via email February 26 , 2014

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

I am pleased to submit my comments on CSA Request for Comment Paper 81-324, Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts (FF). Over 12 million Canadians own mutual funds with total assets approaching $1 trillion. The mutual fund investment represents the core savings vehicle of Canadians for retirement and other life goals.

I applaud the CSA for continuing to improve Fund Facts in response to feedback from stakeholders. Quality risk disclosure is a major value add for FF's. I recognize this is no simple task and there is no magic bullet.

Over the long term ,embedded commission- incented dealer Reps add more risk than stock and bond markets to investor portfolios. The proficiency and Code of ethics for advisors should be increased coupled with diligent and prompt enforcement . A very strong warning about this conflict-of-interest risk is justified and necessary.

Finance academics usually identify risk as the volatility associated with the prices and/or returns of investments. However, I believe this approach is much too complex to be used by a retail investor. Unitholders think of risk as the prospect of an undesirable outcome, such as a financial loss or not meeting a life goal investment objective. They want to know " How much can I lose?". The standard deviation (SD) derived disclosure requires some knowledge of mathematical statistics to be employed effectively for informed decision making. Also, since risk and return are relatives ,they should be reviewed as a pair but this is not possible using Fund Facts

The CSA have guidance in the Companion Policy that they will generally consider a grade level of 6.0 or less on the Flesch-Kincaid grade level scale to demonstrate that the Fund Facts is written in plain language. That is the target audience. Additionally ,Canadian financial literacy and numeracy levels are not supportive of complicated synthetic risk disclosures. Average investors will not understand the standard deviation concept or how to apply it to portfolio construction no matter how well described in plain language. A disclosure which is not understood is no disclosure at all.

Furthermore, the SD methodology is based on the assumption that the underlying statistical distribution is a Gaussian distribution which is controversial. Although I am not a mathematician ,this JP Morgan paper *Non Normality of market returns* http://www.jpmorganinstitutional.com/blobcontent/460/722/1159384839762_NNMR_ES.pdf makes it clear that the standard deviation and the general assumption of normality can cause serious risk rating errors in today's turbulent markets. The paper also says that the time series of returns is not stationary .This research is therefore very relevant to mutual fund risk rating and I ask the CSA to consider it in its deliberations. A disclosure should have a fundamental requirement that it not mislead or have the potential to do harm.

Textual Risk descriptors like "Medium " are dangerous since investors will place widely varying interpretation on the word . Most will not understand that it could mean a drop of 35 %. Why not use a sliding numeric or colour code scale? Better yet, provide the worst 12 months performance in dollars and cents over a 10 year period on a base of $1000. (use a combination of actuals and conditioned index returns if necessary) to address the fundamental question retail investors have about risk. If investors understand the potential magnitude of loss , they may not panic at the time it occurs and sell at a loss. They will act as long term investors and will be more likely to stay the course. A professional advisor should explain this when recommending a purchase.

There should be a CSA Panel to check whether fund risks are being properly calculated/disclosed , whether the disclosure is effective and whether new products like structured securities , real estate funds etc. need different methodologies.

A mis- rated risk rating for a retiree/ RRIF account can wreak havoc on the longevity on the portfolio. Note that a rapidly growing segment of the fund investing population will be the elderly and other vulnerable investors.

Six buckets seems to provide just the right amount of segmentation.

Index selection will need to be carefully monitored by regulators. The method of integrating fee-less index data with post- fee SD's needs to be provided. Ditto for fund mergers. The data needs to be conditioned before it can be combined mathematically. The problem is it rewards closet indexers and punishes better risk- reward portfolio managers.

A listing of the primary fund risks of the fund should be provided in plain English.;the Americans use this approach exclusively in their Summary Prospectus .

The simplified Prospectus and/or CSA website should detail the risk classification methodology used .

Finally, unless FF is provided and discussed BEFORE the sale is completed, its disclosure value is virtually NIL no matter how elaborate the mathematics or clear the language.

Hope this is useful.

This letter may be publicly posted. The faster it is posted the greater chance commenters will have to view other people's perspectives before they file a submission.

Stan Gourley