



March 12, 2014

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

c/o
Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Fax: 514-864-6381
Email: consultation-en-cours@lautorite.qc.ca

and

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor, Box 55
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
Email: comments@osc.gov.on.ca

RE: CSA Notice 81-324 and Request for Comment – Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts

The Consumers Council of Canada appreciates the opportunity to provide comments re *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts*.

While the Council is normally supportive of disclosure that informs and educates consumers about choices they face, it is not supportive of the approach taken in the proposal. In the Council's experience, the average small investor, whom you are charged with protecting, does not have a symmetric risk profile, nor does their risk tolerance profile correlate well with a normal distribution curve. Also, typical investors are likely to be misled by the proposed use of statistical measures. The Council urges the CSA to abandon this proposed classification methodology and instead focus on communicating facts and information that allow the individual investor to make their own assessment about mutual fund past variability.

Inappropriate measure

Standard deviation, as a statistical measure, does indicate the variation or dispersion of data points around the mean. However, these are **known** data points – i.e. historical data. Standard deviation is used in forecasting ranges of future outcomes with certain levels of statistical confidence, *ceteris paribus* – but it cannot and should not be interpreted as predicting specific outcomes at specific future dates. To take the statistical measure known as standard deviation and use it to categorize and communicate the riskiness of an investment about to be made is, in the Council's opinion, an inappropriate use of the statistical measure and likely to mislead.

When used correctly, the measure of standard deviation is given in conjunction with the level of probability the data point or data range represents. That is to say, +/- one standard deviation around the mean includes 68.2% of the distribution curve. To use the measure of "standard deviation" and label as, for example, "medium" is only half the story. Most users will not understand that the measure itself includes less than $\frac{3}{4}$ of the statistical range of past performance.

Consider the example of a fund with a mean return of 7.8% and a standard deviation of 11.8%: This fund would be classified as medium risk under the proposal.

Statistically, one can say that returns ranged from a loss of 4% to a gain of 19.6% in 68.2% of occurrences. One can also say that returns ranged from a loss of 15.8% to a gain of 31.4%, 95% of the time.

Is there any evidence to support a conclusion that this degree of variability is considered "medium risk" by most investors? The Council challenges whether such a classification has any meaning at all and whether one can legitimately divorce the use of standard deviation measure from its accompanying probability.

In the United States, use of standard deviation is prohibited. In the European Union, standard deviation may be used only when accompanied by mandatory disclosure.

Inappropriate presentation

Standard deviation is a measure of past volatility. The Fund Fact proposal presents this measure of past volatility as though it is time-neutral and gives an indication or assurance of future variability. Based on that, the average risk-averse investor will conclude how “safe” they will be in the future and whether their investments will decline in value. A single phrase – low, low-to-medium, medium, medium to high, etc. – will be a powerful and time-neutral signal to an investor making an investment choice.

Most small investors have not taken statistics in school. The explanation of the risk classification will be incomprehensible to most if it involves the use of statistical terminology. However, to explain what variability means, when summarized into a single indicator, necessarily takes the advisor into the realm of statistics. The words “medium” or “low” when used as risk labels, do not sufficiently communicate variability and the range of possible outcomes in a way that best supports an informed choice.

In July 2011, Dan Hallett wrote this insightful observation: “[M]ost funds investing primarily in larger-company stocks are rated as ‘medium’ risk. But what does this mean? It may depend on who you ask but I’m guessing that almost nobody would equate ‘medium risk’ with a 40% to 50% decline in value every 8 to 9 years with a 2- to 4-year recovery time frame. And yet that’s exactly the kind of downside risk to which such stock funds expose investors.”¹

It is said again and again that past performance is not an indicator of future performance and yet small investors hear phrases such as “standard deviation” and “risk” used in a way they often interpret as the boundaries of future downside and losses – as if they are being presented facts about the future, when, in fact, future performance will be shaped by unknown future events. Unless one has been schooled in statistics, one can easily misinterpret what standard deviation means and, therefore, what the proposed risk measure means.

It is of particular concern to the Council that the term “risk” is described as time-neutral in the proposals. Consideration should be given to using the phrase “past volatility” or “past variation”; it should not be used in a time-neutral or future sense. It should not suggest or imply to the unschooled safe “boundaries” for future results over specific time horizons.

