

February 23, 2016

CRM2: Missing the Mark

Introduction

The Client Relationship Model (CRM) is coming into effect in Canada with advisors/dealers (from now on referred to as “managers”) and investors trying to digest the new retail investment industry standards. The Investment Industry Regulatory Organization of Canada’s (IIROC) previous President and CEO, Susan Wolburgh Jenah, described CRM as “a comprehensive reform package designed to promote transparency, enhance investor protection and raise industry standards. These objectives are critical to promoting confidence in the quality and integrity of investment advisors as a profession.”¹



In essence, IIROC received approval by the Canadian Securities Administrators (CSA) in 2012 to begin implementation of its comprehensive reform package with the goal to enhance the relationship between investors and advisors. With phase one of the reforms completed, regulators has moved to phase two of CRM (CRM2) and a critical component of the reforms lies in performance reporting, impacting managers and investors. Canadian regulators have to be commended for their effort in trying to create transparency, always a herculean task met with significant resistance by market participants. Unfortunately, the reforms related to performance do not go far enough.

CRM2 Performance Requirements

Before we go into the shortfalls of CRM2, it would be preferable to begin with what CRM2 requires with performance related information. Key performance areas covered by the regulations are market values, changes in market values, deposits and withdrawals, performance return methodology, reporting periods, benchmarks and performance reporting. The following provides a short summary of what is required.

Market Value Requirements:

CRM2 aims to present the investors the change in account value for periods including 12-month and since inception, where the market values represent all cash and investments. The 12 month and since inception change in value are to be calculated in the following manner:

12 Month Change in Market Value (MV)

Change MV = End MV – Beg MV – Deposits/Transfers + Withdrawals/Transfers

- where Deposits/Withdrawals/Transfers include cash and investments

¹ IIROC News Release, Dec 12, 2013, “Final set of Client Relationship Model (CRM2) Reforms”

Since Inception Change in Market Value

Change MV = End MV – Begin MV – Deposits/Transfers + Withdrawals/Transfers

- where:
 - o End MV as at the end of the year
 - o Begin MV as at the inception of the account
 - o Deposits/Withdrawals/Transfers include cash and investments since account inception

A provision is provided for accounts where the market values, deposits, withdrawals, and transfers are not available since the opening of the account. The regulators require that the change in market value is calculated as such:

Change in MV = End MV – Beg MV - Deposits/Transfers + Withdrawals/Transfers

- where:
 - o End MV as at the end of the year
 - o Beg MV as **at July 15, 2015** (or earlier date)(“reference date”)
 - o Deposits/Withdrawals/Transfers include cash and investments since the **reference date**

Performance Return

The biggest impact CRM2 has on performance is the methodology that the regulators decided on was necessary to meet the stated objectives. Traditionally, fund managers have been presenting performance using the Time Weighted Rate of Return (TWRR) methodology but CRM2 decided on using the Money Weighted Rate of Return (MWRR). Any MWRR approach that is generally accepted in the securities industry, is acceptable by CRM2 requirements.

Discussion during the period of comments had the majority of commenters preferring that the choice of methodology remain the sole discretion of the registered firm. Some preferred only the presentation of the MWRR or the TWRR, while a smaller amount of commenters, recommended the use of both. In the end the regulators decided on the MWRR because they feel that it “enables investors to directly measure how they are progressing toward their goals” and “encourages communication between investors and managers”. Regulators believe that managers can use the MWRR to educate the client as to the impact of moving money in and out of their account.

For those commenters who preferred that the CRM2 requirements side on providing both return methodologies, the requirement of presenting MWRR does not prohibit firms from presenting the TWRR as well. In the end, Canadian regulators overriding objective with respect to the return measure is to “show clients how their accounts have performed.”

Benchmarks

Regulators have decided to make the use of benchmarks optional in client reporting under National Instrument 31-103. If benchmarks are used, a general description is required, discussed with clients in terms they can understand, and determine if their information needs are met.

