Kenmar Associates
Investor Education and Protection

**Via email**

**December 23, 2015**

**Kenmar Associates Comment Letter**

**CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts - Proposed Amendments to NI 81-102 Investment Funds and Related Consequential Amendments**
https://www.osc.gov.on.ca/en/SecuritiesLaw_ni_20151210_81-102_mutual-fund-risk-classification-methodology.htm

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Kenmar is pleased to comment on the latest proposals for the risk rating disclosure of

mutual funds and ETF's. We restrict our comments to mutual funds as ETF issues are far more complex and our resources are limited. Our last ETF Facts Comment letter can be found at https://www.lautorite.qc.ca/files/pdf/consultations/valeurs-mobilieres/sept-2015/kenmar.pdf It raised a significant number of serious investor protection concerns including risk disclosure. One BIG issue is that ETF Facts will be delivered after the sale which means there is in effect no disclosure allowing the investor to make an informed investment decision.

Kenmar appreciates the CSA's effort in trying to integrate 13 securities regulators, multiple industry participants and investors/ investor advocates. We acknowledge all the time and effort it took to get agreement to deliver FF's prior to sale. Risk disclosure is a complex topic but we must all remember the main purpose- giving investors dependable information to make an informed decision related to their objectives, time horizon and risk profile. We agree that if a risk rating system is to be used that it should be standardized and under CSA cognizance.

A great deal of effort was put into our previous 2013 submission to the CSA (see Reference 1). We talked to dozens of investors, regulators , advisors, lawyers , investor advocates and uncovered a wealth of independent academic research on mutual fund risk disclosure. Typically, the main risks of a Canadian mutual fund are market risks of securities in the portfolio, product structure/terms risks, PM risks, and advisor risk ( embedded commissions for distribution /advice often accounts for about 50% of product cost which is bundled into fund pricing). The proposed risk rating methodology does not effectively deal with these risks and as such fails to meet its intended purpose- to answer the question " How risky is it ?" where " risky " is defined as *attended with risk or danger : hazardous* according to the Merriam-Webster dictionary

We believe our submission was an informed one. We are therefore more than a little surprised and disappointed that this input has had virtually no impact on the CSA's decision to retain the SD-based risk rating methodology and use it as a proxy for fund risk disclosure for unsophisticated retail mutual fund investors. In this Comment letter we restate our main concerns and buttress our position with further critical research and information that has come to light since then. It is our hope that this level of additional analysis will cause the CSA to re-assess its decision.

We realize this consultation has been framed so as to be limited to the fund risk rating classification methodology mechanics but we , with all due respect , feel it cannot and should not be assessed in isolation from the other variables that will impact its practical effectiveness ( or otherwise). Accordingly, we raise issues that deal with unintended consequences, critical gaps,the definition of "risky", examples of ratings breakdowns and the linkage to behavioural finance. To the extent FF is to act as a tool for better investor investment decisions, it is to that extent we feel these other matters must be dealt with on a holistic basis before even commenting on the mechanics of the methodology/ SD risk rating classification system. An unduly narrow viewpoint could cause harm and that

should never occur as a result of a regulatory disclosure. That is our perspective on the meaning of investor protection and how we are responding.

Mutual funds must currently include in the so -called Simplified prospectuses a detailed narrative disclosure describing the major risk factors associated with a fund. Fund managers go into such detail for a number of reasons, including the desire to respond to comments on prospectuses by Commission staff and efforts by fund counsel to minimize disclosure liability. As noted by securities regulators, behavioural economists and investor advocates, such detailed legalistic disclosure can deter the reading of the Prospectus and can obscure a fund's overall risks.

Hence the need for a Fund Facts and our support for the document. Kenmar believe that it is important that FF disclosure should focus more on a fund's broad investment objectives, its strategies to reach those objectives, and the fund's principal risks accompanying those strategies. Using a holistic approach to risk disclosure would greatly enhance investor understanding, particularly when reinforced by MRFP/discussions of the relevant market conditions and general investment strategies and techniques pursued by the fund that materially affected performance.

We are strongly opposed to a risk rating that doesn't actually annunciate the risks of investing in the fund and thereby misleads investors. With about $1.2 trillion invested in mutual funds, this is a HUGE issue since poor risk disclosure is the #1 root cause for unsuitable investments/complaints . Kenmar has put defective risk disclosure on its TOP 5 investor protection list  for the past 5 years. IOSCO have also expressed concerns about risk disclosure in its latest report , *A Survey of Securities Market Risk Trends 2015 Methodology and detailed results* ( Reference 10).

Mutual funds are a key component of retirement income security for millions of Canadians, so robust risk disclosure is critical, especially in an environment where advisors do not have an obligation to act in the client's Best interests.

In the current consultation we find that the CSA  is employing the Standard Deviation (SD) using the five-Category approach based on fund industry lobbyist IFIC's methodology except that a 10-year SD period is being used. The CSA has also changed the standard deviation ranges proposed in the 2013 Proposal, which now make them consistent with the SD ranges in the IFIC Methodology. As requested by industry participants,the CSA has removed the list of index acceptability criteria, but has retained the list of reference index principles and amended it ( Assumed to be Total return versions if that is the basis for which performance data is provided ).Per industry feedback , the investment risk level must now be determined upon the filing of a Fund Facts or ETF Facts and, in any case, at least annually rather than monthly as last proposed. It should be noted that an index is a costless and friction-less benchmark indicator. Heeding industry recommendations, the CSA has removed the requirement to maintain records for a ten-year period  to determine the investment risk rating of a mutual fund , reducing it to 7 years.

On the other hand, the proposed  risk rating disclosure has not addressed most of the issues we and others raised in the earlier consultation . We continue to argue that the SD

approach is not an actual disclosure of the risks of the fund and its word descriptors are misleading retail investors . Our approach here is to systematically discredit the chosen approach even while offering commentary on its mechanics.

It is instructive to see what an actual retail investor, a Mr. S. Gourley, said in his submission : " *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* " Source : https://www.lautorite.qc.ca/files/pdf/consultations/anterieures/valeurs-mobilieres/81-324/gourley.pdf Numerous other letters from investors make the same point over and over again. Their voices should not have been discounted by the CSA.

Our primary argument is that fluctuations around a mean are not what long-term retail investors define as risk. Although the standard deviation is the basis for statistics and probability theory, its use as a measure of risk is currently in the middle of a raging debate. Theorists indicate that "outliers" near the tails of the conventional probability distributions are perhaps more frequent, and mathematics should account for these occurrences. Some academics are suggesting doing away with Bell distribution curves completely. Investors think of risk in terms of losing money or failing to meet objectives .

Since standard deviation is really a measure of up and down fluctuations, one could, theoretically speaking, have an investment that is smoothly declining to zero. In this case, because there is no zigging and zagging (no fluctuation), the graphical ruler could indicate a "low risk" fund. To carry the argument to an extreme, you could market the world's worst investment as a low risk, low volatility fund! Investors think of risk as the chance of a loss based on valuations and economic factors present at the time of being sold the fund. That is why we oppose using SD as the primary mutual fund risk disclosure. Our objection is not based on theory alone – investors have lost their savings by utilizing the FF rating.

We are supported by information from our Panel of Professional advisers. They tell us that although they appreciate many features of Fund Facts, they never use the risk rating when recommending a mutual fund. They tell us that getting involved with volatility discussions is time consuming and ineffective in ensuring that investors understand the risks involved. Other independent research confirms this ( See References). We also note that submissions by SIPA, FAIR Canada. the OSC Investor Advisory Panel, mutual fund analyst Dan Hallett and individual investors are uncomfortable with the proposed risk rating methodology for use with retail fund investors. They are joined by Morningstar Canada , a leader in mutual fund analysis, rating and research who have expressed concern about unintended consequences in using a single standardized risk measure

across funds [ https://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20140312_81-324_mackenzies.pdf ].

The Financial Planning Standards Council which represents CFP's had this to say " *While we appreciate the appeal of standard deviation as a risk measure, we advise against it as the sole measure for assessing risk. Given the low likelihood of consumers accurately translating this measure into possible real outcomes, we feel the use of standard deviation will run counter to the CSA's objective of providing investors with clear and meaningful information to help in making informed investment decisions.* [ https://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20140312_81-324_financial-planning-standards-council.pdf ] Finally, the Canadian Advocacy Council for Canaadian CFA Institute Societies which represents Certified Financial Analysts said : ' *However, we question the starting premise that volatility is the risk measure that should be required for the Fund Facts document. For example, an investment in Long Term Capital Management would have shown a low standard deviation just prior to its collapse, and thus low volatility risk does not necessarily mean that an investment is devoid of risk. We do not believe that most investors understand the meaning of standard deviation within the context of their portfolio, nor have a sufficient understanding to interpret the results*. " [ https://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20140310_81-324_litvinova.pdf ]

So, what we have is a situation where investors, investor advocates , consumer groups and the professionals that provide investment advice are uncomfortable with the proposal and yet it continues to breathe. We remain cautiously optimistic that the CSA will make adjustments to its proposal before implementation based on this Letter and the inputs of FF users.

