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My COMMENT LETTER ON MUTUAL FUND FEES

CANADIAN SECURITIES ADMINISTRATORS
DISCUSSION PAPER AND REQUEST FOR COMMENT 81-407
MUTUAL FUND FEES

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Reference : http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_2012123_81-407_rfc-mutual-fund-fees.pdf

It is a great idea to give investors an opportunity to comment on Mutual Fund Fees . My experience with mutual funds has been a disappointment .I was surprised right away when I wasn't given a copy of the Prospectus when I was sold the funds .It arrived about ten days later.

Until I read the Consultation paper I did not realize that I was paying for advice. It is built into the price. I was told it was free. I already have a adviser and an accountant (who does my taxes) and don't see why I should be paying for a service I neither asked for nor use.

I also didn't realize that my "advisor " was being paid by the fund Company and not by my dealer. It is only now that I understand why I was never told about low cost Index funds and Exchange Traded funds.

As I now understand it the trailer commission was originally intended to compensate the salesperson for providing service to the client. But since there is apparently no rules to provide a certain level of service , the trailer has effectively become more like a sales commission. Because trailer commissions are embedded in the management expense ratio, Main Street fund investors don’t usually know that their adviser gets paid an ongoing commission. This is unhealthy.

Also ,the deferred sales charge option was never explained to me. I should have been sold the front load since the price is the same and there is no restriction on selling.

Based on my experience I would like to make some suggestions :

(a). Give people the Prospectus BEFORE they are sold the mutual fund .

(b) Disconnect fund fees from the MER so investors can decide on their own if they want to pay for advice and determine the type of advice wanted . According to a recent Investor Economics report:

Understandably, when the cost of advice is uncoupled from the provision of investment management services, the MER will be lower. This is the case with F-series funds although, to date, it is generally the case that the combination of the MER and the advice fee negotiated between the advisor and the investor has not resulted in discernable savings to the investor.

This means that the industry should be neutral as to how fees are charged. Charging directly gives investors freedom of choice and a basis on which to engage/evaluate their advisers.This will lead to better advice with no increase in costs.

(c) The MER should decrease as the number of dollars invested grows.

(d). Do not allow Deferred Sales Charge funds to be sold to people unless there is very good reason to do so. DSC funds should not be sold the the elderly-it is a form of elder abuse.

(e). Establish rules for “ Free lunch” seminars and where they can be done. These are most often nothing more than sales pitches subsidized by fund Companies.

(f) Prepare booklets and website materials that alert people to sales tricks . While the CSA does a good job on educating people on fraud, there is little material warning about all the tricks brokers and salespersons can play that while, not strictly illegal, are harmful to investor retirement savings. Excessive mutual funds is one example. Unbalanced portfolios with a bias towards equities is another.

If the advice component of the management fee were purchased separately , it would be a tremendous step forward . In **Alpha , Beta and now....Gamma** , according to a 2012 study co-authored by Morningstar analysts David Blanchett, the Chicago-based head of retirement research, and Paul Kaplan, director of research at Morningstar Canada ,they concluded that astute financial planning could increase a retiree’s income by about 30 %.Key elements of value-added advice that Blanchett and Kaplan highlighted were:

- Asset allocation that’s based on the investor’s total wealth, including income-earning capacity;
- Withdrawal strategies that are adjusted over time, based on an individual’s changing needs;
- An allocation to annuities to provide guaranteed income;

- Tax-efficient allocation of holdings between an investor's registered and non-registered accounts;
- Taking account of the risks faced by retirees, including the risk of outliving their assets.

According to the 2012 Ombudsman for Banking Services and Investments Annual Report complaint data,the major cause of complaints is unsuitable investments . Advisers acting in the investor's best interests would dramatically reduce this as a source of complaint.

We ask that the CSA also consider some of the findings of a newly released survey conducted on behalf of the Ontario Securities Commission's Investor Advisory Panel and the Investor Education Fund . It found that just 20 % of the more than 2,000 Ontarians surveyed "strongly agree" that they generally trust their adviser's advice. As for fees, 24 % strongly agreed and another 39 % agreed that how an adviser is paid affects the advice they give. Advisors need to give their clients greater assurance that their best interests are being served and this can be done if fund company compensation to those providing advice is eliminated.

I ave annexed some independent research that the CSA may find useful .

Please feel free to contact me if any additional information is required.

