By email December 29th. 2015

PETER WHITEHOUSE Submission -

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 comment on the fund risk rating methodology.
As a retired senior I have had more than my fair share of problems with mutual fund disclosures over the years.

In " Why Bogle and Buffett tell investors to ignore market noise " John Bogle, one of the

giants of the mutual fund industry says "Don't pay a lot of attention to the volatility in the market place. All these noises and jumping up and down along the way are really just emotions that confuse you. The question isn't "Will my investments go up or down?" — because of course they will. The question one should ask is, "Will the fact that investments go up and own bother me enough to do something dumb? " The article is very clear – VOLATILITY is NOT Risk.

Bogle's words resonate with me. I think for most people saving for retirement ,risk is the chance of losing money - the bouncing around of monthly returns for someone investing over 10, 15 or 20 years is a useless statistic further made useless with sugar coated words with no numerical or other context .Not only is it useless in portfolio construction but it is actually misleading and harmful.

In a June 2013 US News and World Report article Risk and Volatility aren't the same we find the following statement : "Risk and volatility are not interchangeable, and trying to minimize volatility can actually hurt returns over time. The financial services industry is rife with advisers, compliance departments and research departments who embrace constructing portfolios with a serious allocation to bonds because they will lower volatility. Not only is it well proven that stocks outperform bonds over the long term, but at today's interest rates, the interest payments on bonds are having a hard time even outpacing inflation . So in the interest of reducing short-term volatility, portfolios are being constructed with investments that increase the probability of actually impeding long-term growth...." Yet FF says " One way to gauge risk is to look at how much a fund's returns change over time. This is called "volatility"..." If that isn't misleading disclosure I don't know what is.

It's not just the mischaracterization of volatility as risk that bothers me. I'm not a mathematician but it seems to me to be a deception when a Fund can advertise a Low to Medium risk rating when say 108 months of data are derived from an index selected by the fund rather than actual data. FF does not even warn the investor that this is a back-tested rating. It's like building a house of Jello on a foundation of quicksand!Even the prescribed method of converting the standard deviation of monthly returns isn't quite right. In What's wrong with multiplying by the square root of 12?
Morningstar explain the biases in the formula. I leave it to others to determine if this formula is accurate enough for its intended purpose.

The " How risky is it? Section in Fund Facts deals with volatility. No matter how many times I read it it comes across as baffle-gab. We all know stocks go up and down but what I want to know is what exactly are the risks in the fund? In fact monthly volatility over the long run really does not translate to risk in my mind at all. Some mutual funds are actually offering to sell me low volatility funds that offer superior returns so does high volatility really mean higher risk? (BMO news release on low volatility stocks https://www.bmo.com/gam/pdf/press-release/Press-Release-White-Paper-Low-Volatility.pdf)

From the perspective of a retail the word **Medium** risk is misleading. Consider the Dynamic Power American Growth Fund A Series . The Fund Facts for this fund's A-series units fund for example rates risk as Medium risk; according to its Fund Facts performance it lost **44.1%** in 2008. Too many people may use this rating

without correlating it with the fund's historical returns. For new funds there may not be a historical record to view and people will be deceived by the word "Medium". The word **Medium** risk means nothing and does not help an investor deciding to accept a salesperson's recommendations. I can almost see a fund dealer defending against a client complaint by citing this risk rating. That would be the ultimate insult to the retail investor.

Consider again the Dynamic Power American Growth Fund A Series . The Fund Facts for this fund's A-series units says that it's suitable for investors • seeking the capital growth potential of investments in equities of businesses based in the United States and • able to accept some variability of returns and are investing for the long term. The Fund Facts for the very same fund's T-series units includes the same description as above but adds that it's also suitable for investors "seeking stable monthly distributions". These are not two similar funds but rather two series of the same fund – i.e. the identical legal entity. Accordingly, suitability recommendations should also be identical. Mandating regular distributions – as is done with T series funds – does not change suitability.

