MACKENZIE Investments | CONFIDENCE IN A CHANGING WORLD

VIA E-MAIL:
comments@osc.gov.on.ca; consultation-en-cours@lautorite.qc.ca

June 9, 2017

British Columbia Securities Commission
Alberta Securities Comission
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

The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, ON M5H 3S8

Me Anne-Maire Beaudoin
Corporate Secretary
Autorité des marches financiers
800, rue du Square-Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3

Re: Canadian Securities Administrators (CSA) Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions (Consultation Paper)

About Mackenzie Investments

We are pleased to provide comments on behalf of Mackenzie Financial Corporation (Mackenzie Investments) on the CSA's Consultation Paper dated January 10, 2017.

Mackenzie Investments was founded in 1967 and is a leading investment management firm providing investment advisory and related services to retail and institutional clients. The company is registered as a portfolio manager and investment fund manager with total assets under management as at April 30, 2017 of approximately $68.2 billion including mutual fund assets under management of approximately $54.2 billion. We distribute our products to over 1 million clients across Canada through approximately 175 dealers representing over 30,000 financial advisors.

Mackenzie Investments is a wholly owned subsidiary of IGM Financial Inc., which in turn is a member of the Power Financial Corporation group of companies.

Overview of Key Comments

Everything we do starts with the needs of investors, whether they are saving for a child's postsecondary education, setting money aside for the future needs of a family member with a disability, or funding their own retirement. In fact, our focus is summed up in our Vision statement: we are committed to the financial success of investors, through their eyes.

With this in mind, Mackenzie Investments fully supports the CSA in its efforts to build better alignment of interests of investment fund managers, dealers and representatives with those of investors; to provide greater clarity of the services provided to investors and their costs; and to empower investors in the dealer and representative compensation process. We see such recent regulatory initiatives as the newly implemented Fund Facts pre-sale delivery (POS) and Client Relationship Model (CRM) projects, as well as the current proposals in CSA Consultation Paper 33-404 (the CSA CP 33-404),[1] all contributing to these important objectives.

We believe that when fully implemented, the outcomes that will be achieved by these regulatory reforms, together with market changes already underway, will substantially address the key investor protection and market efficiency issues identified in the Consultation Paper. In our view, any potential incremental or possible "complementary" benefit that the CSA anticipates may be achieved through the discontinuation of embedded commissions will be minimal, by comparison to the very real and significant adverse impact such a regulatory action will have on some dealers, their representatives and most importantly, their clients.[2]

We are also very concerned with the impact discontinuing embedded commissions could have on the efficiency and competitiveness of the financial services industry in Canada. What struck us as very problematic in the framing of the Consultation Paper is the CSA's position that because the "majority" of mass-market households purchase mutual funds through a deposit-taker owned dealer, whose representatives are generally not compensated via embedded commissions, the impact in transitioning away from embedded commissions (particularly for mass-market households) will be negligible. We strongly disagree. Any outcome that may cause there to be fewer independent dealers will not be without 'impact' to investors. An even more concentrated fund distribution industry

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[1] CSA Consultation Paper 33-404 Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward their Clients (April 28, 2016).

[2] Source: MFDA Bulletin #0721-C - *MFDA Client Research Report: A Detailed Look into Members, Advisors and Clients* (May 23, 2017) ("MFDA Client Research Report").

will mean fewer product and financial advisory choices, reduced price competition as well as less innovation in the market.

In the Consultation Paper the CSA also seems to suggest that active management is somehow an undesirable outcome for investors that will be remedied through the discontinuation of embedded commissions. We strongly believe that passive and actively managed investment products are both important for investors and for maintaining efficient and vibrant capital markets. As currently expressed by the CSA, we are concerned that some registrants will be inclined to favour index managed products, not because it is what's most suitable for the client, but because of the perceived regulatory bias against actively managed funds solely based on cost relative to index managed products. This, in our view, is contrary with the CSA's stated objectives for dealers and their representatives to offer clients products that are most suitable to their particular investment needs and objectives.

In our submission, we provide insights and specific data of our experience in the Canadian market. We also put forward alternative regulatory options for the CSA to consider that we believe addresses the investor protection and market efficiency issues identified by the CSA, but without the significant negative impact to some dealers, their representatives and clients and the market, that a ban on embedded commissions may cause. In the appendix to our letter, we provide more detailed responses to some of the operational and tax questions posed in the Consultation Paper and also give some insights into the value of active management. At the centre of our submission is the desire that (i) we retain an innovative, competitive and efficient financial services industry in Canada, which provides investors with access to a broad range of choices of products and advisory services, and (ii) financial advice in Canada remains accessible and affordable, particularly for modest investors.

Finally, we believe it is noteworthy that while regulators globally have been focused on issues similar to those articulated by the CSA in the Consultation Paper, a growing number of regulators and their respective governments have explicitly chosen not to ban embedded commissions. Their reasoning, in part, includes the recognition that it would be detrimental to impose a reform that will have a negative impact on independent and smaller firms and manufacturers and create further concentration of asset management with deposit-takers. In these jurisdictions, they have instead moved forward with disclosure and conduct regulation.

We encourage the CSA to consider and provide a more detailed analysis as to why the approaches taken in such countries such as Sweden, Hong Kong, Germany, New Zealand and Singapore, all of whom have chosen to not ban embedded commissions, would not be appropriate approaches for the Canadian market and for Canadian investors.[3]

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[3] Currently, we are aware of only four countries that have imposed a ban on embedded commissions: Australia, Netherlands, South Africa and the United Kingdom. In the Netherlands, the discontinuation of embedded commissions is a voluntary arrangement among the five large banks that dominate investment fund distribution. While under the MIFID II reforms, the imposed ban on embedded commissions only applies to independent financial advisors, which make up only 11% of the European market. Despite MIFID II, a number of jurisdictions have concluded not to impose a ban on embedded commissions, including:

1. Current Regulatory Initiatives Will Substantially Achieve Key Investor Protection and Market Efficiency Issues Identified

In our view, the POS and CRM projects together with the proposals in CSA CP 33-404, significantly address each of the issues the CSA has identified with respect to embedded commissions. To the extent there remains any gap, we believe market changes underway (which we discuss later in our submission) as well as other regulatory actions, can achieve the CSA's desired objectives without the need to ban embedded commissions.

Issue 1: Embedded commissions raise conflicts of interest that misalign the interests of investment fund managers, dealers and representatives with those of investors

Investment Fund Managers

To suggest that investment fund managers who pay embedded commissions to dealers and their representatives may be incentivized to rely more on those payments than on generating performance to attract and preserve assets under management is simply not our experience, nor do we believe it is an accurate portrayal of today's competitive market environment.

As we identify below in our discussion of market forces driving changes independent of regulation, our data indicates that while a few outliers remain, the majority of embedded commissions offered by investment fund managers are substantially the same across asset classes and series and that manufacturer margins and costs (management expense ratios) are decreasing. We also note that the trend of firms and advisors is to shorten the number of fund manufacturers with whom they are working, with the key drivers for firms and advisors in their choice of fund manufacturers being overall cost of the company's products and consistent performance.[4] All of this means that investment fund managers today are aggressively competing on fund costs and performance.

