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The Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8

M^e Anne-Marie Beaudoin
Secrétaire Générale
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3

Sent via Email to comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

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

I am pleased to share my thoughts on this important topic; and I am doing so individually (not on behalf of my employer) since this has no bearing on the business of my employer. For the purposes of background, I am a CFA charterholder and CFP licensee with nearly 20 years of experience as both a client-facing ‘advisor’ (primarily as an Advising Representative of firms registered as Portfolio Manager) and independent analyst.

1. Flesch-Kincaid grade level considers raw statistics but ignores context

Fund Facts documents were designed to read at a grade 6 reading level on the Flesch-Kincaid scale. I would urge the CSA to put less emphasis on this scale and put more emphasis on the context. The Flesch-Kincaid rating is driven by two ratios – the ratio of the total number of words to the number of sentences; and total syllables to total words.

The F-K scale assigns weights to these ratios to first come up with a score from 0 to 100 and then translate this to a U.S. grade level. But this is of little value if the reader knows little about the subject matter. I urge you to keep this in mind as you evolve Fund Facts and as you review and consider the remainder of my comments.

2. The CSA should mandate a standardized risk measurement method

Fund managers can currently choose how to measure and assess a fund's risk. The Investment Funds Institute of Canada has created guidelines to help in this regard. Any method decided upon by the CSA should be mandated in my opinion so that investors can readily compare funds knowing that risk measurement and assessment is standardized.

There remain some striking examples of materially different risk ratings for identical and highly similar funds. The [HSCB Small Cap Growth fund](#)'s risk is rated at *Medium-High*¹. The [BMO Enterprise](#)² fund is also rated as *Medium-High*. Both of these funds are sub-advised by Mawer Investment Management Ltd. of Calgary. And both of these funds are effectively versions of the sub-adviser's own fund, Mawer New Canada. Despite boasting significantly lower fees, [Mawer New Canada](#)³ is rated as *High* risk.

To complicate matters, the HSBC version of the fund was rated as *High* risk when I first reviewed its Fund Facts in July 2011. But when searching for its updated Fund Facts in early 2012 I found that the Small Cap Growth fund's risk rating had fallen to *Medium High*.

I found no rationale for the reduced risk rating. Nor can I imagine a circumstance or event that would prompt a lowering of a fund's risk rating. A possible explanation is that its standard deviation (which fluctuates wildly when measured over rolling 3- or 5- year periods) may have fallen. Or perhaps HSBC changed the basis for its risk assessment. In any event, this example illustrates a weakness of the status quo. A single standardized risk measure, on the other hand, should result in otherwise identical funds having equal risk ratings.

Another interesting case study is the burgeoning group of floating rate income funds. As I wrote in a [September 2013 article](#)⁴, Floating Rate Income funds sport widely diverse risk ratings – ranging from *Low* to *Medium*. Two interesting observations can be made as a result.

First, the *Medium* risk rating for BMO Floating Rate Income fund is the same rating used by most funds investing in large cap common stocks. In relative terms, floating rate debt should probably be lower risk than an all-stock portfolio (though they have different risk exposures).

¹ See http://www.hsbc.ca/1/PA_ES_Content_Mgmt/content/canada4/pdfs/personal/funds/fundfacts-smcap-grth-inv.pdf

² See http://fundfacts.bmo.com/AdvisorEnglish/BMO_Enterprise_Fund-EN-Advisor_Series.pdf

³ See <http://www.mawer.com/assets/Mutual-Funds/Fund-Documents/Fund-Facts/MawerNewCanadaFundJune282013ClassA.pdf>

⁴ See <http://thewealthsteward.com/2013/09/industry-risk-rating-failing-investors-of-floating-rate-note-funds/>

Second, while the BMO fund's risk rating is seemingly based on its full history – which includes the 2007-09 bear market – newer funds that invest with a similar mandate (i.e. high credit risk debt) are assessed a low risk rating because the benchmark volatility over the trailing three years – conveniently excluding the bear market – puts them in a low risk band.

It is nonsensical for virtually identical portfolios to have different risk ratings. Moreover, I do not understand giving fund managers the latitude to conveniently deny that bear markets have occurred and will repeat at some point in the future.

