Kenmar Associates
The voice of the retail investor

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Kenmar Associates Comment Letter

CSA NOTICE AND REQUEST FOR COMMENT IMPLEMENTATION OF STAGE 2 OF POINT OF SALE DISCLOSURE FOR MUTUAL FUNDS
PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 81-101 *MUTUAL FUND PROSPECTUS DISCLOSURE*, FORM 81-101F3
AND COMPANION POLICY 81-101CP MUTUAL *FUND PROSPECTUS DISCLOSURE* AND CONSEQUENTIAL AMENDMENTS
(2nd PUBLICATION)
http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120621_81-101_rfc-stage2-pos.htm

Kenmar Associates welcomes the opportunity to comment on the proposed amendments to NI81-101. We are glad to see a number of the changes to Fund Facts (FF). We are delighted to see the actual percentage of each of the top 10 holdings disclosed .Providing a delineation of some of the principal risks of a fund is a giant step forward . Abbreviated one liner descriptions should be permitted. The addition of the 5-year GIC index as a Benchmark is a particularly reasonable proxy given that many mutual fund investors are GIC refugees. The graphical presentation is excellent in our view.

Disclosure of the worst 3 month loss and the associated calendar period is very good although we feel a 12 month figure would also be instructive. The addition of conflict-of-interest text to the trailing commission narrative should

help prevent problems and misunderstandings. Allowing the fund Code to be included is wise. More importantly, we recommend inclusion of the applicable CIFSC Fund Category in the Quick facts section as it provides valuable information to investors .There is space in the Quick facts section for its inclusion.

The use of a scale and the Standard Deviation as a risk measure

Notwithstanding the many improvements, the Standard Deviation (SD) , which measures performance *volatility*, remains a show-stopper issue .To obtain a meaningful sample for computation, standard deviation is per IFIC guidance , based on monthly returns with three years as a timeframe over which to measure standard deviation). It is far from clear how meaningful the volatility of monthly returns would be for a retail mutual fund investor investing for the long term. In our experience ,retail investors view risk as the likelihood of a decline in investment value, or the failure to meet a benchmark, *over a long -term time horizon*. In fact, a number of surveys suggest that most investors *do* view risk in this manner. Indeed ,the fund industry ,time and time again ,states that mutual funds are long-term investments. There is no reason to think that a measure of *short-term volatility* will correspond to the risk of *longer-term underperformance*. Indeed, some research suggests that the two have a slightly *negative* correlation.

Thus, if standard deviation is used as *the* measurement of fund risk, many investors might be misled and inappropriately favor funds with lower short-term volatilities, thereby imperiling their long-term investment goals. Unfortunately, current evidence exists that many Canadians *already* may be making investment decisions ill-advisedly on this basis. It would be deeply disturbing to further aggravate this alarming trend.

The risk of any particular investment needs to be considered in light of the *other* elements of an investor's portfolio. Many mutual fund sponsors, dealer Reps, personal finance columnists, academia and others have long stressed the importance of evaluating investments within the context of one's overall portfolio. Even assuming the appropriateness of short-term volatility (as measured by SD) as a risk measure, one cannot be sure of any one investment's effect on the overall volatility of an investor's portfolio (which from an *investor's* perspective would be the more relevant consideration). For example, if Fund A has a relatively high standard deviation but its performance negatively correlated with that of Fund B, an investor in Fund B might very well *reduce* risk by investing in Fund A. As such, investors are

highly unlikely to be able to use the standard deviation of a particular fund to evaluate the effect of an investment in a particular fund on their overall portfolio.

"Besides encouraging a false sense of security, spending too much time on a risk-measure debate can . . . imply that a single measure is in fact desirable. It is not." —Eileen Makoff, Morningstar Mutual Funds

Legitimate concerns that existing risk disclosure is too lengthy and complex (and therefore not read) has provided the impetus for the CSA's current search for a standardized risk measure. It seems ironic, then, that the volatility risk measure is so complex, that only a small portion of investors will likely understand its message and limitations. It is also ironic that, because any mandated risk measure presumably is accompanied by substantial explanatory prospectus disclosure, it further burdens fund prospectuses, making them less likely to be read, understood, and used by investors. In the case of the IFIC Volatility Risk classification Report , it's lack of public availability and weak process for acceptance as a managed Voluntary Industry Standard has added to investor frustration and concern.

