Comment Letter on Risk Disclosure Research to SEC, April 1996

April 8, 1996

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Improving Descriptions of Risk by Mutual Funds and Other Investment Companies (File No. S7-10-95)

Dear Mr. Katz:

The Investment Company Institute[1] is writing to supplement our comment letter of July 28, 1995 (the "Institute Comment Letter") concerning the Commission's concept release on investment company risk disclosure.[2] In that letter, we indicated our intention to conduct a comprehensive survey of fund investors concerning risk disclosure (the "Institute Survey"). We are pleased to be able to share with the Commission the results of this research.

In our judgment, research of the sort undertaken by the Institute is essential to help resolve issues raised in the Concept Release. In particular, the Commission's consideration of various methods to describe risk must take into account the extent to which the average mutual fund investor will understand and properly employ the disclosure methods discussed in the Concept Release. We believe that the Institute Survey sheds light on these important issues.

I. Overview of Research Findings

The Institute retained an independent consultant, Response Analysis Corporation ("RAC") of Princeton, New Jersey, with 27 years' experience in professional research analysis, to conduct the Institute Survey. Between August and October 1995, RAC conducted in-person interviews with 657 U.S. investor households who had purchased at least one stock or bond mutual fund in the previous five years. The survey respondents had demographic characteristics similar to mutual fund shareholders nationwide.

In order to respond to the issues raised in the Concept Release, the Institute Survey examined how shareholders assess three risk disclosure approaches identified in the Commission's Concept Release: (1) narrative disclosure; (2) graphic disclosure of a fund's total return over a ten-year period, together with a presentation of the fund's average annual returns over one, five and ten year periods; and (3) quantitative risk measurements (in particular, standard deviation, beta, and duration).[3]

The findings of the Institute Survey are detailed in the accompanying report entitled "Shareholder Assessment of Risk Disclosure Methods." As is set forth below, we believe the results of the Institute Survey assist in better understanding how mutual fund investors perceive risk, the utility to fund investors of the various risk disclosure techniques, and the susceptibility of quantitative risk measures to misunderstanding and misapplication of investors. We also believe the findings bear importantly on the Commission's regulatory policies concerning risk disclosure, as we discuss by way of conclusion below.

II. Investors Have Diverse Perceptions of Risk

The Institute Survey demonstrates that mutual fund investors care about risk. Respondents were asked to indicate from a list of specific issues related to the selection of a mutual fund (e.g., fund risk, performance, fees and expenses, portfolio manager's background) those that they had inquired about before making their most recent fund purchase. Sixty-nine percent of respondents said that they examined the fund's investment risk. Only fund performance was cited more often.

At the same time, notions of "risk" differ among shareholders. The Institute Survey requested that respondents state which of eight

concepts they include in their definitions of mutual fund risk. [4] All of these concepts were included in the definitions of at least some shareholders.[5] The Institute Survey also asked respondents to define "risk" in their own terms. Some investors provided definitions that were different from any of the eight concepts (e.g., susceptibility to stock market volatility, the uninsured nature of mutual funds).

"Risk" also appears to be a multifaceted concept for most shareholders. For example, when asked to select which of the eight risk concepts apply to them, 84% of respondents selected more than one. Moreover, an investor's perceptions of risk depend largely upon his or her investment time horizon. For example, 30% of investors who have a time horizon of less than one year say they are concerned about short-term fluctuations in the value of their mutual fund shares, compared with only 5% of respondents with an investment horizon of more than 10 years.

III. Investor Evaluations of the Three Disclosure Approaches

The Institute Survey suggests that narrative disclosure can facilitate the evaluation of risk for most investors and that most investors also would find the bar graph to be useful. By contrast, the Institute Survey indicates that quantitative risk measurements would complicate an evaluation of risk for most investors—including those who report that they have used these measurements in the past.

A. Investors Find Narrative Disclosure Useful To Their Evaluation of Risk

Fifty-one percent of respondents stated that they are very confident of their ability to use narrative disclosure to assess the risk of a single fund and 46% stated that they are very confident of their ability to use it to compare the risks of different funds. Most respondents stated that narrative disclosure simplifies risk evaluations, can be readily used, and provides the right amount of technical information. A significant minority of respondents did indicate that narrative disclosure could be less technical, however.

B. Graphic Presentation Also Would Help Investors

Respondents stated that they have a high degree of confidence in their ability to use the bar graph. In particular, 51% of respondents stated that they are very confident of their ability to use the bar graph to compare the risks of several funds and 49% stated that they are very confident of their ability to use the bar graph to assess the risks of a single fund. Most investors stated that the bar graph would simplify risk evaluations and would provide information that they could readily use.

C. Investors Do Not Favor—And Appear Unable to Use—Quantitative Measures

1. Limited Utility of Quantitative Measures

Most investors indicated that the quantitative risk measurements would complicate an evaluation of mutual fund risks, would be too technical, and would require further study. The Institute Survey also found that most investors are not very confident of their ability to use the numerical risk measurements. For example, only 28% of respondents stated that they are very confident of their ability to assess the risks of a single fund based on standard deviation (this being the quantitative measurement that attained the highest confidence rating of the three surveyed).

According to the Institute Survey, only 26% of recent fund purchasers have used standard deviation, duration or beta, or other numerical measures such as alpha or Sharpe's ratio, to assess mutual fund risks. Even these respondents, however, stated that they are not very confident of their ability to use the three quantitative risk measurements to assess fund risk. For example, only 44% of respondents who have used standard deviation feel very confident about using it again to evaluate a fund's risk. Twenty-three percent are not confident at all.

