Via email transmission December 28, 2015

Comment letter by Mr. Arthur Ross

CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts (FF) and ETF Facts - Proposed Amendments to NI 81-102 Investment Funds and Related Consequential Amendments
https://www.osc.gov.on.ca/en/SecuritiesLaw_ni_20151210_81-102_mutual-fund-risk-classification-methodology.htm

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I appreciate the opportunity to again comment on the mutual fund risk rating methodology. As a mutual fund investor I have had more than my fair share of problems with mutual fund risk disclosures over the years. When I last commented on this topic my letter was based on actual experiences and backed up by solid references. I am therefore very disappointed to see the CSA basically going along with industry proposals and ignoring my input.

In my letter I expressed concerns about the standard deviation (SD) as a measure of risk, the inability of the average fund investor to comprehend the disclosure and make use of it, ICI research supporting narrative disclosure of risk , advisor risk etc. My opposition to this methodology remains even stronger today after a year of struggling with the risk disclosure portion of Fund Facts (FF).

Of course my opposition to the methodology is also backed up by some of the world's top investors based on the ideas that SD is not risk for the long-term investor and that the Gaussian distribution is not a good approximation of real world return data. Morningstar UK is forthright about this and demonstrates it by analyzing UK funds results using the SD as the indicator (Reference 2). A sparsity of data to support the 10-year SD averaging period adds to the criticism of the CSA methodology.

In an article **"Does volatility equal risk?** Edgepoint Wealth , a prominent Toronto-based Asset Manager said this " The formula for standard deviation treats all volatility the same. It tells you how much results have deviated from their historical average, whether above or below it. Thus, an investment with nothing but positive returns can nevertheless have high volatility if those results have varied from slightly positive to massively so. Put simply, volatility measures how a stock trades and not necessarily how much business risk it holds."
http://www.edgepointwealth.com/en/Resources/EdgePointAcademy/Does-volatility-equal-risk

A whole added set of issues relates to ETF's . I note that the OSC's own Investor Advisory Panel has provided critical commentary on the issues surrounding ETF Facts. Some ETF's like reverse and leveraged ETF's do not seem to me to be suitable to the proposed methodology . My comments relate only to mutual funds.

Here are some suggestions to improve the selected methodology :

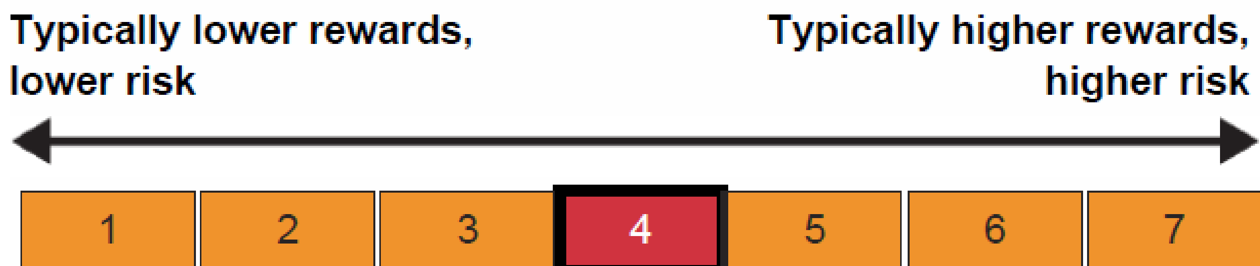
a. A note should be added when a fund has used proxy index data to calculate SD so investor is made aware of what he is looking at. Change the Section heading to : " How volatile is it?"

b . All funds should include a note highlighting risks not captured by the volatility calculation as is done in Europe. Risks that are typically not captured by the indicator can be credit risks, liquidity risks, counterparty risks, operational risks ,risks due to shorting, currency risks and the impact of financial techniques (for example, derivative instruments) or unique terms like those found in Return of Capital funds.

c. Specialized funds like Life Cycle Funds should use a modified calculation approach per ESMA Guidelines (Reference 1) and /or disclose risks not represented by the volatility calculation . Since the portfolio composition of a Life Cycle Fund changes substantially over time, it may be the case that not all of the return history of these funds is representative of their current overall risk profile. As a consequence, the ESMA requires that the SRRI computation methodology for life cycle funds needs to be modified to reflect the changes over time of the portfolio reference asset allocation as envisaged in their investment policies. The CSA should do the same and allow an extra sheet of text if necessary.

d. The scale should be retained at six (6) buckets to prevent clustering - the goal is to ensure that, for example, a Canadian equity fund would, in the normal course of events , be rated as Medium to high NOT medium (Canadians do not perceive a loss of 35-45% as Medium risk).

e. The scale should use numbers NOT words. Viz. Sample from Europe



The dictionary defines Medium as *something that is the middle size when compared with things that are larger and smaller* which isn't particularly informative. This will also alleviate one concern that the words in FF would be confused with KYC documentation: The Europeans use 7 buckets compared to CSA's proposed 5.

