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Via E-mail.
March 11, 2014

Response:

CSA Notice 81-324 and Request for Comment
Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts
http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_20131212_81-324_rfc-mutual-fundrisk

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Superintendent of Securities, Nunavut

Dear Sirs/Madam

I laud the CSA's efforts to increase the effectiveness of the **Fund Facts** document and welcome the opportunity to comment on its proposal to standardise the disclosure of risk. My interest in this topic is as a finance faculty who teaches one of the few courses on pensions in Canada and also as any other Canadian faced with the growing challenges to old age security. As an academician I am acutely aware of the complexity of long term financial decisions. My approach to this complexity is straightforward and clear; long term financial decisions should be the ultimate responsibility of experts. What I have found disconcerting in my over two and a half decades of research and teaching in India; UK and now in Canada is the willingness of the financial services industry to profit from the long term financial needs of the ordinary hardworking individuals and at the same time refuse to be recognised as a profession and accept professional responsibility for its advice. This is what made me look at the rather difficult issue of fiduciary responsibility, and even go on to acquire accreditation as a fiduciary analyst in the financial services area. However, I have not used this accreditation for any services for profit. What it has allowed me to do is to introduce the discussion of fiduciary responsibility in at least one course in finance which addresses the agency issues in (retail) investment finance. The hope is that we are laying the foundation of a small group of finance professionals who do not see fiduciary responsibility as a graft on their expertise when they acquire professional certifications but as integral to their decision making. It is with this spirit I am responding to your call for comments. I hope you find it meaningful and constructive as you seek to reform the Fund Facts document.

I have read carefully the CSA proposal and the comments submitted to date. I am mindful of the extensive consultations that the CSA has conducted in arriving at its principal

recommendation, that the standard deviation of returns be standardised and consistently reported to allow (ordinary) investors to compare and assess risk of different mutual funds.

After reading the call for comments document and the responses I feel it will be useful to reiterate the context in which we are discussing the disclosure of risk methodology. This will allow for a constructive and pragmatic conversation on disclosure of risk. The context also provides the basis of my comments and suggestions.

The context:

1. The target audience of the Fund Facts is the typical investor. The evidence and recommendations of the Task Force on Financial Literacy in Canada and longitudinal studies on US Households, are that financial literacy and long term financial decisions are a challenge for the average retail investor[1].
2. Old age financial security is facing a growing deficit .There is a decline in the incidence of defined benefit plans and a growing reluctance to sustain let alone expand the scope of publicly funded income replacements into retirement despite growing incidence of the 'working poor' and longevity. Sovereign states increasingly have to compete for the investments of global businesses.

The consequence of the above evolving context is that the financial services industry and markets are increasingly being entrusted with a social stewardship role towards the realisation of greater retirement security. It has to be acknowledged that the financial services industry has also seen this as a business opportunity to expand into this important social policy concern from its traditional role of facilitating entrepreneurial capitalism, connecting users of funds with suppliers of funds through the development of innovative risk instruments[2].

It is in the above context that one has to assess the CSA's efforts to standardise the disclosure of risk. My comments primarily relate to the first two points of your call for comments document:

A. Should the CSA mandate the proposed methodology in the Fund Facts document and/or

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[1] **Task Force on Financial Literacy**, http://www.financialliteracyincanada.com/. Accessed on March 08, 2014; Lusardi, A. and O.S. Mitchell, How much do people Know About Economics and Finance? Financial literacy and the Importance of Financial Disclosure, **Michigan Retirement Centre, Policy Brief**, March 2008, Number 05

[2] Investment Funds Institute of Canada (2010); Submission to the **Standing Committee on Banking**, Trade and Commerce, Banking Committee Study on TFSAs and RRSPs. Letter dated, April, 30, 2010

B. Adopt the proposed methodology only as guidance for investment fund managers

However, before I get into the specifics on these questions I have a more general point to make – the standard deviation is only a window to the multifaceted risks that ordinary investors face in financial decisions that impact the long term goals, such as old age financial security.

Standard Deviation is Not a Risk Disclosure Methodology

I find this claim of the CSA that they are seeking to standardise the risk disclosure methodology untenable. What the CSA in effect is proposing is the use of the standard deviation as the proxy for risk and it is seeking to 'standardise' the measurement of standard deviation across mutual funds. Risk and more specifically risk associated with long term financial decisions is a complex variable as the findings in finance, behavioural, sociological and now even neurological finance reveal[3]. To collapse it into a statistic, in essence to one of the four moments of a statistical distribution of historical returns assumed to be a normal distribution is oversimplifying a complex phenomenon.

The belief that standard deviation is a proxy for risk assumes mean reversal of returns. Mean reversal of returns is a methodological simplification that allows for econometric studies in finance based on secondary, (historical) price data. Fama and Hansen got the 2013 Nobel Prize for pioneering this work. Well Shiller, also won the same prize and his work points to the inefficiencies of the market and the role of human behaviour and cognition in financial decision making. It will be not unreasonable to assert that the Fama and Hansen studies represented a dated paradigm of atomistic investors setting prices through the invisible hand while the current paradigm is one of large institutions and sovereign funds dominating the market with computational and quantitative hardware, where prices have a domino like interdependency. Furthermore, as pointed out earlier, recent research across disciplines is showing that financial decisions are a complex interplay of, individual cognition, behaviour and sociology.

