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Analyze fund ads for clues

According to Nielsen Media Research, Canada's mutual fund industry spent $67.3-million on advertising in 2000. That figure plunged dramatically to $13.5-million last year. The fund industry has consolidated, margins have been squeezed and discretionary advertising budgets cut. Meanwhile, the sales approach has shifted as well, from selling a product to the investor-consumer to more sophisticated targeting of financial consultants, planners and brokers. [Source: Keith Damsell, “RRSP season opens with less flashy campaign ”, Globe and Mail, Jan. 3, 2005 pg B6].”Find the money," the Bank of Nova Scotia’s 2005 mutual fund RRSP campaign theme, emphasizes financial planning, disciplined saving and prudent borrowing. About a decade ago, the bank's "reality check" ads struck fear into investors' hearts with the warning that you must sock away $1-million to retire comfortably. Regardless of where the promotion comes from or the form (ad, brochure, the web, billboard or TV), investors have to be on guard.

Like any advertiser, mutual fund companies advertise to sell you their mutual funds. The greater the assets under administration, the greater their fees. Fund companies have regulatory restrictions on their ads but mistakes are made and regulatory enforcement is, shall we say, less than diligent. The July 2004 OSC Capital Markets Compliance Report was a real eye-opener. It contained a number of serious concerns to investors regarding repetitive non-compliances and a negative trend. For example, when marketing mutual funds, the requirements of Part 15 of National Instrument NI 81-102 must be adhered to. As an example, during the reviews, the review team observed the following:

- Marketing materials contained information that was incorrect
- Marketing materials were outdated or had inadequate disclosure
- Web-site information was incorrect, outdated or contained inadequate disclosure
- Performance data incorrectly used return data from a different fund/period
- References to the Association for Investment Management and Research ("AIMR") were used when the firm was not AIMR compliant or was incorrectly worded
- Claims of "superior performance" were made that could not be substantiated
- The disclosure and warning language required by 15.2(2) of National Instrument NI 81-102 was not always present

Fund ads can provide useful clues and warning signs. In this report we cover the most prominent of these.

All ads contain a boilerplate paragraph somewhere telling you that past returns may not be repeated. You should take this very seriously. The disclaimer also advises that the returns posted exclude sales loads, optional fees and taxes and assume that all distributions are reinvested [tax-free is implied]. These assumptions rarely fit anyone .If you buy a front-load fund in a non-registered account, your returns will vary significantly from those published.

The Canadian Investment Awards actually provide awards for marketing –in 2003 the winners were:
- Print Collateral – **AGF Funds Inc. (‘***Mutual Funds Basics Brochure’***)**
_ Print Advertising – **Mackenzie Financial (‘***Basketball’, ‘Girl Genius’, ‘Twins’, Dinosaur’)*
- Overall Campaign – **AGF Funds Inc.** *(‘ Montreal Canadiens Hockey Cards’***)**

These awards recognize the power of fund ads in attracting cash inflows. Don’t let your mind be hijacked by fund ads –their purpose is to get their hands on your money. Look at all the relevant facts before parting with your hard earned cash.

Industry critics and others have critiqued fund advertising for years, particularly equity fund ads. The main complaint: Funds that tout high performance often are more volatile than similar funds. They also tend to have higher expenses, which tend to be a drag on future returns. Combine high volatility with high expenses, and you have the potential for a really awful experience when the stock market tumbles. Does this sound familiar? Because fund companies have organized themselves with a vast array of different types of funds, there’s always some fund that has performed well. Are they preying on ill-informed small investors who chase returns and ignore risk and fees? Never forget the old industry adage-Mutual funds are sold not bought.