Sincerely ,

William Schalle

ANNEX

What renders financial advisors less treacherous? – On commissions and reciprocity
https://papers.econ.mpg.de/esi/discussionpapers/2010-036.pdf "An advisor is supposed to recommend a financial product in the best interest of her client. However, the best product for the client may not always be the product yielding the highest commission (paid by product providers) to the advisor. Do advisors nevertheless provide truthful advice? If not, will a voluntary or obligatory payment by a client induce more truthful advice? According to the results, only the voluntary payment reduces the conflict- of-interest posed by advisors.

Do financial advisors improve financial performance? According to Do financial advisors improve portfolio performance?, a study of German investors at Vox by university professors Andreas Hackethal, Michalis Haliassos and Tullio Jappelli. says they don't. The reason is the old bugaboo - costs and fees.Advisors add value but ... "*Even if advisors add value to the account, they collect more in fees and commissions than they contribute.*" Apparently the authors found that richer, older people tend to use advisors more which accounts for a preliminary gross conclusion that "*Investors who delegate portfolio management to a financial advisor achieve on average greater returns, lower risk, lower probabilities of losses and of substantial losses, and greater diversification through investments in mutual funds.*" They note that the financial industry would love to grab that statement for publicity. However, the net truth is completely opposite: "*Once we control for different characteristics of investors using financial advisors, we discover that **advisors actually tend to lower returns, raise portfolio risk, increase the probabilities of losses**, and increase trading frequency and portfolio turnover relative to what account owners of given characteristics tend to achieve on their own.*"

Financial Abuse - (this insightful exposition was written several years ago before the IDA morphed into IIROC). Author Andrew Teasdale is an expert on suitability, KYC and portfolio construction) http://moneymanagedproperly.com/new_folder/rights%20and%20abuse/financial%20abuse.htm " "**...Trailer fees:** Trailer fees are annual fees paid by a mutual fund company to an investment advisor for recommending the mutual fund. The investor does not need to be told about this even though the money is paid from the investor's own funds. Likewise the advisor has no obligation to do anything for the client to earn these fees. Trailer fees and other referral type fees are an abuse of the client -advisor relationship and, unless these fees are disclosed and used to offset valid and identifiable services performed by the advisor, they increase costs and are detrimental to an individual's financial position. The greed of the industry has seriously affected the ability of mutual funds to meet the objectives and needs of the individual. Indeed, the benefits of one of the most efficient investment vehicles ever invented have been submerged under the self interests and costs of an industry that has lost sight of its reason for being...." **[** The fact tha**t** trailer commissions as a percentage of "adviser" income has risen since 1996 was not known to retail investors .The lack of disclosure added to investor risks and may explain the rapid rise of mutual fund wrap accounts]

Mutual Fund Investors: Sharp Enough?
Who are mutual fund investors? The answer is critical to regulatory policy. The mutual fund industry portrays fund investors as diligent, fairly sophisticated, and guided by professional financial advisors. The SEC paints a more cautious portrait of fund investors, though touts improved disclosure by the fund industry as a sufficient antidote. However, an extensive academic literature finds that fund investors are unaware of the basics of their funds, pay insufficient attention to fund costs, and chase past performance despite little evidence that high past fund returns predict future returns. These findings suggest that policymakers should rethink current regulatory policy. Disclosure may not be enough. http://ideas.repec.org/a/ris/jofitr/0948.html

Out of Sight , Out of Mind:The Effects of Expenses on Mutual Fund Flows
http://faculty.haas.berkeley.edu/odean/papers%20current%20versions/Out%20of%20Signt.pdf The more opaque the fees , the easier it is to bamboozle retail clients. The paper by Brad Barber, Terrance Odean and Lu Zheng concluded that :"..*We report evidence that mutual fund marketing does work. On average, any negative effect of expense fees on fund flows is more than offset when that money is spent on marketing; non-marketing expenses, however, reduce fund flows. Though [front load] load fees are also spent on marketing, the positive effect of marketing on flows does not appear to be sufficient to offset investors growing awareness of and aversion to loads…" While operating expenses (including embedded trailers) constitute a steady drain on a fund's performance, the effect of that drain is masked by the considerable volatility in the returns on mutual funds..."*

Mutual fund Loads , fees , DSC
http://ssl5.van.ca.securedata.net/canadianmoneysaver.ca/article_retrieve.aspx?article_id=2375 Ken Kivenko

The Changing State of Retirement in Canada – Fidelity (Oct. , 2007)
http://m.twmg.net/state_of_retirement_cda.pdf A survey of more than 2200 households shows that Canadians are on track to replace only 50% of their pre-retirement income. To maintain a comfortable lifestyle they may need as much as 80% of pre-retirement income. That's one reason that investing fees and expenses are so important. They can mean the difference between a happy retirement and a very stressful one.

