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## Comments on:

## "Proposed Framework 81-406 Point of Sale Disclosure for Mutual Funds and Segregated Funds"

I am pleased to provide written comments on the important subject of consistency of regulation among Seg Funds and Mutual Funds in the form of feedback to Proposed Framework 81-406.

I write as a private investor with more than 25 years of investment experience in funds, individual equities and derivatives. My formal training was as a scientist (PhD in Chemistry), but I also earned an MBA (Ivey Business School) and the CFA designation (CFA Institute), and am now largely retired and managing my personal finances.

In addition to my own finances, my experience attracts a number of friends and colleagues who seek my opinions on their existing portfolios. As a result, I have seen how 20-30 investors with portfolios of $15,000 to $3 million react to securities market information and practices, including those relating to mutual funds and seg funds.

## Prior Input Given

I previously wrote on March 22, 2003 to respond to Consultation Paper 81-403 (Point of Sale Disclosure for Segregated Funds and Mutual Funds) and on August 29, 2003 on Proposed Guidelines for CAP funds (Capital Accumulation Plans). My employer at the time provided an insurance company CAP fund that had major deficiencies in the accuracy, timeliness and honesty of investor communications in comparison with similar mutual funds.

**Recommendation #1**

Regulators should lump Capital Appreciation Plan (CAP) funds, mutual funds and seg funds together because they are basically the same commodity to the investor, especially in the absence of an insured component, and are indistinguishable to the vast majority of investors.

The urgent reasons for including CAP plans are:

- The "death" of private sector defined benefit pensions is directly linked to rational future investment expectations and has become a major public policy issue where the regulators have to lead financially unaware politicians
- Defined benefit pensions are being replaced with defined contribution pensions, and group RRSP or CAP plans where
  - Investment Options are limited
  - Fees increase from 30-50 bp for large DB fund to 125-200 bp for CAPs
  - Disclosure needs increase exponentially as naiive investor decision-making is increasingly required
  - Default choice will be critical
  - CAPs should be diversified with low cost index ETFs and fixed income
  - It now takes 24% of salary to provide an indexed pension (e.g. OTPP)

What disclosures to naiive investors and industry regulations do we need in a forced do-it-yourself pension environment?

**Outline.** After laying out my direct comments on Proposed Framework 81-406 in Part 1, I will loop back to my original comments to see how responsive the proposals are in Part 2, comment on setting rational expectations in Part 3, and summarize the $7B problem that won't be solved with Fund Facts alone in Part 4.

## Part 1: Direct Feedback to Specific Issues and Questions

**Content of Funds Facts.** I broadly like the approach and current proposals for Fund Facts. It should definitely be limited to 2 pages and a modest reading level. Here are a couple of additional recommended changes:

- **Year-to-Date Performance should be Included.** The examples of Fund Facts provided shown only annual performance bars. If updates are to be

**Recommendation #2**

meaningful, Fund Facts should also include the year-to-date performance for the stub period since the last full year.

- **Changes in MER over the Historical Record should be Noted.** In the interest of accurate representation, the Fund Facts representation of past performance should either (a) correct the historical record to the current MER, or (b) note what the MER has been in different periods. This is particularly important for fixed income and money market funds, where I have noted a tendency for MERs to increase over time. In these cases, the historical "record" is biased downward by lower MERs.

**Clarification Needed**

**Cooling Off Period.** A cooling off period is a good idea. I think the provision for mutual funds that investors can cancel at any time if they do not get the Fund Facts before or at the point of sale is fair. The industry may squawk at this, but the existing prospectus provisions are much abused and investors need to be treated fairly.

**Methods of Delivery.** The proposals with respect to methods of delivery are reasonable. The Joint Forum should be cautious of industry objections as this is the only chance to get objective information into most investors' hands.

