

## **Sent via email**

Me Anne-Marie Beaudoin, Corporate Secretary

Autorité des marchés financiers

800, square Victoria, 22e étage, C.P. 246, Tour de la Bourse

Montréal, Québec, H4Z 1G3

e-mail: [consultation-en-cours@lautorite.qc.ca](mailto:consultation-en-cours@lautorite.qc.ca)

John Stevenson, Secretary

Ontario Securities Commission

20 Queen Street West , Suite 1900, Box 55

Toronto, Ontario, M5H 3S8

e-mail: [jstevenson@osc.gov.on.ca](mailto:jstevenson@osc.gov.on.ca)

## **CSA Notice 81-324 and Request for Comment**

**Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts template** [http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa\\_20131212\\_81-324\\_rfc-mutual-fund-risk.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_20131212_81-324_rfc-mutual-fund-risk.pdf)

I am pleased to submit my comments on CSA Consultation Paper 81-324, Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts. Many of the disclosure issues arise because the Canadian advice industry operates under a lowly Suitability regime and salespersons are compensated by advice- skewing incentives provided by fund companies. This is where real regulatory reform is required. This consultation is only nibbling around the edges of investor protection.

The actively-managed mutual fund is the investment of choice for Canadians. Over 12 million Canadians own them with total assets approaching \$1 trillion. Canadians pay over \$4.6 billion in trailer commissions annually not including sales loads , switch fees and early redemption penalties. Thus, robust risk disclosure is a critical investor protection initiative for retirement security.

Investment academics usually identify risk as the volatility associated with the prices and/or returns of investments. However, I believe this approach is much too narrow for the CSA to use. This is because clients do not think in terms of narrow mathematical terms. Indeed, clients often think of risk as the prospect of an undesirable outcome, such as a financial loss or not meeting a life goal investment objective.

### **Late delivery of risk information adds to risk**

A big risk is that Fund Facts is received by the investor about a week after the sale. It doesn't feel right that an industry entrusted with Canadians' retirement savings, and has the power to cause investors to lose all of their savings, should have a responsibility to come clean on risks at a time that is meaningful. Investors have a right to receive, before they are sold a fund, complete information about risks, front end sales charges, account maintenance or service charges, or early redemption penalties, none of which are reflected in the return calculation. Of course, with Fund Facts being delivered after the sale, there is no chance for investors to ask questions which would, I admit, slow down the sale but would lead to more informed decisions and better outcomes. As things stand at present, there is in actuality no real disclosure of fund risk levels no matter what risk rating methodology is chosen. Also, two days to deal with a disclosure/representation issue is too short, I recommend a cooling off period of at least a week be mandated to allow time to reflect, discuss with family and get second opinions. It should be uniform across Canada.

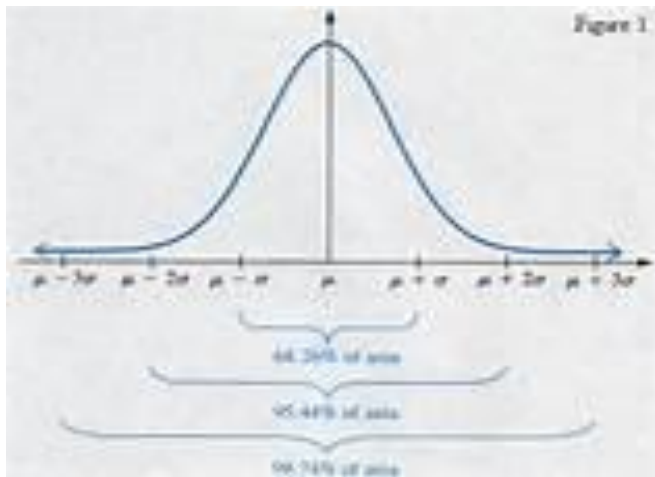
### **Does the Standard Deviation (SD) answer "How risky is it?"**

The CSA have proposed the SD, based on 120 months of pre-tax return data, to answer the question of risk disclosure. It is not clear whether the CSA will require disclosure of the specific standard deviation in addition to simply showing the scale and where the fund fits on that scale. I also query whether the additional category (aimed at precious metal/commodity funds) of "Very High" is necessary.

