Financial Services Regulatory Authority of Ontario
Life and Health Insurance Sector

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CONSULTATION ON PROPOSED TOTAL COST REPORTING TOOL

This letter is provided as a response to FSRA's request for commentary concerning proposed total cost reporting for segregated fund contracts.

I am fully in support of improved requirements for cost disclosure with respect to segregated fund contracts.

That disclosure should include:

- Disclosure of total costs, including:
    - Embedded fees
    - Management expenses
    - Trading expenses
    - Any fee assessed by an advisor for asset management
    - Any insurance fees or costs
    - Any embedded taxes payable (e.g. HST on investment fees, or provincial premium taxes)
- Awareness of seg fund investment performance:
    - Comparison to an investable and comparable benchmark, ideally an index-based ETF identified by a neutral third party such as S&P or Morningstar
- Description of the contractual guarantees:
    - Indication of what the current level of guarantees is and under what circumstances those guarantees would be effective
    - Any steps that can be taken to increase available guarantees, such as contractually available guarantee resets.
    - The impact of a notional withdrawal on those guarantees (e.g. showing what happens if a client withdraws 10% of their invested assets, expressed in dollar terms)
- Comparison of the cost of owning seg funds to other possible investments:
    - What if, from day 1 of their investment life cycle, the investor had invested in a similarly benchmarked fund with an MER of:
        - 50 basis points
        - 100 basis points
        - 200 basis points
        - 300 basis points

- Consideration for other possible fees that may not be immediately obvious to the investor.
    - The seg funds industry has, for example, introduced 'advisor charge-back' funds in response to the DSC ban on seg funds
    - These advisor charge-back funds purport to remove any possible harm to the investor for an early redemption, as the charges for that redemption would now be borne by the advisor
    - However, this still presents a conflict of interest in which the advisor may be prone to select the advisor charge-back option that will produce a higher commission for the advisor at the expense of the investor

All disclosures provided should be presented in a manner consistent with best practices for consumable presentation of information. For this, best practices can be drawn from smoking cessation and other public health initiatives. Part III of this report from the FCAC includes some good examples, and links to a helpful OECD initiative. https://www.canada.ca/en/financial-consumer-agency/programs/research/best-practices-financial-consumer-protection.html FAIR Canada and the National Institute on Aging would also be good examples of agencies to consult when it comes to the adequacy of consumer disclosure.

At the time of writing this submission, there is already at least one submission posted on the FSRA site suggesting that fees should not be a focus for investors. I believe this is materially incorrect and speaks to a lack of intellectual rigour on the part of financial advisors. If the financial advisor isn't willing to put the work in to help a client correctly understand the risks of investing, then a seg fund with investment guarantees (as all seg funds have) is not a valid solution to a problem. If the advisor is serious about financial literacy, they will help their client to understand investment risk and the long-term costs associated with investing.

As an example, let's look at a Global Balanced (roughly 60% equity and 40% fixed income, globally diversified) portfolio, and some of the investment choices available here. In all cases, the funds selected are exclusive of investment advisory fees, and those fees may be charged in addition to any fees described below. In all cases, the MER is used to arrive at a roughly apples-to-apples comparison.

Categories should be determined using Canadian Investment Funds Standards Committee (CIFSC) criteria. CIFSC has a flow chart available at https://www.cifsc.org/mutual-fund-categories/flow-chart/

Comparable investments in this category might include:

- Fund A: Sun Life MFS Global Total Return GIF estate series. This seg fund provides a 100% death benefit guarantee and a 75% maturity guarantee. MER: 1.75%
- Fund B: Sun Life MFS Global Total Return GIF estate series. This seg fund provides a 75% death benefit guarantee and a 75% maturity guarantee. MER: 1.30%
- Fund C: Dimensional Fund Advisors Global 60EQ-40FI Portfolio. This mutual fund provides no death benefit guarantee and no maturity guarantee. MER: .30%
- Fund D: Global X Balanced Asset Allocation ETF: Also no guarantees. MER: .18%

Considering the lifetime costs of investing, using the following assumptions:

- Investing starting at age 30
- Investing $10,000 per year, adjusted annually for inflation
- Inflation of 2.1%
- Gross annual investment return of 6.8% (straight-line growth only projected here)
- Retire/stop investing at age 65

Projected accumulation at age 65:

	Value at Age 65	Difference vs Fund A	Difference vs Fund B	Difference vs Fund C	Difference vs Fund D
Fund A	$1,230,886		-$123,785	-$454,473	-$500,069
Fund B	$1,354,671	$123,785		-$330,687	-$376,283
Fund C	$1,685,358	$454,473	$330,687		-$45,596
Fund D	$1,730,955	$500,069	$376,283	$45,596	

The fundamental questions, as I see it, posed by this project are:

- Is the investor capable of understanding the costs of the benefits provided by seg funds?
- Would disclosure by the advisor of the lifetime costs of using seg funds cause investors to make different decisions?
- Would disclosure by the advisor of the lifetime costs of using seg funds cause advisors to more thoroughly examine the recommendations they are making?

Looking at the table presented above, I believe the numbers represented are highly material. In the most extreme example, using a seg fund has cost this investor over a half million dollars over the course of a reasonable accumulation period.

The advisor might purport that this half million dollar cost is worth paying. If we explore the value of guarantees, which are often touted as the primary benefit of seg funds, this claim is fairly easy to debunk.

For the following analysis, I used the closing month values of the T&S/S&P index inclusive of dividends from June 1979 to April 2019. I assessed the likelihood of seg fund guarantees paying in each of those periods. Assuming just a 1% MER causing the fund to underperform the index by that amount over the period in question, here is what I found:

- Guarantee paid 6 months after initial investment:
    - 473 month-ends captured
    - A 75% guarantee would have paid in 2.11% of those months
    - A 100% guarantee would have paid in 35.52% of those months
- Guarantee paid 5 years after initial investment:
    - 419 month-ends captured
    - A 75% guarantee would have paid in 0% of those months
    - A 100% guarantee would have paid in 14.8% of those months
- Guarantee paid 10 years after initial investment:

    - 359 month-ends captured
    - A 75% guarantee would have paid in 0% of those months
    - A 100% guarantee would have paid in 2.23% of those months
- Guarantee paid 15 years after initial investment:
    - 299 month-ends captured
    - A 75% guarantee would have paid in 0% of those months
    - A 100% guarantee would have paid in 0% of those months

The full set of data is available at Appendix A.

It's clear from this analysis that the only way the guarantees from seg funds are likely useful is if:

- The investment badly underperforms its index
- The investor dies relatively soon after their initial investment

Since both of these outcomes are statistically unlikely, expecting to receive a benefit from the purchase of a seg fund could be seen as a high risk investment choice, rather than the conservative option that it is usually framed as.

Advisors will also present the estate benefits of seg funds (direct beneficiary designations, bypass of probate, and confidentiality) as worthwhile for the additional costs. If the investor is using registered funds, those benefits are generally duplicated. If the investor has non-registered assets, those same benefits can be achieved by using a trust structure.

Creditor protection is often cited as a benefit of using seg funds. Registered accounts have comparable protections here, and so can a properly structured trust. If creditor protection is truly a concern, the advisor should be fully exploring a wide range of risk mitigation tools.

Not to say that seg funds have no value, but the fully educated client should recognize that the costs of using these tools is quite high when the investor's full life cycle is considered. If advisors and insurers aren't compelled to fully disclose these costs, investors continue to be vulnerable.

Sincerely Yours,

Jason R. Watt

Appendix A

Segregated Fund Guarantee Analysis

	6-month data					
	3% Below Index	2% Below Index	1% Below Index	Index	1% Better	2% Better
Number of Events	473	473	473	473	473	473
75% Guarantee would pay	13	12	10	10	10	8
Percent of Times when 75% pays	2.75%	2.54%	2.11%	2.11%	2.11%	1.69%
Average Value when 75% Guarantee Pays	$67,820	$67,983	$67,425	$68,168	$68,902	$68,142
Average 75% Guarantee Paid	$7,180	$7,017	$7,575	$6,832	$6,098	$6,858
Maximum Guarantee Paid at 75%	$18,615	$17,735	$16,869	$16,015	$15,173	$14,343
Events Attributable to Fees / Underperformance	23.08%	16.67%	0.00%			
100% Guarantee would pay	188	177	168	161	155	138
Percent of Times when 100% Guarantee Pays	39.75%	37.42%	35.52%	34.04%	32.77%	29.18%
Average Value when 100% Guarantee Pays	$90,810	$90,810	$90,889	$91,057	$91,276	$90,785
Average 100% Guarantee Paid	$9,190	$9,190	$9,111	$8,943	$8,724	$9,215
Maximum Guarantee Paid at 100%	$43,615	$42,735	$41,869	$41,015	$40,173	$39,343
Events Attributable to Fees / Underperformance	14.36%	9.04%	4.17%	N/A	N/A	N/A