Financial Knowledge and Rationality of Canadian Investors by Cecile Carpentier, Jean-Marc Suret : SSRN "...Canadian investors' financial knowledge is limited. On average, they obtain a mediocre knowledge score; only 5% score above 66%. The vast majority of respondents scored between 40% and 57%. Significant gaps were noted regarding knowledge of risk and return of asset categories. Knowledge of past returns of the main asset categories is abnormally low, particularly for equity, an area where all of the respondents are involved. Mediocre knowledge of the performance of categories and of the concept of risk premium calls into question investors' financial planning ability. One out of five investors is unaware that the return of a small growth company comes not from dividends, but rather from a capital gain. One-third of investors are certain that they will receive future dividends from a company that usually pays them. Almost 30% of respondents are unaware that stock indices are greatly influenced by the returns of the largest capitalization stocks. Three-quarters of investors do not systematically compare the return on their portfolio with that of a stock market index. Half of the investors do not clearly grasp the link between lack of liquidity and share value. Many investors do not know that if they invest in the stocks of small companies listed on the TSX Venture Exchange, they might lose all their capital. The risks associated with shareholding are largely underestimated ….."http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2038930

Conflict -of- interest can cause harm In "Conflicts of Interest and Competition in the Mutual Fund Industry," Ajay Khorana (Georgia Institute of Technology) and Henri Servaes (London Business School) examine how conflicts-of - interest in the U.S. mutual-fund industry affect competition and investor behaviour (their database covered the period 1979-1998). Overall, their paper "highlights a number of conflicts between fund families and investors," say the authors. For example, they found "no evidence that investors derive any benefit" from annual fees for marketing and distribution (12b-1 fees in the U.S). Furthermore, "fund families generally want to maximize assets under management … and the resulting management fees," an objective at odds with investors' "desire for high risk-adjusted performance at low cost." (U.S. 12b-1 fees are similar to Canada's trailer commissions)

Taxation impact on fund returns Michael Thorfinnson and Jason Kiss of TD Quantitative Capital published a classic paper *"The Overlooked Piranha"* regarding mutual fund taxation in the Fall 1996 issue of Canadian Investment Review. Using typical MER's, portfolio turnover rates, tax rates, etc., they concluded "Portfolio turnover is the largest detriment to after- tax returns, yet may be the hardest portfolio variable for active managers to control... Selecting an investment strategy which maximizes after-tax returns through low turnover is therefore critical in determining ultimate performance ". Keep in mind, the portfolio manager's job does not include financial planning for the individual. The job means managing an investment vehicle in accordance with the mandate of the fund as stated in the prospectus. If that means, say, high portfolio turnover resulting in net capital gains in a volatile technology fund that's his call. But, this aggressive portfolio turnover can dramatically alter your after-tax returns. A 5-year history of Turnover % statistics is included with the Management Report of Fund Performance.. Unfortunately, unlike U.S. Regulators ,Canadian regulators do not require presentation of active -tax returns but they do require disclosure of Portfolio Turnover rate and Transaction fees which are indicators of potential tax issues.

BAD advice on RRSP's leads to investor problems C D Howe Institute-Richard Shillington, "Poverty traps: Means testing and modest income seniors", Backgrounder No.65, April, 2003 (a damning indictment of the current retirement savings system in Canada because of GIS clawbacks & minimum annual withdrawals in RRIF's and their negative impact on lower income people's RRSP's) http://www.cdhowe.org/pdf/backgrounder_65.pdf "*Millions of Canadians accept the homogenous advice of governments and the financial community and put billions into RRSPs. However, for many lower-income Canadians RRSPs are a terrible investment. They are victims of a fraud, however unintentional. Only when more Canadians are aware of the perverse treatment of lower-income citizens' savings will Ottawa be forced to develop measures that reward, rather than punish, their savings efforts.*"

CFA Institute Global Market Sentiment Survey 2013
"Investment professionals are cautiously optimistic about the global economy in 2013, but ethical culture within financial firms needs to be addressed to solve systemic problems that led to the fiscal crisis. "
http://www.cfainstitute.org/about/research/surveys/Pages/global_market_sentiment_survey_2013.aspx

cc British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Nunavut