As a possible replacement for standard deviation measurements, we have proposed the worst 12 months returns be published ( or better the maximum drawdown) . It is published now but only for the worst 3 month period. That is far too short of a timeframe in our view. To really indicate the "riskiness" of an investment, we should know the maximum drawdown in percent over any period. As an illustration, most retail investors who consider an index-based fund would be staggered to know that the maximum drawdown for the S&P 500 index is an astonishing -56% . Most investors have already forgotten that the stock market dropped 56% from October 2007 to March 2009. Maximum drawdown disclosure numbers, without a doubt, would snap investors back to reality . We do not agree with the CSA that "SD is still the best general risk indicator and one that is useful as a first test to measure overall risk. " Indeed, as proposed , it is quite likely that an investor could end up comparing the " risk"( as represented by a word or set of words) of two funds, neither of which are based on real world data! That can't be good. One might as well establish a risk rating for each CIFSC Category and represent that as the risk rating of all funds in that Category. It would be just as inappropriate but would cost the industry much less to implement.

We believe behavioural finance, more than mathematical elegance deserves a place in defining the optimal risk disclosure methodology for retail investors. An understanding of fund risk is key to designing a suitable fund portfolio and that is why we are placing a heavy emphasis on its robust disclosure.

As we have expressed in our previous Comment letters on the POS project, “volatility risk” is only one of the material risks that a retail fund investor should consider before making an investing decision. One of the risks that weigh heaviest on the minds of most investors is the risk of losing part of their initial investment. But the returns of a mutual fund that loses 10% of its value each and every month would have a SD of zero and would be classified as low risk under the Proposed Methodology, even though such an investment would lose nearly all of its value over the course of a year. Our research and experience reveals that most retail investors would NOT consider such investments to be "low risk" investments. Sadly, other research suggests that retail fund investors chase past returns making the need for robust and clear risk disclosure even more important. According to OSC Investor Education Fund research ( Reference 9) , Risk of loss is a major factor only for deciding NOT to buy. That is why clear, unambiguous disclosure of the potential for loss is so important.

A SD-based risk rating is NOT risk disclosure and it is not how retail investors perceive risk. If there is evidence otherwise, the CSA should present it.

**Standard Deviation, Volatility and Risk**

We dedicate this section to counter the arguments that volatility is meaningful under the “How Risky is it?” label in Fund Facts. Volatility refers to the amount of uncertainty or risk about the size of changes in a security's value. A higher volatility means that a security's value can potentially be spread out over a larger range of values. This means that the price of the security can change dramatically over a short time period in either direction. A lower volatility means that a security's value does not fluctuate dramatically, but changes in value at a steady pace over a period of time . It's useful when one is trying to write an equation, publish a paper or defend a thesis, but amounts to a vast over-simplification, one which threatens to put investors in harms way when used in FF's. While the use of volatility as a proxy for risk provides a statistical basis for describing the randomness of capital market movements, its reliance on assumptions and its demonstrably poor predictive power mean that volatility is both a weak proxy for risk, and an unreliable way to predict or reveal potential severe capital loss. It is therefore of limited or no use in matching funds to retail client portfolio needs.

The CSA calculation of volatility makes two big assumptions: first, that returns are normally distributed, and second, that correlations are stable. Neither is true. A cursory glance at equity return data over very long periods shows that the distribution of returns is subject to both skewness and positive kurtosis. This means that the typically used metrics of mean return and SD (volatility) do not fully describe the distribution of returns. To overcome this problem, advisors and investors need to spend less time looking in the rear-view mirror and instead focus on their instruments and the view

through the windscreen. As volatility has become increasingly discredited, many investors are moving towards more sophisticated measures such as the maximum drawdown or 'mean conditional value at risk' that focus on the potential loss . Risk must once again become a conversation between the advisor and client rather than a simplistic 'tick-box' exercise which the chosen methodology actually discourages in our view.

The standard deviation does not fully address an investor's risk concerns. The field of behavioral finance has contributed an important element to the risk equation, demonstrating asymmetry between how people view gains and losses. In the language of prospect theory, an area of behavioral finance introduced by Amos Tversky and Daniel Kahneman in 1979, investors exhibit*loss aversion*- they put more weight on the pain associated with a loss than the good feeling associated with a gain. (read *Behavioral Finance: Prospect Theory*.) Thus, what investors really want to know is not just how much an asset deviates from its expected outcome, but how bad things look way down on the left-hand tail of the distribution curve. Value at risk (VAR)attempts to provide an answer to this question. The idea behind VAR is to quantify how bad a loss on an investment could be with a given level of confidence over a defined period of time. For example, the following statement would be an example of VAR: "With about a 95% level of confidence, the most you stand to lose on this $1,000 investment over a two-year time horizon is $200." The confidence level is a probability statement based on the statistical characteristics of the investment and the shape of its distribution curve. Not perfect but at least comes closer to the type of information sought by retail investors.

There are many asset price occurrences and events globally which occur outside the mean and with far greater frequency than typical option pricing theory suggests . Ironically, outlier events outside the mean can be sown by the seeds of persistent LACK of volatility. Additionally, recent research has uncovered the " Volatility Effect" wherein low volatility funds have outperformed higher volatility funds. Indeed, a number of such mutual funds and ETF's are on the market that exploit that effect. See "**The volatility effect: lower risk without lower return**"
https://www.robeco.com/en/professionals/insights/quantitative-investing/low-volatility-investing/the-volatility-effect-lower-risk-without-lower-return.jsp )

In *Why Volatility does not Equal Risk* famed Berkshire Hathaway CEO Warren Buffett says volatility does not measure risk. Past volatility is not a measure of risk he says. It's nice math, but it's wrong. If a farm in Nebraska used to sell for $2,000 per acre, and now it sells for $600 per acre investment theory would say that the beta of farms has gone up, and that they are more risky than before. If you tell that to people, they'll say that that's crazy. But farms don't trade daily the way stocks do. Since stock prices jiggle around, finance professors have translated that into these investment theories. According to Buffet , risk is not knowing what you're doing. If you know who you're dealing with, and know the price you should pay, then you're not dealing with a lot of risk.
Read more: http://www.investorwords.com/tips/1594/why-volatility-does-not-equal-risk.html

In his most recent annual letter to shareholders , Mr. Buffett wrote about the difference between risk and volatility and how many investors conflate these concepts, costing themselves money." *Stock prices will always be far more volatile than cash-equivalent holdings. Over the long term, however, currency-denominated instruments are riskier investments – far riskier investments – than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is far from synonymous with risk. Popular formulas that equate the two terms lead students, investors and CEOs astray.* Does the CSA really want to challenge Buffet's powerful arguments and logic?

Peter Bernstein was an American financial historian, economist and educator whose development and refinement of the efficient-market hypothesis made him one of the best known authorities in popularizing and presenting investment economics to the general public . In **Can we measure risk with a number? ,** https://secure.halberthargrove.com/hh/announcement/FINAL%20T&M%20Q2%202007.pdf , Mr. Bernstein says the return of events – a replay of the patterns of the past seventy-five years of capital market history – will happen only for the most part. Most is not all. There is no certainty. Rational people do not bet the ranch on a model with an R2 of less than 1.00, that works out only for the most part. And God forbid it works out only for the minor part! Consequences, not probabilities, determine the decisions that matter. This is why it is critical not to characterize volatility as risk in FF and why we prefer stronger words concerning all aspects of risk disclosure in FF. Canadian's life savings are at risk with misleading and misunderstood risk disclosure.

For those who are drawing on their portfolio for income and have a shorter time horizon, volatility is certainly something to be cognizant of. These investors can't afford to have markets dip just when they need money. But for investors who have the luxury of time, volatility doesn't equal risk -these investors can hold assets with a higher potential return knowing that short-term price swings are inconsequential. Long-term returns are what matter and mutual funds are long-term investments. Risk is holding overpriced assets, being too concentrated on one type of investment, and having no protection against inflation. Risk is having a portfolio that doesn't fit with an investor's objectives. For long-term investors, in principle ,volatility shouldn't be a risk factor, but it clearly is. Dan Hallett of Highview Financial Group has done research that suggests investors in less volatile balanced funds have a longer holding period and achieve better returns than those in all-equity portfolios. Volatility is therefore related to investor behaviour but it is not risk and shouldn't be labelled as such.

One could argue that an undue emphasis on volatility is not a positive feature of the proposed risk rating regime. Volatility may be used to justify inaction or inadequate capital allocation, and prevent an investor from accessing opportunities that are suitable for his or her actual, but perhaps unrecognized, investment requirements.( Reference 8) . We recommend that the CSA focus its investor research initiatives on investor behaviour in order to provide better more effective regulation.

