

March 10, 2014

**BY EMAIL**

British Columbia Securities Commission  
Alberta Securities Commission  
Financial and Consumer Affairs Authority of Saskatchewan  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
Financial and Consumer Services Commission (New Brunswick)  
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland and Labrador  
Superintendent of Securities, Northwest Territories  
Superintendent of Securities, Yukon  
Superintendent of Securities, Nunavut

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  
Email: consultation-en-cours@lautorite.qc.ca

-and-

The Secretary  
Ontario Securities Commission  
20 Queen Street West  
22nd Floor, Box 55  
Toronto, Ontario M5H 3S8  
Email: comments@osc.gov.on.ca

Dear Sirs/Mesdames:

**Re: CSA Notice 81-324 and Request for Comment – Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts (the “Notice”)**

The Canadian Advocacy Council<sup>1</sup> for Canadian CFA Institute<sup>2</sup> Societies (the CAC) appreciates the opportunity to comment on the Notice and wishes to provide the following general comments on the proposed risk classification methodology.

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<sup>1</sup>The CAC represents the 13,000 Canadian members of CFA Institute and its 12 Member Societies across Canada. The CAC membership includes portfolio managers, analysts and other investment professionals in Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. See the CAC's website at <http://www.cfasociety.org/cac>. Our Code of Ethics and Standards of Professional Conduct can be found at <http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx>.

The CAC is supportive of the CSA's initiative in standardizing risk methodology, and agrees that if every mutual fund manager was required to use the same calculation, it would be useful to investors and provide more consistency, as well as assist in comparing the risks across different mutual funds. As a result, as a primary comment, we are of the view that the CSA should mandate the proposed methodology and not adopt it only as guidance.

We understand that the Fund Facts currently requires managers to use volatility of past returns in assessing the risk classification of mutual funds (volatility risk). We also understand that through consultations, the feedback received by the CSA indicated that a number of stakeholders agreed with the use of standard deviation as the risk indicator because it is a widely accepted measure of volatility. We also agree that, assuming volatility risk is the appropriate measure, standard deviation may be an appropriate measure to assess that risk.

However, we question the starting premise that volatility is the risk measure that should be required for the Fund Facts document. For example, an investment in Long Term Capital Management would have shown a low standard deviation just prior to its collapse, and thus low volatility risk does not necessarily mean that an investment is devoid of risk. We do not believe that most investors understand the meaning of standard deviation within the context of their portfolio, nor have a sufficient understanding to interpret the results.

In our August 30, 2012 letter to the CSA in response to its request for comments on National Instrument 81-101 *Mutual Fund Prospectus Disclosure*, we indicated that the visual representation of the risks of any one particular fund can be enhanced so that an investor without any financial background can better understand the fund's level of risk. Members of the CAC have experience in dealing directly with investors and the Fund Facts document, and in our experience most investors can understand graphs and tables far more readily than calculations such as standard deviation. It might be possible to express standard deviation differently as confidence intervals, for example, as a statement that in the past x years, in y% of the time, a fund lost up to 10% of the initial investment and gained up to 10% of the initial investment (gross of fees and taxes). Whenever a concept is presented in percentage terms, it can be accompanied by an example in dollar terms to help illustrate the point.

Investors understand risk in terms of potential dollar losses in their portfolio more easily than percentage returns. As an example of alternative disclosure, in conjunction with the use of the "risk bands", it could be helpful for an investor to be provided with information such as the amount of money that could be lost if an investment fell within one of the bands – i.e. \$1000 in a high risk band could have lost \$X over the last 10 years.

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<sup>2</sup> CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 113,000 members in 140 countries and territories, including 102,000 CFA charterholders, and 137 member societies. For more information, visit <http://www.cfainstitute.org/>.

Fund returns alone may not be sufficient to measure risk, as in many cases the fund will not have been in existence long enough for the fund's track record to have any statistical meaning. There are a variety of methods that can be used to express such risk, and a number of possibilities were set out as an appendix to our letter. While we did not advocate one such method over another, we do believe that including additional information in conjunction with the existing risk scale, particularly in graphic form, would provide additional transparency to retail investors.