Using the Dynamic Fund once more as an example we find that it's T series is also rated Medium risk. The 'T' in T series is short for 'Tax'– so called because of its perceived tax advantage. The appeal of a T series fund lies in its highly marketed relatively high and level cash distributions. The tax moniker is given because the majority of the monthly cash payout is not taxable when received because it's classified as "return of capital" for tax purposes. In reality if the fund distributes out more than it earns , the value will fall and the investor will be shocked and confused . Many people are mis-sold these funds and I think FF's should tip them off about this but this rating system isn't geared up to do that because it's rated solely on volatility. In an article entitled **T SERIES FUNDS: THE TAX EFFICIENCY MYTH AND STRUCTURAL RISK** Dan Hallett noted " We have a record of identifying T-series funds that are at risk of cutting distributions. Most notable was our December 2001 prediction that IA Clarington Canadian Income-T8 would be forced to cut its distribution. We were proven right. When so many investors use the cash for living expenses, advisors must set the right expectations at the outset. Doing so will make your clients much happier than if you have to explain to them why the cash they've been spending cannot continue." Amen. Ditto for FF's.

As to Bond funds which make up about 50% of my portfolio, virtually all are rated LOW risk . The Dynamic Canadian Bond Fund FF's for example shows a LOW risk rating after a decade of postive returns in a record low interest rate environment. Should interest rates rise, it seems to me this fund will suffer badly, impairing my RRIF account. A robust disclosure on risk shouldn't let that happen. And by the way , up to 50% of assets can be invested in foreign bonds, adding currency and other risks to the mix. So to really avoid the loss to my retirement savings I'm back to having to read the prospectus again. Makes no sense.

The other issue I have with the risk rating is the fact that nearly half the cost of buying a equity mutual fund has nothing to do with the fund. It is for advice from a salesperson paid by the fund company. From bitter experience I can tell you this is a risk at least as big as any risks from the fellow managing the fund. There should be a clear bold warning in Fund Facts that the salesperson is in a conflict- of- interest. No mincing of words. This would encourage investors to ask more questions and/ or do more research.

Finally, the risk rating methodology is fundamentally defective because it doesn't even

try to match risk and return. How can a person decide on a word acting as a proxy for risk (but no actual standard deviation numeric is provided) with a return that is also not provided? Isn't it true that the idealized Bell curve needs two metrics to describe it not just one and that's assuming the Bell curve is a good fit with the actual pattern of returns we see in real life markets?

Given the data density and fogginess of FF's, I think a Users Guide is critically needed. Suggested Key elements :

a) An explanation of each section and how to use it for decision making
b) A plain language explanation of volatility
c) A concise paragraph on each of the five fund ratings and their meaning
d) A short discussion on conflicts of interest vs unbiased advice
e) Why fees are important and how the DSC can cause investors to hold on to losers
f) Some gauge as to what long-term investing means
g) A short glossary of key terms
h) References/ links to other CSA investor educational materials

I do not find the section " How risky is it? of any value and I would never use it in my decision making. Because it deceives , I cannot support this methodology no matter how much the administrivia surrounding it are tuned up as a result of this consultation. It is based on unsubstantiated statistical assumptions, surrogate numbers , undefined word(s) standing in for standard deviation which itself is not understood by retail investors , goes against the wisdom of the world's greatest investors and in the end still doesn't actually identify the risks of investing in the fund.

If I was the CSA I would get the opinion of CFA's , CFP's , investor advocates , SIPA , Kenmar and FAIR Canada before going further with this risk rating scheme. It's a ticking time bomb.

Fund Facts is a step in the right direction and it's more likely to be read by retail investors. But there is a lot of work to do, so I hope that both regulators and the industry will view Fund Facts as a document that is a work in progress . In particular,Fund Facts needs to improve its risk disclosure and suitability guidance- guidance not aimed at fund managers but at better informing ordinary Canadian investors.

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Peter Whitehouse