

From: Jim Cripps  
[mailto:jcripps@assante.com]<mailto:[mailto:jcripps@assante.com]>  
Sent: September-14-12 2:32 PM  
To: 'cbabin@bcsc.bc.ca'  
Subject: Comment re National Instrument 31-103

Dear Sir/Madam:

As a financial advisor who has grappled with rate of return reporting concepts for years, I would like to comment and make some proposals with respect to Rate of Return Reporting as described in Section 10 of Appendix A of the Proposed Amendments to NI 31-103 and its Companion Policy. (See Below.)

#### APPENDIX A

##### Summary of Comments on the 2011 Proposal and Responses to Comments

This appendix summarizes the public comments we received on proposed amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103 or the Rule) and Companion Policy 31-103 *CP Registration Requirements, Exemptions and Ongoing Registrant Obligations* (the Companion Policy) related to cost disclosure and performance reporting as published on June 22, 2011 (the 2011 Proposal). It also summarizes our responses to those comments.

I was particularly heartened by the clear, complete, and considered discussion of this matter in Section 10 of Appendix A. (See Below.)

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##### **Percentage return calculation method**

We received comments suggesting that we should prescribe one method of calculating percentage returns for performance reporting purposes in order to promote consistency from one registrant to another. We had previously proposed to permit registrants to choose between a time-weighted or dollar-weighted performance method for calculating annualized total percentage returns. Commenters differed as to which we should require.

We now propose mandating that registrants use the dollar-weighted method in calculating the percentage return on a client's account or portfolio.

The two methods can produce significantly different results, and the differences hinge on whether there are external cash flows. If there are no external cash flows, the two methods will produce identical percentage returns. When there are external cash flows (contributions to, and withdrawals from, an account), there can be a significant difference in the rate of return calculated under the two methodologies.

The dollar-weighted method most accurately reflects the actual return of the client's account, while the time-weighted method shows how much value a registrant has added to the performance of the investor's account. Time-weighted methods are generally used to evaluate the registrant's performance in managing an account. These methods isolate the portion of an account's return that is attributable solely to the registrant's actions. The philosophy behind time-weighted methods is that a registrant's performance should be measured independently of external cash flows, because contributions and withdrawals by an investor are out of the registrant's control.

Given that the two methods are used for different purposes and can produce materially different results, we think there is a compelling reason to choose between the two methods. We have decided to mandate the dollar-weighted method because it most accurately tells an investor how an account has performed. We believe that giving investors information that allows them to measure progress toward their investment goals is essential.

While I have long been a proponent for money-weighted reporting for the purpose of evaluating returns that are relevant for making projections of the adequacy of resources to provide retirement income, it should be obvious that investors will compare reported rates of return on their account to reported rates of return on indexes and for individual mutual funds. Here is an example which shows why this is important.

Initial Amount	\$100,000.00													
Annual Y/E Contribution	\$10,000.00													
Base Return	0.00%	Date	Return Ratio			Wealth Amount			Internal Rate of Return (IRR)					
Fluctuating Return	10.00%		Pattern 1	Pattern 2	Pattern 3	Pattern 1	Pattern 2	Pattern 3	Pattern 1	Pattern 2	Pattern 3			
		2000-12-31				\$100,000.00	\$100,000.00	\$100,000.00	-\$100,000.00	-\$100,000.00	-\$100,000.00			
James B.F. Cripps	\$10,000.00	2001-12-31	1.1000	0.9091	0.9091	\$120,000.00	\$100,909.09	\$100,909.09	-\$10,000.00	-\$10,000.00	-\$10,000.00			
2012-09-14	\$10,000.00	2002-12-31	1.1000	0.9091	1.1000	\$142,000.00	\$101,735.54	\$121,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00			
	\$10,000.00	2003-12-31	1.1000	0.9091	0.9091	\$166,200.00	\$102,486.85	\$120,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00			
	\$10,000.00	2004-12-31	1.1000	0.9091	1.1000	\$192,820.00	\$103,169.87	\$142,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00			
	\$10,000.00	2005-12-31	1.1000	0.9091	0.9091	\$222,102.00	\$103,790.79	\$139,090.91	-\$10,000.00	-\$10,000.00	-\$10,000.00			
	\$10,000.00	2006-12-31	0.9091	1.1000	1.1000	\$211,910.91	\$124,169.87	\$163,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00			
	\$10,000.00	2007-12-31	0.9091	1.1000	0.9091	\$202,646.28	\$146,586.85	\$158,181.82	-\$10,000.00	-\$10,000.00	-\$10,000.00			
	\$10,000.00	2008-12-31	0.9091	1.1000	1.1000	\$194,223.89	\$171,245.54	\$184,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00			
	\$10,000.00	2009-12-31	0.9091	1.1000	0.9091	\$186,567.17	\$198,370.09	\$177,272.73	-\$10,000.00	-\$10,000.00	-\$10,000.00			
	\$10,000.00	2010-12-31	0.9091	1.1000	1.1000	\$169,606.52	\$218,207.10	\$195,000.00	\$169,606.52	\$218,207.10	\$195,000.00			
			1.0000	1.0000	1.0000			IRR	-1.4898%	1.8095%	0.3400%			
			<b>Time-Weighted Return</b>	<b>0.0000%</b>	<b>0.0000%</b>	<b>0.0000%</b>								
			Mutual Funds, Indexes, and the CFA Institute Report Time-Weighted Returns									The calculation proposed by Securities Regulators is IRR. How is a client to make sense of this?		
Notes: Cash Flows are Deposited on the Dates Shown. At the end of every year after the Initial Amount is deposited (\$100,000 above), the Annual Year-End Amount is Deposited (\$10,000). The Base Return is the average compound return of the account; the Fluctuating Return is a volatility factor. The spreadsheet allows these parameters to be changed.														

