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Are investment products lacking transparency?

If transparency is essential to preserve investor confidence, why isn't there more of it?

By Laura Bobak

Let's face it: many financial products leave clients perplexed. The fees behind principal-protected notes are confusing; mutual funds can be elaborate; the details of hedge funds are vague and opaque; then there's the complexity of asset-backed commercial paper.

Although some efforts are being made to clarify fees and the structure of widely used products such as mutual funds (which are also the subject of increased regulation), investor advocates and industry analysts say there's still a long way to go on the road to industry transparency.

Indeed, in a speech in Toronto this past month, outgoing **Bank of Canada** Governor David Dodge laid part of the blame for the past summer's market turmoil on lack of information: "Problems related to information contributed to the market turbulence. We have seen the emergence of increasingly complex structured products, which were developed in response to the demand for higher returns.

"And as these securities have become more complex and opaque, in many cases, it has become harder to assemble and understand all the information needed to determine what kinds of assets are backing the security, the quality of those assets and the counterparty risk involved."

If clients insist on greater transparency, they'll get it, Dodge says. Credit-rating agencies should explain more clearly how they rate highly structured products and that their ratings should not be used with the same degree of certainty as ratings for conventional, single-name issuers. Investors also need to be told, Dodge says, that certain instruments do not trade with the same degree of liquidity as others.

There's also the issue of some investors' mistaken belief that they are well briefed about their choices. In fact, many do not have the financial literacy to grasp what's being disclosed, let alone what's not. And that can result in purchasing products that do more harm than good to their financial situations.

"The best way to deal with risk," says investor advocate Ken Kivenko, who runs the www.*CanadianFundWatch.com* Web site, "is really to understand what you are being sold, the fees involved, tax efficiency and how the fund fits into your portfolio's asset allocation."

Canadians are plagued by high fees and a shortage of straight facts, he says: "They're stabbing you in the front, not in the back, with high fees and opaque disclosures."

Some investor advocates also say that simply flagging questionable products for investors isn't good enough. "Transparency is not a substitute for the investment industry's duty to design products with minimal red flags," says investor activist Diane Urquhart. "The financial advisor needs to market products without deception. In the retail market, financial literacy is not high. The complexity is so high, people don't understand transparency, in any case."

Here's a look at some of the red flags raised by some of the industry's murkier products:

Principal-Protected Notes. The lack of transparency in PPNs has led the federal government to announce that, as of April 1, it will require more disclosure both before and after the sale of these interest-bearing deposit products. Clients should understand that fees are high relative to the return, which is linked to the performance of underlying assets such as funds linked to stock market indices or commodities, say investor advocates.

"By and large, even if the PPN has a few good years, those fees just eat away at you," says Kivenko, who points out that often the underlying products linked to PPNs are Canadian mutual funds, which are themselves plagued with high fees. "If there are fees on top of that for the note, what chance do you have?" he asks.

And although the principal is guaranteed, PPNs are not as low-risk as a GIC because they are not covered by deposit insurance. In addition, clients may not be aware that only a relatively small portion of the amount invested is placed in products with upside potential: the rest is used to cover the principal returned at maturity.

"PPNs are opaque," Kivenko says. "People don't have a clue what they're buying. The people selling them are not always professionals. If it were a mutual fund, you'd have to be a registrant. But we don't know who is selling PPNs. It could be some guy in the branch in his office with no professional qualifications."

Kivenko also says it's unclear who regulates PPNs: "We wrote the government and we said: 'Who is it?' We didn't get an answer — yet."

Some firms have improved disclosure, Kivenko says, but he's still concerned, especially since the new regulations proposed by the federal government are principles-based, not mandatory requirements.

"If there's one product that needed absolute uniform ways of communicating to retail investors," he adds, "this would be the one."

Mutual Funds. In comparison to some other products, mutual funds are reasonably good about disclosure, says Dan Hallett, president of Windsor, Ont.-based fund analysis firm **Dan Hallett & Associates Inc.**

Unlike PPNs, which, Hallett says, have fee disclosure in irregular and illogical places such as in a section entitled "net asset value," a mutual fund prospectus is easy to compare with documents from other funds.