Mutual fund ads are creative, using imaginative slogans, charts, tables, slick photos and even comic book characters like those previously used by AGF Funds

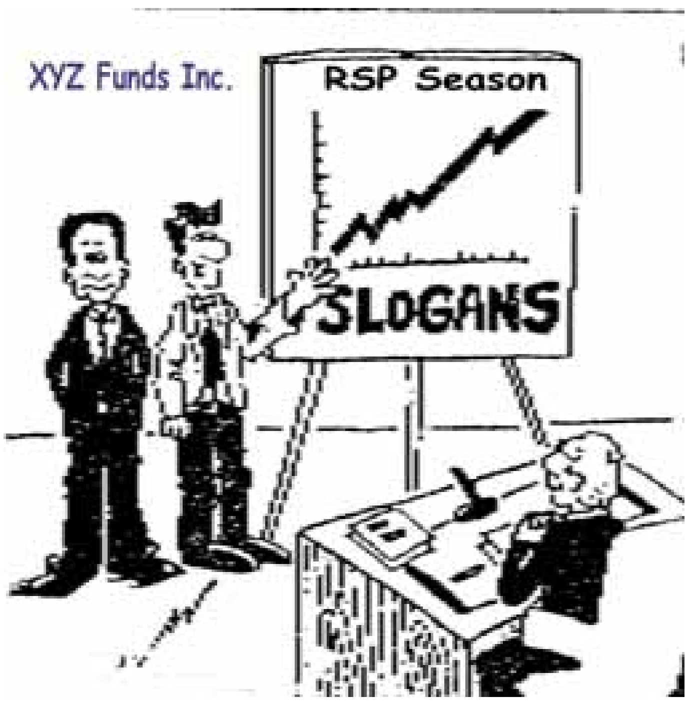
BMO/GGOF is flogging “Reputation matters” this RRSP season, no doubt in response to the market timing scandal. BUT, fund ads have a dark side. Critics have cited examples of selective information, out of context facts/ half-truth's, partial undifferentiated information especially surrounding RRSP investing, cunning choice of words, statistical aberrations, creatively drawn charts and colorful diagrams to put forward an incomplete, flawed argument or position. Some funds have used unreasonable fund return calculation models, flawed mathematical concepts such as DCA, illegible albeit important footnotes and a host of other marketing promotional tools to aggressively promote the sale of mutual funds.

Here’s some of the most popular slogans and quotations:

- Mutual funds take the risk out of investing;
- The CPP is a "bust" so you have to provide for your own retirement;
- Freedom 55 et al [The advertising slogan "Freedom 55" was introduced by the London Life Insurance Company in the 1980's. It suggests that it is possible to

exit your full-time career, more or less at the age of 55, and enjoy an exotic lifestyle, or a second, part-time career and live happily ever after;
- Don't time the markets;
- The power of discipline: The rewards of time
- Maximize your RRSP contribution;
- Demographics mean that "babyboomers" will be buying up equities;
- Buy in a downturn because the market always goes back up;
- Advice as unique as you are;
- Buy and Hold;
- Experience you can trust

These slogans may have some basis, but are dangerous in their oversimplified form.



During RRSP season, the ads proliferate and this is precisely when investors need to put up their defense mechanisms. Be especially alert for those mutual fund ads that quote stunningly high one-year rates of return. Your first thought is "Wow, I've got to own that fund!" It may have done very well last year, but then you look at the 3-year performance, which is lower, and the five-year, which is yet even lower. What's the real story? Consider a real world example-- the figures are from the Globe and Mail (1, 3, 5 and 10 year presentation of returns is mandated by regulation):

1 year	**3 year**	**5 year**
53.0%	20.0%	11.0 %

Last year the fund had excellent pre-tax performance at 53.0 %. But in the past 3 years the average annual return was 20%. What did it do in years 1 and 2 to bring the average return down to 20%? Some simple arithmetic shows us that the fund made an average return of 3.5% over those first two years: 20% = (53% + 3.5% + 3.5%)/3. Because that's only an average, it quite possible that the fund lost money in one of those years. You can get the actual historical year –by-year returns from the Annual Report or Prospectus –be sure you do so.

Looking at the 5-year performance, we see further deterioration. In the last year the fund returned 53% and in years 2 and 3 we are guessing it returned around 3.5%. So what happened in years 4 and 5 to bring the average return down to 11%? By doing some simple calculations we find that the fund must have lost money, an average of -2.5% each year of those two years: 11% = (53% + 3.5% + 3.5% - 2.5% - 2.5%)/5. With this additional insight, the fund's performance doesn't look so good. It should be mentioned that, for illustrative purposes, this example, besides making some big assumptions, doesn't include calculating compound interest. Still, the point wasn't to be technically accurate but to demonstrate how misleading mutual fund ads can be. A fund that loses money for a few years can bump the average up significantly with one or two strong years. This is the so-called end-point bias effect on returns. A 1998 study of 400 Globe and Mail ads by fund analyst Duff Young found that in fully one quarter of the performance-claim ads that have appeared, the subsequent one-year performance fell off a cliff, declining by more than 25 percentage points. Separately, the study concluded that resource funds were the worst offenders. Be aware.