Reported Mutual fund return data assumes that all distributions are re-invested and no taxes are paid which of course is not reasonable for retirees / RRIF account holders like myself. For many, it is the after-tax return that matters and believe me, income taxes play a huge role for retail investors. I will leave this discussion for another time but just wanted to make the point.

The underlying assumption is that the fund returns are Normally distributed. Normal (Bell) curves do not take big moves in the market into account. As

Benoit Mandelbrot and Nassim Nicholas Taleb note in their article, "How The Finance Gurus Get Risk All Wrong", which appeared in *Fortune* in 2005, Normal distributions were adopted for mathematical convenience, not realism. A number of academics argue that the real-world distribution has "fat tails" (like the Cauchy distribution), reflecting dramatically more loss (and profit) potential than would be suggested by the symmetrical Normal distribution (see chart below).



[99.7% of returns fall within plus/ minus 3 SD's.]

In the case of a mutual fund, a lot of non-random factors come into play over a 10-year period. These include but are not limited to fund mergers, manager changes, MER changes, Style drift, increased transaction expenses or even taxation changes. One should therefore be suspicious that Normality, unimodality or stationarity is a robust assumption over a 10-year period.

Most retail investors do not visualize such a curve and hence I feel that SD will not be a meaningful indicator of fund Risk. While it is true that a more volatile fund exposes the long-term investor to a wider range of possible outcomes, it doesn't necessarily impact the likelihood of those outcomes. In many respects, volatility is more like the turbulence a passenger experiences on an aircraft – unpleasant, perhaps, but not really bearing much relationship to the likelihood of a crash.

However, if the FF section were labelled as an indicator of *Riskiness* it could have disclosure value for long-term investors in that it warns them the flight could be bumpy. To the extent, short term fluctuations in value impact bad investing behaviour, such a warning suggests they will need seatbelts, and at least correlate to KYC risk tolerance/time horizon.

As noted below, if two funds have the same SD but the mean of one is significantly higher than the other, than it may well be that the higher SD fund is a less risky investment over the long term. The mean and SD must be assessed together but the consultation paper does not require the presentation of the actual or melded 10 year return.

### **A FF Guide would add to the value of disclosure**

There are no perfect definitions or measurements of risk, but retail investors would do well to think of risk in terms of the odds that a given investment (or portfolio of investments) will fail to achieve the expected return, and the magnitude by which it will miss that target. By better understanding the meaning of risk, and where it can come from ( a listing of principal risk factors), retail investors can work to build investment portfolios that not only have a lower probability of loss, but a lower maximum potential loss as well.

As many advocacy groups have already said, the CSA should prepare a brief plain language Guide on how to effectively use Fund Facts. The brochure should explain volatility and risk. It could also include a section alerting the investor to consider a fund's objectives and strategies (key risk-related information elements not revealed in FF) – such a Guide would have a large payoff in protecting retail investors and seizing the potential benefits of FF's. For one, it could help abate the tendency to chase past returns and panic sell and encourage an assessment of risk before being sold a fund.

### **How have investors lost money?**

For the most part, investors have lost money because they were sold unsuitable investments (i.e. risks that don't match profile or objectives). In the 2001 dotcom boom, excessive valuations were the cause of the meltdown. A disclosure of historic volatility would not have revealed the dangers inherent in e-commerce and internet infrastructure funds but an enumeration of principal risks would have. Ditto for the non-bank ABCP meltdown that required several billion dollars of salvage money to prevent a number of so-called safe money market funds from "breaking the buck". And so it is now with Bond Funds that have risen in value due to record low interest rates. Historical SD data does not paint an adequate risk picture but an articulation of interest rate risk would or at least it would prompt a client discussion with the salesperson. For retail investors, temporal risks are very important not just generic risk with an asset class. Sample disclosure:

“Investments in Bond funds are subject to interest rate, credit and inflation risk. Investors in any Bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates. Diversification does not ensure a profit or protect against a loss in a declining market.”