In any event, short-term volatility should not be put forward as a fund risk in our opinion and if it is , it should be described as Volatility risk and nothing else. The referenced IFIC document needs administration and change management but we are unclear where this responsibility lies or even if it is assigned. Is the IFIC Volatility risk classification recommendation Report a true Industry Voluntary Code ? [See article ***Voluntary Codes: Private Governance, the Public Interest and Innovation*** on the proper use of Voluntary codes
http://www1.carleton.ca/sppa/research/publications/]
The statement, *"The CSA expects fund managers to make the Report available upon request"* should be more prescriptive based on our bitter experiences at trying to extract a copy.

Further,reliance on a single, numerical measure of risk may cause investors to make the wrong investment decisions. Standard deviation , for example, measures the past variability of a fund's return. The Eurozone bonds are under stress. Spain's 10-year bond yields recently crossed the 7% red line , inciting fears of either a collapse or bailout and, concurrently, a race to buy bonds of safer countries such as the U.S., Switzerland and Canada. As a result, our bond markets are now riskier than they have ever been. Bond yields have dropped to levels not seen in at least 50 years. Government of

Canada 10-year treasury bonds currently yield 1.78% after touching a low of 1.62% on June 1. U.S. yields are at 1.62% after touching 1.45% on the same day. Driven by investor demand, assets in Canadian bond ETFs since the end of March have grown by $570-million while assets in equity ETFs have fallen $2.2-billion, though some of that decline is from lower equity prices. A likely scenario is that bond yields will swiftly and suddenly rise sometime in the next six to 12 months. An increase in the yield to a plausible 2.25% would see 10-year bond prices fall by 4%. When that happens, there will be a stampede for the exit. So, looking at past performance volatility alone can cause exactly the wrong purchase decisions to be made.

Under certain conditions, the SD statistic can be used to compute a range or confidence interval that would, on average, contain future returns about two thirds of the time. Many investors, however, are not likely to understand standard deviation or its limitations. Retail investors - especially the many viewing risk as the likelihood that a fund will underperform - may be confused that a fund gaining 5% one month, 10 % the next month and 1 % the month after will have the same SD as a fund *losing 5%* one month, 10 % the next month and 1 % the month after. They also may not appreciate that a fund losing a constant 2 % per month will have a SD of zero.

According to a 2011 OSC Investor Education Fund financial literacy study http://www.getsmarteraboutmoney.ca/en/research/Our-research/Pages/financial-literacy-research.aspx , people need to build their knowledge of investment risks and returns. This appears to be especially true of the prime investing group aged 50-64 and later ages. Seniors need to understand which investments are inconsistent with a capital preservation and income production strategy. As an aside, due to Canadian age demographics , we recommend the CSA establish a minimum font size and encourage Large font and Braille formats.

Even with accompanying disclosure, investors are likely to place undue reliance on a 5-point text-based risk scale at the expense of other important fund risk information. In recent years, investors have been deluged with financial information, and are seeking shortcuts for digesting it all. Providing investors with a risk scale may tempt them to rely on that rating as the sole source of information about a fund's risks. As a result, investors may understand less about fund risks than if the rating had not been provided. In addition, several quantitative measures (including SD) are historically based. Despite standard warning messages , however, investors may unduly rely on them as predictors of future risk or performance, or even promissory in nature—despite disclosure to the contrary. As a result, investors may not

understand that a fund could behave very differently because of changes in market conditions (e.g., changes in interest or foreign exchange rates) or portfolio holdings.

At least two industry studies have demonstrated how unreliable and inconsistent the IFIC methodology can be. In one example a Silver fund was rated as Low to Medium. In another example, an identical fund was rated differently by 2 fund companies. These studies have been communicated to the OSC and CSA. One classic media example is the Mackenzie Growth Fund Series A. The FF assigns it a a Medium risk . Yet this fund fell 60 % in 2008 while the S&P//TSX index fell 35 %. The OSC has also had to intervene and asked fund sponsors to revise ratings. We have provided many examples of FF misrepresentation to the CSA. Risk mis-categorization can leave unsuspecting investors with huge losses. For seniors ,such losses could be life-altering.