An April 2000 U.S. study *Truth in Mutual Fund advertising: Evidence on Future Performance and Fund Flows by* Prem C. Jain of Tulane University, and Joanna Shuang Wu of the University of Rochester, examined 294 advertised US equity mutual funds. In their controlled study, they measured the performance of the mutual funds one-year prior to the first advertisement date, and one year after. The study concluded that the advertised funds performed well above average prior to the advertisement date, but below average in the in the post-advertisement period (the below-average returns were not statistically significant). The study also found that advertised funds attracted significantly more assets than similar funds in the post advertisement period, even though the results of all funds going forward were very close to a random event. So, be careful before you buy into a heavily promoted fund-you may be buying it after most of the gains have already been made.

A July 2002 paper by Brad M. Barber, Terrance Odean and Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows* argued that the purchase decisions of mutual fund investors are influenced by salient, attention-grabbing information. U.S. investors, and no doubt Canadians as well, are more sensitive to salient in-your-face fees, like loads and commissions, than operating expenses. According to the study they are likely to buy funds that attract their attention through exceptional performance, marketing, or advertising.

An Aug. 2003 academic study shows that funds can attract investors in droves simply by adding trendy words to their monikers – even such mundane labels as "large," suggesting that a fund might invest in large-company stocks. The academic research highlights the degree to which mutual fund investors are susceptible to the marketing stratagems used by fund companies, which stand to boost their own profits by increasing the assets in their funds. Source: Cooper M.J., Gulen H. and Rau P. Raghavendra, " *Changing names with style: Mutual fund name changes and their effects on fund flows* ", August 2003 (available at http://www.mgmt.purdue.edu/faculty/mcooper)

A Sept. 2004 Report from CARP www.50plus.com, *Giving Small Investors a Fair Chance*, recommended that all fund ads include benchmark index performance and disclose the fund's worst 12-month performance. Seniors and retirees are especially vulnerable to fund advertising.

A 2003 U.S. study *The Information content of Mutual Fund Advertising*, by professors Thomas Smythe of Furman University in Greenville, S.C., and Michael Jones of the University of Tennessee-Chattanooga, had three key findings:

1.Funds that include charts in their ads tend to have less risk. Common sense suggests that high volatility isn't a strong selling point for a mutual fund. So, how can you promote low risk in an ad? Through a chart. Most people don't understand the statistical measures of risk, like standard deviation. But most people do know what a smooth line is supposed to look like. So it's not surprising that funds that advertise with performance charts tend to be less volatile. However, be alert to the details of the chart. Examples of bad practices that cause a distortion include small chart size, judicious choice of XY scales, confusing perspective, non-linear scales, thick lines, scale truncation, favorable start dates (like after a bubble or crash), the use of a favorable measurement period/interval and/or carefully selected data points.