Regulators see the use of benchmarks as a way for clients to assess the performance of their portfolios. These benchmarks should be based on widely recognized and available indices and reflective of the client's portfolio composition and investment time horizon. Reporting periods should be the same between the portfolio and benchmark. The use of the benchmark should be applied consistently from one period to the next and any changes should be discussed with the client and clearly indicated "what and why" in the explanatory notes.

Indices such as the S&P/TSX Composite Index for Canadian equities, the S&P 500 index for US equities, and the MSCI EAFE index as a measure of equity markets outside of North America, are deemed satisfactory. Regulators do not limit the choice of benchmarks to the above but reflect the kind of benchmark they find acceptable.

Fees

Regulators biggest achievement with CRM2 is the impact on the disclosure of fees. Investors will be able to gain significant transparency on what they are being charged for the management of their wealth. Annually, firms will need to report on charges and compensation received that relates to clients' accounts. Some of these charges and compensation include:

- Operating and transaction charges
 - switch fees
 - account fees
 - transfer out/deregistration fees
 - sales taxes charged on fees
 - financial planning fees
- Sales charges
 - front-end load charges
 - deferred sales charges
- Trailer commissions
- Fee based compensation
- Referral fees
- Debt security transactions

Performance Reporting

Performance reports must be issued on an annual basis to clients and representative managers are encouraged, but not required, to provide additional disclosures and definitions on the performance measures used. In person meetings are encouraged to help clients understand the reports and how they relate to their objectives and risk tolerance. Reports are to be issued on an account by account basis, with optional consolidated account reporting.

Reporting periods required are for 1, 3, 5, or 10 years and since inception and can be presented with the use of texts, tables, charts as well as accompanying notes that provide information on how the client can use the information to assess the performance and the changing value of the clients' investments. Moreover, a disclosure of what "Total Percentage Return" represents, which includes:

- that the total percentage return was calculated net of charges
- the calculation method used
- a general explanation of what the calculation method takes into account

The following performance report is an example of what the regulators feel is acceptable.²

