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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, Yukon Territory
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Nunavut

ATT: Me Anne-Marie Beaudoin, Corporate Secretary, Autorite des marches financiers

The Secretary, Ontario Securities Commission

**RE: CSA notice 81-324 and Request for Comment, Proposed CSA Mutual Fund Risk Classification
Methodology for Use in Fund Facts**

To whom it may concern:

Fundata Canada Inc. (Fundata) recognizes the necessity of having a single, well-defined process for assigning fund risk ratings and we believe that the proposed methodology should be mandated and applicable to exchange traded funds as well as mutual funds.

Issue # 5:

Standard deviation is the single most widely recognized and easily understood risk metric used by the investment fund industry, therefore we agree that it should be used in determining the risk rating of a fund absent the possibility for multiple risk metrics. While understanding the need for a balance between a simplistic and fully comprehensive approach, Fundata would like to propose the addition of both a relative and quantitative element to the disclosure that we feel will give users more pertinent information to assess the volatility risk of an investment.

The CSA is proposing a purely quantitative method for determining a fund's risk rating whereby fund companies will use a significant amount of data applied to a well thought out process. To then translate this data and process to a single word descriptor, essentially making it a qualitative measure of risk, does not give the investor a holistic view of what this risk rating captures. For example, a 'Medium' risk rating

is simply telling the investor that the fund’s risk level is somewhere in the middle of the spectrum. This offers no insight into what ‘Medium’ risk actually means, or the fact that one ‘Medium’ risk fund can have a 10 year standard deviation of 12% while another ‘Medium’ risk fund can have a standard deviation of 6%.

We suggest having the fact sheets display the qualitative description as well as the 10 year standard deviation number and the standard deviation bands for each of the 6 risk categories.

Ex:

Risk Rating	Low	Low to Medium	Medium	Medium to High	High	Very High
Fund's 10 Year SD			11.5%			
Risk Category SD Bands	0% - 2.0%	2.0% - 6.0%	6.0% - 12.0%	12.0% - 18.0%	18.0% to 28.0%	> 28.0%

As many investors may not understand what a standard deviation of 11.5% actually means, the table provides a basis for comparison, allowing the investor to see not only where the volatility of the fund lies within the ‘Medium’ risk category, but also where the volatility lies within the entire spectrum of investment funds. This would allow for a meaningful comparison between two ‘Medium’ risk funds.

A reasonable alternative to the risk bands would be showing the average standard deviations of the funds in each risk category. This would allow the user some insight into the typical behavior of the funds in each category and provide somewhat of a ‘risk benchmark’. Fundata has completed similar analysis on the behavior of funds within each risk category and found that while behavior can differ significantly from fund to fund, the comparison to the mean is very useful in providing an element of relativity to the risk ratings.

Issues # 8, 10:

In general Fundata disagrees with the use of a 10 year period to calculate standard deviation, but understands the desire to capture full market cycles with the risk measure. Fundata calculates the average lifespan of a fund at just less than 6 years, and reports show that the average holding period of a fund is less than 5 years and shrinking¹. This indicates that a typical investor will not experience the smooth, consistent ride that a 10 year standard deviation implies, but will experience the swings in volatility that occur over a 5 year period. We concede that without using flexible risk bands (bands that fluctuate with the overall market volatility) using the 10 year period will ensure that funds are not frequently switching risk categories.

The primary concern with using the 10 year period relates to the lack of available data. Of the current Simplified Prospectus funds in Fundata’s database (including funds that have previously been

¹*Quantitative Analysis of Investor Behavior* (Dalbar Inc. 2012)
Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows. (Barber, Odean, Zheng 2005)
FPA Journal – Investors Behaving Badly: An Analysis of Investor Trading Patterns in Mutual Funds. (2001)

terminated) the average lifespan of a fund is just under 6 years and there are approximately 20% of funds with 10 or more years since inception.

As a result, roughly 80% of funds will have a risk rating determined, in part, by a reference index. This effectively makes the selection of the reference index the most crucial component to the risk classification methodology proposal.

As proposed, the reference index is chosen (or constructed) by the fund manager, which we believe leaves room for manipulation. Fund companies and fund managers looking to keep the risk rating of their fund at a certain level, could choose an index with the lowest possible risk level in mind while abiding by the loose criteria put forth by the CSA.

The following examples illustrate two similar scenarios where manipulation could take place. **We used actual performance data from active funds in Fundata's database; the real names of these funds were not used to protect their identity.*

We highlight two Global Small / Mid Cap funds by back testing historical performance data and demonstrating how they could use the reference index to select a risk category that misrepresents the true volatility risk.