**Question 1: Time of Delivery of Fund Facts for Subsequent Purchases**

I can agree that monthly plan purchases could be excluded, except for an annual update. The proposal already considers 12 months sufficient (as there is an annual update by then). Therefore, where is the right balance to strike between 1 and 12 months?

**Recommendation #3**

**I would like to suggest 90 days.**

The question of how long to allow between separate investments without getting an updated Fund Facts is linked to how often the Fund Facts are meaningfully updated. Based on the current proposals, the Fund Facts has only annual performance (whereas I recommend including the most recent quarterly stub period as well – see below). The largest investments can also change, and the MER as well.

### Question 2: How often to Receive Documentation in a Pre-Authorized Payment Plan

**Recommendation #4**

This should be provided annually. A 2-pager may actually be read, whereas the annual documents sent already (which can be declined) are not usually read.

### Question 3: Other Disclosure Information Sufficient?

Most investors decline the annual and semi-annual information for several reasons, in my experience: (a) it is voluminous; (b) they don't understand it; and (c) they cannot separate the important wheat from "boilerplate" chaff. I agree that Fund Facts should not be mixed in with more complex material unlikely to be read.

### Question 7: What if Advisors Don't have Fund Facts Available

In my view, this would reflect poorly on him/her/firm and suggest they were trying to hide something (MER, compensation, etc.). I try to avoid mutual and seg funds myself (due to excessive fees), but do not see harm in investors waiting for the Fund Facts to become available or choosing another fund or selecting a better organized advisor.

It should not be as easy to abuse the requirement to provide the Fund Facts as it is to currently abuse the provision of prospectuses.

### Question 9: Fund Facts for Multiple Classes of Shares

I am quite convinced that 90% of investors are unaware of the existence of multiple classes of shares. Therefore the provision on Page 2 of the Fund Facts that "Your advisor is obligated to explain whether other classes of this investment, with different fees or guarantees, are available to you." is essential to ensuring the investor gets the most suitable product.

I strongly agree with the position taken that Fund Facts should be for one fund, one class, and NOT mixed into longer documents with other funds. The industry is sophisticated enough to create multiple classes of funds, so they should be sophisticated enough to communicate directly and simply about it to investors. In this day and age, such a low level of required customization is easy to do in either electronic or printed format.

### Question 11: How Current should Fund Facts Be?

Year-to-Date Performance for any quarter end within 30 days should be included. The examples of Fund Facts provided shown only annual performance bars. If updates are to be meaningful, Fund Facts should also include the year-to-date performance for the stub period since the last full year. That means Fund Facts should be no more than 4 months non-current.

### Other General Observations

1. I note with dismay that the 2003 idea of a **Consumers' Guide** has been abandoned. I believe the regulator is in the best and most trusted position to set rational expectations of investors, and to slay some important myths (past performance, future expectations, importance of fees, etc.).

**Recommendation #5**

2. I am also disappointed that despite CAPSA being a part of the Joint Forum, **CAP plans have dodged inclusion in the recommendations**, which are limited to mutual funds and segregated funds. There is no discussion as to why this exclusion is necessary, especially when CAP plan members are likely to be LESS investment savvy that mutual fund and seg fund investors!
3. The Fund Facts is a **good start**. I only wish similar transparency was available for ETFs, PPN products and hedge funds that can have MERs as high as 16%.

**Recommendation #6**

### Part 2: Proposed Framework 81-406 and My 2003 Comments

To put my current feedback in perspective, I reiterate my main prior suggestions relevant to point of sale documentation:

- Standardized disclosure on fees and costs and their impact on investment returns (i.e. MER – not always disclosed by CAP funds; and net historical returns, not gross returns from my CAP fund at the time). *[The information is there in proposed Fund Facts, but impact of fees is never mentioned.]*
- The rights of rescission and withdrawal should be retained and reinforced in the case of a "new investment" (i.e. not already held in the investor's portfolio, or not purchased under the same fee structure as before) when

a) The back-out decision is made within 4 business days of receiving information, or 7 days of the transaction – whichever is later

b) The consumer is liable for any adverse market changes of the underlying investment, but is reimbursed for all sales charges paid and is not subject to surrender or redemption fees.

c) There should be no arbitrary upper limit to the amount of fund purchased.

d) The Fund Summary Document should refer to the right to cancel the purchase.