A mutual fund may be subject to certain risks that are not reflected in the fund's historic volatility, either because the risky event has yet to occur or because it is difficult or impossible for the market to factor the impact of those events into the fund's price. These risks include but are not limited to currency risk, concentration risk, fund governance, illiquidity and counterparty risk, and they are not well-suited to be explained in Fund Facts' summary form. This missing information is best communicated by a concise enumeration of the principal risks of the fund as we have suggested.

Also,while the consultation paper states that the reference index selected by the fund manager must satisfy certain principles, such as having returns and a risk profile that are highly correlated to the returns of the fund at issue, it is likely that the reference index will itself exhibit survivorship bias and could unduly inflate the risk performance of the fund at issue by smoothing out volatility.

The S&P/TSX Total Return Index, an index of the largest companies on the Toronto Stock Exchange by market capitalization, has an annualized 10-year standard deviation of about 13.9%. Under the previous CSA proposal this would have put the Index in the Medium to High risk classification according to the Proposed Methodology. Under the new proposal, the rating will fall to Medium .We believe that a risk rating of Medium to High risk would be more appropriate given the large downside witnessed in 2007-2008. The rationale of reducing the bands back to 5 escapes us other than its inconvenience to industry participants.

Here is further backup for our thesis that volatility (SD) is **not** a indicator of risk:

**Why Volatility is Not an Accurate Measure of Risk** : Morningstar UK
"By focusing on absolute levels of volatility as the key measure of risk, investors are prevented from buying risk assets when prices are low as these typically corresponded to periods of high volatility. Equally, portfolio managers are encouraged to buy risk assets when prices are high. This buy high, sell low strategy is unlikely to be in the clients' best interests.

The practical problems with this approach are especially evident when using absolute levels of volatility to match funds to client risk profiles. Morningstar has recently conducted research that shows that the volatility of a conventional multi-asset portfolio varies widely through the market cycle. We created a series of multi asset portfolios and tracked their volatility using the approach stipulated for the calculation of a fund's synthetic risk return indicator (SRRI) that is included in key information documents (KIID). The volatility of these portfolios varied significantly over time. For example, the volatility of a moderate risk portfolio comprised of recognised benchmark indices varied by 5.3% over the last 9.5 years. This volatility range is greater than the SRRI band (four) used to classify the fund.

This means that a portfolio positioned in the middle of an SRRI band at the beginning of

the period and rebalanced regularly would breach both the upper and lower boundaries of that band over the period. In other words, without changing the allocation, the portfolio fund would be both too risky and not risky enough for the same client over the period. **A risk mapping process that produces such widely varying results for a stable portfolio is clearly not fit for purpose.**"
http://www.morningstar.co.uk/uk/news/134560/why-volatility-is-not-an-accurate-measure-of-risk.aspx#sthash.bCVr86mV.dpuf
http://www.morningstar.co.uk/uk/news/134560/why-volatility-is-not-an-accurate-measure-of-risk.aspx

**Volatility does not measure true risk**: 300 Club
http://www.the300club.org/newsevents/tabid/79/vw/1/itemid/31/300-club-volatility-does-not-measure-true-risk.aspx

**The Greatest Trick the Devil Ever Pulled** …was convincing investors that volatility and risk were the same thing
http://thereformedbroker.com/2015/05/06/the-greatest-trick-the-devil-ever-pulled-2/

**Understanding Volatility Measurements**
http://www.investopedia.com/articles/mutualfund/03/072303.asp

**Never confuse risk and volatility** | Reuters
http://www.reuters.com/article/us-saft-on-wealth-idUSKBN0H52AL20140910#864ZMketssTXUyD9.97

**Is volatility risk?**
http://www.schroders.com/en/SysGlobalAssets/digital/insights/pdfs/investmenthorizons-is-volatility-risk-nov2014.pdf

**The Volatility Anomaly Uncovered** |Swedrowe ETF.com
"..Recent academic papers have shown that low-volatility stocks have provided better returns than higher-volatility stocks. What's more, this is a global phenomenon. These findings, however, run counter to economic theory, which predicts that higher expected risk should be compensated with greater expected returns, resulting in the low-volatility anomaly. Of interest is that this finding holds true not only for stocks, but for bonds..."
http://www.etf.com/sections/index-investor-corner/swedroe-volatility-anomaly-uncovered?utm_source=newsletter&utm_medium=email&utm_campaign=dailynewsletter

**Confusing risk with volatility**
http://www.trendfollowing.com/whitepaper/confusion.pdf

**Volatility is not the same as risk**
http://www.kamny.com/load/publications/p03_eng

**Volatility Is The Square Root Of Time & Fat Tails** | Zero Hedge
http://www.zerohedge.com/news/2015-04-25/volatility-square-root-time-fat-tails

**On time-scaling of risk and the square–root–of–time rule** *
http://eprints.lse.ac.uk/24827/1/dp439.pdf

Even if volatility related to risk there is a fundamental issue because so few funds have a 10 year life. The length of the time period used to calculate the SD is therefore a forced trade off between consistency and relevance of data. The CSA proposal uses 10-year SD while the IFIC Guidelines use 3-year and/or 5-year SD. According to industry sources, only about 20% of mutual funds have been around for 10 years, while only about 4% of exchange-traded funds (ETFs) have a 10-year life. **This means that under the CSA proposal, the majority of funds will have their risk rating based on a proxy not actual fund data.** This is an issue for actively- managed funds or funds that track new indexes that do not have a 10-year track record. About 40% of mutual funds have at least five years of history, while 55% have at least three years of history. We note that this means that the risk classification of a new or newly created mutual fund would be based entirely, or mostly, on the reference index, although we foresee significant practical difficulties in determining which reference index to use for such mutual funds, given the CSA's proposed guidelines for selecting a reference index: Thus , new funds will effectively be given a rating that is based on an index which kind of makes the rating a bit of a sham. This is one more reason why we remain concerned about this system.

One of the asserted benefits of using a 10-year SD is that it eliminates much of the variation in the measure itself. This means that risk ratings should be more consistent, even if the market goes through extended stretches of either high or low volatility, and eliminates the need to adjust the SD bands periodically. In contrast, using 3-year and/or 5-year SD under the IFIC Guidelines allows for the risk measure to capture recent volatility trends in the market and might follow more closely with what retail fund investors actually experience. We would not have thought of this as a bad thing. In addition, the 10 year measurement may be inappropriate as many investors do not hold any one mutual fund for a 10 year period. A study of mutual funds in Canada conducted by Investor Economics for the Investment Fund Institute of Canada in a September 2012 report, used an average holding period of 4.5 years. If the CSA retains the SD approach, consideration should be given to a 5 or 6 year period as a pragmatic trade off.

Further, since downside risk statistics are impacted as fees rise, it is important to consider risk indicators for each individual fund and specific fund class. Differing MER's will necessarily impact statistics such as time to recovery, as well as other indicators, yet standard deviation does not capture these significant differences in real risk to investors based on the often material fee differentials that are inherent in different classes of the same fund.

Frequent changes to risk ratings are certainly not desirable, and risk ratings should be as consistent as possible. But at the same time, investors should be alerted as soon as

possible to shifts in volatility rather than having to wait until an arbitrary date that the company uses as its fiscal year end. We believe the CSA proposal conveys this message by allowing upward changes in risk to be decided by fund managers enabling them to increase the risk rating even if the formula does not reveal the enhanced risk . It is hoped that PM's will take advantage of this exception but if a higher risk rating results in a competitive disadvantage, it's not obvious this will happen .

If the CSA proposal comes into effect despite our recommendation; then we recommend that the FF section on "Risk" be changed to something like the following:

**How volatile is it?** The value of the fund can go down as well as up. Volatility refers to the amount of uncertainty or market risk about the size of changes in a fund's value over a specified time period. A higher volatility means that a security's value can potentially be spread out over a larger range of values. This means that the price of the fund can change dramatically over a short time period either positively or negatively .A lower volatility means that a security's value does not fluctuate dramatically, but changes in value at a steady pace over a extended period of time. Volatility does not measure the direction of price changes, merely their dispersion. Research is unclear as to whether or not higher volatility or lower volatility has a more significant impact on long-term fund returns.

**Volatility rating**

This rating is based on the fund's historical volatility . It doesn't tell you how volatile the fund will be in the future. The rating can increase or decrease over time. Volatility is not the same as risk .Factors such as interest rates, currency fluctuations, Portfolio Manager changes, fund governance or the nature of the fund's mandate/objectives may influence risk and returns .A fund with a low risk rating may still provide superior results..Volatility presents opportunities to buy funds cheaply and sell when overpriced. The fund's risk rating should always be read in conjunction with the fund's performance .

**COMMENTS**

Here are our main Comments:

**The Methodology of Assigning Fund Risk Ratings is Unproven, Raising Concerns About the Efficacy of the Ratings :** The proposed methodology in assigning mutual fund risk ratings is a relatively recent invention with observed field tested deficiencies. Because of actual marketplace experience with fund risk ratings, there is no basis for confidence about the robustness of the ratings. Ratings based on a single parameter such as standard deviation /volatility are not fully tested, and it is not at all clear that they will be sufficient to protect investors when market conditions change. We note that the U.S. SEC decided, after extensive consultation, not to use numeric or alpha symbols to depict mutual fund risk. Instead, they require the principal risks to be enumerated in the Fund Summary Prospectus Document .