The IIAC has stated in their Comment Letter http://www.obsi.ca/images/document/IIAC___July_25_2011.pdf] to the OBSI consultation process : *" We also seek clarification on the stated principle in the Consultation Paper that disclosure does not validate an unsuitable recommendation. It should be clear that,although such disclosure may not make the investment suitable, if full disclosure is followed by informed client consent and direction to make the investment, the client must bear responsibility for losses relating to that investment."* .Thus, defective disclosure can lead to a lot of trouble for retail investors.

In fact,most retail investor complaints stem from unsuitable investments being sold to them. The biggest cause of unsuitable investments is associated with risk . Therefore, any document that has incomplete, inconsistent and misleading risk disclosure such as Fund Facts should not be utilized. Related to unsuitable investments of course is the NAAF/KYC regime. The risk descriptor words in Fund Facts are virtually identical to those on many NAAF forms. Any attempt by the investor or his/her salesperson to connect the two could be disastrous. It could lead to substantial investor losses that may be difficult to file a unsuitable investment redress claim for. This is because fund dealers could argue that the risk disclosure was as prescribed by regulators. It is not hard to envision the kinds of dispute deficient disclosure could lead to.

An alternative to the SD risk disclosure as suggested by the Small Investor Protection Association (SIPA www.sipa.ca) , would be to let actual performance numbers do the talking. Accordingly, they have proposed

presenting the worst month , quarter and 12 months based on rolling averages vs. the benchmark. This would respond to the most obvious question, " How much can I lose?" . We endorse this approach while noting that the US SEC requirement is to reveal the best and worst quarterly performance and the time that occurred.

Other Issues

Besides the risk disclosure there's a number of improvements that we recommend should be made . These are :

- We still believe that there should be a more emphatic statement at the beginning of the document WARNING that it is an abbreviated version of the Simplified Prospectus and emphasizing that if additional details on costs , risks and other material facts are required the SP should be consulted. The Introductory text is too bland in our view . We note that the U.S. SEC requires its "Summary Prospectus." to include a stronger introductory legend as follows:
"*Before you invest, you may want to review the fund's prospectus, which contains more information about the fund and its risks. You can find the fund's prospectus and other information about the fund online at _________. You can also get this information at no cost by calling _________ or by sending an e-mail request to _________.*
- The fund's Objectives need finer articulation (rather than foggy boilerplate language) given the importance of investors choosing funds with objectives and strategies that are consistent with their own objectives and risk/loss tolerances. Our experience suggests that most retail investors are unaware of the objectives and strategies of the funds in which they invest .
- The "What does the fund invest in?"section needs a tweak. In the FF sample provided it says "The fund invests in Canadian companies." Instead, for clarity, it should say "The fund invests in the stock of Canadian companies".Surveys have found that most retail investors were unaware even if their funds invest in stocks or bonds.
- Retail investors are known to ignore fund costs yet the MER is accepted as the most robust predictor of fund performance. Hence, we recommend that cost information should precede performance data. This is consistent with published behavioural finance research and IOSCO recommendations. Given the potential long-term impact of fees on an investor's total returns, relocation of the fee table will place fee information in a more prominent location and encourage investors to give greater attention to costs and cost comparisons. Topology is important in forms design.

- The "How has the fund performed?" section should contain a stronger warning about choosing funds based on past performance. Thus, it would be helpful if past performance were de-emphasized by placing it lower down in the FF document . A strong warning can be effective "Do not expect the fund's quoted past performance to continue in the future. Studies show that mutual funds that have outperformed their peers in the past generally do not outperform them in the future. Strong past performance is often a matter of chance."
- We recommend Average Hold Period (inverse of Portfolio turnover) as an added metric. This will give some indication of the manager's style and a indicator of tax efficiency of the fund. The adverse impact of taxation outside of a registered account can be greater than the impact of fees. The Portfolio turnover metric is already published in the MRFP so including Hold Period should not be burden on the industry.
- As before, we strongly believe that sales commissions should always be stated as a quantitative range rather than" up to xx% ". Accordingly , the trailing commission disclosure would need to be changed from the Sample provided.