Both funds invest according to a global small / mid cap mandate, thus upon inception, a perfectly reasonable reference index would be the Dow Jones Global Small-Cap TR Index which lands in the Medium to High risk category. The following chart shows the 10 year standard deviation of the index is very stable, around 15%, other than the period after the financial crisis in '08/'09. Nevertheless, the index remains within the Medium to High risk category standard deviation bands.

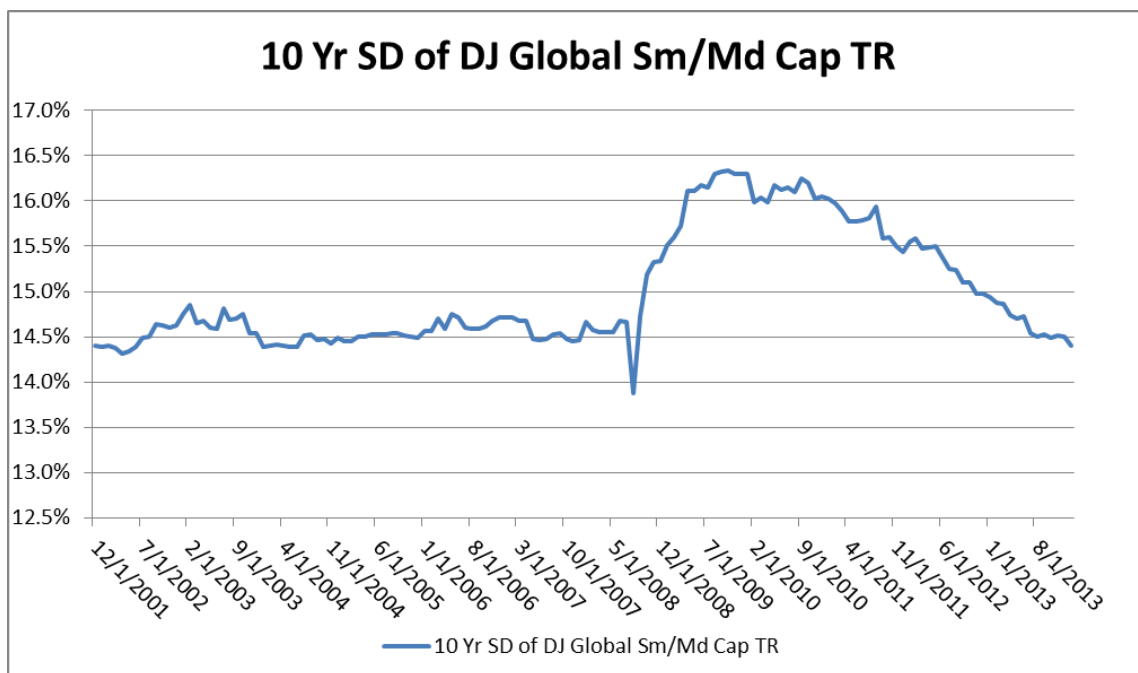


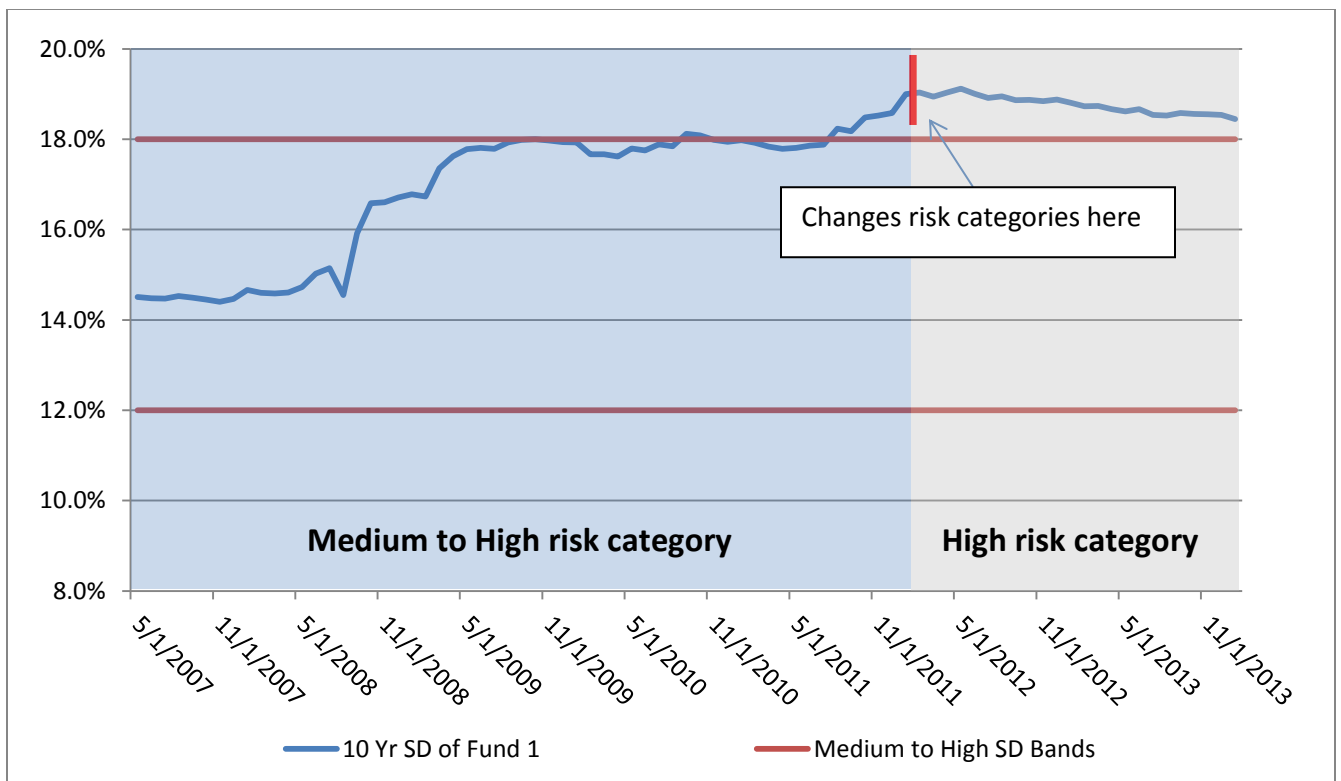
Table 1 shows that as of January 31st, 2014 the standard deviations across different time periods of both funds are considerably higher than that of the index, and the funds should be in the High risk category.

Table 1

Fund type	Global Small / Mid Cap Equity	3 yr SD	5 yr SD	10 YR SD	Risk Category