**Volatility risk rating will be hard to interpret** The proposed methodology suggests that in the event a fund does not have a 10 year history, its manager will be permitted to utilize the monthly returns of an appropriate reference index as a proxy to impute missing data. When the performance of a benchmark index is integrated with the historical actual returns of a fund, it complicates matters as it does not allow investors to determine if the manager's active management style adds volatility to the fund or whether that is a function of its benchmark index selected. The longer the performance history reflects data from the chosen index the less relevant any comparison between the fund's returns and those of the benchmark.

**Investor exposure will be increased** : Investors have paid a heavy price for what we believe is misleading risk rating ( posing as a risk disclosure) . In numerous complaint cases , Dealers/salespersons have utilized Safe Harbour protection to deny redress to victims. Given the choice of word descriptors in the CSA risk rating scale, investors and registered representatives have confused these with similar sounding words on NAAF/KYC documents used for critical suitability determinations. This has led to investor losses and complaints. Risk ratings should NOT equate with suitability – medium risk tolerance person does not mean that a medium (or less risk) rated fund is ipso facto suitable. Product risk rating based on SD does not equate with KYC risk tolerance. Regulator suitability guidelines should avoid referring to FF risk ratings in compliance exams and client complaint investigations. Therefore, we strongly recommend that the CSA's accompanying guidance make clear that the risk classification brought about by the Proposed Methodology, cannot be directly linked to the investor's risk tolerance derived from his or her KYC/suitability risk profile; overall compliance must be judged more holistically.

The proposed disclosure continues to employ word descriptors but no counter argument to our documented concerns has been provided by the CSA. We have suggested using numbers rather than text for risk ratings if this methodology is to be utilized , to partially mitigate this well identified problem. A sliding scale with 10 buckets showing SD's from 0 to 20+ might at least be a better visual presentation. Bucket one would be labeled LOW volatility and the tenth bucket would be labeled HIGH volatility . The CSA might even consider including the actual SD numeric statistic in brackets. While it may not be very valuable to most investors, it should be very valuable to advisors.

**Prevailing investor risk profiling practices are weak :** New research ( Reference 3) from the OSC-IAP suggests the Canadian investment industry lacks objective standards for defining and assessing clients' risk tolerance and that the questionnaires that are used by many advisors aren't up to the task. The research study included an industry survey, a regulatory review and an examination of academic literature. The report, which was prepared by PlanPlus Inc., finds that the task of properly assessing a client's risk profile is a primary area of concern in the industry, and that regulators say it is an area of "high importance." **The research found that many risk concepts do not have a standard definition and that there is a lack of understanding of the factors**

**involved in assessing clients' risk appetite.** While risk questionnaires are widely used in the mutual fund dealer channel, the report found, the vast majority (83.3%) of these questionnaires "are not fit for purpose." The report found that these surveys have too few questions, use poorly worded or confusing questions and involve arbitrary or poorly conceived scoring methodologies. More than half (55%) of risk questionnaires have no mechanism to identify highly risk-averse clients who should be invested solely in cash.

With questionable risk profiling, the FF risk disclosure becomes the last line of defence. Since we argue that the fund risk rating is not robust , investor protection will be compromised.

**This proposed Disclosure does not comply with IOSCO POS disclosure principles.** If the CSA are determined to use a risk rating metric, there is a need to do more than merely describe volatility risk in the risk section. IOSCO's Principle 1 states: "***key information should include disclosures that inform the investor of the fundamental benefits, risks….Its risk and reward profile. Risk disclosures should include the material risks for the product.*** *This may include performance risk/volatility, credit risk, liquidity risks and operational risks.* ***In some jurisdictions, a scale may be considered appropriate to identify the overall risk measurement or classification of the product, rather than a list of specific product risks, and this may be accompanied by appropriate narrative explaining how to interpret the scale. This may assist with risk comparisons, although regulators and investors need to be aware of the inherent limitations in such measures.[footnote] Regulators might wish to include supporting information indicating minimum length of holding relative to short term volatility, what types of "targeted investors" the product is being marketed to and what commitment those investors need to make;…*** *"* The proposed Fund Facts risk disclosure appears to downplay IOSCO's wise counsel.

**IOSCO report on risk education examines what constitutes risk in the mind of the retail investor**

In September 2015 ,the Board of the International Organization of Securities Commissions (IOSCO) published its final report on Sound Practices for Investment Risk Education. The report identifies a number of sound practices for investment risk education initiatives, based on an analysis of the approaches and practices adopted by the members of the IOSCO Committee 8 on Retail Investors in designing and delivering their investment risk initiatives, as well as a review of literature on the topic. IOSCO has long recognized investor education as a key strategy for enhancing investor protection, promoting investor confidence and fostering investor engagement in financial planning and decision-making. Investor education is complementary to other tools such as regulation, supervision and enforcement, and is recognized in IOSCO´s guiding principles for securities regulation. In 2013, IOSCO created Committee 8 to conduct its policy work on retail investor education and financial literacy. Here's what's interesting – they say " **For the purpose of this report, "investment risk" is generally defined as the risk that an investment will not deliver the expected yield and/or lose value and**

**comprises a range of underlying factors.** "
https://www.iosco.org/news/pdf/IOSCONEWS398.pdf So, if investors are going to be educated on risk on this basis, why disclose risk using volatility of returns ( SD approiach)?

**Hallett research points out some issues with SD method (** Reference 4) In the referenced article respected fund analyst Dan Hallett says " A system designed to truly inform and protect investors would look far back enough to capture bear market performance either for the fund or – if it's too new – for its benchmark. Combining this with a more common sense measure – i.e. how much a fund lost in its last big decline – puts these new risk ratings in a different light..." The current proposal does increase the period to 10 years thus partially alleviating part of the disclosure problem but it is still missing the common sense measure – maximum drawdown. In our prior submission we argued that the maximum one year loss be provided as an investor-friendly way to communicate risk . No rationale has been provided by the CSA for not accepting this recommendation.

**Risk and return are related :** If the SD word descriptor is provided, we feel that the other descriptive statistic, the mean return , of the Bell curve should also be provided. It is not reasonable to expect an investor to make an informed decision using only the SD -based risk rating. It could very well be that risk is MEDIUM but return is well above that of an alternative fund being considered. This statistic should be provided even if the figure is partially determined by using augmented index data . Imperfect to be sure, but better than no disclosure.

**Risk disclosure can be partially located in performance section**: We recommend adding this sentence in the performance section of FF " ...This information provides some information of the risk of investing in this fund.." We would also add a note " Results do not include a sales charge; if a sales charge were included , results would be lower".

**Floating Rate Note Funds illustrate the deficiency:** In *INDUSTRY RISK RATING FAILING INVESTORS OF FLOATING RATE NOTE FUNDS* http://www.highviewfin.com/blog/industry-risk-rating-failing-investors-of-floating-rate-note-funds/ the author stated :" My critique of the fund industry's approved risk rating method is not new. Six years ago – before the worst of the financial crisis – I took the industry to task for its meaningless risk and suitability ratings .Then as now, Fund Facts' oversimplification of these two ultra-important factors does not tell investors what simple numbers can clearly communicate. Fund sponsors should use sufficient history (of the fund or its benchmark) to include at least one bear market in assessing a fund's risk rating for investor disclosure documents Investors may not immediately comprehend credit spreads and spread compression. But they understand losing money – and that's what the industry should be showing them before they invest." We couldn't have said it any better ourselves. We feel showing the worst 12 months performance over at least the last ten years would be a huge improvement over the confusing word risk rating disclosures being proposed. See also Reference 5 .

**Bond fund risk ratings a concern :** Bond mutual funds typically make up 40 % of a balanced portfolio; even higher for seniors/ retirees. We argue that 'a risk rating that represents a judgment of how a Bond fund will react to changes in various market conditions is a necessary disclosure. Unlike bond credit ratings, which reflect credit risk, Bond-fund risk ratings reflect the variability of returns. The CSA proposal rates Bond fund risk based solely on past volatility. The main risk with bonds and Bond mutual funds is interest rate risk and we are currently at near record lows. If rates rise which is about the only way they can go from here, Bond funds will lose value. Interest-rate risk - the risk that a bond's or bond fund's share price falls when interest rates rise - can be very painful if you are invested in a long-term Bond fund when rates rise significantly, as they did in 1994.We therefore are concerned that Bond fund risk ratings based on SD would put the most vulnerable of investors , retired investors, in harms way.

