HAPFS Announcement

Inquiry about the Monthly Pricing and Switching Limitation on Money Market Fund

From time to time, members will ask the question why Hospital Authority Provident Fund Scheme ("HAPFS") does not offer pricing and fund switching on a daily basis like the Mandatory Provident Fund (MPF) system. Some members will also ask why there is a 20% limit restriction whey switch their assets to Money Market Fund ("MMF") except for retiring members. The Scheme Office would like to take this opportunity to explain the rationale behind the above arrangements.

<u>Question 1 – Why does HAPFS not offer pricing/valuation and fund switching on a daily basis?</u>

The fundamental design of HAPFS is completely different from the government's MPF system. Let's first give you some background information of the retirement protection system in Hong Kong. Then, we further explain why HAPFS does not offer daily pricing/valuation and daily fund switching to members.

The HA first set up the provident fund scheme in 1991 ("original ORSO scheme") to provide retirement benefits to its employees. At that time, only large corporations in Hong Kong would voluntarily establish retirement schemes for their employees. ORSO, standing for Occupational Retirement Schemes Ordinance, subsequently came into operation in October 1993 to properly regulate those voluntarily established occupational retirement schemes. The government later took a further step in enacting the Mandatory Provident Fund Schemes Ordinance in 1995 to provide a compulsory saving scheme for the retirement of residents in Hong Kong. The MPF System finally came into operation on 1 December 2000. In April 2003, HAPFS was granted the exemption certificate to become an MPF exempted ORSO registered scheme. The new Scheme replaced the original ORSO scheme from that time onwards.

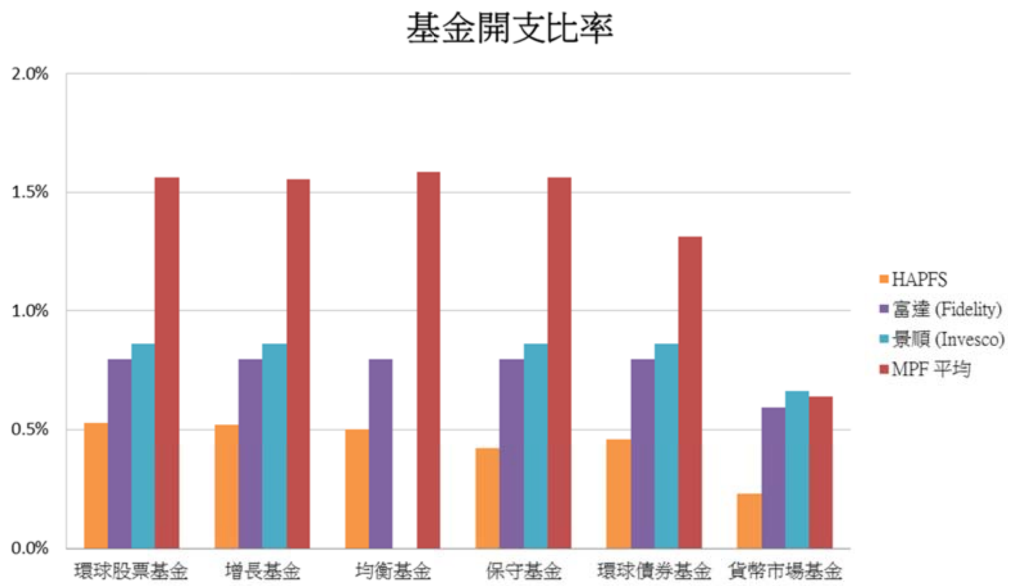
Since the MPF system aims to provide a formal system of retirement protection to a majority of workforce in Hong Kong, its design must be flexible enough to cover people from all walks of life, regardless of whether they are blue-collar workers or white-collar workers, contract or permanent employees, full-timers or part-timers, daily-paid employees or monthly-paid employees, and so on. So, there are **practical needs for the MPF system** to provide daily pricing and daily fund switching in fulfilling the needs of different types of workforce (e.g. daily-paid employees or part-timers).

However, this does not mean the government or the MPFA encourages scheme members to use the MPF platform for short-term day trading. The objective of the MPF system has never changed since its establishment – to establish a system of privately managed, employment-related MPF schemes for members of the workforce in Hong Kong **to accrue financial benefits for retirement**. MPF investments are long-term investments. The MPFA always emphasizes that you should not be over-concerned about short-term market volatility if you are still some time from retirement. The only time that the price actually impacts on you is when you take the money out of the MPF system (either at retirement or other special circumstances allowed under law). This concept is consistent with their recent launch of the Default Investment Strategy ("DIS") on 1 April 2017. DIS basically manages investment risk exposure by automatically reducing risk for scheme members as they get older. Contributions made by scheme members before age 50 will be fully invested into the Core Accumulation Fund ("CAF") which holds around 60% assets in higher risk assets. After a scheme member reaches age 50, the trustee will start automatically moving some investment from CAF to Age 65 Plus Fund ("APF") which holds around 80% lower risk assets every year until the scheme member reaches age 65. You can see from the DIS, no fund switching is recommended before age 50. After that, moving investment to lower risks is only recommended on a yearly basis. This is exactly what we are asking HAPFS members to do so in managing their provident funds in the member forums and other communication channels.