At Mackenzie Investments, performance metrics for our portfolio managers are aligned to generating performance. For instance, a substantial part of annual compensation for our portfolio managers are based on performance against the relevant peer group. More importantly, compensation aligns with the long-term interests of our investors with almost

Belgium, Denmark, France, Germany, Ireland, Italy and Sweden. Additionally, we have seen a number of other jurisdictions decide not to proceed with the regulatory option to discontinue embedded commissions, among them: Brazil, Hong Kong, India, Israel, Japan, New Zealand, Singapore and South Korea. While in the United States, we note that the Department of Labor (DOL) fiduciary rule still permits firms and their individual advisers to receive most common forms of compensation for advice to retail customers under the best interest contract (BIC) exemption, so long as the firm and adviser provide advice in the client's best interest, charge only reasonable compensation, and avoid misleading statements about fees and conflicts of interest (see: The While House, Office of the Press Secretary, *Factsheet – Middle Class Economics: Strengthening Retirement Security by Cracking Down on Conflicts of Interest in Retirement Savings,* April 6, 2016).

[4] Source: Environics Research, *2015 Adviser Perceptions in Canada: A focus on the Future & Consumers* (2015).

50 percent attributed to 5-year returns. We compete on price and performance and it's on these efforts that we expect to attract and retain market share.

The introduction of the proposals in CSA CP 33-404 will only further increase, in our view, the scrutiny by dealers and their representatives on investment fund costs and performance.[5] The explicit requirements in the know-your-product (KYP) and suitability proposals require registrants to take into account the impact on the performance of the product of all fees, costs and charges, including any embedded commissions paid, as part of the suitability analysis. The reforms also propose that dealers and their representatives must assess whether any remuneration, including trailing commissions, could reasonably be expected to inappropriately influence how representatives deal with their clients.

We strongly believe that with the introduction of such factors as costs and performance in the assessment of KYP and suitability, as well as the focus on eliminating conflicts of interest found in CSA CP 33-404, the CSA has effectively addressed any residual reliance there may still be today for investment fund managers to compete on embedded commissions to prompt sales.

Dealers and their Representatives

The central purpose of the proposals in CSA CP 33-404 is "to better align the interests of registrants with the interests of their clients". As noted above, we believe the CSA achieves this aim, and addresses the concerns expressed in the Consultation Paper that embedded commissions may encourage dealers and their representatives to recommend higher cost fund products, or promote a particular purchase option, that pays them a higher commission to the detriment of investor outcomes.

In fact, we consider the breadth of the proposed conflicts of interest requirement and accompanying guidance in CSA CP 33-404 on compensation arrangements and incentive practices to capture much more than simply any potential for influence caused by embedded commissions. The proposed reform will require firms to assess whether <u>any remuneration</u> could reasonably be expected to inappropriately influence how representatives deal with their clients. We support this more principle-based approach to addressing all types of compensation bias, as it recognizes that conflicts of interest and the potential for misalignment of interest may exist in any fee model, not just with embedded commissions. As recognized in the Mutual Fund Fee Research prepared for the CSA by The Brondesbury Group (the Brondesbury Report), "all forms of compensation affect advice and outcomes".[6]

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[5]Please see our comment letter dated September 30, 2016. http://www.osc.gov.on.ca/documents/en/Securities-Category3-Comments/com_20160930_33-404_mcinerneyb.pdf September 30, 2016

[6] Mutual Fund Fee Research prepared for the Ontario Securities Commission on behalf of the Canadian Securities Administrators, written by Dr. Edwin Weinstein, PhD The Brondesbury Group (Spring, 2015) ("The Brondesbury Report") p 4.

Alternative Regulatory Options to Address Issue 1

***Cap Embedded Commissions* –** To the extent that the CSA is not satisfied that the current regulatory reforms underway together with market changes does not fully address the issue of misalignment of interest of investment fund managers, dealers and representatives with those of investors, we believe the CSA should re-consider examining the option of a maximum limit (cap) on the amount of the trailing commission that investment fund managers may pay to dealers or representatives, as an alternative to discontinuing embedded commissions.

As noted in the Consultation Paper, this option would not preclude dealers and their representatives from directly charging their clients commissions or fees, either as a supplement or a substitute to embedded commissions. It surprises us that the CSA states that in pursuing this option it would be taking on a "non-traditional role" to set fee caps and that it would be very challenging to determine and justify the appropriate cap rate in the circumstances. We note that the U.S. Financial Industry Regulatory Authority (FINRA) imposes limits on 12b-1 fees. We would also point out that the CSA does, in fact, set fees, most recently lowering the cap on active trading fees that are listed on a Canadian exchange.[7] We believe that the CSA could, through a public consultation process, come to similar appropriate caps for trailing commissions.

***Allow Embedded Commissions Within Established Parameters* –** The CSA could also consider alone or together with a cap on embedded commissions providing guidance on when the use of an embedded commission arrangement (including DSC) would be permissible, having regard to such factors as the client's income and time horizon. We note that the Financial Services Board in South Africa (FSB) is currently working towards creating an exemption to their ban on embedded commissions for the low income sector.[8]

Issue 2: Embedded commissions limit investor awareness, understanding and control of dealer compensation costs

We respectfully disagree with the CSA that the POS and CRM projects will not effectively address the issues identified in the Consultation Paper with respect to embedded commissions limiting investor awareness, understanding and control of dealer compensation costs.

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[7] CSA Amendments to National Instrument 23-101 Trading Rules and Companion Policy 23-101CP to National Instrument 23-101 Trading Rules (January 26, 2017).

[8] The FSB has indicated that it recognizes "there is a need to find a balance between remunerating advisers sufficiently so that they are encouraged to service the low income sector whilst ensuring access to fair and affordable advice and products that deliver fair outcomes for customers". Factors under consideration by the FSB in allowing embedded commissions include product standards to allow products to qualify for embedded commissions, the types of intermediary and advice services qualifying for embedded commissions, permissible commission limits and permissible product supplier/intermediary relationships (Source: Financial Services Board, *Treating Customers Fairly, General Status Update: Retail Distribution Review*, December 2015 at p 29).

From the beginning, the POS project was intended to increase investors' awareness and understanding of such costs, as well as better equip investors to compare the costs of one mutual fund to another, and to understand the impact of such costs on their investment returns. In fact, in an early release, the CSA indicated that some anticipated benefits of a more effective disclosure regime would include a heightened engagement of investors in determining the product and compensation costs, with "less risk of investors buying inappropriate products or not fully benefiting from the advice services they pay for."[9]

Similarly, the CRM project introduced, in the first phase, new relationship disclosure to investors at account opening, explaining the types of products and services provided by the dealer as well as more fulsome information on charges, including transaction charges which investors may expect to pay in connection with their investment (including the initial sales charge and DSC options and any trailing commissions or other embedded commissions paid). Phase 2 of the CRM project (CRM2) next introduced new annual account level reporting on charges and other compensation of commissions and other amounts paid to dealers, including any embedded commissions in dollar amounts. Like the POS project, the CRM project was intended not only to increase investors' awareness and understanding of dealer compensation costs, but to also lead to better, more informed investor decision making when it comes to dealer compensation costs and the corresponding level of service that's being provided.

The CSA is currently measuring the impact of POS and CRM2 on investor knowledge, attitude and behaviour, on registrant practices and on fees and product offerings.[10] For the CSA to suggest that discontinuing embedded commissions is now necessary to create greater investor fee awareness, or opportunities to negotiate and have greater control over dealer compensation, without yet having the results of this research, seems very premature. This position also appears inconsistent with the continued regulatory initiatives by the Mutual Fund Dealers Association of Canada (MFDA) and the CSA[11] that look to CRM2 disclosures as an effective way to make investors more aware of the embedded fees paid to issuers and the non-cash incentives that may be paid to the dealer or adviser and its representatives.

