**By email** January 10, 2016

**S. Fortier Commentary**

**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. I am responding as an investor rather than as a lawyer, statistician or regulator so my views may be quite different than those from industry people. It is neither fair nor reasonable to comment on this methodology in a vacuum. Comments must relate to how this methodology integrates with Fund Facts (FF's).

As I read the consultation paper, it appears evident it has been written by those who sell mutual funds rather than those who buy mutual funds. Investors buy mutual funds for the long term, thus monthly changes in return are of little concern. For those saving for retirement, it is the downside risk that matters. People want to know that investing in mutual funds will allow them to meet their goals when they need the money. Hence volatility is not risk.

People also don't want to buy high and sell low and that is what a good risk disclosure should prevent them from doing. Bond mutual funds typically make up over 40% of a portfolio - virtually all are currently rated LOW risk. What happens if interest rates rise? Am I buying near a high?

I truly worry about the efficacy of this methodology but it appears that the CSA has already selected it so my comments may have little relevance.

In any event, here are my comments:

<u>Number of risk bands:</u> I believe the number should be at least six; in Europe they use seven in order to prevent huddling together under one risk heading. I do not comprehend why the CSA recommended 6 but now has reverted to the 5 in the IFIC system.

<u>Time period</u>: Ten years seems reasonable as it should contain at least one market downturn.

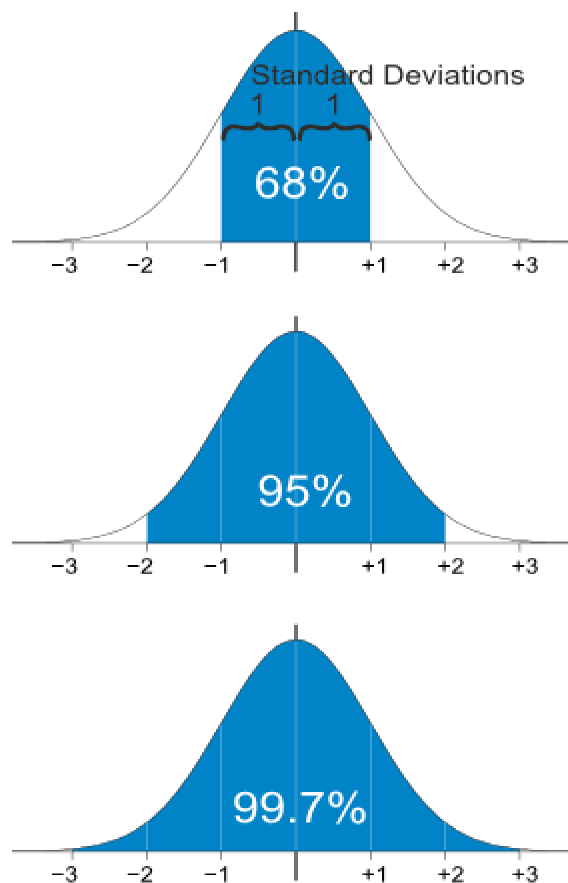
<u>Medium risk is meaningless</u> : From the perspective of a retail investor, the word **Medium** risk is misleading. If you look at a random selection of Canadian and U.S. equity funds, many of the losses in 2008 exceeded 40% yet they are rated **Medium** risk under the current rating system .

To many people, Medium risk means “average” which makes little sense, and average risk means even less to the typical Canadian investor. Comparing two funds each with a Medium rating is a futile, sterile exercise. According to the bands proposed, if a fund with a Medium rating had a mean 7% return, it could vary between -15 percent and 29 percent , 95 % of the time at the low-end of the range, and between -25 percent and 39 percent at the High end. Clearly, adding numerics highlights these sorts of significant differences. This is why I recommend that the actual standard deviation number be provided - ideally on a thermometer type scale ranging from 1 to 10 with 10 being the highest risk in lieu of fixed bands.

<u>Use of words as risk level nomenclatures</u>: This can and has led to investor confusion. I recommend a numeric scale from 1-10 as people interpret words differently especially when the words have no context for the average investor. The European system uses a numeric scale from 1-7. The Securities and Exchange Commission, interestingly, does not use fund ratings because they believe it can lead to investor confusion.

<u>Use of proxy data</u>: It seems to me that only a fraction of mutual funds in Canada survive 10 years. This means that a large fraction of funds will not be reporting their true SD, which makes the methodology kind of silly in those instances, and possibly misleading to investors who aren't even told that the figures/ratings are fabricated.