"If you've gone through a few of them, it's very easy to compare them," Hallett says. "There's a lot of irony that regulators continue to pound away at mutual funds and segregated funds, and they are just getting around to PPNs."

However, Hallett complains that mutual funds no longer have to release statements of portfolio transactions, which in the past could be requested by an investor or through the System for Electronic Document Analysis and Retrieval online at *www.sedar.com*. Hallett argues that without this information, it's hard to tell if a portfolio manager is actually sticking to his or her stated investment policy.

Recent regulatory efforts are also falling short, Hallett says. In his view, the proposed two-page Fund Facts document for mutual funds and segregated funds recommended by the **Joint Forum of Financial Market Regulators**, an umbrella group set up in 1999 to co-ordinate the regulation of financial products, doesn't improve disclosure in a meaningful way in the areas of "risk" and "suitability." Hallett says investors could understand their risk level better if shown a chart showing rolling returns or past declines in the fund's benchmark; this would be preferable to the six-point scale rating risk from very low to high.

Investors also need to know how the advisor is compensated through commissions and trailer fees; whether there is a deferred sales charge; and how high the management expense ratio is compared with other funds in the same category. Clients are also likely to have questions about non-MER expenses, which include trading fees, brokerage commissions and taxes on distributions.

Urquhart says there should be a Web site to which clients can go to see mutual fund portfolio transactions: "You should have the right to receive it if you choose."

Hedge Funds. These funds should not be sold to retail investors unless these funds are prepared to issue a prospectus in the same manner as mutual funds, Urquhart says.

"It's an absurdity for a country to allow that to occur," she adds, speaking of the current regulations allowing minimal disclosure through an offering memorandum. "I don't want accredited investors to have to play Where's Waldo."

Urquhart also suggests that clients who are not privy to the investments held by their funds need to ask questions. How long has the fund been in business? What are the qualifications of the fund managers? How much leverage will the fund take? To what extent will derivatives be used? What are the fees (which are usually 1%-2% plus 20% of the profits above a certain risk-free return, Urquhart estimates)?

"They get 20% of the upside," she says of fees, "but are they going to pay you back when they lose your money?"

Income Trusts. These trusts are not required to disclose their calculations of distributable cash in a standardized format, an item normally dealt with in the publicly traded companies' management discussion and analysis.

The murkiness of income trusts has been questioned by the **Canadian Institute of Chartered Accountants**, which has recommended that trusts be required to use standardized methods of reporting distributable cash. But as of November, only a few trusts have begun using the standard format. The CICA recommends that trusts disclose from what source distributable cash is coming (income, investor capital or debt), and whether the trust's capital spending is adequate to maintain its operations.

Critics of trusts, such as forensic accountant Al Rosen of **Accountability Research Corp.** , have complained that many clients don't understand that they are often merely getting their own money back when trusts make their distributions.

Another scenario, according to Urquhart, is the income trust mutual fund: in a hypothetical example, such a fund could be billed as having a 16% return, when in fact the real return — the amount that remains when the investor's own money or funds from other sources of financing are subtracted from the amount being paid out — is 5%. And of that 5%, a further three percentage points might well be eaten up by MER fees.

"The customer would not buy that if they knew about the fees," Urquhart says. "People construe it to be income, and they might be willing to pay higher fees than they should.

You shouldn't have to pay fees to get your own money back."

Asset-Backed Commercial Paper. One of the reasons investors lost faith in ABCP is that the companies peddling the product released very little information about the underlying assets; this led some investors to stop rolling over their notes.

Hallett says that when he tried to find out about a few ABCP trusts being sold by Coventree Inc. , the firm at the heart of the summer liquidity crisis in Canada, he found very little about the creditworthiness of the underlying assets in the ABCP "information statements" released to investors.

"The disclosure is lacking significantly," Hallett says. "There's really no description of the assets."

As with PPNs, there is also a troubling range in the quality of disclosure among ABCP notes. "It's not that great," Hallett says. "That's the reason we hit this wall of liquidity — because there is no transparency." **IE**