Because Fund Facts is a highly condensed Prospectus we believe there needs to be a bridge built to the Simplified Prospectus and some tools for using Fund Facts in building a portfolio. The CSA has modified its brochure FF *Understanding Mutual Funds* to account for FF but we remain constructively critical that this will fill the bill. In a 2011 OSC Investor Education Fund study, it was concluded that even when people understand a financial or economic principle in theory, applying the principle to a real situation is difficult for them. For instance, the survey found that in the context of choosing a mortgage, people were not able to apply their knowledge that borrowing for a longer time means you will pay more interest overall. In our idea of a Consumer Guide,it would show how to interpret and utilize each section in Fund Facts and provide links to trusted websites for further information . We have in fact provided the CSA a prototype of such a Guide. If the education arms of the securities commissions prepared such a Guide , that would be a satisfactory outcome.

Another OSC brochure ,*Working with a Financial Advisor* lays the responsibility for investment decisions squarely with the investor. It states *"..Advisers appreciate clients who are clear and honest about their financial situation and expectations because it means they can give better advice. Remember, you are paying for this advice.* ***Ultimately, you have to make the decisions and live with the results…"***
http://www.osc.gov.on.ca/en/Investors_res_working-with-adviser.htm *Living*

with the results can have severe economic consequences but that is a direct consequence of Canada's weak suitability standard. It is therefore unreasonable to expect informed decision making when FF provides limited, albeit useful, information and NIL guidance for its use. http://business.financialpost.com/2012/06/14/regulators-again-move-to-improve-investment-disclosure/] That's why we continue to promote a Consumer Guide to FF.

We respectfully take partial exception to the statement in the Request for Comments :"*The CSA remains committed to delivery of the Fund Facts. We think that the disclosure in the Fund Facts provides investors with the opportunity to make more informed investment decisions by giving them access to key information about a mutual fund, in language they can easily understand, at a time that is relevant to their investment decision."* FF may provide an "opportunity" to ask smarter questions but not to make an informed investment decision. Nevertheless, we support FF because it creates investor awareness, is more likely to be read , and should prompt inquiries about issues that are revealed only in the largely ignored Simplified Prospectus. Of course, FF must be effectively delivered prior to or at the time of sale for any benefits of disclosure to accrue.

Fund Facts in perspective

On his incisive blog http://blog.moneymanagedproperly.com/?p=1325 respected industry observer Andrew Teasdale states:" ..In conclusion, the information on the sheet [Fund Facts] is not sufficient to make an investment decision, but it may be sufficient for an investor to question key issues, questions which may ultimately question the relationship, which leads us back to where we all want to go: higher standards; greater accountability; greater service competition; better differentiation of service, and a fiduciary/fiduciary type standard (some are on the left of this, I am on the right)."

Mr. Teasdale has long commented on the incompatibility of securities regulation with the actual implied process and service. Not really just a transaction, but nevertheless regulated as if it were just a transaction. He has repeatedly commented that the obvious answers to this risk issue requires a commitment to open communication about risk, and more importantly how to manage risk . This involves providing professional advice and less emphasis on the transaction – the theme of the now defunct OSC Fair Dealing Model .In order to manage the risk of volatile investments, Teasdale argues you need to combine with other asset classes, which is the

portfolio and the process which combines the assets to manage risk and return – the seeds of a fiduciary type advisory standard. That's a topic for another day.

Bottom line

The use of short-term volatility and a risk scale based on volatility as a proxy for fund risk is very controversial and should be abandoned. Further such a scale that has been developed by the fund industry lobbyist , IFIC, without public comment or regulatory oversight does not give it the credentials or legitimacy of a useable Voluntary Code.

As time passes ,the FF will be ubiquitous and very few people will ever see a SP again. That is why we have put so much effort into making it a safe document for use.

Overall, we feel these proposals are directionally positive and support their implementation (with due consideration to our reasonable/supported recommendations) along with actual Point-of-Sale FF delivery without undue delay.

Incorporation of these changes will improve the image of the $700 billion mutual fund industry and make it a safer place for retail investors to save for their retirement or other life event purposes.

Permission is granted for public posting of this Comment letter.

Should you have any questions, do not hesitate to contact us.

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