The CSA makes two assertions in support of the use of standard deviation as a proxy for risk: The popularity in recognition and use of standard deviation; and cost effectiveness in its compilation and reporting. Given what we know from the Task Force on Financial

[3] Trepel, C., Fox, C.R. and Rusell, P.A. (2005), Prospect Theory on the Brain? Towards a cognitive neuroscience of decision under risk, **Cognitive Brain Research**, Vol. 23, pp. 34-50

Literacy and the findings across disciplines about risk perceptions for long term financial decisions, this justification is weak. Long term investments are a cognitive challenge for ordinary investors. If this were not the case, the typical 401(K) plans in the US , the only example of privately funded pension plans which we have large scale evidence on, would not have a balance of under 90,000 US dollars in the best of market conditions at the point of retirement, and would not have its assets churned in times of market panic and recession[4]. The proposal of the CSA that it is recommending the standard deviation on grounds of cost effectiveness and ease of computation is unrealistic. The financial services industry should not get a pass in the discharge of its responsibility towards its clients for this reason. In this day and age where large scale data mining has become the norm of the industry, cost of computation is the least of considerations.

'Standardised' Standard Deviation should be reported in Fund Facts with Allegorical Qualifiers

The standard deviation is an important statistic but not a proxy for risk disclosure. I support the CSA move to report 'Standardised' standard deviation in the Fund Facts document provided the CSA does not claim it to be a methodology for risk disclosure. It is the responsibility of the CSA that its proposal does not become in the minds of the ordinary investor a heuristic tool to simplify the decision problem and another screen used by the financial advice industry to satisfy the 'suitability' standard of care. The CSA must keep the target audience of the Fund Fact document in sight when emphasising a statistic as a proxy for risk. The standard deviation of the dispersion of historical prices is just a window on risk to long term investments and is contingent upon a number of assumptions.

So how would the CSA qualify its reporting of the standard deviation in the reporting of the standard deviation? My suggestion is that instead of using a quasi-statistical qualifier the Fund Facts document should use a non-technical and allegorical qualifier in its reporting of the standard deviation statistic. There is no reason to go into a deep dive on the non-normality of returns. The reporting of such a statistic should be accompanied by illustration from day-today life as it relates to the investment decisions. I am reminded of an example from finance texts used to caution on the use of historical prices in the investment decisions - the driving analogy. In my class on investment management, I draw upon the student experience of their recent driving lessons and driving tests and remind them that while it is good practice to check the rear view mirror ever so often; it is impractical and dangerous to use it as the principal or the only tool for driving decisions. Given what we know from the

[4] Ghilarducci, Teresa, (2008), **When I a'm Sixty-Four**, Princeton University Press.

Task Force on Financial literacy and the longitudinal studies of US households this appears to be the sensible way of informing the decisions of the ordinary investors – the target audience of the Fund Facts document[5].

Guidance for Fund Managers – Use Standard Deviation only if Financial Services accepts Fiduciary Responsibility towards its Clients

The CSA could recommend the use of standard deviation as guidance for fund managers only if the financial services Industry accept its role as a fiduciary to its clients. As described earlier, the standard deviation represents only one window to risk. If the CSA were to recommend the use of standard deviation as a guidance to fund managers it will legitimise the use of a tool that is only one aspect of risk and provide another foil for the fulfillment of the 'suitability standard'. Use of such a statistic to comply by the 'suitability' standard will be another example of regulatory capture by the financial services industry and legitimise advice based on incomplete information and due diligence.

My intent here is not to cast the financial services industry in a role disruptive to old age security for Canadians. If the financial services industry wants to be a responsible social steward of old age security as the IIFC wants to claim, it should raise its standard of care from 'suitability' to being a fiduciary. The multi-disciplinary contributions in risk assessment are beyond the cognitive limits of an ordinary investor. It becomes the responsibility of the industry and the profession to invest in the incorporation of these findings from across disciplines to raise the standard of care and be recognized as a profession. As in medical and legal practice, financial advice industry needs to equip itself and provide fiduciary care and fulfil a very important social requirement- to help Canadians plan for their retirement. Using statistics from archaic mean variance frameworks as a guise for responsible financial advice and a foil for suitability is not socially responsible behaviour. The financial advice and the fund management industry should embrace fiduciary standard of care and meet the challenge of fulfilling the growing need of old age financial security. This will also be in the interest of the industry. No sector of the economy outlives its social and economic

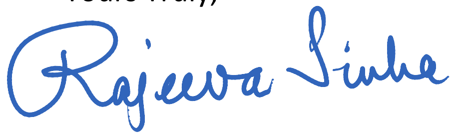
[5]The following allegorical example is quite appropriate to our discussion of risk, "The story of the Blind Men and the Elephant ….has been used to illustrate a range of truths and fallacies; broadly, the parable implies that one's subjective experience can be true, but that such experience is inherently limited by its failure to account for other truths or a totality of truth. At various times the parable has provided insight into the relativism, opaqueness or inexpressible nature of truth, the behavior of experts in fields where there is a deficit or inaccessibility of information, the need for communication, and respect for different perspectives". **Wikipedia, accessed, March 11, 2014**.

relevance. Those who resist change should draw some lessons from the memo by Ferguson and Burghes (2007)[6] in which they write,

"*Perhaps the most fickle and elusive of all business resources is the customer. Customers, too, have largely been neglected and even systematically mistreated by many financial services providers"*. (Make Yourself Attractive – Lesson 3).

I welcome the opportunity to share this document with others in a public posting and I'll be happy to participate in conversations that this document may trigger.

Yours Truly,



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[6] Ferguson, N. and Hughes, W., (2007), The Great Dying, A memo to market dinosaurs and industry leaders, **Oliver Wyman Journal**, pp. 10-18.