HAPFS holds the same objective of assisting HA employees **to accumulate assets for retirement**. Investments in HAPFS are also long-term investments. You are advised to think carefully and clearly about whether you really need to switch out of/into other fund choice(s) just because of the short-term price movements or short-term market volatility. Please note that our investments follow the dollar cost averaging mechanism, which allows you to spend a fixed amount of contribution to buy a fund on a regular basis regardless of the fund price. This means more units can be purchased when prices are low, and fewer units when prices are high. When the market improves, you can have a better return with more units of fund purchased. As an example, the line chart below shows the fund price of Growth Fund since its inception. You can see fund price generally increases over time.

From the social security protection perspective, pension retirement platform should not be designed for short-term day trading. Also, based on our experience, HAPFS members did not switch more frequently when the Scheme increased the fund switching frequency from quarterly to once a month. As such, the Scheme does not offer daily pricing and daily fund switching to members.

Another important reason why HAPFS does not offer daily pricing and daily fund switching is because of the **monthly rebalancing mechanism**, which is a unique feature of our Scheme. In MPF, the trustees directly buy from or sell in the market based on your instructions. As such, the MPF transaction costs and fees are high, compared to HAPFS. In HAPFS, during the rebalancing, the Scheme Office first matches all the buy and sell instructions amongst members before giving/redeeming money to/from investment managers. This internal matching process significantly reduces the transaction costs and fees incurred for the fund subscriptions and redemptions. This makes our fund expense ratio much less than the MPF (as illustrated in the graph below).



So, if we change to daily pricing and daily fund switching, no monthly rebalancing can be made. No internal matching of buy and sell instructions means we need to place members' buy or sell orders directly with the investment managers. This will significantly increase the transaction costs and fees and seriously affect the investment returns.

Last but not least, HAPFS' investment strategy and processes are far more sophisticated than the MPF system. MPF investments are simple. They buy permissible investments prescribed in the MPF legislation. So, most MPF funds are invested in simple and direct securities listed on recognized stock exchanges and thus market price of the securities can easily be obtained on a daily basis.

In HAPFS, the Scheme tries to efficiently invest into many different asset classes to maximize our investment opportunities and at the same time diversify our risks. We try to select funds that can achieve return over its benchmark return. The Scheme will also introduce different investment products and strategies (e.g. fund of hedge funds, global real estate investment trusts, currency hedging, etc.) to reduce emerging risks. As such, **complex investment products** will be used by the Scheme to achieve the above objectives. As some of these complex investment products do not trade frequently and the Scheme currently holds more than 5,000 securities, it is impossible for us to obtain market price of each security and then perform valuation on a daily basis. Furthermore, allowing daily switching means idle cash is required to be kept with investment managers which would sacrifice some investment returns.

So, if we change to daily pricing and daily fund switching, it implies that we could only invest in simple securities or funds with less added value which will ultimately affect the investment returns of the Scheme, needless to say we need to keep extra idle cash for daily liquidity.

Question 2 - Can I switch more or even 100%, instead of currently 20%, into Money Market Fund?

Currently, all members are eligible for selecting MMF but subject to a 20% limit restriction whenever they switch their assets. This restriction is lifted for members aged 55 or above, or within 5 years from their normal retirement age who can invest up to 100% of their provident fund account balance into MMF.

As explained in Question 1, investments in HAPFS are also long-term investments. You should not be over-concerned about short-term market volatility if you are still some time from retirement. In addition, the investments follow the dollar cost averaging mechanism, which allows scheme members to spend a fixed amount of contribution to buy a fund on a regular basis regardless of the fund price. Over the long term, this strategy averages out the unit cost and mitigates the impact of short-term market fluctuations.

Although short-term volatility in investment return would not affect members who are a long way from retirement, it would affect members closer to retirement. The provident fund benefits would be diminished if the members retire and must redeem the benefits during the period of poor short-term investment performance. As such, it is decided to offer a low risk investment strategy (i.e. MMF) to members who are close to retirement for the protection of their provident fund benefits. Please note that the investment strategy of MMF is targeted to achieve an average return higher than bank savings rate but with no guarantee of return nor capital preservation. The fund may experience a very small negative return in very low interest rate environment after deduction of expenses.

Besides, technically speaking, a massive switching out of the lifestyle funds into MMF may cause the liquidity issue and thus increase the portfolio risk of the Scheme. As mentioned, some of the invested securities in the Scheme are complex and intrinsically less liquid. Redemption of investment from lifestyle funds (i.e. sales of liquid assets) will increase the concentration of less liquid assets in the Scheme.

To balance the need of switching the accrued benefits into MMF and the overall liquidity (and thus stability) of the Scheme, the Scheme imposes a 20% limit restriction for members aged below 55 to switch the accrued benefits into MMF. As a matter of fact, if members (aged below 55) are really concerned about the market volatility, other than putting some accrued benefits into MMF, they can further consider switching into other low risk fund choices such as Conservative Fund and Global Bond Fund by stages. What counts important is that the Scheme provides an extra protection layer to members – Membership Extension. This option allows member to extend their membership for a maximum of five years from the date of their cessation of employment with the HA. This gives more flexibility to leaving members so that they would not be forced to sell when the market was very low.

We hope the above clarify your concerns. Please rest assured that the Trustees and the Scheme Office always try their best to provide the best-in-class provident fund scheme that delivers quality service to the members. We constantly review the Scheme to see if there are ways to improve the returns and features. For example, we just shortened the notice period of withdrawal of provident fund benefits for extended members on 1 January 2017.

Thank you again for your continued support and patronage to the Scheme. Should you have any further comments or suggestions, please feel free to contact us.

HAPFS Office
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