Rules and Policies		COMPANION POLICY APPENDIX E																			
<p>Change in the value of your account</p> <p>This table is a summary of the activity in your account. It shows how the value of your account has changed based on the type of activity.</p> <table border="1"> <thead> <tr> <th></th> <th>Past year</th> <th>Since you opened your account</th> </tr> </thead> <tbody> <tr> <td>Opening market value</td> <td>\$51,063.49</td> <td>\$0.00</td> </tr> <tr> <td>Deposits</td> <td>\$4,000.00</td> <td>\$21,500.00</td> </tr> <tr> <td>Withdrawals</td> <td>\$(5,200.00)</td> <td>\$(5,200.00)</td> </tr> <tr> <td>Change in the market value of your account</td> <td>\$2,928.85</td> <td>\$36,492.34</td> </tr> <tr> <td>Closing market value</td> <td>\$52,792.34</td> <td>\$52,792.34</td> </tr> </tbody> </table>			Past year	Since you opened your account	Opening market value	\$51,063.49	\$0.00	Deposits	\$4,000.00	\$21,500.00	Withdrawals	\$(5,200.00)	\$(5,200.00)	Change in the market value of your account	\$2,928.85	\$36,492.34	Closing market value	\$52,792.34	\$52,792.34	<p>Your investment performance report Investment account 123456789</p> <p>Client name Address line 1 Address line 2 Address line 3</p> <p>This report tells you how your account has performed to December 31, 2030. It can help you assess your progress toward meeting your investment goals.</p> <p>Speak to your representative if you have questions about this report. It is important that you tell your representative if your personal or financial circumstances have changed. Your representative can recommend adjustments to your investments to keep you on track to meeting your goals.</p>	
	Past year	Since you opened your account																			
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Change in the market value of your account	\$2,928.85	\$36,492.34																			
Closing market value	\$52,792.34	\$52,792.34																			
<p>Your personal rates of return</p> <p>What is a total percentage return? This represents gains and losses of an investment over a specified period of time, including realized and unrealized capital gains and losses plus income, expressed as a percentage.</p> <p>For example, an annual total percentage return of 5% for the past three years means that the investment effectively grew by 5% a year in each of the three years.</p> <p>The returns in this table are your personal rates of return. Your returns are affected by changes in the value of the securities you have invested in, dividends and interest that they paid, and also deposits and withdrawals to and from your account.</p> <p>If you have a personal financial plan, it will contain a target rate of return, which is the return required to achieve your investment objectives. By comparing the rates of return you actually achieved (shown in the table) with your target rate of return, you can see whether you are on track to meet your investment objectives.</p> <p>Contact your representative to discuss your rate of return and investment objectives.</p>		<p>Total value summary</p> <p>Your investments have increased by \$36,492.34 since you opened the account Your investments have increased by \$2,928.85 during the past year</p> <p>Amount invested since you opened your account on January 1, 2015: \$16,300.00 Market value of your account on December 31, 2030: \$52,792.34</p>																			
<p>Calculation method</p> <p>We use a money weighted method to calculate rates of return. Contact your representative if you want more information about this calculation.</p> <table border="1"> <thead> <tr> <th></th> <th>Past year</th> <th>Past 3 years</th> <th>Past 5 years</th> <th>Past 10 years</th> <th>Since you opened your account</th> </tr> </thead> <tbody> <tr> <td>Your account</td> <td>5.51%</td> <td>10.92%</td> <td>12.07%</td> <td>12.90%</td> <td>13.09%</td> </tr> </tbody> </table> <p>Amount invested means opening market value plus deposits including: the market value of all deposits and transfers of securities and cash into your account, not including interest or dividends reinvested.</p> <p>Less withdrawals including: the market value of all withdrawals and transfers out of your account.</p>			Past year	Past 3 years	Past 5 years	Past 10 years	Since you opened your account	Your account	5.51%	10.92%	12.07%	12.90%	13.09%	<p>Amount invested since opening market value plus deposits including: the market value of all deposits and transfers of securities and cash into your account, not including interest or dividends reinvested.</p> <p>Less withdrawals including: the market value of all withdrawals and transfers out of your account.</p>							
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² National Instrument 31-103, Chapter 5, Rules and Policies

CRM2 Missing the Mark

The changes impacting the Canadian retail investment landscape are significant and worthy of taking notice. It is a moment where regulators are trying to put the investor first by providing them the information they feel is necessary to properly evaluate the progress of their investments with the objective to:

- promote transparency
- enhance investor protection
- raise industry standards

Regulators feel that the above is critical to promoting confidence in the quality and integrity of managers as a profession. Although the Canadian regulators' efforts in raising the investment industry's standards should be supported, they have not gone far enough to reach their objectives. From a fees point of view, they are bringing more transparency than before, but very little transparency is achieved from an overall CRM2 point of view. The tools presented are not sufficient for creating any real transparency and considering the high amount of fees Canadians pay, the industry owes it to them to bring greater transparency.

The change in methodology, leeway in benchmark selection, lack of risk quantification, overall absence of numerical tools to gain insight into the managers' own abilities and lastly, the true progress towards an investors financial objectives, are significant failings in the current regulator s' performance requirements. The field of performance has advanced to such a degree, that what has been proposed by the Canadian regulatory authority, significantly misses the mark on transparency.

Methodology

The decision to go with MWRR methodology is significant and the idea behind it is to present the impact of deposits and withdrawals investors make. A significant portion of commenters to CRM2 would have preferred that it be left at the discretion of firms but regulators did not agree. There is no ideal performance measure and the current requirements only address one aspect of performance evaluation. Before we delve into the impact of this requirement, let's take a moment to review what these performance return methodologies represent.

