the European equity sectors were still in the red.

Buoyed by the accommodative monetary policy of the US in the past few years, global bond funds posted an average gain of 15.28%, while Hong Kong dollar bond funds registered an average gain of 7.66% on a since-launch basis.

The performance of money market and capital preservation products remained subdued. Due to the historic low interest rates, these sectors, which primarily invest in money market instruments and short term bonds, registered meager gains (around 1%-3%) in the period.

Despite the ups and downs in the global stock markets, investors have generally not been swayed by short term market volatilities: switches have been minimal. This is probably attributable to the fact that through the extensive investor education programs launched by providers, the Mandatory Provident Fund Schemes Authority (“MPFA”) as well as HKIFA, more and more employees have appreciated the role of ‘dollar-cost averaging’ (“DCA”) in MPF. Under MPF, contributions are generally made on a monthly basis and DCA can come into full play as it helps to instill

discipline and smooth out short term market volatilities.

Surveys bear out that more and more scheme members understand that they should not take a short-term approach; but should focus on key factors such as investment time frame, risk-return trade-off of the different asset classes, one's risk tolerance and return expectation, and should leverage on the time factor to enable one to meet the retirement liabilities.

#### Choices made by employees

MPF is a member choice system, i.e. employees select their own constituent fund(s). Typically, each master trust has five to six funds. Balanced funds have typically been the most popular choice, whereas the appeal of guaranteed funds seems to have dropped. The drop is probably attributed to the fact that most guaranteed fund providers have slashed the rates of guarantee due to the drop in interest rates in the past few years, which make the original guarantee rates unsustainable. In view of the reduction in the guaranteed rates of returns, employees have been turning to money market funds or balanced funds.

Percentage share of Aggregate NAV of Approved Constituent Funds of MPF schemes by type:

	Mar. 31, 2004	Mar. 31, 2003	Mar. 31, 2002	Feb 28, 2001
Balanced Fund	51%	48%	46%	46%
Guaranteed Fund	16%	20%	20%	21%
Capital Preservation Fund	16%	18%	15%	15%
Equity Fund	15%	12%	17%	15%
Money Market Fund	1%	1%	1%	2%
Bond Fund	1%	1%	1%	1%

Source: MPFA Statistical Digests

#### Looking ahead

According to MPFA's Statistical Digests, between February 28, 2001 and March 31, 2004, the number of approved constituent funds had increased from 299 to 321. It is expected that to further cater for the needs of employees, MPF service providers will expand their fund choices, by introducing more specialist fund types (such as single market or sector funds) and may add products from third-party fund managers to their schemes.

As there are bound to be more product choices and that the investment risks are borne by the employees, it is pertinent that MPFA and the industry should work closely to further increase the transparency and quality of information. Towards this end, MPFA issued a Code on Disclosure for MPF Investment Funds in early July 2004. The Code provides a set of disclosure principles and requires the use of plain language and a variety of tools that will assist members in understanding the MPF information. These tools include a fee table for all registered MPF schemes, an on-going cost illustration that shows the cost over defined time horizons, and fund expense ratios which show the total level of expenses incurred by a fund.

Representing the fund management industry, HKIFA is in full of support of these initiatives as we believe that to enable employees to make informed investment decisions, comprehensible and quality information on MPF funds should be provided readily. To complement the MPFA Disclosure Code, HKIFA has been developing a set of performance presentation standards for the industry. We believe it is necessary to ensure performance figures are calculated and presented in a consistent and easily understood manner so as to facilitate comparison across MPF funds and service providers by members and other interested parties.

The introduction of the MPF system is undoubtedly a major move towards the goal of providing security for the elderly in Hong Kong. However, it seems there are no clear policy intentions to make further provisions for those not included in MPF or in other existing systems. Nor have there been move to develop MPF into an income producing system, rather than its existing lump sum payment structure.

In light of the above, the HKIFA commissioned a research paper – Retirement Income Policy in Hong Kong to consider a number of aspects of present system and to make suggestions that address what may be seen as limitations of the present structure. The paper was announced at a seminar on Retirement Income Policy of Hong Kong organized in May 2004. There are over 50 recommendations being put forward, and the following are areas that HKIFA believes the relevant authorities and the community should aim to address:

- Instead of using the current “lump sum” approach, the MPF system should consider adopting a flexible drawdown approach, along the lines adopted in Australia. What this entails is that on reaching a certain age, and each year thereafter, a scheme member should be allowed to draw down a proportion of his retirement fund, subject to age-dependent maximum and minimum percentages and/or cash limits.
- An overall review of the MPF regulatory approach, especially with respect to investment. At present, the approach is a prescriptive one, i.e. only instruments or vehicles that have been included or covered in the MPF legislation or Codes or Guidelines are allowed. A major shortcoming is that this does not allow sufficient flexibility for the industry to meet the rapidly changing investment markets. We would thus suggest a move to a principles-based approach which would allow the industry sufficient flexibility to leverage on new market developments so as to develop products that can help optimize returns.
- Voluntary contributions should not be subject to salaries tax, on the basis that balances are kept until retirement (maybe to set a cap). Currently, voluntary contributions in MPF are paid out at the end of employment, in a manner similar to ORSO benefits. We suggest that as long as ORSO benefits and MPF voluntary contributions are kept until retirement age, they should not be subject to salaries tax – the objective is to enable the saver to develop his/her own retirement income pool. This would entail a review of the ORSO system, including to introduce mechanisms to ensure that ORSO benefits are retained until retirement age, immediate vesting, same retirement age as MPF, and similar provisions made for early withdrawal of ORSO benefits.
- Open up preserved accounts so that voluntary contributions can be made into them. At present, the MPF legislation is unclear on this and it would be useful if MPFA can provide clarifications so that these accounts can be used more efficiently and effectively for retirement planning purposes.

We believe these recommendations will go a long way to resolving current deficiencies and will ultimately make Hong Kong's pension system one of the most comprehensive and cost-effective in the world.

-End-

Hong Kong Investment Funds Association

Website: [www.hkifa.org.hk](http://www.hkifa.org.hk)

Email: [hkifa@hkifa.org.hk](mailto:hkifa@hkifa.org.hk)