

Via email

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**CSA Notice 81-324 and Request for Comment**  
**Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Factstempltte**  
[http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa\\_20131212\\_81-324\\_rfc-mutual-fund-risk.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_20131212_81-324_rfc-mutual-fund-risk.pdf)

Dear Sirs;

We are pleased to submit our comments on CSA Consultation Paper 81-324, Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts. Many of the disclosure issues arise because the Canadian advice industry does not operate under a Best interest regime. If it did, the necessity to develop elaborate and costly disclosure regimes would be diminished.

The Small Investor Protection Association (SIPA) was founded in 1998 and is registered in Ontario as a national non-profit organization. At the time there were no organizations interested solely in the welfare of investors.

Since its founding SIPA has interviewed hundreds of small investors. Most of these investors have brutally frank comments about mutual fund risk disclosure from their dealer Representatives.

To truly evaluate the CSA proposal SIPA would want to check out the implicit assumptions of the proposals e.g. are returns for funds Gaussian distributed? Are the series stable over time? Etc..SIPA does not have the resources or database

available for such research , however we are pleased to offer our brief comments on this important issue based upon 15 years of interviewing investors who have suffered loss (in some cases, extreme loss) due to the failures of the industry and regulators to afford adequate investor protection.

The mutual fund is the investment of choice for Canadians. Over 12 million Canadians own them with a total assets exceeding \$900 billion and pay over \$4.6 billion in trailer commissions. This makes robust risk disclosure a critical investor protection initiative.

It would seem natural that an industry that deals with Canadians' life savings, and has the power to cause investors to lose all of their savings, should have a responsibility to come clean on risks at a time that is meaningful. We strongly recommend that FF be delivered **before the sale**. This is consistent with the NASAA Investor Bill of Rights <http://www.nasaa.org/2715/investor-bill-of-rights/> :Investors have a right to Receive complete information about risks, commissions, sales charges, maintenance or service charges, transaction or redemption fees, and penalties. Of course, with Fund Facts being delivered after the sale, in effect there is no real disclosure of fund risk levels no matter what risk rating methodology is chosen. Until actually delivery takes place , we recommend a cooling off period of 10 days be mandated.

SIPA commend the OSC/CSA for its leadership in developing an industry-independent fund risk rating methodology. This no doubt required considerable effort and resources. It will help reduce some of the strange and inconsistent ratings we have seen. A great many improvements have been made and Fund Facts is nearing the point where better risk disclosure would make it a truly fine document given the 2 page constraint.

That being said, SIPA wishes to make some recommendations for changes. We agree with the objectives for establishing the Proposed Methodology as outlined in the Paper.

- uniform and applicable to all funds;
- easy to understand;
- meaningful and comparable across funds;
- difficult to manipulate and minimize subjectivity;
- relatively simple and cost effective to implement;
- enable easy and effective regulatory supervision; and

We do not agree that the methodology be a stable indicator of risk over time because retail investors are interested in downside risk at a point in time. As an aside, we repeat again our recommendation that the CSA prepare a brief plain

language Guide on how to effectively use Fund Facts and tie the pieces of information together. It could also include a few words alerting the investor to consider a fund's objectives and strategies ( key risk-related information elements not in FF but in the SEC Summary prospectus )– we believe such a Guide would have a huge payoff in protecting investors and optimizing the benefits of FF's.

The Small investor Protection Association has repeatedly opposed the use of the standard deviation as an Indicator of risk disclosure in Fund Facts. We feel this is misleading to retail investors as it is not easily understood. Will retail investors understand that a high Standard Deviation (volatility,) does not necessarily mean that such a fund is worse than one with a low Standard Deviation.? If the first fund is a much higher performer than the second one, the deviation will not matter much. Additionally, the metric is based solely on mathematical principles and as such omits many types of risk not included in the measure of standard deviation. This is why we recommend that the principal risks of the fund be delineated in plain language to augment the dispersion data.

The mean and the standard deviation of a set of data are descriptive statistics usually reported together. In a certain sense, the standard deviation is a "natural" measure of statistical dispersion if the center of the data is measured about the mean. This is because the standard deviation from the mean is smaller than from any other point. This is what the CSA is proposing. However, since the 10-year SD is utilized in setting the rating, should not the 10 year mean be revealed in FF (even if fund life < 10 years)? It is the relationship between the two that would be of interest to the investor. If the mean is low but SD is "Medium", a risk averse investor might be put in a disadvantaged position if only the fund rating tied to an SD band is disclosed. This might mean that in many cases the return figure in FF would have to be augmented by fee-adjusted index returns in funds with lives < 10 years so a comparison could be made.

We cannot comment on the choice of a 120 month calculation period. We have no background data as to how the CSA arrived at this number. We can however say that time series data have a natural temporal ordering. This makes time series analysis distinct from other common data analysis problems, in which there is no natural ordering of the observations (e.g. explaining people's wages by reference to their respective education levels, where the individuals' data could be entered in any order). A stochastic model for a time series will generally reflect the fact that observations close together in time will be more closely related than observations further apart. In addition, time series models will often make use of the natural one-way ordering of time so that values for a given period will be expressed as deriving in some way from past values, rather than from future values.