[A chilling survey of 30,000 US adults](#), published last year by the Financial Industry Regulatory Authority (IIROC counterpart in the US), found that only 28 per cent of respondents could correctly answer the simple question: “If interest rates rise, what will typically happen to bond prices? Rise, fall, stay the same, or is there no relationship?” After decades of falling interest rates many small investors are unaware of the danger lurking in their Bond fund portfolios. Fund Facts should not add to the problem. [I note that the CSA “..expect these types of changes (risk rating) to occur infrequently and only when there has been a material change in the fund’s Volatility Risk. “. It would appear then that, say, Bond funds facing a interest rate increase headwind would NOT have a rating that reflected trouble ahead]. Presumably, it is the role of the dealer Representative to provide this guidance to the unsuspecting investor.

### **Standard Deviations Need a Context**

After dusting off my old math book and some googling I conclude that the standard deviation as an Indicator of risk disclosure in Fund Facts is controversial. The SD based risk rating may be OK at revealing some information about the dispersion about the mean return but that is not investment risk and without knowing the associated mean tied to the risk, meaningful decision making is not possible. The mean and the standard deviation of a set of data are descriptive statistics reported together. Standard deviations should never be considered on their own. One needs to factor in the expected return as well. For example, Fund A has a standard deviation of 6%. Fund B has a standard deviation of 10%. If you only look at the standard deviation, B is the riskier investment. But what if the 10-year compound average return for A is 4% and 15% for B? At a 95% confidence interval below the expected return, you could actually lose more with investment A than B. Without getting into the calculations, you could lose 5.9% with A and only lose 1.5% with B.

Additionally, the SD is based solely on mathematical principles and as such omits many types of risk and costs not included in the measure of standard deviation. I therefore think that the principal risks of the fund should be delineated in plain English to augment the dispersion data. In any event, the section header should be ***What is the volatility of this Fund?***, so

investors are not misled in misunderstanding the nature of the risk disclosure .

### **Salesperson risk is a major factor**

About half the cost of owning a mutual fund comes from trailer commissions which create a whole set of risks that is independent of market returns and not reflected in performance data. Eg DSC monies paid to exit a toxic fund. Salespersons may also be unqualified to provide advice or be influenced by attractive sales commissions. This can lead to bad behaviours such as fund churning or the undue use of leverage both of which add to investor risk .A really strong warning in FF about salesperson conflict-of-interest would help reduce the risk of mis-selling.

### **ICI Study of Mutual Fund Shareholder Opinions About Risk Disclosure, April 1996**

[http://www.iciglobal.org/pressroom/news/ci.NEWS\\_96\\_RISK\\_DISCLOSE.pprint](http://www.iciglobal.org/pressroom/news/ci.NEWS_96_RISK_DISCLOSE.pprint) This is the most comprehensive research I could find on the subject. The principal findings of the study are:

- Shareholders are concerned about risk. Sixty-nine percent of respondents examined a fund's investment risk before making their most recent purchases. Only fund performance was cited more frequently (by 75 percent of respondents) as information reviewed before investing.
- Investors find narrative disclosure useful to their evaluation of risk. Fifty-one percent said they are very confident of their ability to use narrative description to assess a single fund's risk.
- Investors also find graphic presentation to be helpful. Fifty-one percent said they were very confident in their ability to use the 10-year bar graph to compare the risks among funds.
- Quantitative risk measurements would complicate an evaluation of mutual fund risk for most investors. Most investors, including those who have used quantitative risk measures, are not very confident of their ability to use these methods. The survey indicates that quantitative risk measures have a strong potential to confuse or mislead investors.

This certainly matches my own viewpoint. Assuming US investors and Canadian investors share similar traits, a narrative disclosure of principal risks appears to be very useful.

### **CSA approved Method needed for merging data**

The Consultation defines the criteria for the indexes if they are required to augment actual performance data to satisfy the 10 year computational constraint. These seem generally reasonable but fund managers must also adjust these index returns by the actual MER's of the fund to permit high integrity connectivity. The CSA should also specify that the index used for risk rating should be identical to the index used in the MFRP performance reporting and in marketing materials for the fund.

