CSA Discussion Paper and Request for Comment 81-407: *Mutual Fund Fees*

Comment Letter by Keith Ambachtsheer

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I appreciate the opportunity to respond to the CSA Discussion Paper on mutual fund fees in Canada and the possibility of participating in the round table on this subject scheduled for June 7, 2013. Please note that the views expressed in this Comment Letter are mine, and do not necessarily reflect the views of either the Rotman School of Management or the University of Toronto.

Structure of this Comment Letter

The CSA Discussion Paper provides a great deal of information on the structure and pricing practices of the Canadian mutual fund industry, and raises profound questions about the fees the industry currently charges its millions of customers. These questions revolve around both the elevated levels of the fees, and their allocation between various intermediaries. The Paper lists a number of possible public policy responses to the questions it poses, and invites comments on them.

This comment letter lays out a framework for thinking about the posed questions in a logical, integrated manner. The acceptance of the framework I propose logically leads to the public policy actions required to give Canadians a reasonable prospect of receiving a 'value for money' if they choose to invest in the offerings of Canada's mutual fund industry.

Asymmetric Information and Underperformance

In an editorial to be published in the upcoming May-June issue of the *Financial Analysts Journal (FAJ)*, I compare investment philosopher Charley Ellis's 1975 *FAJ* article "The Loser's Game"[1] with his 2012 *FAJ* article "Murder on the Orient Express: The Mystery of Underperformance."[2] I commend Ellis' steadfast (almost 40- year!) ability to stay "on message" about the investment industry's inability to produce measurable value for its customers. Equally remarkable is that so little has changed over that vey long period of time. Why is that? And what will it take for the industry to produce measurable customer value at a reasonable price in the future? In my view, it can only start with a wide-spread understanding and appreciation of the powerful impact informational asymmetry between buyers and sellers has on market outcomes.

George Akerlof was awarded the 2001 Nobel Prize in Economics for a profound idea captured in his 1970 article "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," in which he showed that the classic "value-for-money" outcomes attached to market competition require informational symmetry between buyers and sellers.[3] If sellers know more about what they are selling than buyers know about what they are buying, the sellers will be able to extract too high a price from buyers for too little value. Although Akerlof chose the used-car "lemons" market to make

[1]Financial Analysts Journal, Vol. 31, no. 4 (July/August):19–26.
[2]Financial Analysts Journal, Vol. 68, no. 4 (July/August):13–19.
[3]Akerlof's paper (*Quarterly Journal of Economics*, vol. 84, no. 3:488–500) was rejected by the first two journals it was submitted to because its subject matter was deemed "too trivial."

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his point, he could just as well have chosen the market for investment management services—it is hard to conceive of a market with greater informational asymmetry between buyers and sellers.[4]

If asymmetric information is the underlying problem in the market for investment management services, then removing that informational asymmetry must be the solution. Can we create a demand side in that market that understands the realities of financial markets, security pricing, product distribution, and the economics and motivations of security issuers as well as the supply side does? This question is essentially about institutional design and market regulation. So, more specifically, can we create investment institutions and market regulation that embody both the requisite knowledge of finance and behavioral economics, as well as a legal requirement to use that knowledge solely in the best financial interests of their clients?

Institutional Solutions

My *FAJ* editorial goes from there to pursue institutional solutions, pointing out that logically, the simplest path to informational symmetry in investment markets is to create smart, non-commercial, fiduciary institutions endowed with scale, good governance, and sensible investment beliefs, and to require such institutions to act in the sole best interest of its clients. *Ontario Teachers' Pension Plan* was explicitly designed with these attributes in mind almost 25 years ago. Today, it is globally recognized as a premier investment institution that has generated over 2% (200 bps) excess return per annum over its risk-equivalent market return for over 20 years, net of all investment expenses. In contrast, overwhelming empirical evidence confirms that, on average, commercial mutual funds underperform their risk-equivalent market returns by their MERs.[5] In other words, funds with MERs

[4] For example, the CSA paper observes that most Canadian mutual fund investors don't know or understand the fees they are paying, and don't know how advisors get paid.
[5] See the cited forthcoming *FAJ* article "Fixing the 'Losers' Game': What It Will Take" for multiple references to these findings.

of 2% (200bps) have on average generated returns -2% (-200bps) per annum below their risk-equivalent market returns.