Alternative Regulatory Option to Address Issue 2

***Dealers Offer a Direct-Pay Option* –** If the CSA concludes there continues to be a need to further investor awareness, understanding and control of dealer compensation, we recommend the CSA consider the regulatory option of requiring all dealers who offer an embedded commission arrangement to also have a direct-pay option accessible to all

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[9] CSA Notice and Request for Comment Implementation of Point of Sale Disclosure for Mutual Funds (June 19, 2009).

[10] See press release: CSA to Measure Impact of Point of Sale Amendments and Phase 2 of the Client Relationship Model (August 22, 2016).

[11] MFDA Bulletin #0671-P – Report on Charges and Compensation – Consultation Regarding Cost Reporting for Investment Funds (December 18, 2015) and CSA Notice and Request for Comment on Proposed Amendments to National Instrument 31-103, Companion Policy 31-103CP and National Instrument 33-109 (July 7, 2016).

clients. We envision that this direct-pay option could be facilitated by investment fund managers collecting payments from the investor's fund investment in much the same way as the Consultation Paper proposes. This is consistent with the structure of Mackenzie Investments' FB series today. The inclusion of a direct-pay option would allow both compensation arrangements to be offered and explained to the client at account opening, or by notification to existing clients, preserving investor choice.

***Enhance Annual Report on Charges and Other Compensation* –** CRM2 does not extend to the ongoing costs of owning securities, such as mutual fund operating and management fees. As a way to make clients even more aware of such fees, the CSA could also consider proceeding with the amendments published in July, 2016,[12] which propose to add a general notification in the client annual report that would remind clients invested in mutual funds, or other securities with embedded fees, about these costs, and that they may reduce the client's investment returns.

As a member of the Investment Funds Institute of Canada (IFIC), we also support IFIC's recent letter to the CSA, MFDA and the Investment Industry Regulatory Organization of Canada (IIROC) dated April 21, 2017, indicating that its members are ready to discuss a plan for extending disclosure requirements to encompass the full management expense ratio of investment funds, commonly referred to as CRM3. Should this work proceed, we believe that it will be important that there be corresponding disclosure to investors of the ongoing costs of similar financial products with embedded commissions, such as the spread on guaranteed investment certificates (GICs) and daily interest accounts (DIAs).

Issue 3: Embedded Commissions paid generally do not align with the services provided to investors

The final issue identified in the Consultation Paper with respect to embedded commissions is the need for advice and services to better align with the costs paid by investors. We agree. However, in our view this is a potential issue that is <u>not limited</u> to embedded commissions, nor solved by discontinuing such payments. Clients selecting direct-pay arrangements today may not be aware of the fee levels other clients are paying, have little to no market strength to negotiate fees and may not realize or be able to calculate the impact those (now external) fees have on the returns of their portfolio.

Today the most common direct-pay arrangements are fee-based accounts, which are generally based on a percentage of assets under administration. From our analysis of a sampling of MFDA and IIROC dealer fee-based program pricing grids, we have found that the majority of firms require investor assets to reach approximately $1 million before the account fee is at or below 1 percent, without necessarily any differentiation of the services provided.

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[12] Ibid.

Recently, we have seen IIROC in their focus on compensation related conflicts indicate that fee-based accounts may not always be in the best interests of clients.[13] This, says IIROC, can be the case with a "buy and hold" strategy where the client will be paying for ongoing fees without receiving a commensurate level of ongoing service. As noted in the Brondesbury Report, no empirical studies have been done to document whether investors have greater after-fee investment returns with fee-based compensation instead of commission-based compensation.[14]

We believe the increased performance reporting and saliency of fund costs and dealer compensation created by the POS and CRM projects will lead to better alignment of overall services and advice with dealer compensation paid. The CSA has indicated that these initiatives are expected to cause investors to question the overall level of services and advice they are receiving, which in turn is anticipated to prompt representatives to better demonstrate their value proposition or, lead to investors switching to lower-cost alternatives. If the CSA's articulated aims for the POS and CRM projects are met, investors will be empowered to make more informed decisions on whether the commissions they're paying are commensurate with their specific needs, expectations and preferences for service and advice.

We further dispute the CSA's claim that the proposals in CSA CP 33-404 will have no impact whatsoever on the concerns they've expressed that embedded commissions paid may not align with services provided to investors. We believe the reforms, particularly the enhancements to know-your-client (KYC) and suitability, will create a more consistent minimum standard of service and advice that must be provided to all investors. This, in turn, will prompt greater price and service competition of dealers and their representatives to demonstrate their value proposition.

Alternative Regulatory Options to Address Issue 3

***Enhanced Dealer Supervision of Advisory Services* –** We would propose that if the CSA wants to address the issue of better alignment of the costs paid by individual investors with the services and advice provided, a more impactful and fulsome regulatory response for the CSA to consider is to focus on the dealer's supervisory obligations. Specifically, the CSA could consider enhancing the guidance related to dealer supervision of their representatives to indicate that this includes ensuring that a commensurate level of advice and service is in fact being provided in exchange for the payment by the dealer to the representative.

***Greater Specificity at Account Opening* -** The CSA could also consider enhancing the guidance related to CRM relationship disclosure, to strengthen the specificity in the disclosure related to the advice and services that will be provided by the dealer and representative in exchange for the compensation to be paid.

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[13] See IIROC Notice 16-0297 Managing Conflicts in the Best Interest of the Client – Status Update (December 15, 2016) and IIROC Notice 17-0093 Managing Conflicts in the Best Interest of the Client – Compensation-related Conflicts Review (April 27, 2017).

[14] The Brondesbury Report, p 18.

Mandating only "D" Series be Available on Discount Brokerage Product Lists - Finally, while we agree with the CSA that it may not be desirable for the CSA to compel investment fund managers to create a new "execution only" or non-advice series (typically denoted "D" series), we would encourage the CSA to proceed with mandating that discount or order-execution only (OEO) dealers not be permitted to offer an advice commission series (typically denoted "A" series) on their product list.

In our view, proceeding with this initiative will address the issue identified in the Consultation Paper that the majority of mutual fund series sold through the online/discount brokerage channel are the full trailing commission fund series despite the increased availability of Discount/DIY fund series (D series) in the market. We agree with the CSA that investors who do not seek services and advice should not inadvertently have to pay for them. We believe this change could be easily implemented by amending IIROC Member Rule 3200, which sets out the minimum requirements for IIROC dealer members seeking approval under Rule 1300.1(t) to offer OEO services.

2. Market Forces are also Driving Changes Independent of Regulatory Response Aligned to Regulatory Objectives

We strongly believe that market changes underway are already effecting many of the outcomes that the CSA believes a ban on embedded commissions will achieve. In particular, we are already seeing (a) the growth and availability of direct-pay (negotiated advisory fee) options to all investors in all channels; (b) reductions in fund fees and fund fee complexity; (c) increased price competition and decreasing fund management costs and (d) market innovations in product distribution and advice. In our view, these changes together with the outcomes of the regulatory reforms discussed above, significantly address each of the issues identified in the Consultation Paper.