The difference between the two comes down to the impact of deposits and withdrawals. The MWRR takes into account the impact deposits/withdrawals have on performance while the TWRR offsets them. In other words, the decision to contribute or withdraw funds from one's portfolio will impact the MWRR but not the TWRR. The larger the cash flow the greater the difference between the two measures and vice versa, to the point where if there are no cash flows during the measurement period, then both approaches will provide the same return.

The issue from our point of view is that by presenting only the MWRR the investor is only receiving one part of the message and missing out on the other. The message lost is the manager's impact on performance because TWRR focuses on the manager's skill. Investors should have both measures to evaluate the impact of their decisions and as well, the manager's. As an example, let's look at the monthly performance of an investor's portfolio where a significant contribution is made mid-month.

Firstly, let's divide the monthly period into two sub-periods (sub-period 1 and 2):

1. During the **Sub-Period 1**, a minimal initial investment is made of \$10,000 with the period's return being 30%.
2. At the mid-point of the month, a significant contribution of \$150,000 is made and **Sub-Period 2's** return is -7.98%.

As can be seen by the table below, from a TWRR the investor's monthly return is 19.63% while the MWRR is -11.16%. What is interesting here is that although the TWRR is positive the investor actually lost money, that is, -\$10,000. So is TWRR wrong? Not at all. The impact here was the decision to invest a significant amount of funds prior to a period of negative performance. MWRR weights returns based on deposits/withdrawals while the TWRR offsets them and equally weights each period's return. The manager did well during the month but the client's decision to deposit overly weighted the negative impact. By looking at both measures, the investor is gaining a clearer message of how his/her performance is being impacted.

Date	MV	Contribution	IRR	TWR			\$	\$Gain/Loss
				Total Return		Sub-Period Return		
2014-12-31	\$10,000							
2015-01-15	\$13,000	\$ 150,000			Sub-Period 1	30.00%	\$3,000	
2015-01-31	\$150,000		-11.16%	19.63%	Sub-Period 2	-7.98%	-\$13,000	-\$10,000

Providing both these measures is beneficial but what would be preferable is to not only provide TWRR and MWRR, but as well as other measures such as dollar, absolute, relative, net & gross, and risk adjusted returns. This comprehensive return presentation would provide much greater insight into if the investor is making money, how well the manager has been managing the portfolio, and the risk taken. It is not enough for an investor to view only the progress of their objective but as well as the ability of the manager. In general, we have limited ourselves to just returns but the field of performance has evolved to the degree where we can gain much more insight into the portfolio strategy and the execution of it. With the current change, we are only taking one very small step towards that. As for being able to view the progress of an investor's objective, considering what is lacking, the objective may not even be correct.

Benchmarks

The optional use of benchmarks by regulators contributes to the issue raised in the previous section, and that is to provide an opportunity to evaluate a manager's ability. A benchmark can be considered a passive representation of a portfolio strategy and is a gauge used to partially isolate the decisions made

in managing the portfolio. If an investor’s portfolio replicates a benchmark, the S&P/TSX for instance, then no active management is required because the investor can just purchase an ETF.

CRM2 does not require a benchmark but it does not prohibit one either. The regulators have set some standards as to what kind of benchmark can be used but these requirements leave too much room for the selection of improper benchmarks. One of the requirements is that it should be a widely held and recognized benchmark but no mention is made that it should also represent the same risk-return profile of the portfolio. Take a situation where a client may have the S&P/TSX shown as a benchmark and at the same time, have a portfolio concentrated in small cap high growth stocks. This provides no value in the performance feedback to the client; it actually makes the message worse and misleading. The example below exemplifies the differences and the issues:

Client Portfolio	Benchmark: S&P/TSX Composite Index
Profile: <ul style="list-style-type: none"> - Long-Term Time Horizon - High Growth - Above Average Risk 	Profile: <ul style="list-style-type: none"> - Large Cap Canadian Equity Stocks - Blended (Value and Growth) - Average Risk
Composition: <ul style="list-style-type: none"> - 90% Equity: Canadian Small Cap Stocks - 10% Bonds: Corporate Bonds 	Composition: <ul style="list-style-type: none"> - 240 Canadian Securities: broad based but dominated by large cap securities

The benchmark does not reflect a passive approach of the client portfolio and does not even include a bond component. While some might say this does not happen, the fact is that this is an all too common occurrence and clients end up seeing their portfolio being compared to benchmarks with little in common with what their manager is doing for them. How can a client rely on the feedback from their manager who has far too much leeway in selecting a benchmark? With greater conditions and guidance clients would be able to compare their portfolios to quality benchmarks.