Unfortunately, financial time series are known to be non-stationary series, whereas statistical calculations, such as standard deviation, apply only to stationary series. Whatever apparent "predictive powers" or "forecasting ability" may well be illusory. To apply such statistical tools to non-stationary series, the series first must be transformed to a stationary series, enabling use of statistical tools that now have a valid basis from which to make investment decisions.

Of course, even if we accept Standard deviation as a fund risk measure it is only appropriate for measuring the risk a fund that is an investor's only holding. The figure cannot be combined for more than one fund because the standard deviation for a portfolio of multiple funds is a function of not only the individual standard deviations, but also of the degree of correlation among the funds' returns. This is why we have expressed concerns that because certain firms and even regulators sometimes evaluate compliance on a per fund risk rating, the choice of word descriptors describing the rating is unjustifiably tied to the investor's KYC/ Suitability profile which uses similar words. If the NAAF/KYC says Medium risk and the Fund risk rating in FF is Medium, all is supposedly well. Conversely, a portfolio containing a Medium to High rated fund might come under undue scrutiny. Wisely, OBSI has not taken this approach in complaint investigations but this had led to unnecessary acrimony between dealers and OBSI.

### In **Finding opportunities through the low volatility anomaly**

<http://www.bmo.com/gam/pdf/BMOGAM-Low-VolatilityPaper.pdf> some interesting results are presented. Low-volatility stocks - those with less price variability than the average stock in the market - deliver higher returns than other stocks. This is an empirical fact, at least insofar as the last 90 years or so are concerned. And it is one of the most surprising market anomalies (a result not predicted by theory) ever found. It's surprising because, as almost everyone believes, return is supposed to be related to risk so that higher-risk stocks should deliver higher returns and lower-risk stocks should deliver lower returns. The low-volatility anomaly stands this sensible theory on its head; as a result this anomaly has given rise to a number of so-called Low Volatility mutfunds.

While FF suggests that higher volatility means higher risk , there is the Low Volatility Paradox to deal with. As described in the referenced Pimco paper there is a low volatility anomaly-it is very real. Consider this chart from the paper:



Composed of risk and return data for individual stocks segmented into risk deciles within the reference index  
Source: Factset 12/31/2001 – 12/31/2010

If a global mutual fund with a 3 year history augments its SD calculation with MSCI World index data, chances are it would be rated as Medium to High or High risk under the CSA proposal. But if the portfolio manager weighted the fund's portfolio with low volatility stocks, the actual returns might well be superior and with lower volatility. Thus, the proposed CSA rating system might deter a purchase by indicating a higher risk rating even though the fund's actual portfolio is less volatile than the index due to smart portfolio construction by the manager. Punishing astute managers doesn't feel right.

We do not see a risk indicator being stable as a good parametric and certainly not one that fails to reveal the principal risks. Risk changes due to differing portfolio strategies, fee changes, style drift, prevailing interest rates, the global economics environment and of course securities valuations. E-commerce fund risks in 2000 were downplayed even as valuations changed from return on equity to web hits per day. Some of the marketing materials of that era were designed to mask risk and quite frankly, effectively drew investor attention away from the Prospectus. It is why we believe the CSA should review current rules, processes and compliance regarding risk tolerance/loss capacity assessment. Today, we see the same situation with Bond funds sitting on the precipice of historically low interest rates. A stable risk indicator can mislead more than illuminate.

Several research papers indicate that volatility and risk as regards actively-managed mutual funds may not be as correlated as a previously thought. For

example, in **Risk Shifting and Mutual Fund Performance** by Jennifer C. Huang, Clemens Sialm, Hanjiang Zhang the researchers found that mutual funds change their risk levels significantly over time. They posit that risk shifting might be caused by ill-motivated trades of unskilled or agency-prone fund managers who trade to increase their personal compensation. Alternatively, the authors suggest that risk shifting might occur when skilled fund managers trade to take advantage of their stock selection and timing abilities. This paper investigates the performance consequences of risk shifting and sheds light on the mechanisms and the economic motivations behind the risk shifting behavior. Using a holdings-based measure of risk shifting, they found that funds that increase risk perform worse than funds that keep stable risk levels over time, suggesting that risk shifting is either an indication of inferior ability or is motivated by agency issues.

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1108734](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108734)

This raises questions about the SD risk rating methodology if data for Canada is similar. There is thus a real question to be asked whether volatility is a reasonable way to disclose fund risk to a retail investor. We suggest that if the standard deviation is used, it should be presented as no more than a dispersion of results over the 10- year time period (likely much less given the short longevity of most active funds).

If the principal risks are also provided, we feel that this disclosure of “return variability” plus other existing aspects of risk disclosure in FF including the ten-year bar chart provides a reasonably good indication of investment risk. Certainly enough to cause the investor to ask questions and do additional research. We recognize there is no one single risk measure and it is potentially harmful to suggest there is.

We believe the consultation paper should have provided details of exactly how costless index returns are to be adjusted in order to link to actual after-fee fund returns to obtain 120 data points where actual data is less than ten years. For us, it is clear that an adjustment is required. Furthermore, SIPA members tell us that the majority of their mutual funds do not survive more than about 5 years. They are either liquidated , change their objectives/name and /or are merged into other funds. The CSA rule methodology should provide specific guidance , especially for fund mergers, as to how the merged fund is to be risk rated.