(a) Fee-based and Direct-pay Options Continue to grow in all Channels

The CSA is correct to identify that the share of mutual fund assets held in fee-based purchase options (F series) is growing, and growing quickly. Competitive market pressures are driving the growth of F series for many fund manufacturers, with frequent changes to the F series offering or pricing. Fee-based program assets as a percentage of total assets is gaining ground in IIROC platforms, and in full-brokerage the shift in advisor compensation is in line with the shift to fee-based.[15] Our experience at Mackenzie Investments is that F series has had the most net new money, which is in line with the experiences of other independent fund manufacturers. In 2016, approximately 30 percent of Mackenzie Investment's gross sales were in fee-based series, and we expect our fee-based series sales will increase to above 40 percent, in line with the industry during 2017 and beyond.

Where we disagree with the CSA is the discussion in the Consultation Paper that direct-pay options today are not available to all investors in all channels. While it is correct that dealers generally do not offer fee-based programs to mass-market households, generally because of a lack of scale and the cost to implement, there are direct-pay options available

[15] Source: Strategic Insight, Retail Brokerage and Distribution, Summer 2015.

to representatives today looking for fee-for-service for smaller investors where the dealer program may be restrictive to high minimum investments or fees for the reasons identified.

At Mackenzie Investments, we launched a negotiable advisor fee series, FB series, in October, 2015 for dealers and their representatives who are registered with the MFDA. This manufacturer sponsored solution allows for the negotiation of an advice and service fee directly between the investor and dealer, through the representative, pursuant to an explicit agreement, and then for Mackenzie Investments to facilitate the investor's payment of dealer compensation by collecting payments from the investor's fund investment (through periodic redemptions). Our FB series works in much the same way as the CSA's proposal to allow investment fund managers to facilitate investors' payment of dealer compensation. While it is our understanding that only a few other fund manufacturers have an FB series equivalent, we know there are a number of other fund manufacturers who offer the same negotiable attributes of the FB series in an existing series.

(b) Reduction in Fund Series and Fund Fee Complexity Underway

In the last few years, we have seen a number of proactive actions taken on the part of investment fund managers aimed at reducing fund fee complexity and series simplification. In fact, at Mackenzie Investments we continue to consolidate the number of series available on our shelf in an effort to continue to reduce complexity and improve advisor and client navigation.

Our own experience has also been that fund management and embedded distribution fees have become more uniform, and are continuing to decline. We have also of course seen the introduction of automated conversions to the lowest priced series upon the investor or house-hold meeting a minimum threshold requirement. We launched this service in April, 2017.

Finally, we continue to see fund managers either simplifying asset house-holding programs or move to a flat fee pricing strategy. While we believe there will always be some differences across the asset management industry, in part because of competition and innovation, this dynamic innovative and competitive environment has led to improved investor experiences and investment outcomes.

(c) Increased Price Competition Occurring

In the last few years, we have seen a number of investment fund managers announcing fee cuts, trailer fee cuts, administration fee cuts, preferred pricing programs as well as an increasing number of share classes with lower MERs year-over-year.[16]

Asset-weighted management expense ratios (MERs) and management fees for long-term funds also continue to decline. In fact, since 2015, the investment fund industry has

[16] December 2014 – December 2015, source: Insight Advisory Service, July 2016.

experienced a significant amount of re-pricing. In total, at least 6000 share classes lowered MERs between December 2014 and December 2015.[17]

(d) Market innovations in product distribution and advice

Canada is now home to more than 80 fintech firms.[18] The CSA is correct to identify the growth of online advice within the Canadian market. We were surprised, however, to see the CSA imply that the adoption by incumbents of online platforms will somehow have a negative impact on the pricing pressures these new entrants have brought to the market. We find no evidence in the Consultation Paper to support this assertion.

In our view, the increasing innovation and technology we're seeing in the market from both fintech start-ups and from incumbents, will continue to offer investors choices in product distribution and advice.[19] It will also continue to put increased price and competitive pressures on incumbents to demonstrate alignment of fees with the overall level of services and advice provided. We welcome this, and anticipate that we will see representatives differentiating themselves from asset allocation, advice 'light' platforms, all to the benefit of investors.

3. Importance of Preserving an Innovative, Competitive and Fair Financial Services Industry in Canada

Avoiding Regulatory Arbitrage

Mackenzie Investments has long advocated that it's important to remember that the securities industry is only one part of the financial services sector in Canada. Insurance and deposit investment products are also significant segments of the industry, and compete directly with the sale of investment funds. As the CSA is aware, there are embedded commissions and costs built in to <u>many</u> of these other financial products, notably segregated funds, as well as spreads on GICs and DIAs.

From the investor perspective, we believe it is critical to have a harmonized approach to the regulation of all financial products and the intermediaries who sell them. This is particularly important in an increasingly more concentrated and vertically integrated distribution landscape dominated by deposit-taker and insurer owned dealers. Different regulatory regimes for different financial products and financial intermediaries can create complexity and confusion for investors, and may lead to inconsistent client experiences and outcomes.

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[17] Excludes funds with performance fees, funds with management fees charged at account level and labour sponsored funds, source: Insight Advisory Service, July 2016.

[18] Source: PwC, Canadian Banks 2016 Embracing FinTech movement, 2016.

[19] Among Canadians, there's still a strong preference for taking guidance from a human financial advisor over advice generated through an algorithm powered by artificial intelligence (Source: HSBC, *Trust in Technology: Country Report/Canada*, May 24, 2017).

We believe it is noteworthy that in each of the jurisdictions that has introduced a complete ban on embedded commissions, the ban has extended beyond investment funds. This is a very important distinction from the Consultation Paper. While we welcome the CSA's support for a harmonized regulatory approach for similar products, and we appreciate that the Canadian Council of Insurance Regulators (CCIR) has indicated it will review the CSA policy direction on embedded commissions and assess its appropriateness for segregated funds, the potential for regulatory arbitrage remains. In addition, the Consultation Paper gives no indication of the timeline for the CCIR's review or a commitment for coordinated action with the CSA, nor is there any discussion in the Consultation Paper of whether a similar review is being considered by the Office of the Superintendent of Financial Institutions (OSFI) with respect to banking products.

As part of the CSA's deliberations, the potential impact of product and regulatory arbitrage cannot be disregarded or discounted. We found it particularly disconcerting that the CSA suggests in the Consultation Paper that the high level of horizontal integration at deposit-taker owned dealers somehow leads these firms to focus less on any one business line and more on "gathering assets across all business lines and on directing clients to the appropriate business line". With the recent CBC Go Public releases, we would submit there is overwhelming evidence to the contrary.[20]

We therefore strongly urge the CSA to work collaboratively with insurance and banking regulators to develop consistent regulatory responses to the issues identified in both this consultation and CP 33-404. We do not believe it is sufficient for the CSA to indicate that it "assumes" that the self-regulatory organizations and regulators of non-securities products will remain vigilant and take any necessary action in the case of non-compliance. If a decision is made by the CSA to proceed with discontinuing embedded commissions, we believe any such securities regulatory reform must only move forward if it is accompanied by concurrent and consistent regulatory initiatives for investment fund-like products across the insurance and banking industries.