Conflicting messages

The problem of misinterpretation exists with current market conditions. In recent months, chief economists and investment pundits at a number of financial institutions [that manage and sell mutual funds] have been making pronouncements about the potential for equity market corrections as quantitative easing is withdrawn in the United States. They have cautioned about corrections ranging up to 15% or more, especially for dividend paying stocks. What they have said is that conditions are changing, that the changes have created significant uncertainty and there will likely be strong and significant downward price pressure on equities.

Assume the classification proposal were in place. How would the risk presentation proposed give the would-be investor any inkling of this conversation about risk in the marketplace?

The reader of Fund Facts may listen to BNN, read the newspaper, talk to their advisor and hear

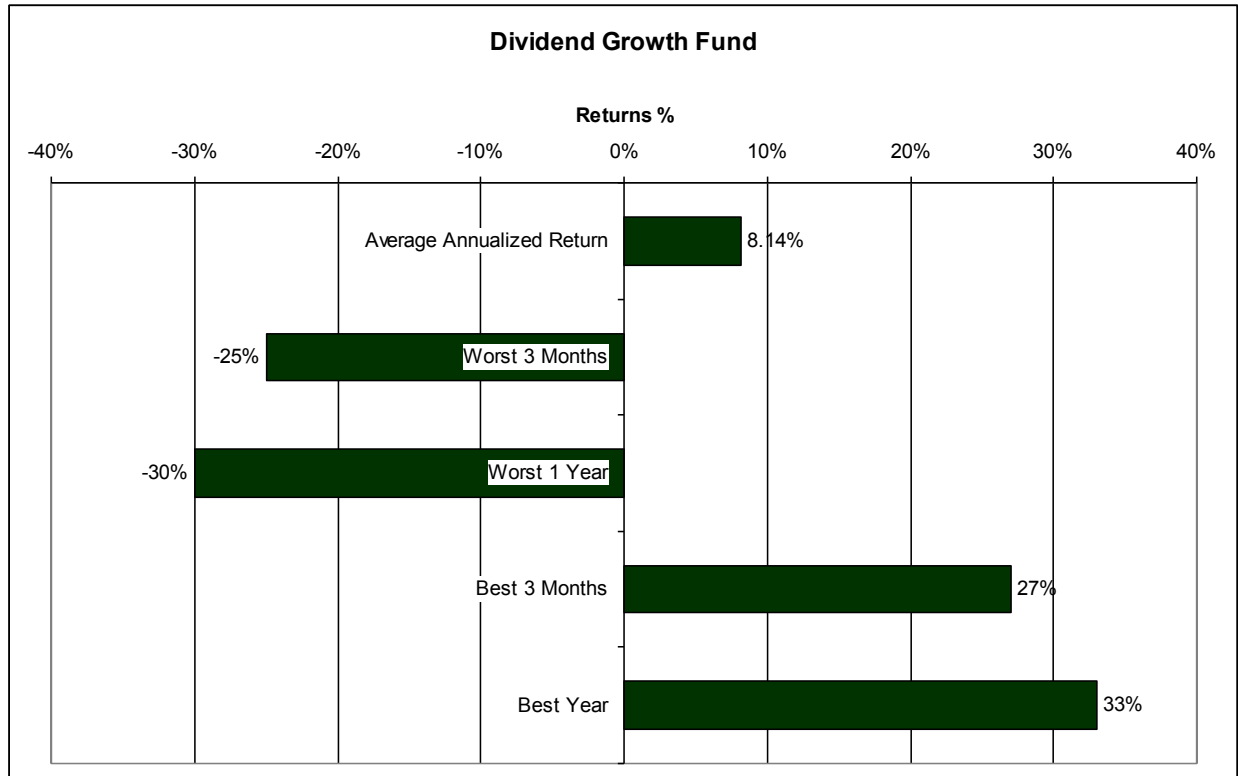
¹ <http://thewealthsteward.com/2011/07/fund-facts-a-good-start-but-risk-rating-suitability-get-thumbs-down/>

what the pundits are saying. But then they will see a Fund Facts rating of an investment product as low-to-medium risk or medium risk. Is it reasonable to expect that most or all would-be investors will understand that the Fund Facts “risk rating” has no relationship to the market risk comments of the chief economist, and that the chief economist would not be surprised if an equity-fund investment dropped 15% in the near term?