Given the structured nature of Target Date Funds, Balanced Funds and T class Funds, it seems to us that a different approach to articulating risk is required for these types of funds. One of the biggest risks to a Target date fund is premature movement to a Safe mode ( a “Triggering Event”) which happened in 2008- such a major risk is not captured by standard deviation. Balanced funds are a challenge because of the constant changing of asset mix. T Class funds return capital each

month making a meaningful index elusive. Further, such funds run the risk of disintegration if payouts are too steep.

According to the OSC IAP and IEF Report " Strengthening Investor Protection in Ontario-Speaking to Ontarions"

[http://www.osc.gov.on.ca/documents/en/Investors/iap\\_20130318\\_strengthening-investor-protection.pdf](http://www.osc.gov.on.ca/documents/en/Investors/iap_20130318_strengthening-investor-protection.pdf) significant investor vulnerability prevails – an investor-adviser power imbalance exists for most, but is particularly **problematic for those who lack confidence in their financial literacy**: Ontarian investors lack confidence about their financial literacy – only 11% describe themselves as 'very confident'. This places advisors in a powerful position. A majority of investors (58%) rely on their financial advisor as their main source of investment information. Fees for advice represent nearly 50 % of the cost of an actively-managed mutual fund -these are paid directly to the dealer . Thus, a conflict-of-interest could easily lead to investors paying higher fees than if no conflict-of-interest existed. "Advisor risk" is not captured by the proposed fund risk rating system. This is why we advocate a statutory fiduciary duty for those dispensing investment or financial advice as well as appropriate proficiency standards. An immediate consequence of this situation is the need for stronger disclosure re conflicts-of-interest. The language in the SEC mandated Summary Prospectus is stronger than in FF.

While actively-managed mutual fund fees have fallen slightly over time , the Investor Economics report on Fund Costs of Ownership *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives*, provides some interesting insights. One indicator is the explosive growth of mutual fund wraps. Fund wraps have captured nearly 80 cents of each dollar flowing into the mutual funds industry between 2007 and 2011. The increased importance of fund wraps which carry a MER premium relative to stand-alone funds (reflecting a higher equity weighting ,a supposedly expanded value proposition and definitely higher risks related to higher fees) counteracted the decline in industry asset-weighted MERs. In effect, tasks such as fund selection, portfolio design and rebalancing formerly done by the dealer Rep were delegated to the wrap manager at a higher price. Wraps generally contain house/proprietary funds and so make no attempt to provide best-in-class economical funds. We therefore see no incremental benefit of wraps for the small investor and in fact question whether they are compliant with KYC /suitability rules in many cases. The benefit to the sales Rep of course is less discussion on fund risks and more free time to explore fee generating opportunities. We recommend that the CSA investigate and find out exactly what is occurring with mutual fund Wraps as it relates to risk disclosure.

The referenced Investor Economics research paper refers to an average hold period of 4.5 years. Since mutual funds are long-term (> 10 years) investments we find

this strange. From our limited database we conclude that the reason for this is partly due to DSC fund churning whereby Reps can collect a 5% fee up front by buying a new DSC sold fund. In most cases the victims are seniors. Besides costing investors an early redemption fee, such trades could trigger capital gains tax obligations. There may be other reasons as well such as trading within wraps (which also trigger capital gains obligations) but we feel the CSA should research this anomaly to better understand the underlying mechanics of the short average hold period and its impact on the approach taken by the CSA for fund risk disclosure based on 10 year data and pre-tax returns assuming 100 % reinvestment of distributions.

We would like to raise another topic indirectly related to risk disclosure. Investors pay higher fees for actively-managed mutual funds in the hope of their fund portfolio outperforming passive benchmarks. It therefore follows that regulators should as a corollary require that investment dealers provide investors with account statements that reveal asset allocation and personalized performance results vs. benchmarks. Such reporting will assist investors in their decision making, situation analysis, risk-reward comparison, and assessment of advisor value-add.

The well known inadequacy of NAAF/KYCs regime to define an investor's needs /risk tolerance can lead to retail investors losing all or a significant portion of their life savings. It is therefore critical that the CSA compel fund firms to articulate precisely what services are included in trailer commissions (until they are prohibited). Our recommendation is to prohibit embedded trailer commissions altogether and let investors contract for professional advice separately. Unbiased advice on Mutual fund risk should be a critical regulatory investor protection initiative.

*This report was prepared by the SIPA Advisory Committee. Ken Kivenko, Chairperson of the Committee is a well known commentator on mutual funds. Mr. Kivenko is also currently a member of the OSC Investor Advisory Panel and provides valuable input on investor issues. SIPA relies upon Mr. Kivenko's Advisory Committee particularly for their knowledge on mutual funds which most Canadians hold in their savings accounts.*

Permission is granted for public posting.

If any questions do not hesitate to contact Mr. Kivenko or myself.

Yours truly,

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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

## **REFERENCES**

The references and research listed below were used in developing our recommendations:

### **1. Do investors care about risk?: Evidence from mutual fund flows**

[http://www.ou.edu/content/dam/price/Finance/Oklahoma\\_conference/2011/Chris%20Clifford%20-%20Do%20Investors%20Care%20about%20Risk.pdf](http://www.ou.edu/content/dam/price/Finance/Oklahoma_conference/2011/Chris%20Clifford%20-%20Do%20Investors%20Care%20about%20Risk.pdf) Using an extensive database compiled from SEC N-SAR filings, the researchers studied monthly flows to equity funds over the period 1996 to 2009. Unlike most previous studies, they separately examined inflows, outflows, and net flows. They found clear evidence that investor inflows and outflows strongly chase past raw performance without regard to risk. In fact, the best performing funds are typically among the riskiest funds, so return chasing leads to apparent risk-seeking behavior for inflows. This behavior is particularly strong for retail investors the study found, but return chasing is also prevalent for institutional investors.

