FINANCIAL PLANNING STANDARDS COUNCIL

Financial Planning Standards Council

Submission on Canadian Securities Administrators' Discussion Paper and Request for Comment on CSA Notice 81-324 Mutual Fund Risk Classification Methodology for Use in Fund Facts

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Nova Scotia Securities Commission
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Proposed CSA Mutual Fund Risk Classification Methodology

Financial Planning Standards Council (FPSC®) is pleased to offer its comments on CSA Notice 81-324 *Mutual Fund Risk Classification Methodology for Use in Fund Facts.*

Financial Planning Standards Council is a not-for-profit organization which develops, promotes and enforces professional standards in financial planning through CERTIFIED FINANCIAL PLANNER® certification. FPSC's purpose is to instil confidence in the financial planning profession. As a standards-setting and certification body, FPSC ensures CFP® professionals and FPSC Registered Candidates meet appropriate standards of competence and professionalism through rigorous requirements of education, examination, experience and ethics. In Canada there are over 17,000 CERTIFIED FINANCIAL PLANNER professionals in good standing, and through our membership in the international Financial Planning Standards Board and corresponding network which spans 24 territories, there are over 150,000 CERTIFIED FINANCIAL PLANNER professionals worldwide.

FPSC supports the notion of the implementation of standardized risk classification methodology. Providing consumers with a "consistent and comparable basis for measuring the risk of different mutual funds", in a manner that is easily digested, understood and relevant to the consumer will no doubt assist them in making a more informed investment decision. While we support the entire list of criteria and objectives articulated in Annex A of your consultation paper, our comments have been focused on two specific indicators:

1. Be easy to understand by all market participants
2. Be meaningful and allow for easy comparison across investment funds.

To provide context, we have outlined the competencies required of a CERTIFIED FINANCIAL PLANNER in Canada as established by FPSC.

Financial Planners Assess Risk Broadly

Financial planning is a disciplined, multi-step process of assessing an individual's current financial and personal circumstances against their future desired state and developing strategies that help meet their personal goals, needs and priorities.

FPSC has developed the *CFP Professional Competency Profile* which identifies the core knowledge, skills and abilities required for what we would consider to reflect competent financial planning practice of all CFP professionals. Competencies fall under multiple financial planning areas. An assessment of risk tolerance is done to gain a firm sense of the client's level of acceptance with taking risks generally in life and more specifically in their investment practices. A CFP professional must assess both the client's comfort with, and their capacity to, sustain financial losses should they occur.

Ease in Understanding: Provide Investors with Statistics That Resonate

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.

Standard deviation does not provide a full picture of a fund's risk nor is it understood in practical terms by most retail investors. Since standard deviation measures volatility of return, it does not address the primary concern of most investors which is their potential real loss of capital. Further, without a clear understanding of what standard deviation measures and how Low-Medium-High risk categories are defined, there is a strong possibility that retail investors will misinterpret the measures resulting in inaccurate expectations of a fund's future performance. For example, we are aware of funds which are categorized as *Medium risk* using a standard deviation measure who have experienced two loss years of over 15% within a five year period. We suspect that relatively few investors would consider this the performance of a fund considered as *Medium risk*.

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 Management Expense Ratios will necessarily impact statistics such as time to recovery, as well as other risk measures, yet standard deviation does not capture these significant differences in real risk to consumers based on the variance in fees that are inherent in different classes of the same fund.

Provide Intuitive Tools to Assess Risk

Meaningful and intuitive statistics such as the frequency of fund losses over specific time periods, magnitude of losses over time, worst single year losses, loss recovery times, and minimum holding periods to mitigate potential short-term volatility will paint an investment risk picture for clients that is easier to grasp and likely far more aligned with their concerns.

FPSC is currently in the process of developing guidance to the *CFP Professional Competency Profile* that will, among other things, assist CFP professionals in effectively carrying out comprehensive assessments of their clients' risk profiles. Definitions and interpretations of *Low*, *Medium* and *High* risk are illusive. Indeed, risk may be best understood by investors in behavioural terms. FPSC's guidance will take a broader view of risk, utilizing real-life situations that clients can easily relate to, and that go beyond simple categorization of risk tolerance as *Low*, *Medium* or *High*.

For example, a CFP professional may be guided to delve more deeply into the client's propensity for, or aversion to, risk by asking questions that will assess client behaviour where

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investments suffer multiple periods of loss, various magnitudes of loss and have various lengths of recovery. Such questions are clear and understandable to investors and serve to create consistency of interpretation between the investor and the advisor. We believe that if Fund Facts reflected a similar, more intuitive approach to assessing risk, advisors could more accurately ensure that their investment recommendations would have risk ratings consistent with the actual risk profile of their clients.

FPSC appreciates the opportunity to present our comments and insights on this important topic. Should you have further questions on our submission, please feel free to contact us.