f. Add a clarifying statement that historical data, such as is used in calculating the SD, may not be a reliable indication of the future risk profile of the fund rather than " It doesn't tell you how volatile the fund will be in the future".

g. Among other things, an explanation must be provided of why the fund is in a certain category. Example: The fund belongs to Medium to high risk category. This means that the fund is subject to higher risk in respect of rises and falls in value. It is also important to explain that the indicator is not a measure of any risk of capital loss, but rather a measure of the past increases and decreases in value of the fund.

h. The risk rating must be promptly updated in the event of significant changes in a fund's risk and reward profile, particularly where the variation in risk is related to a change in the fund's objective or investment policy or prior to major marketing efforts In these cases, the categorisation should be totally revised.

i. Separately risk rate currency hedged funds. See The Investment Funds Practitioner - November 2013
http://www.osc.gov.on.ca/en/InvestmentFunds_ifunds_20131128_practitioner.htm

Other related ideas for improving FF's :

1. Add a section is to inform the unit holder of the objectives of the fund (for example, to provide a steady return on a short-term as well as a long-term basis, long-term capital growth, return in relation to a relevant index, absolute return, etc.), and how the fund management company intends to achieve these objectives .

2. Tighten up the sentence" Higher commissions can influence representatives to recommend one investment over another" I suggest " Your representative is in a conflict-of- interest which can influence the investments recommended to you". A much stronger wording is warranted in light of the Cummings Report findings.

3.If the fund invests in debt securities, information regarding the issuer and minimum credit rating should be stated. Example: The fund invests in bonds issued by companies. These companies must have a minimum credit rating of BBB on Standard & Poor's scale.

4. Provide the actual SD number on the scale so at least the sales representative could interpret the meaning of the number in plain language.

5. Instead of using index data to backfill missing monthly retirns data, consider using actual data from the relevant CIFSC fund category.

6. Include an abbreviated listing of the major risks of the fund in plain language .Even a simple " interest rate risk" statement is better than no disclosure at all. Readers could be referred to the CSA's Guide to Mutual Funds for more details on risks.

7. A CSA Investor User Guide similar to this one used by Capita in Europe is critical. A good way to describe the 5 risk levels is shown below:

Table 3. Category Descriptions of Vanguard Risk Levels

Vanguard funds can be categorized in risk levels from 1 to 5. Knowing the risk level you're comfortable with, and the length of time you expect to invest, can help you select an appropriate fund for your investing needs.	
Conservative funds—Risk level 1	Vanguard funds are classified as conservative if their share prices are expected to remain stable or to fluctuate only slightly. Such funds may be appropriate for the short-term reserves portion of a long-term investment portfolio, or for investors with short-term investment horizons (three years or less).
Conservative to moderate funds—Risk level 2	Vanguard funds classified as conservative to moderate are subject to low-to-moderate fluctuations in share prices. In general, such funds may be appropriate for investors with medium-term investment horizons (four to ten years).
Moderate funds—Risk level 3	Vanguard funds classified as moderate are subject to a moderate degree of fluctuation in share prices. In general, such funds may be appropriate for investors who have a relatively long investment horizon (more than five years).
Moderate to aggressive funds—Risk level 4	Vanguard funds of this type are broadly diversified but are subject to wide fluctuations in share price because they hold virtually all of their assets in common stocks. These funds may be appropriate for investors who have a long-term investment horizon (ten years or longer).
Aggressive funds—Risk level 5	Vanguard funds classified as aggressive are subject to extremely wide fluctuations in share price. These funds may be appropriate for investors who have a long-term investment horizon (ten years or longer). The unusually high volatility associated with these funds may stem from a number of strategies.
Source: The Vanguard Group, Inc.	

Volatility Metrics for Mutual Funds https://www.dol.gov/ebsa/pdf/deloitte2009-3.pdf

It should be made clear that the CSA will be responsible for continuing " ownership" of the methodology and will review it at least annually for effectiveness , possible improvement and to deal with new innovative fund product developments.

In 2015, "safe" preferred share funds tanked mainly impacted by nasty terms in reset preferred shares. As we enter 2016 we find billions of dollars invested in "safe" Bond funds , all rated LOW risk - is this rating a road to ruin for retirees with 50- 70% in these funds?

I fear for all of the small retail investors who will look at the FF risk ratings in making decisions about where to invest their RRSPs this year. They are, without a doubt, like deer in headlights about to be hit by a car. Perhaps they will be lucky. Perhaps not. Is this investor protection? [ref According to a May 2011 Ipsos Reid poll Seven in Ten (72%) Canadians Not Fully Confident Their Math and Money Management Skills Will Help them Plan for a Secure Financial Future
http://abclifeliteracy.ca/files/Financial_Literacy_Research-2011.pdf]

I hope this submission is useful to the CSA and this time will be considered in its decision making.