3. Other Risk Indicators are more stable and meaningful

For my entire career, I have given advice to individual investors and – in so doing – have profiled investors from many walks of life; and communicated with hundreds of 'non-client' investors from across Canada. In my experience, individual investors tend to equate risk with how often they could see losses, how much they might lose and how long it will take to recover. Accordingly, I have long illustrated risk to investors in this context.

Specifically, frequency of losses over various rolling time periods, the magnitude of losses when they occur, biggest declines in value, recovery times from these declines are all measures that I have used for most of my career. Anecdotally, these measures clearly communicate risk to individual investors in a way that standard deviation never will.

I understand the appeal of standard deviation. But even people who understand standard deviation – most don't – require both the standard deviation and the arithmetic average⁵ return to translate the statistics into some range of possibilities. Canadian stocks, for example, have posted an average monthly return of 0.8% when examining the last 120 months through January 2014. The standard deviation during this period was about 4% (not annualized).

This information would allow a statistics-savvy investor to estimate that her monthly returns could range from –11% to +13% (using +/- 3 standard deviations). This is more meaningful than a stand-alone standard deviation statistic. But the reality is that most people would not be able to make sense of these statistics or translate labels like *Medium* or *High* risk into real possible outcomes.

⁵ Investment returns are always quoted as a compounded annual average – i.e. a geometric average. But the "average" used for standard deviation is the arithmetic (or simple) average.

But if the goal is to clearly communicate investment risk, a simpler approach would be ideal in my opinion. (That said, I acknowledge that standard deviation is linked to the risk measures that I have used⁶ since it significantly influences investor returns⁷.)

Consider the example of Canadian stock returns. Canadian stocks' trailing 120-month standard deviation is 13.9% per year through January 2014. This would put Canadian stocks in the *Medium-High* risk category – an improvement over the status quo. The tables below, however, illustrate the kind of illustration that I have long used both for funds and for entire portfolios.

CANADIAN STOCKS: RISK/RETURN PROFILE	
Start Date	Feb-56
End Date	Jan-14
Historical Annualized Return	9.18%
Best Year	86.9%
Worst Year	-39.2%
% of Losing Years	27.1%
% of Years < 5%	38.6%
Biggest Drop	-43.3%
Peak to Trough (months)	9
Trough Thru Recovery (months)	24
Standard Deviation	15.34%
Min holding period to avoid loss	7 years
Best 5-year period	27.8%
Worst 5-year period	-1.9%
Average 5-year period	9.6%
% of Losing 5-year periods	2.0%

CANADIAN STOCKS: RISK/RETURN PROFILE	
Start Date	Jan-04
End Date	Jan-14
Historical Annualized Return	7.97%
Best Year	47.6%
Worst Year	-38.2%
% of Losing Years	21.6%
% of Years < 5%	27.9%
Biggest Drop	-43.3%
Peak to Trough (months)	9
Trough Thru Recovery (months)	24
Standard Deviation	13.93%
Min holding period to avoid loss	6 years
Best 5-year period	12.8%
Worst 5-year period	-1.1%
Average 5-year period	4.3%
% of Losing 5-year periods	6.3%

Intuitive statistics like those above paint a risk-return picture that is more accurate and easier for investors to grasp. I would guess that most investors equate losing 40% or more in bear markets and staying under water for nearly 3 years with *High* risk investments. More importantly, the label will be interpreted differently by different people. The numbers communicate risk more objectively and in a way that can truly be grasped by the investor.

I'm not suggesting that Fund Facts should contain all of these statistics but the tables offer practical measures that can enhance investors' understanding of risk. My comments under section #7 starting on page 6 also make a strong argument for such risk measures.

⁶ For instance, investments with high standard deviations tend to be at risk of experiencing the most severe short-term losses and longer recovery times.

⁷ Through my work on quantifying investor returns, I've found that investors experience higher returns in investments displaying lower standard deviations. See my blog post on the topic for more detail on this phenomenon <http://thewealthsteward.com/2010/10/volatility-measures-behavioural-risk/>

4. Alternatives and other specialty funds require special treatment

The CSA should consider placing a risk rating of *High* or *Very High* on any fund that invests primarily in private placements, makes extensive use of derivatives or employs leverage. These funds are largely – but not perfectly – captured by the [Alternative Strategies](#), [Passive Inverse/Leveraged](#), [Retail Venture Capital](#) and [Undisclosed Holdings](#) fund categories as defined and categorized by the Canadian Investment Funds Standards Committee or CIFSC (of which I am a member)⁸.