Volatility ratings of Bond funds are also difficult to use by retail investors; they are not institutional investors who are in a position to understand the basis of, and limitations inherent of such ratings. Less sophisticated investors are likely to be misled, and to take a Bond fund volatility risk rating as a depiction of the risk most significant to them, when such in fact is not the case. As the CSA is well aware a number of factors can affect the value of a Bond fund. These include, for example, credit risks; interest rate risks; liquidity risks; currency risks (for foreign bonds); political risks; risks from call or pre-payment provisions; risks from the use of leverage, options and derivatives; risks arising from over concentration (lack of diversification); and operational matters .

It has been our experience that Bond fund investors will assume, from their experience in other contexts, that a "Low" risk rating means "superior" and make their investment decisions accordingly. Indeed, in the context of credit ratings, a triple-A rating for a bond really does mean "superior." It would only be natural, therefore, for investors to draw the same conclusion with respect to Bond fund risk ratings. A basic premise underlying bond investors is that have a strong sensitivity regarding the current values of their fixed income investments to changing long -term interest rate trends .A low risk rating for a Bond fund at a time of record low interest rates is misleading to unsophisticated retail investors in our view.

An example of this can be found in Reference 7. In the example, the author shares our concern. Like us, he argues that any investment that has generated strong double-digit returns should not be considered LOW risk. This misleads investors into thinking that low risk and high return is a reasonable expectation. More importantly, the rating doesn’t adequately inform investors about the risks that lie ahead during the next credit market freeze or when the PIMCO managers show their humanity and get some of their bets wrong. Assessing this fund as a low risk fund simply shows the investor protection inadequacy of the SD risk rating methodology **.**

**Target date fund issue(s) not adequately addressed** : As we pointed out in our prior submission ,Target Date funds are unique as they have an end date and a planned approach to decrease risk over a defined time period. As these funds move though their glidepath ,risk is changing in such a way that past returns and SD are irrelevant to future

performance. We had also argued that in regard to Target date funds (TDF), one of the associated risks is a premature movement to a safe mode (a "triggering event") which happened in 2008 -- such a risk is not captured by SD. This event left investors in a fund that had no chance of recovering or meeting its target. The lack of any reference to this possibility in the FF risk disclosure would leave investors exposed without any warning. It is the terms and conditions that present a real risk for TDF's. Further, TDF's are designed such that their risk level changes over time, so a backward looking risk measure may not be a suitable indicator of product risk as it will overstate the designed risk profile ( per the anticipated glide path) of the fund at a point in time. Instead of looking at volatility for these types of investments, it is important that consumers understand the fund's strategy and attendant implications. The CSA response does not match reality since the whole purpose of a TDF is not to have a constant risk rating over its life cycle. Without seeing the CSA analysis, it is hard for us to accept the CSA argument that the methodology is useful and meaningful. To us ,it looks like this is an attempt to force a square peg into a round hole.

In our comments on ETF Facts we pointed out similar problem rating structured funds like leveraged and reverse ETF's.

**Return of Capital (ROC) /T-series fund issue(s) not addressed** : We based our concern on the established fact that there have been so many investor complaints and regulatory proceedings about these funds, especially from retirees. The Return of Capital (ROC) issue is a serious one especially when coupled with misleading marketing materials .The CSA argument that in the 2013 Proposal there are provisions that allows for discretion to use a reference index as a proxy for missing information that best fits the risk profile of such funds. The reference index can , the CSA argues, be a single index or a blend of indices that best fits the risk profile, and therefore, should allow an index to be customized to the risk profile of the fund. This is not the point we are making. ROC funds have left yield hungry seniors with funds that invariably declined in value due to excessively advertised " distribution yields" . This had led to much grief.

Many ROC funds have had to reduce "distributions" leading to investor complaints of misrepresentation .Kenmar have long taken exception to such funds with their two-fold objective of providing investors with monthly cash flow and the potential of capital appreciation. We have argued that such funds handed investors so much of the monthly cash flow that it left no room for its secondary objective of capital appreciation. Accordingly, unit prices have fallen over the years and this shocks investors, not to mention the many tax reporting challenges that result. We see nothing in the proposed FF risk rating disclosure that would warn income seeking investors of this material risk or prevent the sort of problems that have already occurred. Please refer to Reference 6. In our view the chosen methodology actually masks the threats to investors.

**DSC fund fee disclosure takes up a lot of space:** DSC- sold funds have caused investors a lot of grief. A recent MFDA bulletin paints a sorry picture of investor abuse . Nevertheless, we feel this disclosure consumes a disproportionate amount of page space. The good news is that the sale of such funds is in decline on an absolute and relative

basis and the FEL version is available with typically a 0% upfront sales charge. There is also a distinct possibility such funds may be prohibited under proposed regulatory reforms. Until that happens, we recommend that the fee disclosure be compressed providing valuable space for inclusion of a concise statement of the principal risks of the fund.

A condensed table could be provided showing the number of dollars of early redemption penalty per $100 or $1.00 of investment for each year of the redemption schedule. A brief note could also be added pointing out the 10% annual penalty -free provision if it is applicable. With these minor changes and some creative formatting , FF could end up as an excellent document and still stay within the 2-sheet constraint. If the top 3 or 4 risks were revealed with a note telling the investor to refer to the Simplified Prospectus for more detail , Safe Harbour could be provided to dealers and advisors regarding risk disclosure, at least so far as FF pre-sale delivery is concerned.

**Provide a brochure/Guide on how to use Fund Facts** : In *Risk appetite and attitudes of Retail investors with special reference to Capital Markets* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1820862 we read "The retail investor's understanding of the way in which markets work, the nature of risk ,the pricing risk and utilizing risk information in a way that's appropriate to their own circumstances, is still something that is missing-we've got a long, long way to go" .This is one reason Kenmar have suggested a plain language CSA brochure GUIDE on how to effectively use Fund Facts particularly the risk elements of the FF document. The Guide could expand on the DSC , risk, volatility risk and its inherent limitations and as a bonus, a section on any sales charge or fee discounts available to larger investors /families. Again, the CSA makes no mention of this recommendation that we've made several times in the past. We urge the CSA to provide such a Guide. It would be an excellent and sorely needed complement to FF.

Although it is not the focus of the consultation , we take this opportunity to again strongly recommend that the FF language regarding conflict -of-interest risk in trailing commission payments needs to be strengthened. This risk can be of more importance than the volatility risks which are the subject of the consultation and the DSC disclosure that takes up so much page space. Despite an overwhelming body of evidence, the investment industry has persistently refused to acknowledge that these trailing commissions can harm mutual fund investors. Now, that acknowledgment is no longer necessary because of the comprehensive empirical research that Douglas Cumminga , a finance professor at the Schulich School of Business at York University in Toronto, has completed for the CSA.

Cummings and two colleagues sifted through a decade of data from 43 mutual fund companies that manage two-thirds of fund assets in this country. The three key findings of this research align with a mountain of what other independent research have been saying for well over a decade :

1. Mutual funds that don't pay trailing commissions tend to get investment inflows if the funds perform well and lose inflows if they underperform. But it's a different story for funds that pay trailers. Investment inflows gravitate toward those funds even if they perform poorly for investors.
2. This gravitational effect increases as funds pay higher trailing commissions.
3. Where funds are able to attract investment inflows without having to do so through strong performance, their performance worsens. This occurs frequently in funds that pay trailing commissions.

In other words, trailer commissions skew mutual fund flows by letting sales incentives drive "advisor" investment recommendations, and this channels many investors toward more expensive funds exposing them to higher risks and lower returns. Trailers harm investors, and the market as a whole, by facilitating deterioration in fund performance that ultimately impairs retirement income security. These are profoundly serious findings that regulators cannot ignore in any consideration of mutual fund risk disclosure in FF. "Advisor risk" is clearly a material risk of investing in a mutual fund in Canada. We continue to favour the SEC mandated disclosure in the Summary Prospectus which is more forthright than the prevailing disclosure in FF: **"Payments to Broker-Dealers and Other Financial Intermediaries. If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information."**

This strong warning may also mitigate the use of advisor titles designed to mislead investors as to the level of proficiency or advice standard applied.

We add parenthetically that NI 81-105 *Mutual Fund sales Practices* allows a member of the organization of the mutual fund to pay participating dealers the costs of marketing and educational events within prescribed limits and also organize and present conferences or seminars for the sales representatives of participating dealers provided certain conditions are met. In our experience, " Free lunch" educational seminars are bringing harm to elderly and other vulnerable investors and ask again for this NI rule to be reviewed as it increases mutual fund investor risk.

**Conclusion**

In conclusion, we continue to warn of the inherent dangers of using a SD -based risk rating methodology to answer the question " How risky is it?" for mutual funds. The use of a word(s) that attempts to be a single, all encompassing measure of fund risk, without a clear explanation of how the word(s) or number was derived or its meaning, or how to use it provides little useful information to investors. As we have reported numerous times, retail FF users ( and even some advisors) tend to rely too heavily on

such a single measurement of risk without a true understanding of the risks involved. We have provided numerous constructive ideas to improve FF's investor protection attributes.