Of the three different disclosure approaches surveyed, the quantitative measurements were least preferred even by those who reported having used such measurements in the past. For example, of those respondents who have used standard deviation and are very confident of doing so again, 34% stated that they most prefer the bar graph. Only 25% stated that they most prefer narrative disclosure, and only 20% preferred standard deviation.

2. Strong Potential of Such Measures to Confuse and Mislead

Quantitative risk measurements apparently have a strong potential to confuse or mislead investors. A significant percentage of investors who rely upon short-term volatility measurements such as standard deviation or beta to assess mutual fund risks are long-term investors. For example, 71% of respondents who have used standard deviation to assess risk and 80% of those who have used beta stated that their primary financial goal is to save for retirement. These users of standard deviation represented a median investment horizon of 8 years, and beta users 10 years.[6] The short-term volatility measured by standard deviation or beta is not particularly relevant for these long-term investors.

The Institute Survey also indicates that the vast majority of investors who use risk measurements do not understand them well enough to use them for the special purpose for which the measurements were designed.[7] The Institute Survey presented five

categories of possible uses for the risk measurements.[8] Only 35% of beta users stated that they used beta to relate a fund's performance to a benchmark index and only 35% of duration users stated that they used duration to determine a fund's sensitivity to interest rates.

IV. Conclusion

The Institute and its members share the Commission's goal of improving fund risk disclosure. In order to achieve this objective, the Institute in its Comment Letter made three recommendations that are supported strongly by the results of the Institute Survey.

First, the Institute recommended that the Commission improve narrative disclosure by requiring that it focus on the overall risks of a fund portfolio rather than on the individual securities held by the fund. The Institute Survey confirms that narrative disclosure significantly assists investor understanding of mutual fund risk, and that further refinement of narrative disclosure requirements would benefit many investors.

Second, the Institute Comment Letter recommended that the Commission require fund prospectuses to contain the ten year total return bar graph, together with a presentation of the fund's average annual returns over one, five and ten year periods. The Institute Survey indicates that such graphic presentation of the variability of a fund's returns would significantly assist investors in their consideration of mutual fund risk, and would provide information that investors could readily understand and properly employ both to compare the risks of several funds and to evaluate the risks of a single fund.

Third, the Institute Comment Letter strongly urged the Commission to avoid mandating any form of numerical or quantitative risk disclosure. The Institute Survey offers compelling evidence that a Commission-mandated numerical risk measurement would not provide investors understandable and meaningful information with which to evaluate a fund against their own risk sensitivities and investment objectives—but instead would mislead, confuse and ultimately harm fund investors.[9]

Based on the Institute Survey, we continue to recommend that the Commission adopt the ten-year bar graph and more focused narrative disclosure requirements. In addition, we continue to urge that the Commission avoid the pitfalls of a mandated, numerical risk measurement.

The Institute appreciates the opportunity to submit the Institute Survey. If you have any questions concerning the Institute Survey or related issues, please contact the undersigned at 202/326-5810, Craig Tyle at 202/326-5815 or Tom Selman at 202/326-5819.

Sincerely,

Paul Schott Stevens
Senior Vice President and General Counsel
Attachment

cc: Chairman Arthur Levitt
Commissioner Isaac C. Hunt
Commissioner Norman S. Johnson
Commissioner Steven M.H. Wallman
Barry P. Barbash, Director, Division of Investment Management
Robert Comment, Deputy Chief Economist, Office of Economic Analysis
Nancy Smith, Director, Office of Consumer Affairs

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,861 open-end investment companies ("mutual funds"), 451 closed-end investment companies and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $2.964 trillion, accounting for approximately 95% of total industry assets, and have over 38 million individual shareholders.

[2] Investment Company Act Release No. 20974 (March 29, 1995) ("the Concept Release").

[3] The Institute Survey did not evaluate self-assessment by mutual funds of their own risks, because of the uncertainty of how mutual funds should define "high," "medium" or "moderate," and "low" risk, as those terms are used in the Concept Release. Concept Release at 27-28.

[4] These concepts were: (1) the chance of losing some of an original investment; (2) the possibility that an investment will not keep pace with inflation; (3) possible fluctuations in the value of an investment; (4) the possibility of not having enough money at the end of the investment horizon to achieve investment goals; (5) the chance for a decline in fund income distributions; (6) the possibility that

performance will be inferior to that of a certificate of deposit; (7) the chance that performance will be inferior to that of an index; and (8) a possible loss of money within the first year.

[5] The range of response percentages was 23% of respondents (for the possibility of loss within the first year) to 57% of respondents (for the chance of losing some of the original investment).

[6] Indeed, the median investment horizon of all fund investors may be longer than the median investment horizon of respondents to the Institute Survey because the Institute Survey excluded the acquisition of funds through an employer-sponsored retirement or thrift plan. If investors who purchased only through these plans had been included, the median investment horizon of the investor sample presumably would have been longer.

[7] The Concept Release requested comment on whether investors understand "the limits on predictive utility of risk measures." Concept Release at 19. Of course, no quantitative risk measurement can be properly used to estimate future mutual fund returns. Nevertheless, the Institute Survey indicated that 23% of beta users, 45% of duration users, and 44% of standard deviation users perceived these measurements to be designed for precisely this purpose.

[8] The five categories are: (1) to estimate a fund's future returns; (2) to determine the fund's sensitivity to interest rates; (3) to gauge the risk of investing in the fund; (4) to assess a fund's currency risks; and (5) to relate a fund's performance to a benchmark index.

[9] The Institute Comment Letter also recommended that the Commission require funds that hold themselves out as having a stated maturity policy to have a commensurate portfolio duration policy. The Institute has formed a task force of its members to develop specific recommendations for implementation of such a requirement, and will provide those recommendations to the Division of Investment Management upon their completion.

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