Private placement funds are valued internally and infrequently so volatility is often near zero while real risk is significant. Similarly, hedge funds often have strung together many low-volatility years only to make one wrong bet – handing investors significant losses. In these cases, no risk measure that is based purely on historical returns will adequately capture risk.

5. I agree with calculating risk using monthly return data

For quantitative risk measures, using monthly returns is sufficient in my view. If standard deviation remains the risk measure of choice, using a return calculation frequency other than monthly will require an adjustment of the risk bands. In other words, the standard deviation calculated from daily returns will result in a higher annualized figure than that calculated from monthly returns. Monthly data is seemingly widely available and has long been the standard for calculating a variety of risk and return measures.

6. I support the use of longer-term data to calculate risk

I fully support the use of longer-term performance data to calculate standard deviation – should this remain the risk measure of choice. I would suggest, however, that this be modified to “ten years or as far back as required to include at least one bear market for the fund or its relevant benchmark”. Otherwise, the chosen measure risks missing the very kind of market environment about which you are hoping to inform investors before they invest.

⁸ See www.cifsc.org for details of category definitions and constituent funds.

7. I support calculating risk separately for different series of units

There is a good argument for calculating and reporting risk separately for each series of a fund's units. However, the CSA's chosen method of quantifying risk will easily lead to the right answer on this issue.

If standard deviation is the preferred measure of risk, there is no need to calculate risk separately for fund's various series of units. Standard deviation measures return distribution around a simple average. Different fee levels simply 'shift' to the left (if you can picture a normal distribution curve) both the average return and each of the individual monthly returns used to calculate the standard deviation. Fees have zero impact on this definition of risk⁹.

This is one of the reasons why I disagree with using standard deviation as the primary or sole risk measure. While calculating risk separately for each series of units is not atop my regulatory wish list, consider two quantitative illustrations of the impact of fees on risk which isn't measured by standard deviation alone.

In [a 2010 blog post](#)¹⁰ I showed a bond's yield to maturity (i.e. its return potential) and duration (i.e. its exposure to interest rate risk). I then re-calculate both statistics net of hypothetical fees on a cash flow basis. The result: As fees rise, yield to maturity falls and duration rises net of fees. In other words, standard deviation does not change but risk increases.

On the next page I reproduce the risk-return table on Canadian Stocks, with an additional row for Management Expense Ratio (MER). I then added three columns showing the same calculated risk and return statistics for Canadian Stocks at different MER levels.

Notice again that standard deviation is identical at all MER levels. All of the downside risk statistics are impacted as fees rise. While some statistics are only moderately impacted by fees, some results are striking. Even with a modest MER, the amount of time an investor is under water – i.e. the number of months from peak to trough and through recovery to the prior peak – is lengthened considerably. Also, the minimum holding period required to have historically avoided losing money rises from seven to ten years by the time fees approach 1.5% annually.

Both of these examples show significant increases in risk caused by fees that are not captured by using standard deviation as a stand-alone measure.

⁹ Even in this case, it could make sense to calculate separate risk stats for U.S. dollar denominated series units.

¹⁰ See <http://thewealthsteward.com/2010/08/fees-impact-bond-risk-return/>. Note that the illustration contained therein is a crude simplification of a complex computation but it is directionally accurate.

Canadian Stocks: Risk/Return Profiles at various fee levels

Start Date	Feb-56	Feb-56	Feb-56	Feb-56
End Date	Jan-14	Jan-14	Jan-14	Jan-14
Management Expense Ratio	0.00%	1.50%	2.00%	2.50%
Historical Annualized Return	9.18%	7.56%	7.03%	6.50%
Best Year	86.9%	84.3%	83.4%	82.5%
Worst Year	-39.2%	-40.1%	-40.4%	-40.7%
% of Losing Years	27.1%	30.5%	31.5%	32.4%
% of Years < 5%	38.6%	41.0%	42.4%	43.6%
Biggest Drop	-43.3%	-45.0%	-45.6%	-46.2%
Peak to Trough (months)	9	25	25	25
Trough Thru Recovery (months)	24	39	40	40
Standard Deviation	15.34%	15.34%	15.34%	15.34%
Min holding period to avoid loss	7 years	10 years	10 years	10 years
Best 5-year period	27.8%	25.9%	25.3%	24.7%
Worst 5-year period	-1.9%	-3.4%	-3.9%	-4.3%
Average 5-year period	9.6%	8.0%	7.4%	6.9%
% of Losing 5-year periods	2.0%	6.0%	8.5%	9.4%