### **2. UNCERTAINTY AND CONSUMER BEHAVIOR**

[http://www.moneyschool.info/board\\_download.asp?boardid=2&boardnumber=65](http://www.moneyschool.info/board_download.asp?boardid=2&boardnumber=65)

### **3. Mutual Funds 205: Gauging risk and return together--Part 2 | Morningstar Canada | Investor Insight |**

<http://cawidgets.morningstar.ca/ArticleTemplate/ArticleGL.aspx?id=277502> The Morningstar Rating is a measure of a fund's risk-adjusted return, relative to similar funds. Funds are rated from one to five stars, with the best performers receiving five stars and the worst performers receiving a single star.

#### **4. Numerical descriptive measures**

<http://www.prenhall.com/divisions/bp/app/chapters/berenson10.OLDarchived08312007/chap03.pdf>

#### **5. Standard Deviation and Risk**

<http://www.gummy-stuff.org/SD-stuff.htm>

#### **6. Quantifying Investment Risk: The Sharpe Ratio**

<http://fc.standardandpoors.com/sites/client/generic/axa/axa2/Article.vm?topic=5981&siteContent=8042>

#### **7. Mean & Standard Deviation: Analyzing Investment Returns**

<http://www.investing-in-mutual-funds.com/standard-deviation.html>

#### **8. Morningstar rating of mutual funds**

[http://corporate.morningstar.com/CA/documents/MethodologyDocuments/FactSheets/MorningstarRatingForFunds\\_FactSheet.pdf](http://corporate.morningstar.com/CA/documents/MethodologyDocuments/FactSheets/MorningstarRatingForFunds_FactSheet.pdf)

#### **9. MER may be a good indicator of risk in actively-managed mutual funds**

Highly rated blog canadianfinancialdiy proposes MER fee bands as a good indicator of fund risk. This is no doubt because fund fees and expenses are the most reliable predictor of performance and by extension the risk of underperformance.

[Mutual Fund Risk Classification Methodology - a modest proposal](#)

Blogger Jean Lesperance points out that "Regulators are [looking for a methodology](#) to stick a label on mutual funds that tells ordinary Joe investors how much risk they are taking on if they buy into the fund. The regulators want something that is easy to understand, easy to calculate and implement, stable through time, easy to monitor and uniformly applicable to all types of funds. The proposal is to use monthly volatility over the last ten years, expressed annualized, either of the fund itself if it has enough history, or its benchmark index to make a five level Low to High risk scale but is surprised that - the ability of the risk measure to predict the chance and the size of potential loss is curiously missing. **Unlike temporary market volatility, MER money is gone, permanently lost to the investor, it's withdrawn every year. Interesting thought."**

#### **10. TD Low Volatility Funds Rethinking Risk & Reward**

[https://www.cifps.ca/Public/Media/PDF/Conference2013\\_SpeakerPresentations/Babak\\_Rafat\\_Re-thinking\\_Risk\\_&\\_Reward.pdf](https://www.cifps.ca/Public/Media/PDF/Conference2013_SpeakerPresentations/Babak_Rafat_Re-thinking_Risk_&_Reward.pdf)

#### **11. Stock Volatility: Not What You Might Think - PIMCO | Viewpoints**

<http://www.pimco.com/EN/Insights/Pages/Stock-Volatility-Not-What-You-Might-Think.aspx> Investment ideas that capture the mind with promises of huge payoffs are naturally attractive. Also, stock volatility tends to have a high correlation with

growth, which has mass appeal. Lower growth stocks that are not likely to deliver the same potential upside as the more exciting names often get neglected. And herein lies one potential reason for the historical long-term outperformance of low volatility stocks: Higher volatility stocks tend to get bid up by speculators while lower volatility stocks tend to get ignored. This can create a structural anomaly where, eventually, higher volatility stocks may disappoint and be sold while lower volatility stocks may continue to tick along. Lower volatility stocks can still fall short of expectations, but the magnitude of disappointment tends to be less precisely because of the lower volatility.

## **12. Redefining Risk/ Return : Invesco**

[https://www.invesco.ca/commonAssets/resources/pdf/en/PowerSharesETFs/low\\_vol\\_invest\\_ISRTATE\\_0813.pdf](https://www.invesco.ca/commonAssets/resources/pdf/en/PowerSharesETFs/low_vol_invest_ISRTATE_0813.pdf)