There is also the question of how to meld returns when 2 funds merge . To ensure industry-wide consistency, the CSA should prescribe the method for melding actual and fee-adjusted index returns. Finally, there is the question of how to handle the situation where a closed- end fund converts to a mutual fund. Will the CSA permit using historical CEF data?

### **Some products not compatible with SD method**

Some products with monotonically changing asset distributions appear to me to need a different kind of risk disclosure. For example, Target Date Funds (TGF's) and Return of Capital Funds. In the case of TGF's there are other risks such as Event risk. In 2008, several of these funds blew up due the massive disruption of the glide path. Only a delineation of this risk would have warned investors of the embedded danger. See *Target-date funds miss their mark* <http://www.theglobeandmail.com/globe-investor/funds-and-etfs/funds/target-date-funds-miss-their-mark/article4283341/?page=all#dashboard/follows/>

### **Complaint handling should not misuse the Volatility rating**

Of course, even if we accept Standard deviation as a fund risk measure it is only appropriate for measuring the risk a fund that is an investor's only holding. The figure cannot be combined for more than one fund because the standard deviation for a portfolio of multiple funds is a function of not only the individual standard deviations, but also of the degree of correlation among the funds' returns. This is why we have expressed concerns that because certain firms and the MFDA [ MR-069] sometimes evaluate compliance on a per fund risk rating The choice of word descriptors describing the rating is unjustifiably/literally tied to the investor's KYC/ Suitability profile which uses similar nomenclature. If the NAAF/KYC says

Medium risk and the Fund risk rating in FF is Medium, all is not necessarily well because the risk disclosure is really just Volatility risk.

### **Hard to interpret the risk rating**

Retail investors think of risk in terms of a capital loss- downside risk. What exactly will Medium risk mean to an investor? As I understand the scale, a Medium risk rating of Medium is assigned to a fund if it's 10-year standard deviation is as high as 12 %. Will he/she understand that it could mean a 35 % loss in a single year? The Steadyhand prospectus disclosure provides some insight and is a disclosure example that should be considered for FF.

I note that, according to fundlibrary.com, the 10-year SD for the CIBC Precious Metals Fund is stated as 9.362 as of Dec. 31, 2013. According to the proposed scale this would rate the fund as Medium (volatility) risk as it falls between 6%-12%. This doesn't seem to match my experience with such funds.

### **Computation of 10 year SD**

Over the years that I have owned mutual funds, many have been merged, often at a higher MER and/or different mandate. I have read that something like 75 % of mutual funds have less than 10 year histories. If this is correct, then most risk ratings will be the risk of the fund Category or fee-adjusted Index rather than the fund. What use is this? Why go through all the trouble? Would a 5-year SD do the job? The SD methodology is really measuring the **riskiness (volatility) of** the fund rather than its risk. Risk is much more than dispersion about a mean to a retail investor.

### **Risk metrics not congruent**

The FF risk rating is based on 10-year SD data (augmented as required by fee-adjusted return data). Another risk indicator in FF is the worst 3 months return. Funds are required to disclose their worst three-month performance - **ever**- under a new heading "Worst return". The CSA explain that this disclosure is necessary to better inform investors about the possible loss of investment in the fund -it must be provided for the worst three-month period since the inception of the fund (with no 10-year cut-off) -this could put older funds at a competitive disadvantage because of the greater chance that those funds at some point fell into a significant down-turn situation.



Most funds have less than 5 years of history which means that a newer fund will not have a negative 3 month return since about 2009 .Should not the worst 3 month fee-adjusted return of the applicable index be used so as to improve fairness and comparability? I add parenthetically that it is my understanding that most retail investors hold on to funds between 4-7 years , so they are not, in effect, long-term investors if a 10-year hold period is considered as the minimum hold period for a long-term investor. My hold period was about 5 years based on the recommendations of my advisor and involved payment of not insignificant early redemption penalties that don't show up in published fund performance data.