Preserving a Competitive and Innovative Industry

The CSA acknowledge that discontinuing embedded commissions will have more of an impact on some dealers than others. In fact, the Consultation Paper notes that a ban on embedded commissions will have little to no effect on deposit-takers and insurer owned dealers. As noted in the Consultation Paper, most households who purchase investment funds purchase them through a deposit-taker or insurer owned dealer, who today dominate investment fund distribution. The concentrated and vertically integrated distribution landscape in Canada has made it increasingly difficult for independent dealers

[20] See: CBC News reports by Erica Johnson, http://www.cbc.ca/news/canada/british-columbia/td-tellers-desperate-to-meet-increasing-sales-goals-1.4006743 (March 6, 2017), http://www.cbc.ca/news/business/td-bank-employees-admit-to-breaking-law-1.4016569 (March 10, 2017), http://www.cbc.ca/news/business/banks-upselling-go-public-1.4023575 (March 16, 2017), http://www.cbc.ca/news/canada/british-columbia/bank-s-deceptive-titles-put-investments-at-risk-1.4044702 (March 29, 2017) and http://www.cbc.ca/news/business/financial-investment-rules-client-interests-1.4069847 (April 17, 2017).

and investment fund manufacturers to effectively compete and ensure investors have choices in terms of financial advice as well as access to high performing funds.[21]

At Mackenzie Investments, we've identified that over 92% of our retail client base currently hold assets in either client name, nominee or intermediary accounts, which will be affected by the discontinuation of embedded commissions. As we describe in greater detail in the appendix, system enhancements to transition clients to fee-based accounts (the most common direct-pay arrangement), particularly client name accounts, will be challenging and costly and may in fact be prohibitive for many smaller independent firms. We firmly believe that any regulatory action that may prompt an even less competitive financial services industry will effect cost competition and product innovation, to the detriment of investors. We also noted these concerns in our response to CP 33-404.[22] As the CSA now contemplates discontinuing embedded commissions, a consideration of how such a regulatory change will affect the vibrancy of the financial services industry in Canada is critical, as this too has a significant impact on the investor experience and outcomes.

In our view, the assertion in the Consultation Paper that "investment funds are less popular than traditional savings vehicles with mass-market households" is more a result of the oligopoly and horizontal integration of the banks, than a testament to investor preference. We therefore strongly disagree with what seems to be the CSA's position that avoiding an "advice gap", because deposit-taker owned dealers in Canada will continue to service mass-market households, somehow negates the adverse impacts that discontinuing embedded commissions will have on some independent dealers and fund manufacturers, who today already face the challenge of a distribution network that is dominated by the banks.[23] In our view, fewer independent firms and manufacturers will mean a less competitive financial services industry in Canada, to the detriment of investors.

4. Retaining the Accessibility and Affordability of Financial Advice

Mackenzie Investments strongly believes in the value of advice provided to Canadians by financial advisors. Among other things, advised households (i) are twice as likely to save for retirement at all ages; (ii) have significantly higher levels of investable assets at all ages; (iii) improve their regular saving for retirement at all income levels; (iv) rate themselves as more financially knowledgeable; and (v) are more confident in their ability

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[21] As of March, 2017 the top 5 deposit-takers rank 6th, 7th, 8th, 10th and 11th in terms of percentage of proprietary 4 and 5 star Morningstar ratings (Source: Morningstar Direct, March, 2017).

[22] Ibid., footnote 4.

[23] We refer to independent fund manufacturers as those manufacturers not owned by a bank, credit union or life insurance company. In 2005, independent fund manufacturers accounted for 56.4% of the net assets in the industry, while the banks and the credit unions only made up 32%. In 2015, the banks and the credit unions had 43% of the market share, while the independents dropped to 41% (Source: Investor Economics, 2016; see also: Clare O'Hara, *Banks taking share from independent mutual-fund firms,* The Globe and Mail, May 25, 2015).

to achieve a comfortable retirement.[24] We also know that investors' primary source of financial information comes from their advisors.[25]

As the CSA moves forward with its review of whether or not to discontinue embedded commissions, it is important for the CSA to ensure that advice not only remain accessible for mass-market households, but that modest investors continue to have <u>choices</u> in financial advisory services and that such services remain affordable.

Modest investors (those with under $100,000 in investible assets), make up 80% of all Canadian households[26] and 83% of the households that use MFDA representatives.[27] We also know that in 40% of cases where there is a financial advice relationship, it was initiated with financial assets of not more than $10,000. The benefit of wealth accumulation is exponentially greater the longer the advice relationship. Investors who receive professional financial advice save more, accumulate more wealth and feel better prepared for retirement than non-advised individuals with similar socio-economic characteristics.[28]

Research shows that fewer choices of compensation models can limit access to advice, and result in higher overall costs, particularly for households with more modest investment levels.[29] Where regulation has been changed to ban or limit commissions, the absence of embedded compensation has been found to lower the cost of the product, but the cost of advice was seen to go up. As noted in the Brondesbury Report, it has also been found that in jurisdictions that have moved to fee-based compensation, those with less wealth or income have found it more difficult to get advice than others.[30]

Ultimately, we believe it is critical that as the regulatory framework continues to evolve in Canada, that we retain choice for investors not only in how they pay for financial advice,

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[24] Sources: CIRANO, *Econometric Models on the Value of Advice of a Financial Advisor* (2012) and *The Gamma Factor and the Value of Financial Advice* (2016). Advised households, at all age levels, are twice as likely to save regularly for retirement than non-advised households, with advised households having higher net worth than non-advised households across all ages and income levels (Source: IFIC *The Value of Advice,* 2011).

[25] Key Highlights CSA Investor Education Study 2016 prepared for the CSA by Innovative Research Group, Inc., April 2016.

[26] Source: Investor Economics, *Household Balance Sheet*, 2015.

[27] Source: MFDA Client Research Report, p 6.

[28] Sources: CIRANO, *Econometric Models on the Value of Advice of a Financial Advisor,* 2012 and *The Gamma Factor and the Value of Financial Advice* (2016).

[29] Source: Investor Economics & Strategic Insight, *Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios: A Canada-U.S. Perspective,* 2015. The willingness to pay upfront for advice depends on the level of wealth, formal education and financial knowledge of the investor (Source: Michael S. Finke, Sandra J. Huston and Danielle D. Winchester, *Financial Advice: Who Pays*, (Association for Financial Counselling and Planning Education) 2011.

[30] The Brondsbury Report, p 5.

but in the type of advisory service model, so that the benefits of the client-registrant reforms contemplated in CSA CP 33-404 will remain accessible and affordable to all Canadians.

We firmly believe that the effects of the regulatory initiatives undertaken to date, once fully implemented, together with the rapid changes underway in the market, will substantially address the issues identified in the Consultation Paper. To the extent that any residual issues remain, we submit there are a number of alternative regulatory actions available to the CSA that could address such issues, without the resulting significant adverse impacts discontinuing embedded commissions may cause.

As the CSA moves forward with both this consultation and CP 33-404, we recommend the CSA establish working groups, comprised of members of the CSA, MFDA, IIROC and market participants, to ensure that the impacts of any rule proposals, as well as all operational or transition issues, can be efficiently and effectively identified and addressed.

We thank you for the opportunity to provide comments on the Consultation Paper. Please feel free to contact Donald MacDonald, Senior Vice-President, General Counsel & Secretary at (204) 956-3387 or myself if you have any questions or require additional information.