The CFA Institute has a set criteria of what constitutes a valid benchmark³ and they are:

- **Unambiguous:** The individual securities and their weights in a benchmark should be clearly identifiable. For example, we should be able to identify whether Nestlé is included in a global equity benchmark and its weight.
- **Investable:** It must be possible to replicate and hold the benchmark to earn its return (at least gross of expenses). The sponsor should have the option of moving assets from active management to a passive benchmark. If the benchmark is not investable, it is not a viable investment alternative.

³ “Introduction to Benchmarks” by C. Mitchell Conover, PhD, CFA, CIPM, Daniel Broby, FSIP, and David R. Cariño, PhD

- **Measurable:** It must be possible to measure the benchmark's return on a reasonably frequent and timely basis.
- **Appropriate:** The benchmark must be consistent with the manager's investment style or area of expertise.
- **Reflective of current investment opinions:** The manager should be familiar with the securities that constitute the benchmark and their factor exposures. The manager should be able to develop an opinion regarding their attractiveness as investments; he should not be given a mandate containing obscure securities that he could not be expected to have knowledge of.
- **Specified in advance:** The benchmark must be constructed prior to the evaluation period so that the manager is not judged against benchmarks created after the fact.
- **Accountable:** The manager should accept ownership of the benchmark and its securities and be willing to be held accountable to the benchmark.

Adopting such requirements would make a significant impact on improving industry standards and create greater accountability on the manager side. It will avoid comparing apples to oranges and enable investors to ask more informed questions. Some may say that this is too difficult but nothing worthwhile is easy. Although retail investors may lack the necessary knowledge to ask the right questions, these mandatory requirements proposed, will provide an investor more information than otherwise available and leave them less reliant on the manager's knowledge.

Fees

The report will not provide a breakdown of the amounts paid to the advisor. In addition, if client's hold investments in mutual funds, the costs of managing the mutual fund (i.e. management fees, etc.) will not appear in the Report on Charges and Compensation. Those fees are embedded in the NAV provided by the mutual fund. As such, this additional cost will not be available to clients. Clients will still require to perform their own calculation of the additional costs they paid if they want a complete fee picture.

Risk Profile

There's very little mention of any tangible tool to properly measure and evaluate a client's risk profile. From a performance point of view, risk can be considered as the uncertainty of meeting investor objectives⁴. With an objective of empowering investors to monitor the progress of their portfolios towards their objectives, these tool play a key role in monitoring and managing portfolio risk.

Questionnaires are only one part of the risk assessment of an investor but there are numerical tools that quantify the risk and allow for the monitoring of it over the life of the portfolio. Risk adjusted returns and risk measures such as M^3 , Sharpe Ratio, Standard Deviation, and Treynor Ratio are all available for usage by firms. Some might argue that they are too complicated for investors but that argument does

⁴ CIPM Readings

not hold because it is not the mathematical formula that needs to be explained but the message of the number. For example, if a portfolio's Standard Deviation is significantly higher than the risk profile assessment, then the investor would know that the manager has taken on more risk than he/she agreed to. Furthering this feedback would be the Sharpe Ratio: a manager may show a client exceptional performance but if that performance involved a considerable amount of risk, then the Sharpe Ratio would be low relative to a quality benchmark. On the other hand, a higher Sharpe Ratio would show that the manager is getting more out of performance on a risk adjusted basis. The investor needs only to compare these values which would raise the necessary questions into the manager's ability to manage their portfolio.

