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CESR
11-13 Avenue de Friedland
75008 Paris
France

Rotterdam, 14 May 2009

Subject: Consultation paper on technical issues relating to the KID

Dear Sir, Madam

CESR recently published its "Consultation paper on technical issues relating to Key information Document (KID) disclosures for UCITS "(CESR/09-047). Robeco is grateful for the opportunity to comment on the proposals contained in the consultation document. In the reply below we've concentrated our comments on the "Proposed Methodology for the Risk Indicator in the Key Information Document for UCITS".

We will show that the current proposed methodology can be enhanced and thus offering a possible solution for structured & guaranteed funds to better fit into the Synthetic Risk Reward Indicator (SRRI) by using estimated VaR. For other than structured & guaranteed funds, the initial proposal of CESR could in our view remain unchanged since for the remainder of funds VaR and volatility are synonymous.

(a) Introduction

In the CESR Consultation Paper, three major classes of UCITS investment funds are outlined: market funds, strategy funds, and structured funds (including guaranteed funds). It is proposed to use the **historical volatility** as the risk measure for classifying the funds in each of the 7 risk categories. In addition it is shown how the volatility should be estimated for each class of funds. A **facultative risk add-on** is further allowed in which the risk classification is shifted one category upwards, on the discretion of the portfolio manager (for example when proxy returns are used, or when there is event risk exposure). Also a **modifier (!) is advocated** which signals that the risk profile of the fund can change rapidly over time so that the fund's return history is no longer deemed representative, or that the fund's asset mix can change rapidly over time.

For **structured or guaranteed funds** the use of historic volatility can be criticized . Especially it can be said that the use of the "current mix" or "replicating portfolio / delta-representation" approach for structured and guaranteed funds can be perceived as inadequate.
       As an alternative, it can be proposed to use **Value-at-Risk (VaR)**. For the majority of the funds, i.e. "simple funds" using no (or little) non-linear derivatives, VaR could be estimated directly from the historical volatility of the fund. Since for these funds the return distributions are (approximately) normal, this VaR will be a

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multiple of the volatility minus the mean return. For structured funds, including guaranteed funds, the return distribution can be markedly asymmetrical and hence non-normal. For these funds, the VaR can be estimated starting from the current portfolio composition of the fund and the actual returns of the portfolio components over some historical period. This is the so-called "historical simulation VaR".

For the majority of funds, VaR and volatility are synonymous, whereas for structured and guaranteed funds the VaR may be a better gauge for (downside) risk than historical volatility derived from a "replicating portfolio / delta-representation" approach. Below we therefore outline how historical volatility and/or VaR may be used to classify funds in the 7 risk categories. The current CESR proposal is taken as the starting point and where deemed necessary, amendments are suggested.

We hereby suggest to make use of the idea of estimating VaR. However, when doing this you have to specify or motivate the choice of VaR parameters (such as horizon, confidence level) and discuss the methodological set-up for the historical simulation VaR. Below we indicate how this could be taken care of.
For the majority of funds, VaR and volatility are synonymous; hence, for these funds nothing needs to be changed to the CESR proposal there. Also the proposal for adding the modifier (!) or the facultative risk add-on remains unchanged. Also the proposal to deal with incomplete historical return histories is unchanged. For structured / guaranteed funds, we propose a general methodology to estimate the historical VaR. The 7 risk buckets can be redefined in terms of VaR (as percentage of NAV). The historical simulation VaR of structured and guaranteed funds can also be transformed into volatility by assuming normality. This leaves the ranking and classification of funds on volatility or VaR intact.

On the outset we also note that VaR is no panacea. When fund composition can change quite rapidly over time because of active decisions, any historical risk measure (be it volatility or VaR) will fall short of indicating risk over the next year. For these types of funds, additional information is required to derive the volatility or VaR. In addition, for these cases, the risk add-on and the modifier may be appropriate.

Below, first the proposed VaR methodology and the VaR parameters are outlined. Next the application of historical volatility (and normal-VaR) and historical simulation VaR for the fund typology as described in the CESR proposal is summarized. Finally, the risk categories are revisited and it is shown that they can be formulated equivalently in terms of historical volatility or VaR.