Proxy Index	Dow Jones Global Small-Cap TR Index (C\$)	11.03%	13.37%	14.40%	Medium to High
	Fund 1: using reference index for 10 year SD	18.52%	19.30%	18.45%	High
	Fund 2	18.29%	21.44%	20.47%	High

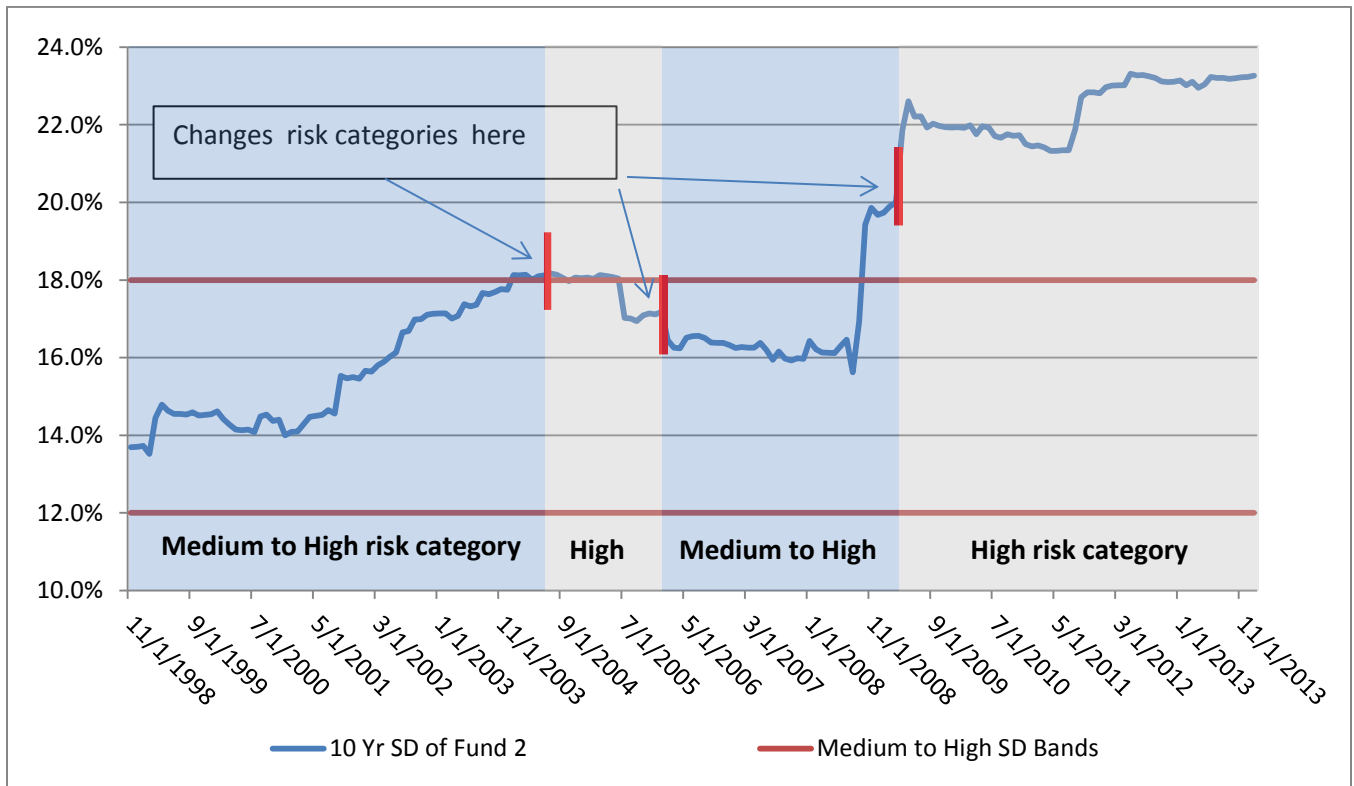
Fund1 has an inception date in April 2007 at which point its risk category would be completely determined by the 10 year SD of the index which was 14.7% placing it in the Medium to High category. As the fund progresses to build performance history, the returns of the fund begin to replace the returns of the index, but the fund doesn't cross the High risk threshold until October 2009, two and a half years after inception. According to the rules outlined in 'Monitoring and changing of risk categorizations' the fund would not change categories until its 12 month average risk band classification reached 5, which is in January 2012, four and three quarter years after inception.