I would like to take this opportunity to comment on a related topic- prevailing methods of assessing investor risk tolerance and loss capacity. See ***The State of Risk Profiling in Canada: Canadian Financial DIY: - Ouch!*** <http://canadianfinancialdiy.blogspot.ca/2013/11/the-state-of-risk-profiling-in-canada.html> It is my experience that risk profiling is wholly inadequate, inconsistent and especially deficient as regards senior investors. A good reference here is *Investor Risk Profiling* from Vanguard <https://www.vanguard.co.uk/documents/adv/literature/investor-risk-profiling.pdf> and ***Client risk tolerance rarely assessed accurately*** - Investment Executive <http://www.investmentexecutive.com/-/client-risk-tolerance-rarely-assessed-accurately> I urge the CSA to examine the state of affairs and introduce the needed investor protection reforms.

I hope this feedback is useful to you.

It is fine to post this Letter on the applicable websites.

Sincerely,

Arthur Ross

January, 27, 2014

## **APPENDIX**

### **1. Risk Tolerance Questions to Best Determine Client Portfolio Allocation Preferences** by Michael A Guillemette, Michael S. Finke,

**Abstract:** The literature on risk tolerance overwhelmingly justifies the use of questionnaires based on validity and reliability or psychometric testing, but there has been little research examining the relation between questions and actual investor portfolio behavior. This study examines risk tolerance questions based on economic theory, prospect theory, and client self-assessment to determine the extent to which they explain variation in portfolio allocation preference and recent investment changes. We conclude that risk tolerance questions based on loss aversion and self-assessment should be used when determining the portfolio allocation of clients. While questions based on economic theory should theoretically be the best measure of a client's portfolio allocation preference, the results of this study indicate that these questions are not very useful when both loss aversion and self-assessment questions are included in a risk tolerance questionnaire. Planners should begin to reassess the risk tolerance level of their clients around age 60, as there is evidence that risk tolerance declines later in life because of cognitive decline.

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2088998](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2088998)

## **2. CSA 2012 Investor Index**

The *Investor Index* also shows that the overall investment knowledge of Canadians is low, with 40 per cent of Canadians failing a general investment knowledge test. According to the findings, 57 % of Canadians say they are confident when it comes to making investment decisions. Yet most Canadians have unrealistic expectations of market returns. When asked what they think the annual rate of return on the average investment portfolio is today, only 12 % of Canadians gave a realistic estimate, while 29 % provided an unrealistic estimate and 59 % explicitly chose not to hazard a guess. Nearly half of Canadians (49 per cent) say they have a financial advisor, up from 46 % in 2009 and 42 per cent in 2006. However, 60 % of those with a financial advisor have not ever completed any form of background check on their advisor. Thirty-one per cent of Canadians say they have a formal written financial plan, up from 25 % in 2009. Although more Canadians have a financial plan, they are reviewing it less frequently (78 % say they reviewed their plan in the past 12 months, down from 83 % in 2009). <http://www.securities-administrators.ca/investortools.aspx?id=1011>

- 3.** A poll from **CIBC Asset Management** by Leger finds released Jan. 24, 2014 reveals that almost 60 per cent of Canadians with a retirement portfolio are unaware that rising interest rates can erode

the value of some of their investments. And, those investors closest to retirement - the "baby boomer" generation between the ages of 55 and 64 - are particularly in the dark, with 65 per cent unaware of the impact of rising

rates. <http://www.newswire.ca/fr/story/1294459/canadian-investors-unprepared-for-the-impact-of-rising-interest-rates-cibc>

**4. Littératie financière et préparation à la retraite au Québec et dans le reste du Canada**

Thomas Lalime , Pierre-Carl Michaud

[http://www.cirpee.org/fileadmin/documents/Cahiers\\_2012/CIRPEE12-37.pdf](http://www.cirpee.org/fileadmin/documents/Cahiers_2012/CIRPEE12-37.pdf)

**5. Volatility metrics for Mutual Funds ( Deloitte)**

<http://www.dol.gov/ebsa/pdf/deloitte2009-3.pdf> Discusses several disclosure metrics such as Sharpe ratio, Best/worst historic returns , Number of trading days with price change in excess of 1% as well as SD.