As we have pointed out ,one major risk that investors tend to overlook is asset allocation/diversification risk. For example, an investor with a low risk tolerance/capacity may, based solely on the traditional risk rating in Fund Facts, select a variety of Bond funds. This type of behaviour leaves the investor particularly vulnerable to loss of capital in a rising interest rate environment, and a investor who does not understand the link between yield and price could feel that the low risk rating was misleading, harming their confidence in financial markets, fund manufacturers and securities regulators. We believe our recommendations would address this issue.

We do not believe that a fund risk rating improves the ability of investors to appreciate the risk(s) associated with a particular fund. Investors that rely on Fund Facts, using the Proposed Methodology, will be seriously deficient in the vital information they need before making an informed investment decision .Changing the section title to Volatility risk alleviates a part of the confusion problem. In fact, RRIF investors might find the section useful, after some rewrite, due to the importance of Sequence of Returns in de-accumulating accounts.

At numerous points in FF's where a risk related disclosure is cited, the light touch has been chosen by the CSA. When one combines poor definitions of risk, deficient risk profiling processes with misleading risk disclosure , critical academic research , actual field failures , criticism from professional advisor Associations and the lack of a Best interests standard for advisors, the unsuspecting retail mutual fund investor will be the loser. The CSA should not allow this to happen if it remains true to its investor protection mandate. We sincerely hope the CSA will give due consideration to our recommendations which are based on real world investor experiences.

In our opinion, investors would get more out of just seeing a chart showing the loss experience of the fund and its benchmark with the main risk factors expressed in plain language. That is essentially what we what we recommend.

It is important for the CSA to be realistic in its communications about the fund rating: it is not a mechanism for retail investors to learn about and understand all of the material risks they need to know before making an informed investment decision. As we have demonstrated ,there are other major risks beyond volatility risk which are not necessarily expressed in the fund's price movements. Maximum Drawdown or the worst 12 month figure ( 10-years) may be helpful in capturing these aspects of risk as would a delineation of the principal risks of the fund ( not just market risks).

We grant permission for public posting of this Comment letter

Should the CSA have any questions, do not hesitate to contact us.

If the CSA establish a meeting or multiple stakeholder Roundtable to discuss these investor-critical issues, we will be glad to participate.

Kenmar strongly supports the CSA in making Fund Facts a world- class document.

Ken Kivenko P.Eng,
President, Kenmar Associates

Kenmar Associates is an Ontario- based privately-funded, non-profit organization focused on investment fund investor education via on-line research papers hosted at www.canadianfundwatch.com.Kenmar also publishes ***the Fund OBSERVER*** on a bi-weekly basis discussing investor protection issues primarily for investment fund investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused investors and/or their counsel in filing investor complaints and restitution claims. Kenmar advocates on behalf of the retail investor.

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2. **Principles on Point of Sale Disclosure Final Report :** IOSCO Feb. 2011
https://about.investorpos.com/documents/IOSCO%20Principles%20on%20Point%20of%20Sale%20Disclosure%20Final%20Report%2001022011.pdf

**3. OSC -IAP Report on Risk Profiling**
*Current Practices for Risk Profiling in Canada and Review of Global Best Practices*
The research found:

- There is a confusing and universal lack of existence or consistency of the definitions of risk concepts and a lack of understanding of the factors involved in risk profiling.
- Almost all regulators surveyed are principles-based and provide little guidance on how a firm or advisor should arrive at the determination of a risk profile. They all recognize and rely on the professional judgment of the advisor and the 'process' created by the advisor or firm to determine a consumer's risk profile. No regulator provides clear guidance on how to combine the multiple factors and form a client risk profile.
- Risk questionnaires are most widely used in retail channels using mutual funds and less so in wealth management and portfolio manager channels.

- Over 53% of respondents to the advisor survey indicated that between 76-100% of their clients had completed a risk questionnaire. Almost half of the firms reported that risk questionnaires were developed in-house and another 36% said that advisors could choose their own risk profiling methodology. Only 11% of firms could confirm that their questionnaires were 'validated' in some way.
- Most of the questionnaires (83.3%) in use by the industry are not fit for purpose - they have too few questions, poorly worded or confusing questions, arbitrary scoring models, merge multiple factors (75%) without clarity or have outright poor scoring models. Fifty five percent had no mechanism to recognize risk-averse clients that should remain only in cash.

The research report offers examples of best practices in other jurisdictions and concludes with recommendations for regulators, industry and the academic community.

**4. Investors need more meaningful risk measures**

Dan Hallett  Special to The Globe and Mail  Published Thursday, Jul. 23, 2015 3:06PM EDT

The measurement and communication of risk for investment funds is high on securities regulators' radar. They continue to review this important issue and we're awaiting their final decision. It's striking how many years have passed and yet the industry continues to debate many of the same issues.

In 1997, I started working for a firm that was trying to move the industry away from opaque academic risk measures like standard deviation to more common-sense methods. I have written several times that the industry standard risk measure and illustration are inadequate and meaningless. The announced changes in fund risk ratings offers plenty of new evidence to support my argument.

I tracked risk rating changes on 44 mutual funds since last October. The table below lists the affected 28 unique funds – excluding 16 funds that are simply other incarnations of the 28 – and summarizes the risk rating changes and related risk statistics.

*Desktop users click on image to enlarge*

| Fund Name | Direction | Previous Risk Rating | New Risk Rating | Risk Rating Method | Biggest Drop in Value | Time Under Water |
|---|---|---|---|---|---|---|
| Franklin Bissett Canadian Balanced | ↓ | Low-to-Medium | Low | Historical Volatility | -28% | 2 years & 4 mos |
| Franklin Bissett Canadian All Cap Bal | ↓ | Low-to-Medium | Low | | | |
| Franklin Bissett Canadian High Dividend | ↑ | Low-to-Medium | Medium | | -35% | 1 year & 9 mos |
| Franklin Bissett Dividend Income | ↓ | Low-to-Medium | Low | | -25% | 1 year & 10 mos |
| Franklin Quotential Balanced Income | ↓ | Low-to-Medium | Low | | -23% | 2 years & 5 mos |
| Franklin Quotential Diversified Equity | ↓ | Medium | Low-to-Medium | | -44% | 5 years & 7 mos |
| Franklin World Growth | ↓ | Medium | Low-to-Medium | | -46% | 3 years & 11 mos |
| Templeton Asian Growth | ↑ | Medium | Medium-to-High | | | |
| Templeton BRIC | ↑ | Medium-to-High | High | | -52% | still recovering (after 7.5yrs) |
| Templeton Global Bond | ↓ | Low-to-Medium | Low | | -13% | 3 years & 7 mos |
| Templeton Global Smaller Companies | ↑ | Medium | Medium-to-High | | -55% | 6 years & 3 mos |
| Sprott Enhanced Equity | ↓ | Medium | Low-to-Medium | Historical Volatility | | |
| Sprott Enhanced Balanced | ↓ | Low-to-Medium | Low | | | |
| NEI Select Conservative Portfolio | ↓ | Low-to-Medium | Low | Historical Volatility | -17% | 3 years & 6 mos |
| O'Leary Canadian Dividend | ↓ | Medium | Low-to-Medium | Historical Volatility | | |
| O'Leary Canadian Balanced Income | ↓ | Low-to-Medium | Low | | | |
| O'Leary Conservative Income | ↓ | Low-to-Medium | Low | | | |
| O'Leary Global Dividend | ↓ | Medium | Low-to-Medium | | | |
| O'Leary Emerging Markets Income | ↑ | Low-to-Medium | Medium | | | |
| RBC O'Shaughnessy U.S. Growth Fund | ↑ | Medium-to-High | High | Historical Volatility | -66% | still recovering (after 7.2yrs) |
| RBC Private O'Shaughnessy U.S. Growth Equity Pool | ↑ | Medium-to-High | High | | | |
| MDPIM Canadian Bond Pool | ↑ | Low | Low-to-Medium | Historical Volatility | | |
| MD Strategic Yield | ↑ | Medium | Medium-to-High | | | |
| MD Precision Moderate Growth Portfolio | ↑ | Medium | Medium-to-High | | | |
| Standard Life Diversified Income | ↓ | Low-to-Medium | Low | Historical Volatility | -17% | 1 year & 6 mos |
| Standard Life U.S. Dividend Growth | ↓ | Medium | Low-to-Medium | | -33% | 5 years & 8 mos |
| Standard Life Canadian Equity Growth | ↓ | Medium-to-High | Medium | | | |
| Standard Life Canadian Equity Value | ↓ | Medium-to-High | Medium | | | |

*Multiple versions of funds (i.e. trust, corporate class, series F, series T, series A, etc.) are excluded for brevity. Risk stats are calculated on longer running version.*
*Raw data source: GlobeInvestorGold.com*

Nearly 2/3rds of the affected funds saw falling risk ratings with just over 1/3rd seeing a bump up in risk rating. In my view, an investor's exposure to risk should not fall after a multi-year run up in prices. A case can be made for risk being higher since we are likely closer than not to the next significant price drop.