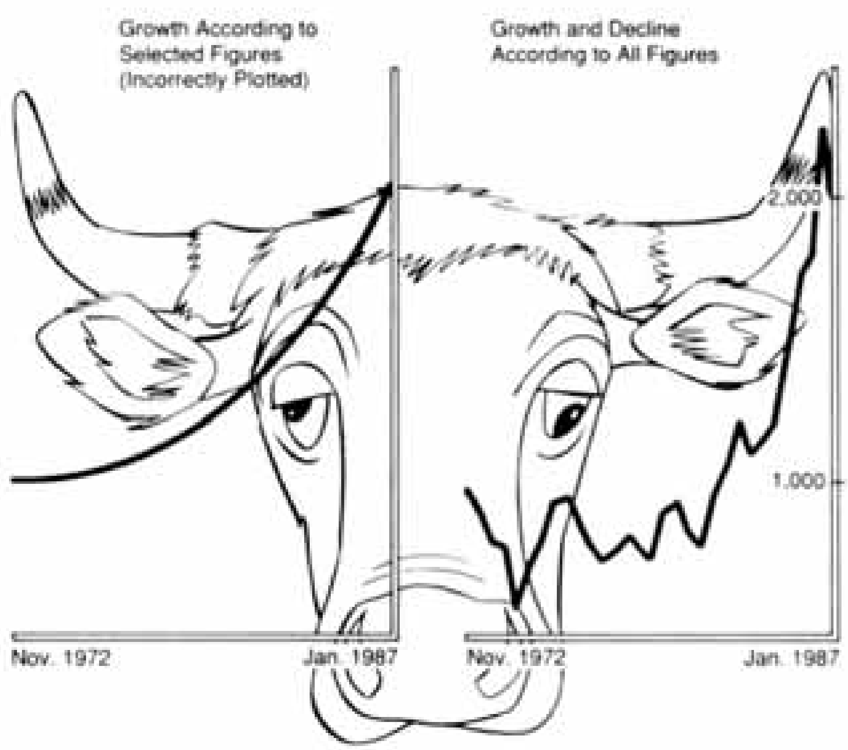


Figure 7 The Bull Behind the Bull Market

Source: “200 % 0f Nothing”, A.K.Dewdney

In order to convey the theme that markets always go up, the illustrator drew the graph using the figure of a Bull’s head from the side view with a smooth upward slope of the Bulls horn depicting a steady increase in the Dow average. The impressively smooth upward curve depicted in the bull graph was achieved by plotting only carefully selected points that fit the curve of the Bulls horn, so that many points along the way were ignored and decreases were not accounted for.

2.Bond funds that advertise tend to have low risk and low expenses. This, too, make sense if you see it through a fund company's eyes. People who buy bond funds aren't looking for a wild investment that's up 50% one year and down 50% the next. They want decent income, low volatility and preservation of capital .A fund's expenses are taken directly from its interest and dividend income or from assets. Thus, the higher the fees, the lower the fund's return. Clearly, high fees expenses take a lot more away from a bond fund than a technology fund, especially in a low interest rate environment.

3. Stock funds that advertise tend to be top performers, even after adjusting for risk. A standard statistical measure of a fund's risk is its standard deviation, a measure of how much a fund's unit value moves up and down from the average. A fund whose share price moves between $8 and $10 has a lower standard deviation than one whose price gyrates between $6 and $14 According to the U.S. study, funds that advertise do, indeed, have high standard deviations. Numerous studies in the United States show they also tend to produce greater return for the risks they take. The higher the Sharpe Ratio, the better the risk-adjusted return. Funds that advertise tend to have higher Sharpe Ratios than those that don’t. It’d be interesting to replicate their study in Canada, although I suspect the results wouldn’t be all that different.

Buying a mutual fund solely on its ads is clearly not a very good idea. But you can garner a few bits of interesting information from them, provided you do some additional homework before you buy.

Since Sept. 20003, new SEC rules require that advertisements mentioning fund performance (which can be left out of advertisements) should tell investors they should also consider other key factors, like expenses, risks and investment objectives. Before the changes, U.S. mutual fund companies were only allowed to post one, five and ten-year performance figures as long as they were from the most recent quarter. With the new rules, the SEC allows mutual fund companies to post more recent results, but the performance period must be clearly stated and must disclose how investors can get their hands on the most current month's performance via the Web or phone.

Investor advocates also have a few hints of their own regarding fund ads:

- If a fund compares itself to a benchmark, this is a good sign [if it does not…]