(b) Value-at-Risk : methodology

When return distributions are (approximately) normal, VaR is a multiple of the volatility minus the mean return. Since it is very difficult to estimate mean returns over a horizon of one year, we propose substituting the **risk free rate** for the mean return (this in fact boils down to assuming risk neutrality). Besides being **pragmatic**, this also makes the VaR estimate more **conservative**. For example, for a 1-year and 95% confidence level, the "normal-VaR" can thus be calculated as :

$$VaR(1 \text{ yr}, 95\%) = 1.65 * (\text{volatility p.a.}) - (\text{1-year risk free rate p.a.})$$

Note that there is a one-to-one relation between the normal VaR and the historical volatility. This normal VaR would be appropriate for market funds and strategy funds (see also below). For completeness we note that for funds characterized by large potential shifts in allocation because of active management (as opposed to formula-trading), historical VaR neither historical volatility can adequately measure risk. The reason is that current fund composition is not representative for the fund composition over the next year and (hence) that the actual fund return history is not representative for the potential returns realized over the next year. For these funds,

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additional information should be taken into account, viz. risk targets, risk limits and pro-forma asset mix. Since the problem for these funds lies in the changing risk exposures (and not as much in the potential asymmetries of their return distribution), volatility or normal-VaR are the appropriate risk measures.

For structured funds, including guaranteed funds, the return distribution can be markedly asymmetrical and hence non-normal. For these funds, the VaR can be estimated starting from the current portfolio composition of the fund and the actual returns of the portfolio components over some historical period. This is the so-called "historical simulation VaR". We propose to estimate this VaR using at least 5 (most recent) years of weekly historical return data. (For funds where weekly data are not available, monthly data can be used.) Using a window of 52 weeks, the return of the fund is measured. Next, the window is shifted one week and the fund return is measured again, until the whole historical data period is covered. For the full period of 5 years of weekly data, this results in 208 yearly returns. Subtract the actual mean of these returns and add the current risk free rate. This shifts the mean of the historically simulated return distribution to the risk free rate, thus correcting for any bias that may occur from bull or bear markets over the past 5 years. Next, rank the returns from highest to lowest. The precise 95% VaR is given by the 10.4^{th} observation, so (linearly) interpolating between the 10th and 11th bottom return gives the 95% VaR.

Given this methodology, the rule-based VaR is easy to monitor by regulators (just as the historical volatility).

(c) Value-at-Risk : parameters

Since the horizon of the KID is up to one year, it is proposed to set the VaR horizon to one year. To allow for a reasonable degree of accuracy in estimating VaR in historical simulation, we propose a VaR confidence level of 95%.

(d) Volatility and VaR estimates for different fund categories

In the CESR proposal, three general types of funds are distinguished:
- market funds,
- strategy funds,
- structured funds (including guaranteed funds).

This distinction is important since different types of funds call for a different risk estimation approach. The basic criteria to construct this fund typology are the relative stability of the portfolio composition (as for market funds), and whether the portfolio composition may change due to (unpredictable) active portfolio decisions (such as total return and absolute returns funds) or due to some formula plan (structured funds, including guaranteed funds).

CESR already outlined the estimation of historical volatility for the fund types. Below, we also incorporate the estimation of VaR, especially for the structured funds, in order to provide a proposal that is as complete as possible.

1. Market funds

Funds investing into fixed segments of the capital markets in such a fashion that their overall risk is predominantly resulting from the risk of the underlying market segments and their development over time, and less from the active investment decisions made by the portfolio manager. These are the "classical" investment funds with mostly a static asset mix, in particular including funds managed closely along a benchmark. Their portfolio holdings can largely be characterized as a "static mix". When allowing limited room for active management, funds are characterized as "static mix plus". This implies that the asset manager can indicate a reference index or asset mix that is representative for the fund's stated investment policy, or even a benchmark along which the fund is managed.
Note : fairly constant asset mixes, limited (if at all) use of non-linear derivatives, and hence approximately symmetric return distributions
→ use historical volatility, or normal-VaR based on that volatility (with mean return set equal to the risk free rate)

2. Strategy funds

These funds are managed such that their overall risk profile is not predominantly driven by the risk of fixed market segments but determined by active allocation decisions made by the portfolio manager following a specific strategy. Since their investment policy allows these funds to change their portfolio holdings substantially over time, these funds can be characterized as "dynamic mix". Within this class, one can distinguish between (a) absolute return funds, (b) total return funds, and (c) life cycle/target maturity funds.