But since the industry remains stuck on measuring risk using standard deviation – and applied to arbitrary scales – fund sponsors are blindly lowering risk ratings in droves. And risk ratings will only rise under this system after the worst of the next decline has already occurred – i.e. when it's too late.

Those using the industry standard risk rating method will update volatility measures annually. If volatility has fallen sufficiently over the past three or five years, there's a good chance the risk rating will fall. The thing is that usually volatility falls during bull markets and rises during bear markets. By the time this is captured by fund companies' annual updates, investors will have already been hurt. Even worse, when bear markets fall out of the three and five years periods used to assess risk, standard deviations are bound to fall.

A system designed to truly inform and protect investors would look far back enough to capture bear market performance either for the fund or – if it's too new – for its benchmark. Combining this with a more common sense measure – i.e. how much a fund

lost in its last big decline – puts these new risk ratings in a different light.

Of the 28 funds in the above table, 13 have enough history to look at past bear markets. Six of these 13 funds sport a new “low” risk rating. These six so-called “low risk” funds lost an average of more than 20% in the last bear market and spent 2.5 years under water. I don’t know anyone who considers this low risk. The few other funds that were re-assessed as having “low to medium” risk sport an average bear market loss of more than 41% and spent more than 5 years climbing back to the previous high.

If the industry continues to argue – as most fund companies have – that the standard risk rating method works well, they will need to rethink the purpose of these ratings. All fund companies are legal fiduciaries. Yet a true fiduciary mindset would attempt to measure and illustrate risk in ways that better inform investors.

In my submission on this topic to Canadian Securities Administrators last year, I clearly outlined the weaknesses of the status quo and provided strong arguments for with examples of more meaningful solutions (e.g. see page 4 of my submission). The latter reflects what we show to clients both before they engage our services and through our periodic reporting. It’s time for the broader fund industry to abandon its opaque technical approach and become more investor-friendly so that its end clients can better grasp risk before they invest.

*Dan Hallett, CFA, CFP is a principal with Oakville-Ont.-based HighView Financial Group, which acts as an outsourced chief investment officer for wealthy families and foundations. He also contributes to* The Wealth Steward blog.

5. **Illiquidity may be floating rate funds’ biggest risk**
http://www.highviewfin.com/blog/illiquidity-may-be-floating-rate-funds-biggest-risk/

**6.BMO income fund sets yield bar unreachably high**
http://www.theglobeandmail.com/globe-investor/investment-ideas/experts-podium/bmo-income-fund-sets-yield-bar-unreachably-high/article2207946/

7. **Lowering of PIMCO fund's risk rating illustrates need for reform** - The Globe and Mail
"...I have written many times over the past several years about the shortcomings of the prevailing method of assessing and communicating risk to mutual fund investors. I felt strongly enough about this to make a personal submission to regulators to share my thoughts on this important issue. A recent change to one popular fund’s risk rating simply confirms the weakness of the current risk rating method and the need for legislated meaningful risk measures...."
http://www.theglobeandmail.com/globe-investor/funds-and-etfs/funds/lowering-of-pimco-funds-risk-rating-shows-why-reform-is-needed/article17830350/

**8. How do you measure risk ?**: Sentry Investments
" Volatility is not the only measure of risk. The most important risk an investor can examine is: *“Will my current capital allocation enable my portfolio to maintain my purchasing power through the inevitable business cycles of life?”* The aggregate pension

portfolio is well structured to provide duration in the income stream together with sufficient growth in income to build capital and deal with benefits increases over time. The aggregate retail portfolio is very similarly placed when you look at the asset mix with balanced funds allocated to their underlying components. Mutual fund flows over the past five years indicate that the broad population is investing new capital in a very conservative manner.I hate to say this but I suspect a lot of 30, 40 and 50 year olds are investing as if they were already running a retirement portfolio. The fear of volatility is preventing appropriate risk taking at a point when investors have ample time for capital to accumulate over multiple cycles.".https://sentry.ca/en/portfolio-team/market-commentary/commentary-view.html?com=3462

**9. Investor behaviour and beliefs: Advisor relationships and investor decision-making study** http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf

10. **IOSCO Publishes results of the third annual Risk Outlook Survey**
See page 22-24 of the report, in particular, which includes the risks in the area of investor protection with a section of Financial Risk Disclosure stating: "An overwhelming majority of respondents reported that inadequate disclosure of financial risks puts investors at risk of buying products or services that are much riskier than individual investors may be comfortable with. As such, there could be a mis-match between the risk appropriate of the investor and the risk embedded in the product."Risk Outlook Survey: Detailed methodology and results 2015,

**OTHER REFERENCES**

**Volatility Inadaptability: Investors Care About Risk, but Cannot Cope with Volatility**
**ABSTRACT :**This article investigates two research questions: do investors see a relationship between risk attitude and the amount invested into risky assets? Further, do investors adjust their investments if provided with assets that have different volatilities? In an experimental study, investors allocate an amount between a risky and a risk-free asset. Investors' risk attitude predicts risk taking. Investors are, however, unable to adapt to risky assets with different volatilities; they choose almost the same allocation to the risky asset independently of its volatility, thus amassing significantly different portfolios. http://rof.oxfordjournals.org/content/18/4/1387.abstract

**Communicating Risks and Benefits: An Evidence-Based User's Guide**
http://www.fda.gov/downloads/AboutFDA/ReportsManualsForms/Reports/UCM268069.pdf

**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..”

**Risk Revisited Again** One of the best plain language explanations of the many facets of investing we have ever seen is Howard Marks of Oaktree Capital's **Risk Revisited Again** . It is well worth a read.

**William Bernstein on the Definition of Risk - A Wealth of Common Sense**
http://awealthofcommonsense.com/william-bernstein-risk/

**ICI Comment Letter on NASDR Release on Bond Fund Risk Ratings** :ICI
https://www.ici.org/policy/comments/97_NASD_VOLATILITY_RTGS_COM

**Fees impact Bond fund risk & return** « The Wealth Steward
http://thewealthsteward.com/2010/08/fees-impact-bond-risk-return/
"....Two observations. First, the MER reduces the yield-to-maturity by slightly more than the stated level. This is due to the compounding impact of fund fees, which are typically charged daily and paid monthly. Second, fees also nudge duration up because they increase the length of time before the purchase price of the bond is recouped. In other words, fees slightly increase duration risk while also slicing into returns. The result is a double-whammy impact on our risk-return ratio....".

**Management Expense Ratios (MER) influence return distribution**
http://retirehappy.ca/management-expense-ratios-do-matter/ Respected blogger Jim Yih looked at the impact of actively- managed mutual fund fees for 4 major fund categories . He found" *Fees matter more over longer time frames.* When you look at 5 and 10 year returns, there is a greater correlation that funds with lower MERs have on average better performance. For example, if we look at the 25 funds with the lowest MERs and compare them to the 25 funds with the highest MERs, the returns on a 5 year basis were on average 50% higher. Over a 10-year period, funds with low MERs performed 25% better than funds with high MERs...." .Thus ,over the long term the risk of underperforming a benchmark increases due to fees ; the amount of underperformance is material. During a market downturn ,the risk of losing money will be greater with high fee funds compared to lower cost counterparts.

**Investors don’t understand the risks of physical ETFs** | Canadian Investment Review
http://www.investmentreview.com/expert-opinion/investors-dont-understand-the-risks-of-physical-etfs-5810

**Risk assessment** Moneymanagedproperly blog

http://moneymanagedproperly.com/Education%20Investor/Risk%20assessment.pdf

**Proposed Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* ("NI 81-101"), Form 81-101F3 and Companion Policy 81-101CP *Mutual Fund Prospectus Disclosure* and Consequential Amendments**
http://www.cfasociety.org/cac/Comment%20Letters/2012/CSA%20NI%2081-101%20Mutual%20Fund%20Prospectus.pdf

**Is Your Bond Fund's Rating a Lie?** - CBS News
http://www.cbsnews.com/news/is-your-bond-funds-rating-a-lie/

**Do Investors Care about Risk? Evidence from Mutual Fund Flows**
Abstract: Using an extensive database compiled from SEC N-SAR filings, we study how risk affects monthly flows to equity mutual funds over the period 1996 to 2009. Unlike most previous studies, we separately examine inflows, outflows, and net flows. We find that both retail and institutional investor inflows and outflows strongly chase past raw performance, but more importantly, they do so without regard to risk. This behavior appears to neither help nor harm investors, but it has significant implications for fund managers. Among other things, the well documented inability of fund managers to produce significant abnormal returns may be due to incentives rather than lack of skill or market efficiency.
http://www.ou.edu/dam/price/Finance/Oklahoma_conference/2011/Chris%20Clifford%20-%20Do%20Investors%20Care%20about%20Risk.pdf

**THE RISK PERCEPTIONS OF INDIVIDUAL INVESTORS**
For those investors who systematically perceive risk according to the same risk measure, semi-variance of returns is most popular. Semi-variance is similar to variance, but only negative deviations fro the mean or another benchmark are taken into account. Stock investors implicitly choose for semi-variance as a risk measure, while bond investors favor probability of loss.
https://dspace.stir.ac.uk/bitstream/1893/335/1/the-risk-perceptions-of-individual-investors-revision-may30.pdf

**Point of Sale Disclosure and Regulatory Failure in Canadian Retail Financial Services:** Tamris Consultancy
No one wants to tell investors that this is a transaction relationship. As far as we are concerned this is misrepresentation at the highest level.http://www.moneymanagedproperly.com/technical%20docs/Point%20of%20Sale%20and%20Regulatory%20Failure%20September%202010.pdf P34 - POS – a communication outside of a suitability process: The Point of Sale document is a regulatory mandated communication between a product provider and the client and not a communication between the client and the advisor. As such it really lies outside the suitability process and therefore cannot be confirmation, on its own, of the suitability of the recommendation.