## **13. Risk and reward closely related? Active Investing by Money Managers Loses in Risk Study | MarketRiders.com**

<http://www.marketridders.com/investing/active-management-loses-in-risk-study/>

"As Mamundi of the WSJ states, "While it has been established that most actively-managed mutual funds lag behind their indexes over time, [this Morningstar] study further twists the knife: Active management suffers even more by comparison on a risk-adjusted basis. The study found that in many cases where an actively managed fund beats its index on an absolute basis, the additional risk it took didn't justify the returns earned. Not only should that be a warning sign for investors — because greater risk means greater volatility — but it also suggests that fund managers aren't living up to what is expected of them." As Mamundi points out, it is typically thought that a riskier fund should reward investors with higher returns, but contrary to this popular thinking, over the past three years higher risk has equaled lower returns. Travis Pascavis, director of equity indexes at Morningstar, further explains that, "The key to thinking of risk in terms of returns versus an index is that, in theory, if investors wanted to take on more risk for greater returns, they could simply buy an index fund and lever up their exposure. That would also increase returns while adding risk - and do so at a cheaper cost than most actively-managed funds. It is against this standard that actively-managed funds should be judged."...". Report "Morningstar Box Score Report: Alpha seekers, Caveat Emptor" <http://corporate.morningstar.com/us/documents/Indexex/MorningstarBoxScoreReport.pdf>

## **14. Mutual Fund Cost of Ownership Investor Economics**

<https://www.ific.ca/wp-content/uploads/2013/08/Canadian-Study-Mutual-Fund-MERs-and-Cost-to-Customer-in-Canada-September-2012.pdf/1655/> " In the case of mutual fund holders who pay either a one-time sales commission at the time of purchase of front-end load mutual fund units or a one-time deferred sales charge

on the redemption of back-end load mutual fund units, we have conservatively assumed an average holding period of 4.5 years..." and " Reflecting the growing importance of pre-assembled solutions, fund wraps have captured nearly 80 cents of each dollar flowing into the mutual funds industry between 2007 and 2011. Figure 30 monitors the growing importance of fund wraps to the fund industry's book of business..."

### **15. The Pension Fund Advantage: Are Canadians Overpaying Their Mutual Funds? By**

[Rob Bauer](#) Maastricht University and [Luc Kicken](#) ,October 1, 2008

[Rotman International Journal of Pension Management, Vol. 1, No. 1, Fall 2008](#)

Abstract: The institutional structure through which individuals accumulate retirement savings is an important issue. Ideally, it is expert and low-cost. This article compares the cost-effectiveness of the pension fund structure with the mutual fund structure. The authors hypothesize that the pension fund structure provides investment management services at lower cost because most mutual funds are conflicted between providing good financial results for their clients and good financial results for their shareholders. Specifically, they compare the investment performance of a sample of domestic fixed income portfolios of Canadian pension funds with those of a sample of Canadian fixed income mutual funds. **They find an average performance differential of 1.8 percent per annum in favor of pension funds. This performance gap is approximately equal to the average cost differential between the two approaches.** They conclude that high mutual fund fees significantly reduce the net returns of mutual fund investors. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1290645](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1290645)

### **16. Morningstar research :How Expense Ratios and Star Ratings Predict**

**Success** If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better [ purchase] decision. In every single time period and data point tested, low-cost funds beat high-cost funds. To see the results, click [here](http://factualfin.com/blog/blog2.php/how-expense-ratios-and-star-ratings-pred). <http://factualfin.com/blog/blog2.php/how-expense-ratios-and-star-ratings-pred> In other words, The message here is Fees Count!

### **17. Conflict -of- interest part of DNA** In "[Conflicts of Interest and Competition in the Mutual Fund Industry](#),"

Ajay Khorana (Georgia Institute of Technology) and Henri Servaes (London Business School) examine how conflicts-of - interest in the U.S. mutual-fund industry affect competition and investor behaviour (their database covered the period 1979-1998). Overall, their paper "highlights a number of conflicts between fund families and investors," say the authors. For example, they found "no evidence that investors derive any benefit" from annual fees for marketing and distribution (12b-1 fees in the U.S). Furthermore, "fund families generally want to maximize assets under management ... **and the resulting management fees," an objective at odds with investors' "desire for high risk-**

**adjusted performance at low cost.”** (U.S. 12b-1 fees are similar to Canada's trailer commissions)

**18. CSA 2012 Investor Index** The *Investor Index* also shows that the overall investment knowledge of Canadians is low, with 40 % of Canadians failing a general investment knowledge test. According to the findings, 57 % of Canadians say they are confident when it comes to making investment decisions. Yet most Canadians have unrealistic expectations of market returns. When asked what they think the annual rate of return on the average investment portfolio is today, only 12 % of Canadians gave a realistic estimate, while 29 % provided an unrealistic estimate and 59 % explicitly chose not to hazard a guess. Nearly half of Canadians (49 %) say they have a financial advisor, up from 46 % in 2009 and 42 % in 2006. However, 60 % of those with a financial advisor have not ever completed any form of background check on their advisor. Thirty-one per cent of Canadians say they have a formal written financial plan, up from 25 % in 2009. Although more Canadians have a financial plan, they are reviewing it less frequently (78 % say they reviewed their plan in the past 12 months, down from 83 % in 2009).

<http://www.securities-administrators.ca/investortools.aspx?id=1011>

### **19. Risks to Customers from Financial Incentives**

<http://www.fsa.gov.uk/static/pubs/guidance/gc12-11.pdf> [UK FSA] This is an excellent UK regulator document demonstrating how incentives distort advice. After extensive research the FSA found that:

- Most firms did not properly identify how their incentive schemes might encourage staff to mis-sell. This suggests they had not sufficiently thought about the risks to their customers or had turned a blind eye to them.
- Many firms did not understand their own incentive schemes because they were so complex, making it harder to control them.
- Firms did not have enough information about their incentive schemes to understand and manage the risks.
- Most firms relied too much on routine monitoring, rather than risk-based monitoring, such as performing more checks on staff with high sales volumes.
- Some firms had sales managers with a clear conflict- of- interest that was not properly managed.
- Many firms had links to sales quality<sup>1</sup> built into their incentive schemes that were ineffective.
- Some firms had not done enough to control the risk of potential mis-selling in face-to-face situations.