*[I am gratified to note that items b, c, d and some of (a) are proposed to be implemented.]*

- **Separation of Communication Function.** In 2003 I also proposed separation of investor information into four categories that should not really be mixed:

  a) Education (Consumer's Guide)

  b) Specific fund information (Fund Facts and Foundation Documents)

  c) Investor specific information including transactions, value, unit holdings, rate of return, etc

  d) Advertising and promotion.

  The separation is critical because intermingling these different types of information confuses consumers, and may contribute to a reduced desire to read information supplied by the fund companies (dismissing the entire package as a form of advertising or hype, and hence not worthy of their complete or immediate attention). *[The Fund Facts is separated (good), but the Consumers' Guide has evaporated (bad). The more that Fund Facts can arrive independently of other information the better.]*

- In addition to proposed contents of 81-403, the … Fund Facts… should include:

  a) A plain statement referring to the right of rescission, withdrawal or cooling off

  b) The MER must be the MER to the individual and include all costs

  c) A standardized statement about where the investment fits in risk-return space

  d) Should include portfolio turnover range typical of the fund

e) Should try to get to a single page; two permissible if duplex-printed. This is inexpensive to produce and might actually get read.

f) Past performance information was more appropriate in the Foundation Document than in the Point of Sale document

*[Again, it is gratifying that four of my ideas not previously considered were incorporated. Missing is any reference to turnover. Although past performance was included, it at least takes the most useful form of annual returns rather than the compound returns to a given date. Annual returns display their historical volatility, which is good. Compound returns to a given date are all potentially distorted by one or two exceptional years. I've always told fellow investors to look to the annual performance.]*

- A First Cost-Benefit Estimate. I made a first attempt to quantify the huge benefit opportunity to consumers from good regulation, knowledge and education was on the order of several $Billions per year (from some shopping around more carefully to reduce fees, and some degree of avoidance of selling low and buying high).

Only 20-25% of my original recommendations related to point of sale disclosure documents, so, at best, point of sale disclosure is only a partial solution to existing regulatory shortcomings.

## Part 3: The Importance of Setting Rational Expectations

The main shortcoming of the proposed Fund Facts is that it fails to set rational expectations for the investment returns. Since the Consumers' Guide has been abandoned, regulators should consider how best to communicate rational expectations within or outside the Fund Facts.

How many investors know the following?

1. It is widely recognized that MERs directly reduce the long run potential return dollar for dollar because the average mutual fund does not beat its index before fees.
2. The rationally expected return for a money market fund is close to the T-Bill rate plus a small nominal spread for bank or corporate money (if any, and in

proportion to the amount of these funds) less the MER. These days that is a lot less than the yield (and lacks the CDIC guarantee) of many high interest savings accounts.

3. The rationally expected return for a bond fund is the government bond rate for the same term plus a small, proportional, nominal spread for provincial or corporates, less the MER. These days that is something like 4.5% + 0-30 bp – MER (not generally more than 2.5%). Historical returns are often higher because interest rates used to be higher (but the volatility due to interest rate sensitivity would be reflected in annual returns).
4. The rationally expected long run return from equity funds is future inflation (e.g. 2%) plus the real growth in EPS (e.g. 2%) plus dividends (e.g. 1.8%) = 5.8% LESS the MER. Historical returns have been higher for the past 25 years because (a) P/E ratios were generally rising; and (b) in 2002-06 real EPS grew faster than its long run historical average. *[Even corporate pension plan actuaries and the investment industry don't like these facts, but this line of thought is growing among the more reflective CFA industry.]*

Only when investors realize that fund MERs are likely to consume 30-50% of their prospective return, will we be able to make a dent in Canada's terrible reputation for the highest MERs among developed countries.