SD/Normal curve not really representative of risk: I note that numerous commenters have expressed in their previous submissions on the Point of Sale project that volatility (risk)  is only one of the material risks that an investor should consider before making an investing decision. One of the risks that weigh heaviest on the minds of most consumers is the risk of losing their initial investment or not meeting their financial objectives. But the returns of a mutual fund that loses 10% of its value each and every month would have a standard deviation of zero and would be classified as low risk under the Proposed Methodology, even though such an investment would lose nearly all of its value over the course of 12 months. I find it unlikely that most retail investors would consider such investments to be "low risk" propositions. I certainly wouldn't. I also doubt whether most fund investors have a mental picture of the underlying distribution so they can interpret volatility.




In addition, the volatility rating methodology is based on the well-behaved Normal distribution. In the real world, Skewness and kurtosis are important because few real world investment returns are Normally distributed as assumed by the CSA. These tail risks distort the left tail which of course will understate true risk. The Ontario Securities Commission Investor Advisory Panel Comment letter
https://www.osc.gov.on.ca/documents/en/Securities-Category8-

Comments/com_20140307_81-324_iap.pdf
contains some very good ideas on risk disclosure that should be considered. I can relate to that kind of disclosure. A recent research paper **A Risk and Complexity Rating Framework for Investment Products** http://skbi.smu.edu.sg/sites/default/files/skbife/A_Risk_and_Complexity_Rating_Framework_for_Investment_Products_July_2014_final.pdf also contains some interesting approaches to risk rating that might be of interest to the CSA .

Be clear on "Representative risk ": About half the cost of buying a mutual fund includes paying for investment advice (typically a 1% trailer sales commission). This advice element is not captured by the monthly standard deviation movements resulting from market dynamics. In fact, the advice may not even be provided as in the case when a fund is bought via a discount broker, it may be provided but at a level of effort well below what is being paid for and in the worst and very common case, the advice may be conflicted and work against the best interests of clients.

The statement" *Higher commissions can influence representatives to recommend one investment over another* "has got to be the understatement of 2015! " Can " makes it sound like it could happen, sort of maybe … whereas the reality is that conflicted advice is widespread. According to overwhelming research, including the CSA's own ,trailer commissions influence not only the recommendations made but also those not made ( eg paying down debt , increasing life insurance etc.) I strongly urge the CSA to make this warning much stronger emphasizing the conflict-of-interest between the representative ( receiving money from the fund manufacturer) and the investor assuming the purchase recommendations is unbiased. See Reference 1 for the significant impairment of savings such a conflict imposes on the unsuspecting investor as well as Professor Cummings report for the CSA **A Dissection of Mutual Fund Fees , Flows and performance** http://www.osc.gov.on.ca/documents/en/Securities-Category5/rp_20151022_81-407_dissection-mutual-fund-fees.pdf .

Specialized funds: Even if the mean return and standard deviation are clearly presented and brought to the investor's attention, there are certain investment funds where past statistical information is not relevant to the fund's future risk profile. For example, Target date funds or return of capital (ROC) funds use investment strategies such as shifts in lifecycle asset allocation and cash flow smoothing which render any information gleaned from their historical standard deviation data irrelevant or misleading in the hands of retail investors. Instead of looking at volatility for these types of investments, it is important that consumers understand the fund's strategy and attendant implications. ROC funds have caused investors a lot of harm that a simple risk disclosure might have prevented. Too many people have seen distributions and fund value drop unexpectedly. Ditto for some of the more complex ETF's like Smart Beta or 3x leveraged ETF's.

Risks not captured by the Standard Deviation: There are numerous risks that are typically not captured by the SD indicator – these include securities lending risks, liquidity risks, counterparty risks, operational risks ,risks due to shorting, currency risks and the impact of financial techniques (for example, derivative instruments), unique terms and conditions related to a product ( eg. " triggering events" in Target Date Funds) or simply risks that did not manifest themselves during the 10-year period. A prime example is liquidity risk in money market funds which manifested itself during the non-

bank ABCP crisis a few years ago. The methodology must provide for prominent disclosure of these material non-SD related risks.

Worst 3 months metric : I recommend this be replaced by worst 12 months over a period of 10 years. If the fund is less than 10 years old, then surrogate data can be used to bridge the gap. All years that were surrogate years would be identified to follow fair disclosure ground rules. This would give an investor a better feel for the potential loss.