Such results have caused the FSA to essentially ban commissions.

**20. Mutual fund client statements keep investors in the dark** The results from DALBAR's 2012 *Trends and Best Practices in Mutual Fund Statements* demonstrate that the quality of Mutual Fund statements has not shown any improvement since the last study conducted in 2010. Relative to other industries, mutual fund statements do not provide value-added account details that give investors a well-rounded and complete view of their investments.

<http://www.dalbar.ca/Portals/dalbarca/cache/News//2012%20Press%20Release%20-%20MF%20TBP%20Newswire%20Canada.pdf> Better client statements would allow investors the opportunity to track progress and assess the value of advice.

**21. Investor behaviour and beliefs: Advisor relationships and investor decision-making study** OSC Investor Education Fund

<http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf> “In summary, advisors are the key influence in investor decision-making. Investors rely upon their advisor for planning and asset mix advice, as well as advice on what specific investments to buy. Other sources of information are secondary to the advisor’s opinion. Investors trust their advisor to provide advice that benefits the client first. This trust is underpinned by a belief that their advisor has a legal responsibility to ‘put the client’s best interest first’. With this as a foundation of investor belief, investors find little reason to be concerned about fees, and perhaps as a result, fewer than half of advisors disclose what they are paid..”. Another troublesome finding is that disclosure of trailing commissions declines as the age of the investor increases. Some 40% of 20-39 year olds agree that trailing commissions were disclosed versus 24% for age 40-59 and just 18% for those age 60+. This suggests to us that a seniors vulnerability issue has developed.

**22. What Do Consumers’ Fund Flows Maximize? Evidence from Their Brokers’ Incentives** by SUSANE E. K. CHRISTOFFERSEN, RICHARD EVANS, and DAVID K. MUSTO. **ABSTRACT** We ask whether mutual funds’ flows reflect the incentives of the brokers intermediating them. The incentives we address are those revealed in statutory filings: the brokers’ shares of sales loads and other revenue, and their affiliation with the fund family. We find significant effects of these payments to brokers on funds’ inflows, particularly when the brokers are not affiliated. <http://onlinelibrary.wiley.com/store/10.1111/j.1540-6261.2012.01798.x/asset/j.1540-6261.2012.01798.x.pdf?v=1&t=hckxeghx&s=3bcea6c51c751e62a4f9b8a974adf03762dd1e61> February 2013.

February 2013.

**23. Introduction To Stationary And Non-Stationary Processes**

[http://www.investopedia.com/articles/trading/07/stationary.asp?onswipe\\_redirect=no](http://www.investopedia.com/articles/trading/07/stationary.asp?onswipe_redirect=no)

**24. Time- varying predictability in mutual fund returns**

[http://pages.stern.nyu.edu/~sternfin/mkacperc/public\\_html/predictability.pdf](http://pages.stern.nyu.edu/~sternfin/mkacperc/public_html/predictability.pdf)

Abstract We provide novel evidence that mutual fund returns are predictable after periods of high market returns but not after periods of low market returns. The asymmetric conditional predictability in relative performance cannot be fully explained by time-varying differences in transaction costs, in style exposures, or in survival probabilities of funds. Performance predictability is more pronounced for funds catering to retail investors than for funds catering to institutional investors, suggesting that unsophisticated investors make systematic mistakes in their capital allocation decisions.

**25. Prediction of financial time series with hidden Markov Models**

[http://www.cs.sfu.ca/~anoop/students/rzhang/rzhang\\_msc\\_thesis.pdf](http://www.cs.sfu.ca/~anoop/students/rzhang/rzhang_msc_thesis.pdf)

**26. Lessons from proprietary mutual fund returns** - Yahoo! Finance Canada

<http://ca.finance.yahoo.com/news/lessons-proprietary-mutual-fund-returns-195227448.html>

**27. What are the important long term investing risks? (Volatility is NOT one of them)** <http://howtoinvestonline.blogspot.ca/2013/12/what-are-important-long-term-investing.html>

**28. Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds**

<http://www.ncbi.nlm.nih.gov/pmc/articles/PMC2872995> ABSTRACT: We conduct an experiment to evaluate why individuals invest in high-fee index funds. In our experiments, subjects allocate \$10,000 across four S&P 500 index funds and are rewarded for their portfolio's subsequent return. Subjects overwhelmingly fail to minimize fees. We can reject the hypothesis that subjects buy high-fee index funds because of bundled non-portfolio services. Search costs for fees matter, but even when we eliminate these costs, fees are not minimized. Instead, subjects place high weight on annualized returns since inception. Fees paid decrease with financial literacy. Interestingly, subjects who choose high-fee funds sense they are making a mistake.[ The composition of their subject pool , college staff/MBA students made it more likely that they would find support for rational theories; given the dismal results it is thus no surprise that ordinary Canadians have trouble figuring out fund fees]

**29. DISCLOSURE IS NECESSARY BUT INSUFFICIENT** The mutual fund industry argues that investor education, not regulation, is the way to salvation. This is a diversion. Indeed, a paper by Professor Lauren Willis *Against Financial Literacy*

*Education* argues against too much emphasis on education. The professor believes the day of the informed investor is implausible, given the velocity of change in the financial marketplace, the gulf between current consumer skills and those needed to understand today's complex non-standardized financial products, the persistence of biases in financial decision making, and the disparity between educators and financial services firms in resources with which to reach consumers. The search for effective financial literacy education should be replaced, the author states, by a search for policies more conducive to good consumer financial outcomes.