I note in my forthcoming *FAJ* editorial that the United Kingdom has decided to offer this kind of smart, non-commercial institutional solution to all UK workers without employment-based pension plans. The resulting organization *NEST (National Employment Savings Trust)* is now in the process of enrolling millions of UK workers into this professionally-managed, low-cost investment arrangement. In my 2008 C.D. Howe Institute paper titled “The Canada Supplementary Pension Plan (CSPP): Towards an Adequate, Affordable Pension for *All* Canadians”, I proposed a similar initiative for Canada. The CSPP proposal was explicitly rejected by Finance Minister Flaherty at the December 2010 Finance Ministers Conference in PEI. Legislation allowing Canadian financial institutions to offer Pooled Registered Pension Plans (PRPPs) has been drafted instead.

Unfortunately, with PRPP participation voluntary, and PRPP regulation seemingly undemanding, a great opportunity to deliver professionally-managed, low-cost, retirement-related investment solutions to millions of Canadians without employment-based pension plans is being squandered. As a result, most of these Canadians will continue to see little alternative but to turn to Canada’s commercial mutual fund industry for their retirement finance solutions. This perpetuates the opportunity for this industry to take advantage of the material informational advantage it holds over its clients. Predictably, retirement savers paying 200bps or more in MERs will continue to pay too much for too little….unless a far more pro-active stance is taken by the regulators appointed to protect the financial interests of these people.

Regulatory Solutions

What regulatory instruments can be marshaled to address the profound asymmetric information problem in the market for commercial investment management services? The CSA Paper lists a number of them that could be somewhat helpful at the margin: the Fund Facts initiative, the new performance reporting initiative, requiring a listing of the services performed for the trailer fees received, eliminating the cross-subsidization problems, setting commission caps, devising some kind of fiduciary duty test for advisors.

Fortunately, the CSA Paper doesn't stop there. It points out that regulatory authorities in both the United Kingdom and Australia have reached the obvious conclusion that in a market with material asymmetric information problems, only un-conflicted, knowledgeable individuals with a clear 'duty of loyalty' to their clients should be permitted to provide financial planning/investment advice. <u>The clear implication is that it is in the public interest to completely sever the link between financial/investment 'advice' and fund sales-based compensation. Canada must follow the UK and Australia in providing retail investors with this basic protection</u>.

How important is it to legislate this requirement in Canada now? Consider the situation of a family earning $70,000/yr for 40 years willing to save $14,000/yr of its earnings to finance its post-work standard of living. Assuming a 3% real rate of return during a 40-year accumulation period, and a 1.5% annuity purchase interest rate at the end, the family can purchase a 20-year annuity to generate a $57,400/yr pension at a typical pension fund MER of 0.4%. At a mutual fund MER of somewhere between 1.5% and 3%, annuity income drops to somewhere between $44,800/yr and $32,200/yr., a pension income drop of somewhere between 22% and 44%. No sales commission-driven 'advisors' in their right mind would lay out these stark economics to his/her 'clients'.

These calculations show clearly why Canada must follow the UK and Australia in completely severing the link between advice and sales-based compensation. Only un-conflicted, knowledgeable people with a clear 'duty of loyalty' to their clients should be permitted to offer financial/investment advice on a transparent fee-for-service basis. The time to offer Canadians this basic protection is <u>now</u>.

Keith Ambachtsheer

Appendix A

Keith Ambachtsheer is **Director** of the Rotman International Centre for Pension Management (Rotman ICPM), an **Adjunct Professor of Finance** at the Rotman School of Management, University of Toronto, **Academic Director** of the Rotman-ICPM Board Effectiveness Program, and **Publisher and Editor** of the *Rotman International Journal of Pension Management*. Rotman ICPM's primary mission is to foster 'better pension design and better pension management' around the world.

His firm, KPA Advisory Services Ltd, has provided strategic advice on governance, finance, and investment matters to governments, industry associations, pension-plan sponsors, foundations, and other institutional investors around the world since 1985. He is also a co-founder of CEM Benchmarking Inc which monitors the organizational performance of 300 pension plans around the world.

Keith is the author of three books on pension management and has received pension industry awards for his work in Europe, the USA, Canada, and the Pacific Rim. They include EBRI's Lilywhite Award for "outstanding services enhancing Americans' economic security", the CFA Institute's James R. Vertin Award for "producing a body of research notable for its relevance and enduring value", and its Professional Excellence Award for "exemplary achievement, excellence of practice, and true leadership in the profession".

He recently served as Board Chair of the Princess Margaret Cancer Foundation and continues to serve as a member of two corporate boards.