Yours truly,
MACKENZIE FINANCIAL CORPORATION

Barry S. McInerney
President and Chief Executive Officer

Appendix - Tax Impacts

Overview

Generally, mutual funds pay a management fee to the investment fund manager, and the investment fund manager then compensates the dealer out of its management fees. Within this structure, the management fees paid to the investment fund manager are deducted by the fund to arrive at taxable income. Typically, in a mutual fund, distributions are paid to the investors to eliminate taxable income in the mutual fund. If there is a ban on embedded commissions, then the management fees paid by the mutual fund are reduced, and conversely the taxable income of the mutual fund would increase. There would be additional taxable income in the mutual fund requiring additional distributions to be paid to investors to eliminate taxable income in the mutual fund.(1)

In a direct-pay model, the investor is responsible for compensating the dealer. Generally, these advisory fees are tax deductible to the extent that these fees are reasonable, are for non-registered accounts, are not commissions, and are:

- For advice as to the advisability of purchasing or selling a specific share or security of the taxpayer, or;
- For services in respect of the administration or management of shares or securities of the taxpayer.

Generally, the additional distributions paid to investors should be offset by the advisory fees paid to the dealer.

In order to facilitate the payment/collection of the advisory fees, the investment fund manager/investor/dealer may agree to redeem units to fund the payment of the fees. The advisory fee is subject to GST/HST/QST (Sales Tax).

We set out below our observations of the key implications to investors, investment fund managers and dealers in transitioning all clients to direct-pay arrangements.

Impact of Removing Embedded Commissions	**Investor**	**Investment Fund Manager**	**Dealer/Advisor**
More fund series are likely to require distributions and quantum of distributions are likely to increase	Additional administration required to track distributions and report for tax purposes.	Increased demand on system resources to process higher volume of distributions.	Additional system resources to track the transactions. Additional investor support to track and understand transactions
Tax neutrality of “embedded commission” component not ensured	Tax deductibility of fees paid by the investor to its dealer dependent upon the services being provided in exchange for the advisory fees being charged.	N/A	Communication with the investor to be managed
Additional volume of transactions as a result of redemptions to fund direct-pay fees	Additional administration required to track transactions and report gains/losses for tax purposes including monitoring superficial losses.	Increased demand on system resources to process higher volume of transactions.	Additional system resources to track the transactions.
Advisory Fee subject to Sales Tax	Amount of Sales Tax payable by the investor on the advisory fee will be determined by the investor’s province of residence as opposed to the “blended rate” of the fund.	Impacted to the extent the investor’s units in the funds are redeemed to pay for the advisory fees. The investment fund manager requires the systems to determine the quantum of the Sales Tax to withhold on behalf of the dealer.	Exempt commission paid by the investment fund manager being replaced by a taxable advisory fee paid by the investor. Systems to be enhanced to handle the additional administration and

	Generally, Sales Tax paid will be added to the cost of the advisory fee.		compliance required to collect, report, and remit the Sales Tax (and related taxable revenue).
Rationalization of fund series would require an exchange of investors' units within a fund	Generally, an exchange of units from one series of a fund to another can be accomplished on a tax deferred basis. Eliminates a level of complexity in understanding offering.	Initial increased demand on system resources to process transfers to be offset by ongoing administrative efficiencies due to reduced number of series. Simplifies investment fund manager's offering.	Initial additional system resources to track the transfers to be offset by ongoing administrative efficiencies due to reduced number of series. Eliminates a level of complexity in product offering.

(1) A mutual fund corporation can only distribute (by way of dividend) its net capital gains and dividends to shareholders. A reduction of management fees within the corporation could result in trapped income, which would be subject to tax. The end result is double taxation on the income; once in the corporation and again in the investor's hands upon redemption.

Appendix – Operational Impacts

General operational impacts of discontinuing embedded commissions on the back office service processes of investment fund managers and dealers

Many investment fund managers and dealers will face operational challenges in transitioning to direct-pay arrangements, namely because of systems complexities and associated costs. This, in turn, may impact both the client experience, as well as overall costs for the client.

At Mackenzie Investments, over 92% of our retail client base currently hold assets in either client name, nominee or intermediary accounts that will be affected by the discontinuation of embedded commissions. A move to fee-based accounts (the most common direct-pay arrangement and the model we anticipate will most likely be utilized) will be particularly challenging for dealers with client name accounts. Nominee accounts allow for a cash position through which all security buys, sells and daily calculations and accrued account fees can be processed. A cash position enables the client to maintain a cash balance and allows the dealer to collect client fees from the cash balance without having to sell any mutual fund positions to cover the fee. It also enables the dealer to automate the collection of the client's accrued fees part way through the month based on the client's transactions through the cash position. Client name accounts, on the other hand, are challenging to automate and effectively administer because transactions to collect the fee must be charged directly to one or more mutual fund positions held within the account.

The move to direct-pay arrangements will likely cause an increase in the number of transactions we currently see in client accounts which hold mutual funds with embedded commissions. This, in turn, will raise the costs of administering these accounts. These increased transactions will be due to increased fund distributions as a result of additional taxable income in trust funds (with the discontinuation of embedded commissions), the introduction of client fee transactions and possibly additional redemption transactions to facilitate client payments. We envision there will be a need for systems upgrades to process these increased transaction volumes and the additional reporting to clients by both the dealer and the manufacturer.

Adding to the challenges facing dealers in transitioning to direct-pay arrangements for all clients, whether in nominee or client name accounts, is that many dealers rely on third-party systems vendors today for transfer agency functions, client confirmations and client statements. These vendors typically provide such services to many dealers, which means that the transition to direct-pay arrangements will place higher demand on them from the dealers they service. Vendor resources and cost constraints may also limit their ability to meet the needs of dealers within the CSA's proposed transition period. In addition, vendors will have to deal with the complexity of each dealer potentially choosing a slightly different direct-pay arrangement which may further impact the timing of transition and cost to the dealer.

The recent experience of implementing the POS and CRM2 projects provide good insights into the extent to which systems, procedural and educational enhancements will be needed by dealers, investment fund managers and systems vendors to effect a smooth transition to direct-pay arrangements. Our experience is that there have already been significant cost expenditures in these project implementations with systems and website changes; file enhancements to provide additional details on advisor fees and commissions; and enhanced training and ongoing advisor support. We are mindful of the additional complexity and costs that a transition to direct-pay arrangements will cause some dealers, particularly smaller and medium size independent dealers, and that this may create business viability concerns.

Other unintended consequences that may arise for fund industry stakeholders and investors with the discontinuation of embedded commissions

An additional challenge with transitioning to direct-pay arrangements within a prescribed period of time will be that while business and pricing models will continue to be contemplated and evolve, investment fund managers and dealers will have to begin to plan for the process of moving existing clients to some type of direct-pay arrangement and platform immediately. This will likely require the creation of client/nominee fee-based platforms to minimize switches, which have the potential for triggering negative tax consequences for clients (i.e. capital gains). In addition to a consideration of immediate tax impacts, additional reporting and the implementation of new administrative procedures will be required, along with the associated costs, for existing clients.

Discontinuing embedded commissions may also adversely impact the account minimum and maximum calculations for registered retirement income funds (RRIFs) and life income funds (LIFs), and how fee payments are made from registered education savings plan (RESPs) and registered disability savings plan (RDSPs) accounts today.

For RRIFs and LIFs, the minimum and maximum calculations will be impacted by the decrease of the market value due to the application of fees in the account. RRIF and LIF minimums are calculated based on year end market value. The application of the fees will decrease the year end market value and consequently the minimum in the following year. LIF maximums are also calculated based on year end market value but can also be calculated based on the growth realized in the previous year. The application of fees in these instances will decrease the maximum in the following year.