Approvel is granted for posting this letter on regulator websites.

Arthur Ross

REFERENCES

1. ESMA Guide to calculation of volatility
https://www.esma.europa.eu/sites/default/files/library/2015/11/10_673.pdf

2. **Why Volatility is Not an Accurate Measure of Risk** : Morningstar UK
“By focusing on absolute levels of volatility as the key measure of risk, investors are prevented from buying risk assets when prices are low as these typically corresponded to periods of high volatility. Equally, portfolio managers are encouraged to buy risk assets when prices are high. This buy high, sell low strategy is unlikely to be in the clients’ best interests.

The practical problems with this approach are especially evident when using absolute levels of volatility to match funds to client risk profiles. Morningstar has recently conducted research that shows that the volatility of a conventional multi-asset portfolio varies widely through the market cycle. We created a series of multi asset portfolios and tracked their volatility using the approach stipulated for the calculation of a fund’s synthetic risk return indicator (SRRI) that is included in key information documents (KIID). The volatility of these portfolios varied significantly over time. For example, the volatility of a moderate risk portfolio comprised of recognized benchmark indices varied by 5.3% over the last 9.5 years. This volatility range is greater than the SRRI band (four) used to classify the fund.

This means that a portfolio positioned in the middle of an SRRI band at the beginning of the period and rebalanced regularly would breach both the upper and lower boundaries

of that band over the period. In other words, without changing the allocation, the portfolio fund would be both too risky and not risky enough for the same client over the period. **A risk mapping process that produces such widely varying results for a stable portfolio is clearly not fit for purpose.**"
http://www.morningstar.co.uk/uk/news/134560/why-volatility-is-not-an-accurate-measure-of-risk.aspx#sthash.bCVr86mV.dpuf
http://www.morningstar.co.uk/uk/news/134560/why-volatility-is-not-an-accurate-measure-of-risk.aspx

3. AMF (France) guide for Key Investor Information Document (KIID)
http://www.amf-france.org/technique/multimedia?docId=573eed3a-0b6f-455a-a558-bb1bd8f7ba0d

4. **The challenge of providing clear product disclosure:** Blackrock
https://www.blackrock.com/corporate/en-ca/literature/whitepaper/challenge-of-providing-clear-product-disclosure-april-2011.pdf

5. **. Key Investor Information Document (Sweden)**
http://www.fondbolagen.se/PageFiles/6246/UK%20Manual%20Faktablad%20140317-eng.pdf

6.**STANDARD DEVIATION AND PORTFOLIO RISK JARGON AND PRACTICE**
"... When we teach jargon-related concepts, we need to simultaneously teach students how to describe these concepts to non-specialists. When we use the word "risk" to describe the attribute of a portfolio that is measured by variability, we need to explain the shortcomings of this interpretation. In particular, we need to discuss in finance classes what "financial risk" might mean to various lay-persons. I would suggest that this is not merely "service course" material - it is needed by the experts too,"
http://people.stat.sfu.ca/~weldon/papers/29.sdrisk.pdf Published by Simon Fraser University

7. CARP helps mutual fund dealers understand what the average older investor expects : CARP Canada http://www.carp.ca/2013/10/18/carp-help-mutual-fund-dealers-understand-what-the-average-olderinvestor-looks-like/

8. **Comment letter from Mr. W.Schalle**
https://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20140203_81-324_schallew.pdf

9. **Volatility vs. Tail Risk: Which One is Compensated in Equity Funds?** by James X. Xiong, Thomas Idzorek, Roger G. Ibbotson :: SSRN James X. Xiong Ibbotson Associates, a Morningstar company; Thomas Idzorek Ibbotson Associates - A Morningstar and Company and Roger G. Ibbotson Yale School of Management; Zebra Capital Management, LLC (May 30, 2013) Abstract: Research that has led to what is known as the "low volatility anomaly" in cross-sectional stocks from a similar universe indicates that volatility is not compensated with a "volatility" premium. We find evidence of a risk premium, but it depends on the definition or measure of risk. "Tail risk" measures the probability of having significant losses and should be what investors care about the most.

We investigated several risk measures, including volatility and tail risk, and found that volatility is not compensated but tail risk is compensated with higher expected return in both U.S. and non-U.S. equity funds. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2274295

10. **What Behavioral Finance Teaches on How to Discuss Risk With Clients**
http://www.thinkadvisor.com/2011/07/18/what-behavioral-finance-teaches-on-how-to-discuss

11. **Dow Jones 100 Year Historical Chart** | MacroTrends
http://www.macrotrends.net/1319/dow-jones-100-year-historical-chart

12. **U.K. Risk rating methodology research report**
https://www.cass.city.ac.uk/__data/assets/pdf_file/0017/32525/risk-rating-comp.pdf