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1105384](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1105384)

**30. Advisor Risk** <https://docs.google.com/viewer?a=v&pid=forums&srcid=MDQyNjM4MzIyMTkzMjczODgyNDABMTQxNTYxNzExMTMwMjcyMzE2NzEBV2IUMEYtb1ZrejBKATQBAXYy> Trailer commissions are embedded in

the management fee rather than shown separately. Many retail investors mistakenly believe there is no cost to buying or owning a mutual fund. They don't grasp the significance of distribution costs on Rep recommendations. Dealer Representatives aren't required to disclose all forms of their compensation, such as trailer commissions, that they earn from clients' fund investments. If mutual fund costs aren't mentioned to clients, they don't become a factor in a client's decision-making. This creates a risk for unsuspecting clients. [ Costs deter only one of six investors from buying, according to an Investor Education Fund survey which is a major financial competency problem in itself.]

**31. Do financial advisors improve financial performance?** According to [Do financial advisors improve portfolio performance?](#), a study of German investors at Vox by university professors Andreas Hakenethal, Michalis Haliassos and Tullio Jappelli. says they don't. The reason is the old bugaboo - costs and fees. Advisors add value but ... *"Even if advisors add value to the account, they collect more in fees and commissions than they contribute."* Apparently the authors found that richer, older people tend to use advisors more which accounts for a preliminary gross conclusion that *"Investors who delegate portfolio management to a financial advisor achieve on average greater returns, lower risk, lower probabilities of losses and of substantial losses, and greater diversification through investments in mutual funds."* They note that the financial industry would love to grab that statement for publicity. However, the net truth is completely opposite: *"Once we control for different characteristics of investors using financial advisors, we discover that advisors actually tend to lower returns, **raise portfolio risk, increase the probabilities of losses**, and increase trading frequency and portfolio turnover relative to what account owners of given characteristics tend to achieve on their own."*

**32. Mutual Fund Investors: Sharp Enough?**



Who are mutual fund investors? The answer is critical to regulatory policy. The mutual fund industry portrays fund investors as diligent, fairly sophisticated, and guided by professional financial advisors. The SEC paints a more cautious portrait of fund investors, though touts improved disclosure by the fund industry as a sufficient antidote. However, an extensive academic literature finds that fund investors are unaware of the basics of their funds, pay insufficient attention to fund costs, **and chase past performance despite little evidence that high past fund returns predict future returns.** These findings suggest that policymakers should rethink current regulatory policy. Disclosure may not be enough.

<http://ideas.repec.org/a/ris/jofitr/0948.html>

### **33. SteadyHand Prospectus**

<http://www.steadyhand.com/forms/2013/02/26/prospectus%202013.pdf>

They have used text to augment the simple one word risk descriptors which provides a little more context to the risk rating.

### **34. The Changing State of Retirement in Canada** – Fidelity (Oct., 2007)

[http://m.twmg.net/state\\_of\\_retirement\\_cda.pdf](http://m.twmg.net/state_of_retirement_cda.pdf) A survey of more than 2200 households shows that Canadians are on track to replace only 50% of their pre-retirement income. To maintain a comfortable lifestyle they may need as much as 80% of pre-retirement income. That's one reason that investing fees and clarity on risk are so important. They can mean the difference between a happy retirement and a very stressful one.

**35. BAD advice on taxation adds to investor risk** C D Howe Institute-Richard Shillington, *"Poverty traps: Means testing and modest income seniors"*, Backgrounder No.65, April, 2003 (a damning indictment of the current retirement savings system in Canada because of GIS clawbacks & minimum annual withdrawals in RRIF's and their negative impact on lower income people's RRSP's) [http://www.cdhowe.org/pdf/backgrounder\\_65.pdf](http://www.cdhowe.org/pdf/backgrounder_65.pdf) *"Millions of Canadians accept the homogenous advice of governments and the financial community and put billions into RRSPs. However, for many lower-income Canadians RRSPs are a terrible investment. They are victims of a fraud, however unintentional. Only when more Canadians are aware of the perverse treatment of lower-income citizens' savings will Ottawa be forced to develop measures that reward, rather than punish, their savings efforts."* The point here is that mutual fund investing carries many forms of risk and that is why we ask for stronger conflict-of-interest disclosure in FF.