Standard deviation alone does not help explain whether the volatility is due to the market or the manager performance. In addition, there is a particular concern with using standard deviation as a proxy for market risk in a fixed income fund, and it could be complemented by also describing duration risk in plain language (e.g. an increase of approximately w-x% in interest rates will result in a y-z% change in net asset value).

In the event volatility risk must be expressed for the Fund Facts document, and standard deviation is employed to measure such risk, we have the following comments on the proposed methodology itself.

The proposals would require a 10 year annualized standard deviation. It is our observation that only a minority of mutual funds have a 10 year history. This may in part be due to survivorship bias, where under-performing funds are closed by their managers and merged with other funds. In addition, the 10 year measurement may be inappropriate as many investors do not hold any one mutual fund for a 10 year period. A study of mutual funds in Canada conducted by Investor Economics for the Investment Fund Institute of Canada and described in a September 2012 report, used an average holding period of 4.5 years.

The proposed methodology suggests that in the event a fund does not have a 10 year history, its manager will be permitted to utilize the monthly total returns of an appropriate reference index as a proxy to impute missing data. The CAC is of the view that this is not an appropriate method of representing true expected volatility of any fund and may lead to unintended consequences. A fund's benchmark may be selected based on the boost to fund history it would provide, or artificial benchmarks may be created to show historically low volatility not representative of real risks. As noted above, standard deviation of the benchmark alone does not help explain the reasons behind the volatility of a fund. When the performance of a benchmark is compiled with the historical returns of a fund, it complicates the matter further as it does not allow clients to determine if the manager's active management style adds volatility to the fund or whether that is a function of its benchmark. The longer the performance history reflects data from the benchmark, the less relevant any comparison between the fund's returns and those of the benchmark.

While the Notice states that the proposed methodology does not allow for qualitative factors or manager discretion to impact the risk ranking process, we believe that permitting a manager to choose a reference index for missing data elements will in fact insert a measure of uncertainty and discretion into the calculation. In order to reduce some of the discretion, we would recommend that if such a compilation were permitted, managers should also be required to perform the calculation based only on the actual returns of the funds and show that information alongside the compiled information, and explain (if there is a difference) how the fund would fit in a different risk band if the actual performance history and not a 10 year compilation were used.

We note as well that for a period as long as 10 years, the standard deviation calculation would be quite end-point sensitive, and would be expected to change frequently. Alternatively, managers could be required to complete the calculation for each of a 3 year history, 7 year history and 10 year

history. In each case it would be important to clarify at what point the returns are based on a compilation with an index and thus no longer reflects the actual performance of the fund.

Investors usually perceive risk as the combination of the totality of risks affecting their portfolio, including risks other than volatility risk. In essence, investors want to be informed about all risks that impact the question “what are the odds in % terms of losing more than X% of my portfolio?”

One such potential risk is liquidity risk, in that the liquidation value of an investment may not be the same as the market value of an investment as otherwise displayed in the Fund Facts document, particularly during a liquidity crisis. For example, it is well known that during the ABCP crisis, it was impossible for investors to actually sell some of their “low risk” commercial paper holdings. As a result, the potential downside to a mutual fund investment may in fact be greater than that indicated by normal historical volatility.

Recognizing that funds governed by National Instrument 81-102 Mutual Funds contain investment restrictions in order to ensure daily liquidity, it may be helpful to include a specific reference to other risks, including liquidity risk, in plain language, in the Fund Facts document as well. It may be surprising to investors to find out that in a crisis scenario, it is sometimes the liquid securities which present the most risk of loss as market participants rush to sell the most liquid securities first.

### **Concluding Remarks**

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at [chair@cfaadvocacy.ca](mailto:chair@cfaadvocacy.ca) on this or any other issue in future.

(Signed) *Ada Litvinov*

**Ada Litvinov, CFA**  
**Chair, Canadian Advocacy Council**