Note: For a given annualized return, R , returns net of MER = $(1+R) / (1+MER) - 1$ *not* $R - MER$. For example for a 10% return and a 2% MER the net return is 7.84% not 8% due to daily accrual and monthly payment of fund MERs and the resulting compounding effect.

8. Older series' returns should be used to calculate risk of younger versions

Each of a fund's series of units is not necessarily launched all at the same time, resulting in virtually the same fund potentially being assessed different risk ratings. For example, [IA Clarington Strategic Income Y](#) was launched in December 1996¹¹. But [this fund's series T8 units](#) were just launched in August 2011. In cases like this, it doesn't make sense to 'back fill' pre-August 2011 returns on series T8 with benchmark performance. Rather the returns of the older series Y should be used to calculate the risk of the T8 series (and all versions) of the same fund¹².

Using the older fund's returns should also be used where an older fund's units are being merged into a newer series of the same fund. It's not a common situation but one that should be considered.

¹¹ This fund was originally the Clarington Canadian Income Fund.

¹² In this particular case, both versions of the IA Clarington fund have the same assessed risk level.

9. I agree with your index selection criteria but some flexibility may be needed

I agree with your list of index selection criteria and associated prospectus disclosure pertaining to the chosen benchmark. There are no perfect solutions to choosing a benchmark. Some mandates are simply so flexible and so unique that none of the widely available benchmarks nicely capture the fund's exposure or strategy. Examples in this context include Chou Associates and Mackenzie Cundill Recovery funds, among many others.

Using the Mackenzie Cundill as an example; it has no constraints or formal policies. Technically it is a global equity fund with no geographic, sector or size constraints. Based solely on this information, the MSCI All Country World Index might seem like a reasonable benchmark. Its classification as a global small-mid cap equity fund by the CIFSC might imply that a global small cap index would be more appropriate.

But considering this fund's tendency to invest in emerging markets stocks and in companies that tend to be smaller, a better (albeit imperfect) benchmark might look more like 65% MSCI World Small Cap + 35% MSCI Emerging Markets Index. Where a fund's prospectus or internal investment policies contain well defined constraints, this should drive the choice of benchmark based on your criteria. In the absence of any formal policies or constraints, fund managers require some flexibility to exercise judgement in their benchmark selection.

On the notion of the availability of benchmark historical data, ideally this should not include back-tested or back-filled benchmark returns.

10. With standard deviation as your risk measure, proposed risk bands are good

The proposed risk bands and break points – when combined with the longer term calculations – are reasonable and a significant improvement over IFIC's proposed risk bands. I still struggle with the labels – i.e. low, medium, high, etc. – because some investors will interpret these differently than others. And they don't adequately capture risk.

11. I agree with the proposed monitoring process if using standard deviation

Given that you're proposing to use standard deviation as your chosen risk measure, I agree with your proposed monitoring process. But as noted, I do not agree with standard deviation as the chosen risk measure. And if something more practical is used, monthly monitoring won't be required, making it easier for fund managers to comply.

12. This proposal should apply to other fund structures aimed at retail investors

Given that exchange traded funds (ETFs) are competing side-by-side with retail mutual funds both for do-it-yourself investors and advice seekers; and given that ETFs are generally structured as mutual fund trusts I don't see why this proposal wouldn't apply to both ETFs and mutual funds. For ETF return data, I favour using market price data rather than net asset value since it is more reflective of the returns investors are likely to realize.

Thank you again for the opportunity to share my thoughts. I would welcome the opportunity to further discuss this issue with you as you move toward a final decision.

Sincerely,

Dan Hallett, CFA, CFP
Windsor Ontario
dan@danhallett.com
519-980-0091