Chart 1: Rolling 10 year SD of **Fund1** using a combination of the reference index returns and the fund returns



Fund2 has an inception date in October 1998 at which point its risk category would be completely determined by the 10 year standard deviation of the reference index which was 13.7% placing it in the Medium to High Risk category. The 10 year standard deviation of **Fund2**'s return combined with the index doesn't cross the threshold until January 2004. According to the rules outlined in 'Monitoring and changing of risk categorizations', the fund would not change categories until its 12 month average risk band classification reached 5, which is in June 2004, over five and a half years after inception. In this case the fund remains in the High risk category until January 2006 before switching back to the Medium to High category, and then shifts back in to the High risk category in March 2009.

Chart 2: Rolling 10 year SD of **Fund2** using a combination of returns from the reference index and the funds.



We believe that there are many situations such as these where the fund's risk can be understated early in its existence by using a reference index. Given that 80% of funds will be using a reference index, we suggest implementing stricter guidelines around index selection.

Ultimately having a third party select the reference index on behalf of the fund company would eliminate the conflict of interest. Approved third parties could be data providers or industry participants that meet set criteria put forth by the CSA and would follow a quantitative, documentable process for assigning indices.

We also have concerns as to whether or not the CSA has the means to effectively monitor index selection to ensure the chosen benchmarks accurately reflect the potential volatility of a fund. Having a third party select the index would help alleviate this problem.

If the fund company is to assign their own reference index, they should be required to follow set guidelines. Examples of such guidelines and requirements could include one or all of the following:

- **Sufficient history:** Have no risk categorization for the first year of a fund's existence with a written explanation in the fund facts stating that the fund has insufficient history to determine the risk category. This would follow along the current guidelines of not requiring performance on the fund facts for the first year of the fund's existence.
- **Tracking Error:** Require that the tracking error of the fund to the index be within a set range. For new funds the tracking error would be calculated as soon as there was sufficient data.
- **Correlation:** Require that the correlation between the fund and the index be above a set threshold. For new funds the correlation would be calculated as soon as there was sufficient data.
- **Standard Deviations:** When the data become available, require that the 3 and 5 year standard deviations be within a set range from the index.

By requiring the use of 10 year standard deviation, the vast majority of funds will have a risk classification determined by the use of a reference index. As a result, the choice of the index becomes the key element of the Mutual Fund Risk Classification Methodology proposal. As demonstrated above, under the current proposal, it is very possible that a fund's risk could be understated in the early years of its existence. Fundata believes strict guidelines are necessary in the index selection process and the suggestions listed above would help solve this problem.

We appreciate the opportunity to comment on the proposal and would be happy to discuss our comments further.

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