Price breakpoints: I recommend they be included in FF's .

Link to KYC -Suitability: Simultaneous with the CSA mandating use of the Proposed Risk Rating Methodology, I recommend that it issue accompanying guidance that makes clear that the risk classifications computed by the Proposed Methodology are but one factor to consider as part of an advisor's Know Your Product and Know Your Client suitability assessment obligations.

As discussed, volatility risk does not capture all of the material risks that should impact a investor's investing decision; I believe it would be incorrect for industry or investors to use the Proposed Methodology's output as a proxy for a proper suitability assessment. For example, if based on a client's NAAF or KYC, the client demonstrates a "medium to high" risk tolerance, this should not automatically mean that any mutual fund which falls in the Proposed Methodology's Medium to High risk band is *de facto* suitable.

This is particularly the case as the mutual fund is likely to make up just one part of a larger portfolio. Whether the overall portfolio risk is compliant with the client's stated risk tolerance must be viewed holistically, in the context of the investor's financial plan. This includes a consideration of the risk represented by the other investments in the client's portfolio and in the context of the client's investment objectives, risk profile, tax considerations and time horizon. For that particular client, a mix of higher risk and lower risk investments may be better suited, rather than simply filtering for those funds that the Proposed Methodology would classify as medium to high risk. Unfortunately, that is a inherent drawback of risk rating a mutual fund.

Performance benchmark: I recommend a performance benchmark be included in FF's. It is important for an investor to determine if the MER associated with active management is worth the money. It should be provided for 10 years using surrogate data if necessary. Armed with this information an investor could compare the cost-risk- return profile of one fund with another. Without it, he/she can't.

DSC disclosure: I recommend that the amount of space for this disclosure be reduced by simplifying the table. This will give a little more page area for more pressing data like the actual risks the fund is exposed to. For Bond and Balanced funds this is especially important given the low interest rates prevailing at this time. As an aside, I note the recent MFDA report on DSC, that seniors are being adversely impacted by this class of fund. It may be time for these types of funds to be prohibited altogether.

Section on " What if I change my mind?": Anything that requires going to see a lawyer probably provides very little value-add to FF's. This section takes up a lot of space that I suspect will be of zero value to the vast majority of readers. I recommend that this

section be deleted and the real estate be used for material with more useful information content. I add parenthetically that there should be a standardized right of rescission across Canada: investors should not be disadvantaged simply on the basis of the province or territory in which they reside. It seems industry participants believe that it would be in the best interests of Canadians for the CSA to bring uniformity to investors' rights of rescission and withdrawal. It is my understanding that various industry stakeholders have, for well over a decade, emphasized the pressing need for harmonization of these rights and for clarification of how they are to be interpreted and applied.

ETF's add a lot more complexity – I simply do not have the experience to comment on them except to note that the OSC-IAP had a significant number of Comments on ETF Facts RE http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20150806_41-101_iap.pdf

Finally, I hope there is widespread recognition of the need to treat disclosure as part of a broader range of measures, including measures to improve the quality and integrity of financial advice and to increase investor financial literacy.

I sincerely hope this Main Street feedback is useful to the CSA.

You may publicly post this comment letter.

Sincerely,

Sophia Fortier

**REFERENCES**

1 **The Costs and Benefits of Financial Advice** http://www.hbs.edu/faculty/conferences/2013-household-behavior-risky-asset-mkts/Documents/Costs-and-Benefits-of-Financial-Advice_Foerster-Linnainmaa-Melzer-Previtero.pdf Stephen Foerster, Juhani Linnainmaa, Brian Melzer Alessandro Previtero ,March 8, 2014 Abstract :We assess the value that financial advisors provide to clients using a unique panel dataset on the Canadian financial advisory industry. We find that advisors influence investors' trading choices, but they do not add value through their investment recommendations when judged relative to passive investment benchmarks. The value-weighted client portfolio lags passive benchmarks by more than 2.5% per year net of fees, and even the best performing advisors fail to produce returns that reliably cover their fees. We show that differences in clients' financial knowledge cannot account for the cross-sectional variation in fees, which implies that lack of financial sophistication is not the driving force behind the high fees. Advisors do, however, influence client savings behavior, risky asset holdings, and trading activity, which suggests that
benefits related to financial planning may account for investors' willingness to accept

high fees on investment advice.