Impact of Pension Funds on Capital Markets
(Hong Kong Experience)

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May 2005
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Agenda

- Pension funds as a saver
- Pension funds as an investor
- Pension funds as a product innovator
- Conclusions
Pension Funds as a Saver

A vibrant capital market requires:

- Active participants
- Means to satisfy the participants’ needs:
  - Investment returns
  - Hedging mechanism
  - Capital raising
- Steady supply of innovative products

Pension funds are one of the important participating groups.
Pension Funds as a Saver (2)

They are active participants because:

- They form one of the largest pools of assets
- They are return seekers
- They are long term investors
- They have hedging requirements
- They represent collective wishes of their members / sponsors
Pension Funds as a Saver (3)

Hong Kong Pension Funds have played a significant part in the region’s capital markets:

- First privately sponsored began in 1919
- The Occupational Retirement Schemes Ordinance said the foundation of regulated and funded pension schemes
- The Mandatory Provident Fund regime in 2000 began the era of compulsory funded, members oriented savings programme
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Pension Funds as a Saver (4)

Despite MPF, ORSO schemes remain a significant pool of assets:

<table>
<thead>
<tr>
<th></th>
<th>30/9/99</th>
<th>31/3/01</th>
<th>31/3/02</th>
<th>31/3/03</th>
<th>31/3/04</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of schemes</td>
<td>17,529</td>
<td>14,627</td>
<td>7,462</td>
<td>6,603</td>
<td>5,941</td>
</tr>
<tr>
<td>Number of members</td>
<td>926,737</td>
<td>776,000</td>
<td>617,000</td>
<td>638,000</td>
<td>565,000</td>
</tr>
<tr>
<td>Assets (HK$m)</td>
<td>136,531</td>
<td>178,178</td>
<td>157,445</td>
<td>156,718</td>
<td>177,714</td>
</tr>
<tr>
<td>Annual Contributions (HK$m)</td>
<td>22,735</td>
<td>21,538</td>
<td>18,819</td>
<td>19,640</td>
<td>17,401</td>
</tr>
</tbody>
</table>

Source: Insurance Commission Annual Report, MPFA Annual Reports and Statistical Digest

Notes: Daily turnover of the Hong Kong Stock Exchange is about HK$10bn per day.
Market statistics

- As at end of 2004, MPF total asset size at HK$120,183 million (US$15,408 million)
- 19 companies provide MPF services to just over 2.2 million working population in HK with over 93% compliance rate
- The MPF Authority has registered a total of 24,639 MPF intermediaries, comprising of 437 service-providing companies and 24,202 individuals

Registered individuals by line of business

- 39.0% Insurance
- 59.0% Banking
- 2.0% Securities

Source: MPF Schemes Statistical Digest, December 2004
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MPF market

**Employed population by type of retirement scheme**

<table>
<thead>
<tr>
<th>Type of Retirement Scheme</th>
<th>No. of Scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td>Master trusts</td>
<td>43</td>
</tr>
<tr>
<td>Industry schemes</td>
<td>2</td>
</tr>
<tr>
<td>Employer sponsored schemes</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>47</td>
</tr>
</tbody>
</table>

Source: MPF Schemes Statistical Digest, December 2004
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Growth in MPF assets

Source: MPF Schemes Statistical Digest, December 2004
Pension Funds as a Saver (5)

Conclusions:

- Pension funds represent a significant pool of assets
- Their continuity is guaranteed by legislative
- Overall assets under management will continue to rise
- These funds are very long term investors
Pension Funds as an Investor
Pension Funds as an Investor

Peculiarities of the Hong Kong Pension Funds Investment Strategy:

- Domestic investments are limited to mainly local equity market
- Typical pension funds have significant exposure to equities
- Lack of a deep and liquid bond market has been handicap
- The currency peg means that the US markets have been acting as proxies. Will this last?
Pension funds as an Investor (2)

Common MPF funds and preference

Capital preservation fund – mandatory option, administration fee can only be deducted when returns exceed “prescribed savings rate”

Guaranteed fund

Bond fund

Lifestyle fund

Equity fund

Source: MPF Schemes Statistical Digest, December 2004
Pension Funds as an Investor (3)

Benchmark asset allocation of life style funds:

<table>
<thead>
<tr>
<th></th>
<th>Stable (30/70)</th>
<th>Balanced (70/30)</th>
<th>Growth (90/10)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>10</td>
<td>24</td>
<td>30</td>
</tr>
<tr>
<td>Asia ex Japan ex HK</td>
<td>4</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>Japan</td>
<td>4</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>Europe</td>
<td>6</td>
<td>14</td>
<td>18</td>
</tr>
<tr>
<td>US</td>
<td>6</td>
<td>14</td>
<td>18</td>
</tr>
<tr>
<td><strong>Bonds</strong></td>
<td>60</td>
<td>25</td>
<td>7</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>10</td>
<td>5</td>
<td>3</td>
</tr>
</tbody>
</table>
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Pension funds as an Investor (4)
All MPF funds asset allocation

By asset class

- Equities: 51.0%
- Debt Securities: 23.0%
- Deposits & Cash: 26.0%

By geographical region

- Hong Kong: 55.0%
- Asia (exclude HK): 16.0%
- North America: 15.0%
- Europe: 14.0%

Source: MPF Schemes Statistical Digest as at end of September 2004
Pension Funds as a Product Innovator
Pension Funds as a Product Innovator

Two main areas of innovation:

- New investment vehicles
- New fund options for Members Choice Programme
Pension Funds as a Product Innovator (2)

New investment vehicles – recent examples:

- **Hedge Funds**
  - Investments in these funds provide credibility to the asset class
  - New asset allocation tool

- **Funds of Funds**
  - Departure from traditional investment arrangements
  - Is this the new paradigm?

- **Hong Kong Dollar Bond**
  - Very little exposure
  - Poor liquidity and supply
  - Natural demand due to currency matching benefits
  - Form anchored investors for new product in this area
Pension Funds as a Product Innovators (3)

Demand for new products:

- Investments are driven by individual members
- Currently conservative products dominate the choices
- As members become more knowledgeable, more “risky” and sophisticated products will be picked
- REITs? Hedge Funds?
- Legislative changes may be necessary
Conclusions
Conclusions

- Due to its nature, Hong Kong pension funds will become a stabilizing factor in the local capital markets, both equities and bonds.
- There will be continuous demand of innovative investment vehicles and investment products.
- MPF is 3 years old, the regime will get to a stage for revamp.
- So far, the system has resisted attempts to weaken its position.
- Beyond capital markets, pension funds also have profound impact on the financial services industry.
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