For RESPs and RDSPs, based on the Promoter Agreement signed with Employment and Social Development Canada (ESDC), Mackenzie Investments as a promoter cannot charge fees on the grant portion of these accounts. Therefore, the fee, if charged, will have to be on the income portion and then the capital portion (not against the government's incentive portion).

Transition and timing

For dealers and investment fund managers, we anticipate multiple internal and external systems upgrades will be required to manage transaction workflow, data management, fee payments and fund distributions if the CSA moves forward with discontinuing embedded commissions. These changes will impact various procedures on how we manage, process and report transactions, adjustments, taxes and documents.

The required system development, training, reporting (confirmations and statements) and change management costs for us at Mackenzie Investments, however, will only be fully understood when each dealer determines and provides us with details of how they intend to structure their direct-pay arrangement and the degree to which they want us to assist in the facilitation of the payment. We can, however, anticipate significant vendor costs to prepare our specialized registered and income plan accounts.

The current securities regulatory framework requires client approvals of switches between mutual fund series and moving clients from client name accounts to nominee accounts as well as changing from an embedded commission to a direct-pay arrangement. Such transitions also require significant client communication and administration challenges, all of which can mean additional expenses for dealers and investment fund managers and most often, significant disruptions to the client. The ability for dealers and investment fund managers to notify clients of these changes as part of an automatic transition to direct-pay arrangements, instead of obtaining and administering client approvals, would significantly simplify the process and most importantly, minimize client disruption.

The CSA proposes two possible alternatives for dealers to transition to direct-pay arrangements. From both an operational and client experience perspective, we believe the best approach is to set a definitive transition date that allows dealers, investment fund managers and systems vendors sufficient time to determine how best to manage the transition. In our view, a phased account transition approach as described in the Consultation Paper may not fit the particular circumstances of a client holding multiple account types, and may be very difficult to achieve without significant client disruption.

In light of all the above, we believe that a transition period of 36 months may be too aggressive a timeframe to allow for a seamless transition for all stakeholders, particularly clients. Should the CSA determine to proceed with discontinuing embedded commissions, we strongly encourage a commitment by the CSA to engage with the industry at various points, to ensure that a smooth transition is underway, and to consider and address operational issues throughout the process.

Appendix – The Value of Active Management

Overview

Active and passive management are both beneficial in helping investors reach their financial goals. Active managers have shown that they can add value where market inefficiency exists, while generating potential alpha by exploiting off-benchmark opportunities when appropriate. In constructing a well-conceived portfolio, investors should view investing from a total portfolio perspective and utilize active asset allocation strategies to add value.

Active managers subscribe to a common belief that markets are not perfectly efficient, which creates an opportunity for portfolio managers to exploit security mispricing and outperform the overall market. Passive managers, on the other hand, seek to replicate the return of a given market index.

Market efficiency describes the degree to which the price of securities reflects all public and non-public information (timeliness and interpretation). Hypothetically, if the capital markets were perfectly efficient, active managers on average would not outperform the markets as securities would already reflect their fundamental value. On the contrary, if markets could be described as inefficient, there would be many opportunities for active managers to identify and profit from mispriced securities and hence outperform the overall markets. In practice, capital market efficiency resides somewhere in between these two scenarios. Active management can add value to portfolio returns over a broad range of different asset classes.

Active management generally refers to an investing strategy whereby a portfolio manager makes specific investment decisions with the typical goal of outperforming an investment benchmark or index. Active management can have advantages over market capitalized indices - and more importantly - protecting investor wealth over full market cycles - particularly during market downturns.

Actively managing asset allocation enables investors to be focused on individual objectives beyond benchmarks and the short term. This is essential for aging investors as they move from wealth accumulation into decumulation, where the emphasis is on consistency and persistency of income. It is much more difficult for wealth levels to recover from an investment loss when capital is being liquidated in retirement.

To better protect investors' capital, active managers are able to purchase securities that are undervalued and sell securities that become overvalued. They are also able to minimize losses by avoiding troubled securities and overly concentrated sectors or regions. Many active investment strategies also have the ability to hedge currencies, buy put options to lessen drawdowns, retain cash to reduce volatility, and utilize other tools to minimize potential investment losses. Furthermore, actively managed funds are able to effectively diversify their assets by avoiding the limitations of the benchmark through the avoidance of security and sector overconcentration.

Challenges

Successful active management is by no means an easy task. By simple definition, and for the most part, it can be a "zero sum game" where the gains of one investor come at the expense of another. Vanguard Asset Management describes it as follows:

> "The concept of a zero-sum game starts with the understanding that at any one time, the holdings of all investors in a particular market make up that market. As a result, for every invested dollar that outperforms the total market over a given period, there must by definition be another dollar that underperforms. Another way of stating this is that the asset-weighted performance of all investors, both positive and negative, will equal the overall performance of the market."

Writing in The Financial Times, Yves Choueifaty CEO of TOBAM noted an additional challenge:

> "By definition the average active manager cannot outperform the benchmark because the benchmark is determined by the sum of activity carried out by both active and passive managers. And because passive managers have no impact on the benchmark – they merely follow it – it is, in fact, the sum of all the bets taken by active managers that determines the benchmark. It is obvious that it is impossible for the average active manager to outperform (or underperform) the average active manager. The benchmark is, after all, the output of all the activities carried out by active managers".

Investing in the index does not on its own however ensure a positive outcome. For example, over the 25 year period beginning in 1929, the S&P 500 index did not recover to its former high until 1954. Yet, considerable wealth was amassed during this period through effective trading of individual securities. As cited by the CMG Capital Management Group:

> "It's a little-known but startling fact: The average buy-and-hold stock market investor spends 74% of his or her time recovering from cyclical downturns in the market (from 1900 – May 2015). We like to think of investment approaches as types of aircrafts. Passive investments are like hot air balloons. In favorable conditions, they can indeed carry passengers to their financial goals.
>
> Active investments, on the other hand, are like planes. When winds are fair, they, too, can carry you in the right direction. They also have the flexibility to maneuver through bad weather, protecting their passengers from harm and keeping them moving toward the destination".

The relevance of these numbers gain even greater importance in the context of Deutsche Bank's Bradley Jones whose analysis revealed that a portfolio comprised of 60% equities and 40% bonds produced negative real returns over a rolling ten year holding period for almost a quarter of a 111 year period in the US market commencing in 1900. This is perhaps even more pervasive in a low interest rate environment where negative returns have come into existence and depending upon global events, could become more prevalent.

With this in mind, arguably the ultimate goal and value of active management is to provide downside protection, with secondary consideration given to muting volatility and out performing in bull markets. MFS Investment Management stresses this importance in their piece, "There's No Substitute for Skill":

> “To outperform in falling markets, active managers must have differentiated risk management. It should be an important part of their investment process, rather than an overlay, using active security selection to view risk from multiple perspectives before adding a security to a portfolio. Through a strong risk framework, they must manage risk on several levels, from the security to the portfolio to the firm. Investors consider this capability a high priority.”

Opportunities

Russell Investments has stated:

> “Dynamic active management – the real-time management of portfolio exposures to specific factors, countries, sectors, or currencies – can be used to help to avoid downside risk in chosen asset allocations. With this kind of focus, active management works to help create a smoother ride that can help to keep investors from exiting the market at the worst possible time”.