I have attached the spreadsheet from which this screenshot has been taken so that someone can check the calculations. The Analysis Toolpak in the Add-Ins section of the Options Menu Item must be installed to get access to the XIRR function.

To highlight the issues that can arise from making such comparisons, I have shown the IRRs that result from three different return patterns with a zero (0) ten-year growth rate, annual returns that are 10% above and below zero, and a \$10,000 year-end annual contribution. (The initial amount, the annual amount, the base return, and the volatility can easily be changed in the attached spreadsheet.)

It should be clear from the variation of the above returns that comparing these returns to unadjusted index returns would yield no useful information whatsoever and would be quite misleading in a number of cases. Therefore, if account returns are to be reported only on an money-weighted or "Internal Rate of Return" basis, then returns for an appropriate set of indexes should be calculated for each account using the same set of cash flows. This would need to be done on an account by account basis by creating a set of dollar-weighted indexes for the account. This calculation would use the same cash flows as the IRR calculation to create a "pseudo index" based on the same cash flows for the account [James Cripps] by using the cash flows to purchase and redeem units in the relevant index. It should not be difficult for dealers to obtain daily index values to do these calculations.

Alternatively, dealers could provide time-weighted (which would also entail creating an index of the account value for each account) and dollar-weighted numbers for the account and leave it to third parties

or advisors to explain the different uses for each number.

Another alternative to requiring dealers to calculate additional returns would be to require dealers to provide client account data in an electronic form that would make it economically viable for clients or third parties that they hire help them calculate and interpret the return data. Maybe dealers could even provide return data to advisors and a provide an approved comparative return "calculation app". This latter notion would be a lot more cost effective and actually provide relevant information to those clients who wanted to see and understand comparative return data.

Daniel Kahneman, the Nobel Prize-winning behavioural economist points out that one of the key ways the individuals make decision errors is to engage in "narrow framing", i.e. looking only at the immediate context in order to make a decision. His solution is for them to use "broad framing" and consider more data. Showing a client only account returns without a relevant comparison standard would be classic example of narrow framing and almost certainly lead to worse decisions than having no information at all.

Finally, from a philosophical point of view, I suggest that there is no one Rate of Return Method that is "more accurate" as is stated in the Appendix above. Each return calculation is suitable for its designed purpose and cannot replace the other one.

I hope that the foregoing comments are useful and lead to an improved basis for reporting investor returns.[James Cripps] Please note that the foregoing views are mine personally and in no way purport to represent the views of Assante Financial Management Ltd. or its associated companies.

Respectfully submitted,

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Initial Amount \$100,000.00  
 Annual Y/E Contribution \$10,000.00  
 Base Return 0.00%  
 Fluctuating Return 10.00%

	Date	Return Ratio			Wealth Amount			Internal Rate of Return (IRR)			
		Pattern 1	Pattern 2	Pattern 3	Pattern 1	Pattern 2	Pattern 3	Pattern 1	Pattern 2	Pattern 3	
	12/31/2000				\$100,000.00	\$100,000.00	\$100,000.00	-\$100,000.00	-\$100,000.00	-\$100,000.00	
James B.F. Cripps	\$10,000.00 12/31/2001	1.1000	0.9091	0.9091	\$120,000.00	\$100,909.09	\$100,909.09	-\$10,000.00	-\$10,000.00	-\$10,000.00	
09/14/2012	\$10,000.00 12/31/2002	1.1000	0.9091	1.1000	\$142,000.00	\$101,735.54	\$121,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00	
	\$10,000.00 12/31/2003	1.1000	0.9091	0.9091	\$166,200.00	\$102,486.85	\$120,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00	
	\$10,000.00 12/31/2004	1.1000	0.9091	1.1000	\$192,820.00	\$103,169.87	\$142,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00	
	\$10,000.00 12/31/2005	1.1000	0.9091	0.9091	\$222,102.00	\$103,790.79	\$139,090.91	-\$10,000.00	-\$10,000.00	-\$10,000.00	
	\$10,000.00 12/31/2006	0.9091	1.1000	1.1000	\$211,910.91	\$124,169.87	\$163,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00	
	\$10,000.00 12/31/2007	0.9091	1.1000	0.9091	\$202,646.28	\$146,586.85	\$158,181.82	-\$10,000.00	-\$10,000.00	-\$10,000.00	
	\$10,000.00 12/31/2008	0.9091	1.1000	1.1000	\$194,223.89	\$171,245.54	\$184,000.00	-\$10,000.00	-\$10,000.00	-\$10,000.00	
	\$10,000.00 12/31/2009	0.9091	1.1000	0.9091	\$186,567.17	\$198,370.09	\$177,272.73	-\$10,000.00	-\$10,000.00	-\$10,000.00	
	\$10,000.00 12/31/2010	0.9091	1.1000	1.1000	\$169,606.52	\$218,207.10	\$195,000.00	\$169,606.52	\$218,207.10	\$195,000.00	
		1.0000	1.0000	1.0000				<b>IRR</b>	<b>-1.4898%</b>	<b>1.8095%</b>	<b>0.3400%</b>
<b>Time-Weighted Return</b>		<b>0.0000%</b>	<b>0.0000%</b>	<b>0.0000%</b>							

Mutual Funds, Indexes, and the CFA Institute Report Time-Weighted Returns

The calculation proposed by Securities Regulators is IRR. How is a client to make sense of this?

Notes: Cash Flows are Deposited on the Dates Shown. At the end of every year after the Initial Amount is deposited (\$100,000 above), the Annual Year-End Amount is Deposited (\$10,000). The Base Return is the average compound return of the account; the Fluctuating Return is a volatility factor. The spreadsheet allows these parameters to be changed.