### **36. The effect of governance mechanism and structure on fees and performance of Mutual Funds in Canada (2012)**

[http://dr.library.brocku.ca/bitstream/handle/10464/3998/Brock\\_Singh\\_Deepak\\_2012.pdf?sequence=2](http://dr.library.brocku.ca/bitstream/handle/10464/3998/Brock_Singh_Deepak_2012.pdf?sequence=2)

**ABSTRACT:** Taking advantage of the unique Canadian setting, this study empirically analyzes the impact of presence of the board of directors, as an internal governance mechanism, on fees and performance of mutual funds. Further, the impact of the board structure on fees and performance of corporate class funds is analyzed. We find that corporate class funds, which have a separate board of directors for the fund, charge higher fees; however, they also provide superior performance than trust funds. Furthermore, we find that for corporate class funds, smaller board, with higher percentage of independent directors, and with the fund CEO acting as the chairman of the board is likely to charge lower fees. Also, more independent boards are strongly associated with superior fee-adjusted performance.

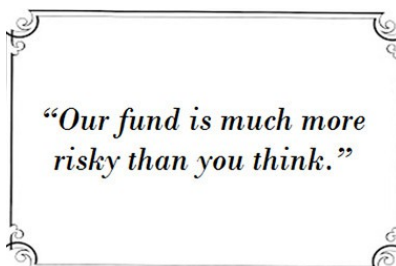
**37. Fees intended for active management aren't getting it** : It's one thing to carp about high Canadian fund fees but paying high fees for active management and not getting it moves the abuse to the next level. "Actively managed mutual funds are facing a more serious hurdle than the growing popularity of ETFs. A new study finds some aren't being managed as actively as their fees suggest. Dr. Martijn Cremers, professor of finance at the University of Notre Dame, recently examined the 20 largest Canadian funds (excluding ETFs), representing three main categories – Canadian equity, Canadian-focused equity, and Canadian dividend. What he found was nothing short of a revelation: only 2 funds were truly active, while 12 were in what he calls the "closet index" category. The rest were dubbed moderately active". <http://www.advisor.ca/investments/market-insights/viks-pick-most-active-funds-arent-really-active-90942> Read the full report **The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance** at <http://www.inquire-europe.org/seminars/2012/papers%20Budapest/summary%20Ferreira.pdf>

**38. Financial Knowledge and Rationality of Canadian Investors** by Cecile Carpentier, Jean-Marc Suret: SSRN "...Canadian investors' financial knowledge is limited. On average, they obtain a mediocre knowledge score; only 5% score above 66%. The vast majority of respondents scored between 40% and 57%. Significant gaps were noted regarding knowledge of risk and return of asset categories. Knowledge of past returns of the main asset categories is abnormally low, particularly for equity, an area where all of the respondents are involved. Mediocre knowledge of the performance of categories and of the concept of risk premium calls into question investors' financial planning ability. One out of five investors is unaware that the return of a small growth company comes not from dividends, but rather from a capital gain. One-third of investors are certain that they will receive future dividends from a company that usually pays them. Almost 30% of respondents are unaware that stock indices are greatly influenced by the returns of the largest capitalization stocks. Three-quarters of investors do not systematically compare the return on their portfolio with that of a stock market index.

Half of the investors do not clearly grasp the link between lack of liquidity and share value. Many investors do not know that if they invest in the stocks of small companies listed on the TSX Venture Exchange, they might lose all their capital. The risks associated with shareholding are largely underestimated ....”[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2038930](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2038930)

### **39. 7 mutual fund ads you’ll never see - MarketWatch**

<http://www.marketwatch.com/story/7-mutual-fund-ads-youll-never-see-2013-06-19?pagenumber=1>



“Funds are required to warn investors that past performance is no guarantee of future performance and that diversification doesn't protect against market risk. Many equity funds could honestly add:

*" Our portfolio owns lots of technology stocks, and historically this asset class has suffered losses up to 80% from time to time. You should not invest in this fund unless you are willing to lose more than half your money. "* At the peak of the technology boom in the late 1990s, many fund companies scrambled to create new tech funds in order to lure investor dollars. They knew (accurately as it turned out) that a huge bust was likely. But they never told investors that."

### **40. Recommendation of the Investor Advisory Committee (U.S.): Target Date Mutual Funds**

<http://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-recommendation-target-date-fund.pdf>

### **41. Strengthening Investor Protection in Ontario - Speaking with Ontarians.**

The study, conducted on behalf of the independent OSC Investor Advisory Panel and the Investor Education Fund (IEF), explores the views of more than 2,000 Ontario investors regarding their relationships with their financial advisors and how they perceive and use investment product information and advice. Highlights of the study include:

- *While investors generally trust the advice of their financial advisors, two things highlight the skepticism that many investors feel. Only 20% of investors strongly agree that they generally trust their financial advisor’s advice and 25% strongly agree (39% agree- 64% overall) that how a financial advisor is paid impacts the recommendations that they receive.*

*Advisers need to give their clients greater assurance that their best interest is being served.*

- *There is strong support for a statutory best interest duty: 93% agree that it is needed (with 59% strongly agreeing that it is needed).*
- *Investors want strengthened regulation of financial advisors, including clearer professional standards on use of the title, rigorous educational requirements and ethics training, and stricter regulatory enforcement of the rules.*
- *An investor/adviser power imbalance exists for most but is particularly problematic for those who lack confidence in their financial literacy. This places advisors in a powerful position. The majority (58%) rely on their financial advisor as their main source of information. More than four in ten do not know how their advisor is being paid.*

Source: [http://www.osc.gov.on.ca/en/Investors\\_nr\\_20130318\\_iap-adviser-investor-relationship.htm](http://www.osc.gov.on.ca/en/Investors_nr_20130318_iap-adviser-investor-relationship.htm)