2.a Absolute return funds

These funds aim at generating positive returns over an implicit or explicit cash benchmark by employing active strategies, and are likely to use long-short derivatives. Because of the cash benchmark and the long/short decisions, there is no index or asset mix representative for their portfolio holdings. From the active and dynamic nature of their allocation decisions, these funds are characterized as "active dynamic mix".
→ use the maximum of (a) the actual historical volatility and (b) the volatility risk limit or the target volatility of the fund, or use the normal-VaR based on the relevant volatility (with mean return set equal to the risk free rate)
Note : the historical VaR cannot be estimated by back testing because the current asset mix can change rapidly and drastically over time

2.b Total return funds

These funds aim at maximizing total return relative to a benchmark by participating in rising equity and fixed income markets. Within their investment policy, and according to market dynamics and the portfolio manager's views, the allocation over assets and asset classes may change rapidly. A risk limit or target volatility may or may not be available. From the active and dynamic nature of their allocation decisions, also these funds are characterized as "active dynamic mix".
→ take the maximum of (a) the actual historical volatility, (b) the volatility of the pro-forma asset mix that is consistent with and representative for the fund's investment policy, and (c) the volatility / VaR limit or target volatility / VaR of the fund
Note : The CESR proposal outlined how VaR limits can be translated into volatility limits, but VaR limits can also be used directly, see below.
→ alternatively, take the normal-VaR based on the relevant volatility as above

2.c Life cycle / target maturity funds

The fund's asset allocation changes over time and tends to become more defensive as the target date approaches. Since the target allocation within the fund changes over time, not all of its return history may be representative for the current allocation of the fund. Since the allocation of these funds does change (gradually) over time, but not because of active (i.e. view-based) management, these funds can be characterised as "passive dynamic mix".

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→ use historical volatility, or normal-VaR based on that volatility (with mean return set equal to the risk free rate)

3. Structured funds (including guarantee funds)
These funds provide investors with formula-based (contingent) payout profiles, linked to market indexes or asset mixes, and often providing protection from full volatility of markets. Depending on the level of these underlying indexes or mixes, the risk profile of these funds will change. Examples of these funds are capital protected funds, guarantee products and floor products. Since the allocation of these funds does change over time but not predominantly because of active (i.e. view-based) management, these funds are characterized as "passive dynamic mix". The difference with life cycle / target maturity type of funds is that, depending on market dynamics, the structured fund allocation – and hence its risk profile – can change quite quickly and drastically. For this reason, no fund return history is deemed representative for the current allocation of the fund and hence for the estimation of the volatility.
→ estimate the 1-year 95% VaR from historical simulation
Note : since the fund composition only changes because of some predefined rule (dynamic trading rule, option replication rule, or some other formula), the dynamic fund allocation can and should be accounted for in the historical simulation VaR (starting from the current fund composition).
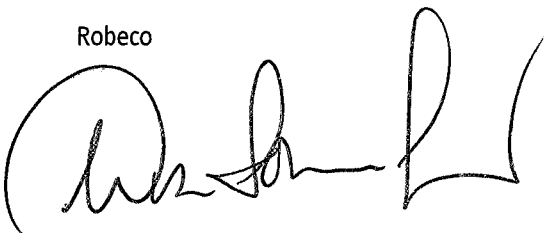
(e) Risk classification

In the CESR draft proposal, the 7 risk categories are based on volatility buckets. Without loss of generality, these buckets can be defined in terms of VaR. In this way, the structured funds can be accommodated right away. For the other funds, nothing changes because of the one-to-one relation between historical volatility and the normal-VaR based on that same volatility. We acknowledge that the limits for defining the risk buckets have yet to be set.
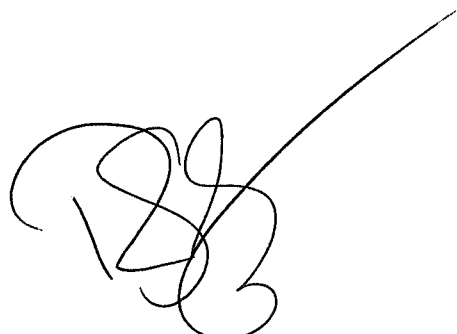
(f) Conclusion

We are of the opinion that with our suggested approach, the proposal will be greatly enhanced as it takes different fund characteristics and the relevant risk methodologies better into account. As always, we are willing to further assist CESR in its efforts to further refine the methodologies for a SRRI. A SRRI, combined with some narrative explanations/warnings, is in our view, as opposed to a narrative approach, the only real solution that gives the investor a proper indication of risks attached to its investment. A narrative approach will lead, as it is today, to a list of possible events while nothing is said about probability of the event and the effect of it. This is in our view of little use to the investor. As further each fund producer can choose its own text, two funds with a different risk profile could in the narrative approach have similar texts on "risks", or two similar funds could have different texts. A narrative approach will therefore not only lead to incomparability, but can possibly also be misleading for investors.

Yours sincerely,

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