

Objet : Comments on CSA Notice 81-324 - Proposed Mutual Fund Risk Classification Methodology for Use in Fund Facts

Good morning,

Here are some comments I had regarding the proposed risk classifications for fund fact sheets. For background, I have 16 years of investment industry experience and am a CFA charterholder. I had also worked for OSFI for a couple years so I can appreciate the work you are trying to do in establishing industry-wide recommendations and/or requirements.

Methodology for the calculation of a fund's Volatility Risk

Standard deviation is fine but in evaluating funds, looking at risk alone can be misleading and lead to sub-optimal decisions for the investor. Risk should always be evaluated in the context of returns in order to properly assess the investment manager's use of risk. With this in mind, I would like to see some sort of risk/return metric disclosure as a supplement to any type of risk disclosure. For instance, here is the risk level of this fund, here is how effectively the manager is utilizing risk to better the returns of the fund. While concepts like up-capture and down-capture are easy for an unsophisticated investor to understand, I think the industry should provide the most useful tools possible to the investor and let them educate themselves on how to use these tools should they wish. Metrics such as Sharpe ratios and Information ratios would provide additional clarity to how effectively investment managers use risk and how consistent their returns are (standard deviation can capture this as well, but I think more information paints a clearer picture).

Monthly total returns

Given the length of the track record required, I think that either monthly or quarterly returns are fine.

10 year history

This seems high. I believe that if we are using monthly returns, five years is sufficient. If you use ten years, you will have too many funds using benchmark data and it will normalize the risk and not paint a true picture of the fund's individual risk level.

Use of reference index data

Regardless of the fund's correlation with its benchmark, the benchmark of the fund will always be the most appropriate substitute for lack of track record. This is why five years of returns are more appropriate than ten.

Six category scale and risk bands

I personally think it's a little silly to have a distinction between high and very high. You are not going to find a risk profile of an investor who is comfortable with high but not with very high. A standard deviation of 21, for instance, represents Canada's Small Cap sector. This sector, between 2008 and 2011 had returns of -47%, +75%, +39%, -14%, respectively. That is only 21 standard deviation and, according to CSA's proposed guidelines Canadian Small Cap would not exhibit "very high" risk but only "high". I think IFIC has it right that this type of risk should be classified as "high" which is the top rating and would find itself at the top of a horizontal scale.

I think a better choice would be to have a 20-point scale from low to high. Investment managers must plot their risk on this 20 point scale and not offer a 'range' of risk but rather a specific point.

I propose the following reference key:

Standard Deviation Range	Default Risk Index
< 2.0	1
2.1-3.3	2
3.4-4.7	3
4.8-6.0	4
6.1-7.4	5
7.5-8.7	6
8.8-10.1	7
10.2-11.4	8
11.5-12.8	9
12.9-13.8	10
13.9-14.4	11
14.5-15.1	12
15.2-15.8	13
15.9-16.4	14
16.5-17.1	15
17.2-17.7	16
17.8-18.4	17
18.5-19.1	18
19.2-20.0	19
> 20	20

The midpoint of the scale should be about 13.5 standard deviation which is what IFIC currently considers 'medium' risk. The one adjustment we could potentially make is what should the top of the risk scale contain. I propose right now anything about 20 standard deviation should be high (as does IFIC). Given the earlier example of Canadian Small Cap's return dispersion at 21 standard deviation, I think that would and should belong at the top of the scale at, "high."

3. Transition issues

The most impactful transition issue would be how many portfolios and plans are setup with a certain amount of risk to match the risk tolerance of the investor. If the risk ratings change in a material way, this will trigger numerous communications to clients advising them that their portfolio is now suddenly out of synch with their risk profile and requires immediate attention. This change will have to be managed carefully to not panic investors.

Records of standard deviation calculation

Seven years seems to be the industry standard and is more than sufficient. Changing it to ten will require changes to company's compliance policies, record-keeping policies and many automated processes. The additional cost of all of this does not justify the incremental additional benefit.

I hope that these comments are helpful. You may call or write me should you wish to discuss any of them.

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