	5-year data					
	3% Below Index	2% Below Index	1% Below Index	Index	1% Better	2% Better
Number of Events	419	419	419	419	419	419
75% Guarantee would pay	13	1	0	0	0	0
Percent of Times when 75% pays	3.10%	0.24%	0.00%	0.00%	0.00%	0.00%
Average Value when 75% Guarantee Pays	$72,597	$73,728	N/A	N/A	N/A	N/A
Average 75% Guarantee Paid	$2,403	$1,272	N/A	N/A	N/A	N/A
Maximum Guarantee Paid at 75%	$5,107	$1,272	$0	$0	$0	$0
Events Attributable to Fees / Underperformance	100.00%	100.00%	N/A	N/A	N/A	N/A
100% Guarantee would pay	120	87	62	48	35	18
Percent of Times when 100% Guarantee Pays	28.64%	20.76%	14.80%	11.46%	8.35%	4.30%
Average Value when 100% Guarantee Pays	$87,643	$88,333	$89,099	$91,351	$93,802	$95,247
Average 100% Guarantee Paid	$12,357	$11,667	$10,901	$8,649	$6,198	$4,753
Maximum Guarantee Paid at 100%	$30,107	$26,272	$22,269	$18,095	$14,063	$9,542
Events Attributable to Fees / Underperformance	60.00%	44.83%	22.58%	N/A	N/A	N/A

	10-year data					
	3% Below Index	2% Below Index	1% Below Index	Index	1% Better	2% Better
Number of Events	359	359	359	359	359	359
75% Guarantee would pay	0	0	0	0	0	0
Percent of Times when 75% pays	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Average Value when 75% Guarantee Pays	N/A	N/A	N/A	N/A	N/A	N/A
Average 75% Guarantee Paid	N/A	N/A	N/A	N/A	N/A	N/A
Maximum Guarantee Paid at 75%	$0	$0	$0	$0	$0	$0
Events Attributable to Fees / Underperformance	N/A	N/A	N/A	N/A	N/A	N/A
100% Guarantee would pay	52	36	8	0	0	0
Percent of Times when 100% Guarantee Pays	14.48%	10.03%	2.23%	0.00%	0.00%	0.00%
Average Value when 100% Guarantee Pays	$88,331	$94,071	$98,387	N/A	N/A	N/A
Average 100% Guarantee Paid	$11,669	$5,929	$1,613	N/A	N/A	N/A
Maximum Guarantee Paid at 100%	$21,753	$13,353	$4,151	$0	$0	$0
Events Attributable to Fees / Underperformance	100.00%	100.00%	100.00%	N/A	N/A	N/A

	15-year data					
	3% Below Index	2% Below Index	1% Below Index	Index	1% Better	2% Better
Number of Events	299	299	299	299	299	299
75% Guarantee would pay	0	0	0	0	0	0
Percent of Times when 75% pays	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Average Value when 75% Guarantee Pays	N/A	N/A	N/A	N/A	N/A	N/A
Average 75% Guarantee Paid	N/A	N/A	N/A	N/A	N/A	N/A
Maximum Guarantee Paid at 75%	$0	$0	$0	$0	$0	$0
Events Attributable to Fees / Underperformance	N/A	N/A	N/A	N/A	N/A	N/A
100% Guarantee would pay	8	2	0	0	0	0
Percent of Times when 100% Guarantee Pays	2.68%	0.67%	0.00%	0.00%	0.00%	0.00%
Average Value when 100% Guarantee Pays	$88,401	$93,132	N/A	N/A	N/A	N/A
Average 100% Guarantee Paid	$11,599	$6,868	N/A	N/A	N/A	N/A
Maximum Guarantee Paid at 100%	$21,579	$8,734	$0	$0	$0	$0
Events Attributable to Fees / Underperformance	100.00%	100.00%	N/A	N/A	N/A	N/A