Perhaps most importantly for the retail investor, Russell also singles out the importance of after-tax returns, for of all the costs incurred by an investor - be it trades, investment management, or advice, the greatest cost will be taxation.

> “As so many of us have heard over the years, ‘It’s not what an investor earns. It’s what they keep.’ Being active around after-tax returns is often an underappreciated way active managers can help to provide value to investors. Unlike index-based passive investing, active management can use an expanded toolkit to actively maximize after-tax returns. This includes active loss harvesting – potentially increasing the absolute return an investor sees. Active, by its very nature, strives to do better”.

For many managers active management employs innovative factor weightings to outperform market capitalized indices. Morgan Stanley identifies these new approaches as:

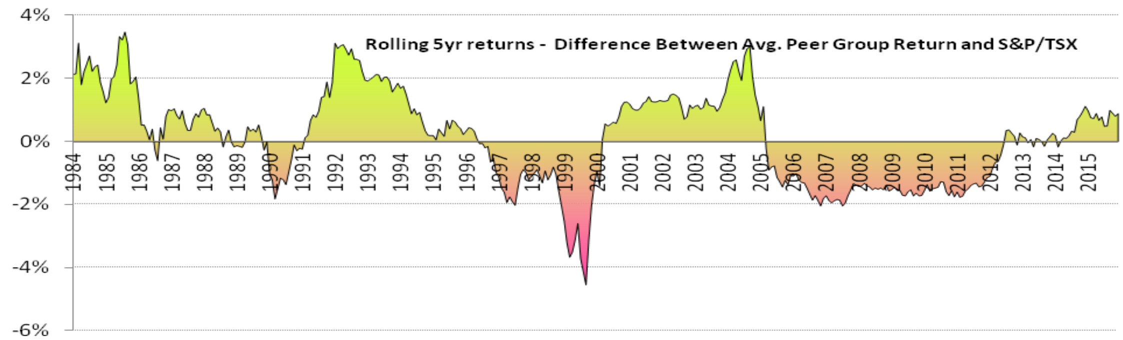
> “’Smart-beta’ strategies which attempt to replicate pure factor strategies (like value, momentum or low volatility) are the next evolution in the active/passive debate. While their systematic approach may be a low-cost replacement for some active managers, we still believe that 35 to 40% of the top managers add idiosyncratic alpha over long periods of time and thus their investment selections can be additive to diversified portfolios.”

Employing new approaches to challenge long held beliefs enables diverse opportunities for active managers**.** MIT’s Andrew Lo, well known for his paper, “Physics Envy May Be Hazardous to your Wealth!” (that demonstrated how the economic system developed by financial markets created a false sense of mathematical precision as the models developed were not as predictive as those used in physics) urges investors to view financial markets and institutions from the perspective of evolutionary biology rather than physics:

> “Markets are well behaved most of the time, but like any other human invention, they are not infallible and they can break down from time to time for understandable and predictable reasons”.

Analysis

According to data from Morningstar Canada, the average performance of the actively managed Canadian Equity peer group (Canadian Investment Funds Standards Committee (CIFSC) category) has exceeded that of the benchmark S&P/TSX index 58% of the time since 1980. Even more impressively, 1st quartile funds in the same category outperformed the index 79% of the time.



During each bear market since 1980, the benefits of active management have been quite evident as the average return of the CIFSC Canadian Equity peer group exceeded that of the passive index as can be seen in the following table.

Start	End	S&P/TSX Composite	25th Percentile Return	50th Percentile Return	Cdn. Equity Avg. Fund Return
Jun-81	Jun-82	-36.7	-26.7	-29.1	-30.8
Aug-87	Nov-87	-25.4	-20.8	-25.0	-24.1
Jan-90	Oct-90	-20.1	-10.5	-15.1	-12.8
May-98	Aug-98	-27.5	-23.7	-25.7	-25.5
Sep-00	Oct-02	-22.6	-12.0	-14.9	-14.5
Jun-08	Feb-09	-43.5	-39.8	-43.4	-42.6

Various studies and writings in recent years have pointed to the seeming inability of most actively managed funds to match or beat their index benchmarks. Most of these studies, however, looked only at average equity funds without making distinctions between those that were truly active and those that were not.

A more discriminating study in 2009 by Martijn Cremers and Antti Petajisto found that investment funds that were truly active, taking positions that significantly deviated from their benchmarks, were able to outperform those benchmark indices both before and after expenses.

Supporting Strong Capital Markets

Passive investment vehicles have low costs mainly because they do not do any of the research and trading that active managers do. Without this research and making prices informative, individual securities can become mispriced and markets distorted. According to Lasse Pedersen of AQR Capital Management:

> "If most investors were passive, the liquidity in individual securities not included in the index would vanish as investors would only trade the index. Securities could become severely mispriced. The collapse of liquidity and the lack of active management would make the process much less informative. When the secondary market is illiquid and uninformative, buying in the primary market becomes much riskier."

A lack of liquidity in the market is not an issue if you don't have to sell or buy immediately. Actively managed funds are not forced to liquidate securities to meet investors' needs as they usually maintain a cash reserve. This cash reserve also benefits active management strategies by allowing them to exploit the market when mispricing occurs. In fact, the more investors use ETFs and other passive strategies, the more opportunities are created for active managers and the larger those opportunities are.

A further benefit is that within the market, active managers can profit at the expense of passive strategies in assessing the value of an initial public offering (IPO). Pedersen continues:

> "Research has shown that IPO securities are, on average, sold at a discount relative to their price in the secondary market when the shares start trading on the exchange. Informed investors can buy the new shares cheaply and then sell some in the secondary market to other (passive) strategies at a premium. As a result, passive investors are not guaranteed the same IPO performance as the group of active investors since they trade at different prices and quantities."

In competing for outperformance, active managers seek relevant information, analyse it to determine value, and select securities accordingly. In the process, they help to set prices and provide trading liquidity. The efficient allocation of capital in our market-based economy relies on this mechanism. According to Nitin Mehta, managing director of the CFA Institute for Europe, the Middle East and Africa:

> "Passive investors are relative free riders, having to pay only the marginal cost of market participation as price takers, rather than the higher average cost for making fair prices and supporting the real economic purpose of financial markets".

Conclusion

Active and passive investments are both beneficial in helping investors reach their financial goals. Active managers have shown that they can add value where market inefficiency exists, while generating potential alpha by exploiting off-benchmark opportunities when appropriate. In constructing a well-conceived portfolio, investors need to view investing from total portfolio perspective and utilize active asset allocation strategies to add value.

Active managers have shown they have the ability to outperform the index and can be less volatile than the index during bear markets. They are able to avoid less attractive, slow growing companies and provide greater exposure to companies with superior valuations or growth potential. Equities are inherently risky and active strategies can diversify that risk by investing in stocks with lower correlations, and by underweighting sectors that are overly concentrated in the index.

Effective diversification is about maintaining the right balance of stocks, not simply owning a basket of the largest stocks. Active management does not aim to invest only in the largest companies nor look to match the weight of the best performing stocks in the index. Instead, the focus is on selecting the most fundamentally sound and profitable companies, as well as those that are not highly correlated and so can be expected to react differently to market events.

Given the many uncertainties that global capital markets present, investing in stocks and bonds has never been more challenging. Actively managing those risks is critical for those who depend on stocks to grow their wealth and bonds to add an element of stability to their investment portfolios.

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