Let investors be the judge

What many investors need are facts, graphs and info-graphics. Consider this information presented either in a chart or graph, or in words:

Fund A –	Dividend Growth Fund
Average return	8.14% An investment of \$10,000 at the beginning of 10 years ended the 10-year period with a value of \$20,749
Worst 3 months	-25% An investment of \$10,000 at the beginning of the 6 months ended the 6-month period with a value of \$7,532
Worst 1 year	-30% An investment of \$10,000 at the beginning of the 6 months ended the 6-month period with a value of \$6,010.
Best 3 months	27% An investment of \$10,000 at the beginning of the 3 months ended the 3-month period with a value of \$12,694
Best 1 year	33% An investment of \$10,000 at the beginning of the 3 months ended the 3-month period with a value of \$13,280



Under the CSA proposal, this fund would be classified as medium risk. It has a standard deviation of 11.8%.

An investor with moderate loss tolerance may choose to avoid this fund when presented with the detailed facts above because of the downside data. It is not clear that same investor would make the same decision if they were simply told the fund had a risk classification of medium.

What is lost in the use of the risk classification is the sense of variability in returns, which is ironic considering that this is what the classification system is trying to communicate. However, unless an investor has a background in statistics, it may be best to communicate past variability by allowing the investors to actually see the variability and to judge for themselves.

There is no evidence, of which the Council is aware, that would suggest that an individual investor's risk tolerance profile is likely to correlate with a normal distribution curve. In fact, the asymmetry of risk tolerance, combined with the limitations of statistics to describe fund performance for investment decisions, make strong arguments against using standard deviation as a proxy for communicating actual fund variability to a potential investor.

Graphs, charts, info-graphics and other visual aids, may be far more powerful tools of communication and the Council asks the CSA to consider them as the preferred method of communicating historic variability in fund performance. However, even such a presentation can be insufficient because funds with shorter times since inception may or may not have been affected by significant market events, in which case risk presentations based in any way on historical results may be insufficient to inform an investor.

Supplementary comments

The Council is cognizant of the fact that the industry has long been using normal distribution theory to measure and describe the quantitative aspects of fund performance. In that regard, we anticipate that our objection to the use of standard deviation may well be a minority position.

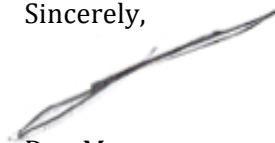
While the Council advocates against a standard deviation-based methodology, it offers these supplementary comments should our advice be disregarded:

- **Verify that your calibration matches typical small investor risk profile.** The calibration of risk will have a profound effect on investor decisions. Has the calibration been tested with actual small investors? Has this been done for investors who have long-term investment horizons [e.g. retirement] as well as shorter-term horizons [e.g. to buy a house, a car, or save for education funding or family wedding]? Before this methodology can be used, it is incumbent upon the CSA to have evidence that there is some basis for concluding that, for example, a standard deviation of +/- 11% is considered “medium risk” by an investor.
- **Consider using +/- two standard deviations.** Product testing for consumers’ protection in all other areas of their life seeks higher levels of confidence than 68%. When one uses one standard deviation as a proxy for risk, then that is the associated level of confidence, statistically speaking. Because of the asymmetry of many investors’ risk appetite, the Council believes the calibration, if it is to be based on classical distribution theory, should be set at a higher level of confidence.
- **Consider “high risk” default measure.** In the example above, one standard deviation below the mean results in a 4% loss; this is because the standard deviation exceeds the mean return. The Council would propose that whenever the standard deviation exceeds the mean return, the fund should be classified as high risk. It proposes this based on the shape of the classical distribution curve and the average investor’s asymmetric risk profile. If in 1 of out every 6 data points, the fund has incurred a loss the Council would argue that the fund’s performance would be “high risk” to many small investors regardless of the absolute measure of standard deviation. And the limited risk scale adopted may not appropriately stratify all investment products on offer in the high-risk category. So a more detailed scale would become necessary.

Therefore, for example, the Council would propose, and ask that the CSA consider, that a fund that has an annualized return of 4% and a standard deviation of 5% would be classified as “high risk” by default, rather than “low to medium risk” as in the proposal. That is because historically, 15.8% of the time [1 in 6], the fund returned a loss.

In closing, the Consumers Council of Canada urges the CSA to consider alternative methods for communicating past variability of fund performance, and would be pleased to engage in further discussions about this.

Sincerely,



Don Mercer
Vice President and Chair, Financial Services Committee
Consumers Council of Canada