- If a fund ad includes a risk measure or indicator, this is a very good sign [too rare of course]
- Try to find out why the fund had such great performance –a spate of hot IPO's, a spike in the price of oil or really astute portfolio management
- Chuckle at the images but focus on the numbers
- Don't be swayed by stars. In 1996. Fidelity, desperate to get a Canadian equity fund with decent performance, had wooed high profile manager Veronika Hirsh from rival AG F. She got a brand-new fund, Fidelity True North, and the defection caused a blaze of publicity because AGF had built a massive TV advertising campaign around her. But Ms. Hirsch soon parted company with Fidelity when it emerged that, while at AGF, she had invested in a junior gold stock and then bought it for her fund. She paid $140,000 to regulators to settle the case and now runs her own fund company, Hirsch Asset Management.
- Check the dates-fund firms sometimes, inadvertently, use stale data. Base your returns on the most recent information available on several reliable web-sites such as www.morningstar.ca and www.fundlibrary.com
- Double check the fund's portfolio holdings; mutual fund names are notoriously misleading
- Don't be swayed by images of Spiderman or any super hero –they don't really exist and anyways who knows if they really own mutual funds
- Get a magnifying glass for any text in small font
- Be also alert to the business media –Low cost fund Company Phillips, Hager & North have even published an article to help small investors withstand the hype. *Users' Guide to the Business Media*; available at http://www.phn.com/planni/planni_featur_cutting11.asp NOTE: PH&N do not advertise.

If you were to conduct a reasonably sophisticated search for a mutual fund, you'd probably come up with the same funds that advertise. The catch: You still don't know how the fund will perform in the future. Unreliable as it is, however, past performance is one of the few bits of information that investors have for assessing a fund. You can get a few clues from ads. BUT you can supplement this with a chart plotted from www.globefund.com to increase the visibility of volatility (risk). Quantitative measures of risk are available at www.fundlibrary.com. While returns may not persist, research has shown that volatility parameters do persist.

If you're trying to gauge danger points in the market, you can get some valuable hints by watching which types of funds - value, growth, energy, resources, tech - are doing the most advertising. After all, funds with the best 12-month performance tend to do the most advertising. The key point is that prices of financial assets tend to be cyclical. Piling on when certain sectors appear to be "big winners" inevitably leads to poor performance and disappointment.

You need much more information to make an informed investment decision than you'll find in an ad, such as how the fund might fit within your portfolio Nevertheless, you can glean some information from fund ads. Just don't rush out and buy a fund because you liked its ad and recent returns. If reading newspaper stories or mutual fund ads makes you anxious, you should probably talk to your investment advisor about why you shouldn't pay so much attention to short-term fund performance ads.

As with any investment, a fund's past performance is no guarantee of its future success. When reading fund ads always remember that over the long-term, the success (or failure) of your investment in a mutual fund also will depend on factors such as:

1. the fund's sales loads, the MER, optional fees, and fund expenses like broker commissions;
2. the income taxes you may have to pay when you receive a distribution (the portfolio turnover ratio is an indicator but does not appear in ads);
3. the age and size of the fund. Newly created or small funds sometimes have excellent short-term performance records which they aggressively advertise. Because these funds may invest in only a small number of stocks, a few successful stocks can have a large impact on their performance. But as these funds grow larger and increase the number of stocks they own, each stock has less impact on performance. This may make it more difficult to sustain initial results;
4. the fund's risks and volatility. Generally, the more volatile a fund, the higher the investment risk. If you'll need your money to meet a financial goal in one year, you probably can't afford the risk of investing in a fund with a volatile history because you will not have enough time to ride out any declines in the stock market.; and
5. recent changes in the fund's operations. Has the fund's investment advisor or investment strategy pr objective changed recently? Has the fund merged with another fund? -this can also distort advertised fund family returns due to survivorship bias as crappy funds are merged out of existence or shut down entirely .Has the MER been increased? Operational changes such as these can affect future fund performance.
6. how the fund fits into your portfolio. When choosing a mutual fund, you should consider how your investment in that fund affects the overall diversification of your investment portfolio. Maintaining a diversified and balanced portfolio is key to maintaining an acceptable level of return and risk.

The numerous studies have strong policy implications for the investment fund industry. It is clearly evident that past performance is not a reliable indicator of future returns. Several leading researchers have documented this fact over the years. Yet mutual fund Companies continue to use ad campaigns whose sole purpose appears to promote past performance. Are the fund companies acting in an ethical manner? Are they encouraging the public to invest a way that is to the detriment of the average small investor and to the benefit of the financial services industry? Are the Board of Directors/trustees of these mutual funds, whose responsibility is to protect unitholders, looking the other way as marketing department takes charge? These questions and more need to be answered by the already scandal-ridden mutual fund industry.

In any event, by considering some of the points made here, you should be a more informed mutual fund investor and avoid many bear traps.

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