## Part 4: A $7B Problem that won't be Solved with Fund Facts Alone

**Canada Tops World MER Shame List.** The vast majority of Canadian financial industry players claim to have the highest ethical standards, yet in the aggregate extract a large and unwarranted fraction of the returns on investment.

| | MER |
|---|---|
| CANADA | 1.84% |
| Spain | 1.46% |
| Italy | 1.42% |
| Japan | 1.25% |
| Sweden | 1.15% |
| Britain | 1.13% |
| France | 0.98% |
| Germany | 0.98% |
| Austria | 0.95% |
| Australia | 0.89% |
| United States | 0.87% |
| Netherlands | 0.69% |

On May 8, the Globe & Mail reported ("The mutual fund sucker factor: Either way, we're No. 1 in fees paid." by Rob Carrick) that Canada pays the highest mutual fund fees of 20 countries studied.

Although IFIC (the self-regulatory lobby group for the industry) complains that disclosed Canadian fees contain items not found in other countries, so are not directly comparable, these factors are worth less than a decimal point.

Small countries with concentrated financial industries like Austria, Australia and the Netherlands sell a much more cost effective product than Canada.

Consider the following:

- $700B in mutual fund and seg fund assets at $1.84% MER = $13B annual industry revenue
- Assets expected to grow at 5.3% gross investment return or $38B (60/40 equity/fixed income) so the industry extracts 35% of expected return
- Every 13 bp decrease in MER saves Canadian investors $1B per year
- Matching closest comparative (Australia) is worth 95 bp or nearly $7B. Regulators should consider than $7B in excess MER is equivalent to 14 Norshields per year or 10 Norshields plus Portuses per year. Are investors being protected from what matters?

**Recommendation #7**

Other countries should be studied to understand the source of $Billions in investor losses to excess fees. The extraordinary Canadian situation should greatly concern policy makers because the aggregate losses suffered by investors far exceed any of the recent scandals that consume so much regulatory attention. Policy makers should be trying to understand (and then address) whether this arises due to a concentrated industry with high barriers to entry, fragmented and ineffective regulation, investor lack of knowledge, an ill-informed or ineffective financial press or a weak education system that ignores financial matters.

Point of Sale Disclosure in general, and the proposed Fund Facts in particular, are not sufficient to completely address the power and information imbalance represented in these comparative MER data. Implementation of Fund Facts is but one tiny step on a long road required to empower Canadian investors – and is moving ahead at a glacial pace. The industry cannot be counted on for education, and the press and education systems are weak. Only the regulators have the position of trust to provide real education about rational expectations.

## Summary

The Fund Facts point of sale disclosure document and the proposed rules necessitating its delivery are an advance on current investor disclosure regulation in the right direction. Huge conflicts of interest prevent the industry from fairly representing many important investment issues.

Some suggestions for further improvement of the Fund Facts have been made:

- Capital Appreciation Plans should be included with mutual and seg funds
- Year-to-Date Performance should be Included
- Changes in MER over the historical record should be clarified
- Purchases more than 90 days after a first purchase should require a Funds Facts
- A pre-authorized payment plan investor should get a new Funds Facts annually
- The regulator is in the best and most trusted position to set rational expectations
- A similar document should be available for ETFs, PPN products and hedge funds
- Other countries should be studied to understand the source of $7Billion per year in Canadian investor losses to excess fees

Fund Facts is but a small belabored step toward trying to restore a $7B annual power and information balance between investors and the investment product industry. Much more remains to be done and setting rational expectations should be part of point of sale disclosure.

I appreciate the opportunity to have provided my input and sincerely hope that this gradual process will lead to some improvements in investor communication.

Respectfully submitted,

Tony Paine
Private Investor