**Volatility and Mutual Fund Manager Skill** by Bradford D. Jordan, Timothy B. Riley :: SSRN

**ABSTRACT** Low volatility mutual funds outperform high volatility funds to a remarkable degree, and, in a standard four factor framework, past volatility is a reliable, persistent, and powerful predictor of future abnormal returns. Analyses patterned after Kosowski, Timmerman, Wermers, and White (2006) and Fama and French (2010) indicate that low volatility fund managers have significant skill. However, the addition of a factor contrasting returns on diversified portfolios of low and high volatility stocks eliminates differences in risk-adjusted performance. We conclude that either our volatility measure is associated with a pervasive, systematic pricing factor, or else the volatility effect is a market inefficiency of extraordinary size. Either way, failure to account for the volatility effect can lead to substantial mismeasurement of fund manager skill. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2365416&download=yes

**Junk Fund's Demise Fuels Concern Over Bond Rout** - WSJ
A firm founded by legendary vulture investor Martin Whitman is barring investor withdrawals while it liquidates its high-yield bond fund, an unusual move that highlights the severity of the months long junk-bond plunge that has swept Wall Street. The decision by Third Avenue Management LLC means investors in the $789 million Third Avenue Focused Credit Fund may not receive all their money back for months, if not more. Third Avenue said poor bond-market trading conditions made it almost impossible to raise sufficient cash to meet redemption demands from investors without resorting to fire sales of assets. http://www.wsj.com/articles/as-high-yield-debt-reels-mutual-fund-blocks-holders-from-redeeming-1449767526

**Management Expense Ratios (MER) influence return distribution**
http://retirehappy.ca/management-expense-ratios-do-matter/ Respected blogger Jim Yih looked at the impact of actively- managed mutual fund fees for 4 major fund categories . He found" *Fees matter more over longer time frames.* When you look at 5 and 10 year returns, there is a greater correlation that funds with lower MERs have on average better performance. For example, if we look at the 25 funds with the lowest MERs and compare them to the 25 funds with the highest MERs, the returns on a 5 year basis were on average 50% higher. Over a 10-year period, funds with low MERs performed 25% better than funds with high MERs...." .Thus ,over the long term the risk of underperforming a benchmark increases due to fees ; the amount of underperformance is material. During a market downturn ,the risk of losing money will be greater with high fee funds compared to lower cost counterparts.

**Risk-assessment tools inadequate, study finds**
http://www.investmentexecutive.com/-/risk-assessment-tools-inadequate-study-finds
While the focus group testing done by the CSA indicated that investors had difficulty understanding the principal risks that were described in the section, we are of the firm conviction that the principal risks need to be disclosed on FF; a way to present this info needs to be found in a manner that would alert investors to the other risks involved with fund ownership. To tell them to go to the Simplified Prospectus is simply not adequate.

NOTE: The IOSCO document (see Appendix) on page 20 states *"However focus groups alone may not be the most effective way to test the usability of a document or to learn how well an individual really understands what is written."*

**Vanguard Principle 3: Minimize cost Impact of costs on return and risk of loss**
https://personal.vanguard.com/us/insights/investingtruths/investing-truth-about-cost A powerful
presentation on how fees impact return profile and risk.

**Mutual Fund Risk Classification Methodology - a modest proposal**
Respected fund blogger Jean Lesperance proposes MER fee bands as a good indicator of fund risk. He 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.

**Should Canada's Financial Advisors Be Held to a Fiduciary Standard? ,** January 30, 2015 "While Canada's regulators have proposed a number of regulatory reforms to better serve the public trust, well-entrenched conflicts of interest will continue to impact the quality of advice that consumers receive. Despite potential challenges in its implementation, holding financial advisors to a fiduciary standard represents one of the most important steps Canadian regulators can take to ensure that the advice consumers receive is truly in their best interests. "
http://dtpr.lib.athabascau.ca/action/download.php?filename=mba-15/open/punkon-aprj-final.pdf

**Risk literacy**: Italian research
http://gflec.org/wp-content/uploads/2015/03/Risk-Literacy-Ital-Econ-J-2015.pdf

**Fooled-by-Randomness-Investor-Perception-of-Fund-Manager-Skill.**
http://www.evidenceinvestor.co.uk/wp-content/uploads/2015/08/Fooled-by-Randomness-Investor-Perception-of-Fund-Manager-Skill.pdf

**Financial knowledge and rationality of Canadian investors**
https://www.lautorite.qc.ca/files/pdf/fonds-education-saine-gouvernance/finances-perso/fin-perso_ulaval_knowledge-rationality.pdf

**The Canadian Money State of Mind Risk Survey 2014: Investor Risk, Behaviour & Beliefs** | Our research | GetSmarterAboutMoney.ca

Almost one-quarter of individuals who identify themselves as low-risk investors own "medium- to very high-risk" products; conversely, seven in 10 self-identified high-risk investors own "low- to medium-risk" products. One-in-three Canadian investors had a major loss (at least 20 per cent of their investment value) in one year. Of those who had a major loss, 51 per cent stayed the course and didn't change their investments in response. Just over half of investors have regretted an investment decision based on emotion, although most have done so only once or twice.
http://www.getsmarteraboutmoney.ca/en/research/Our-research/Pages/Investor-Risk-Behaviours-and-Beliefs-2014.aspx#.VnAiIq_EirU

**Risk and a Investor Behaviour**
http://www.investmentreview.com/files/2009/12/Risk_Kalirai1.pdf

**What's wrong with multiplying by the square root of 12?**
http://corporate.morningstar.com/US/documents/MethodologyDocuments/MethodologyPapers/SquareRootofTwelve.pdf

**Risk Profiling - Urgent Need for Risk Appetite Testing**
http://riskprofiling.com/blog/November-2015/needreliablerisk

**Investment risk and financial advice:** Vanguard
https://www.vanguard.co.uk/documents/adv/literature/investor-risk-profiling.pdf

**Canadian Association of Retired Persons - Submission on financial advice and Planning**
Canadians' investment and financial literacy is very low. A recent study of Quebec and Ontario investors' knowledge found that there are "significant gaps" in investor knowledge of risk and return of asset categories, and that the general level of investor knowledge is "mediocre."**viii** The study notes that this "mediocre knowledge of the performance of categories and of the concept of risk premium calls into question investors' financial planning ability."**ix** Investors fail to understand a number of significant aspects of sound financial investment, according to the findings of the study:**x**
http://www.fin.gov.on.ca/en/consultations/rfp-submissions/canadian-retired.html

**Measuring Investors' Risk Appetite** http://papers.ssrn.com/sol3/papers.cfm?abstract_id=872695

**The Trouble With Target-Date Funds** | Canadian Investment Review
http://www.investmentreview.com/expert-opinion/the-trouble-with-target-date-funds-6531

**Risk Profiling: Suitability**- EY
http://www.ey.com/Publication/vwLUAssets/EY-risk-profiling-consumer-protection-agenda-investment-suitability/$File/EY-risk-profiling-consumer-protection-agenda-investment-suitability.pdf

**The Costs and Benefits of Financial Advice**
http://www.hbs.edu/faculty/conferences/2013-household-behavior-risky-asset-mkts/Documents/Costs-and-Benefits-of-Financial-Advice_Foerster-Linnainmaa-Melzer-Previtero.pdf
Stephen Foerster, Juhani Linnainmaa, Brian Melzer Alessandro Previtero ,March 8, 2014
Abstract :We assess the value that financial advisors provide to clients using a unique panel dataset on the Canadian financial advisory industry. We find that advisors influence investors' trading choices, but they do not add value through their investment recommendations when judged relative to passive investment benchmarks. The value-weighted client portfolio lags passive benchmarks by more than 2.5% per year net of fees, and even the best performing advisors failto produce returns that reliably cover their fees. We show that differences in clients' financial knowledge cannot account for the cross-sectional variation in fees, which implies that lack of financial sophistication is not the driving force behind the high fees. Advisors do, however, influence client savings behavior, risky asset holdings, and trading activity, which suggests that benefits related to financial planning may account for investors' willingness to accept high fees on investment advice.