Performance Reporting

Clients will be receiving, annually, a report that includes the most basic of information but very little to properly evaluate their portfolio and the manager managing it. From the basic change in \$ value of the portfolio and the limited multi-period returns, clients do not have access to more complete reporting that provide a comprehensive story.

A comprehensive view of an investors overall portfolio requires a consolidated report, where all accounts are grouped into one, providing a better gauge to investors of how far their portfolio has progressed. No bank or investment firm views their accounts on an account-by-account basis only, they always look at the total level, for performance and risk. Retail investors should be afforded the same quality of reporting as institutional when it comes to consolidating their accounts.

Secondly, performance should be presented on a monthly basis for 1 year with the MWRR and TWRR displayed side to side. In addition, the net contributions/withdrawals would also be included for clients to understand the impact of their decisions to deposit/withdraw funds. Furthermore, it will create a better discussion between manager and investor as to the previous 12-month performance. For example:

Date	Market Value	Net Deposits & Withdrawals	IRR	TWR	Cash Decision Impact
2014-12-31	\$ 100,000	-	-	-	-
2015-01-31	\$ 175,000	\$ 55,000	15.70%	12.90%	2.80%
2015-02-28	\$ 180,000	\$ 35,000	-15.63%	-14.29%	-1.34%
2015-03-31	\$ 240,000	\$ 40,000	9.99%	11.11%	-1.12%
2015-04-30	\$ 215,000	\$ 45,000	-26.49%	-29.17%	2.67%
2015-05-31	\$ 230,000	\$ -	6.98%	6.98%	0.00%
2015-06-30	\$ 250,000	\$ -	8.70%	8.70%	0.00%
2015-07-31	\$ 215,000	\$ -	5.31%	5.91%	-0.60%
2015-08-31	\$ 170,000	-\$ 47,000	-7.53%	-8.11%	0.58%
2015-09-30	\$ 130,000	-\$ 30,000	6.88%	5.88%	0.99%
2015-10-31	\$ 90,000	-\$ 50,000	-8.76%	-7.69%	-1.07%
2015-11-30	\$ 120,000	-\$ 30,000	11.11%	11.11%	0.00%
2015-12-31	\$ 135,000	\$ -	12.50%	12.50%	0.00%

A properly educated manager would be able to convey this information in a clear and concise manner to clients. Over time, clients will be able to learn and begin asking questions themselves.

Lastly, returns should be broken down by asset class, sector, and country/region so investors can view the breakdown of their returns and see how well the adviser/dealer decisions played out. All this information is critical to evaluating the portfolio thesis in terms of numerical values and provide the true insight the investors require.

The majority of managers are supported by large Canadian banks with significant amount of financial and technical resources to support and train managers in providing and understanding all these additional tools. Lack of resources is not an acceptable excuse for requiring more from performance than what CRM2 currently proposes.

Conclusion

Regulators move to greater transparency is encouraging as it imposes on the retail side of the investment industry a more structured and professional approach to performance measurement. The institutional side of the industry is considerably ahead of the retail side, even though it still has considerable room to grow as well. Although we commend regulators on their effort, we also felt that the current performance requirements are not sufficient to meet the stated objectives. Why has it taken so long and why hasn't there been a more comprehensive and worthwhile change implemented? Fear.

Transparency creates fear within people and in this case, it creates fear for managers since clients would be empowered to ask more questions, challenge them and complain more if they felt that they are not being serviced properly. A lot of the pressure to institute any performance methodology was met with resistance as evidenced by the comments period of CRM2.

Taking it one step at a time so people feel comfortable by keeping transparency to a minimum is not the best approach. A more aggressive response is required because the retail industry lags so far behind the current state of the investment performance field. Providing unbiased numerical tools with the proper education, for both managers and investors, will create a transparent environment where investors would truly be able to evaluate the progress of their portfolio.