

Response to consultation document CESR on content and form of Key Investors Information disclosures for UCITS

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General comments

I welcome the initiative to develop a Key Investors Information document for UCITS at the European level. There is a large body of evidence in the academic literature that shows that individuals are not well equipped to take investment decisions. In recent years the possibilities to exchange risks on financial markets have developed exponentially and individuals can benefit widely from the supply of financial products. The complexity of these products however has increased.

Not surprisingly the Simplified Prospectus is judged to be no longer satisfactory. In my view narrative descriptions of risk components will never suffice for individuals because they leave the need to interpret and evaluate all this information with the individual. The risk management techniques that are available in the industry to model risks internally are to be exploited to provide investors with adequate information on risk as well as on the reward and up-side potential of investing in risky investments. A synthetic indicator seems central to enable individuals to benefit optimally from the opportunities that are offered by financial markets. Of course such an indicator will not cover all risks that can be conceived. The focus in providing information to individuals should however not be in describing all potential risk factors (with a possible aim to avoid legal liabilities) but rather in provision of relevant information in a ready to interpret way. This e.g. implies (indirect) reference to probability statements based on the most dominant risk factors even if not all risk factors are incorporated and even if precise probability statements would be hard to make. Likewise accessible information on charges is essential.

A key driver for the success of a Key Investor Information document will be the extent to which one succeeds to visualize and summarize the most relevant information. The literature has shown e.g. that the default behaviour induced by transparent information is much more effective to improve efficient use of financial markets than financial education of individuals, which is topical in a number of European countries. The example of how a KII document could look like in annex 8 of the consultation document is definitely a huge step in the right direction. However, graphically the information on past performance dominates. In fact the academic literature provides ample evidence that the past performance of a financial product provides very little information (if any) over and above the more relevant average long term return and volatility of the product class at hand. I propose to put more emphasis on the risk and reward profile and the charges, e.g. by also classifying the charges in a number of classes and by presenting these classifications in more prominent ways. In fact the proposed number of only five classes might be on the low side to provide adequate consumer information.

A crucial question (see 6.16) in the consultation document is the question whether a technical possibility exists to take most risks and rewards into account, and to calculate a synthetic indicator for most funds, with limitations that are likely to be understood by investors, with implementation costs which are acceptable and without opportunities for manipulation to achieve a particular value indicator. My answer is definitely affirmative. The core of the technique exists and is widely used e.g. in risk management and derivation of the required solvency buffers for banks and insurers. It should be very well feasible to enable individuals to benefit from the existing expertise. Obviously the existing

techniques have their limitation and the industry is working hard to improve the models further. Nevertheless I am convinced that the existing models can be very useful once their implications are adequately presented to individual investors.

Main limitations

The main limitation of the current proposal as a device for adequate information of consumers seems to be that it only addresses the risk of an individual product and neglects the portfolio context. A financial product can be risky in itself but risk reducing when added to an existing investment portfolio or to an individual's total wealth (financial, housing, human capital). While this is an important limitation to recognize it does not imply that a KII document would not be very helpful for individual decision making.

A second important limitation of the current proposal is that it seems to be tailored to risk in nominal (e.g. Euro) terms. Especially for long term products, such as life assurance and products for retirement provision, it is primarily the purchasing power generated by the financial products that is relevant for the investor. It seems quite well possible to incorporate inflation characteristics of the pay-out stream in the proposed document.

Main criticism: The reliance on past performance of the product.

The main criticism based on academic literature seems to be the exclusive reliance on past performance of the product. As argued before, past performance of the product itself is a poor predictor of future performance. This is the more true if past performance over periods as short as only three or five years is used. Estimates of expected returns on such short spans of data are simply extremely volatile. Moreover emphasis on past performance opens up opportunities for gaming, e.g. by initiating a number of mutual funds and subsequently closing down all of them apart from the best performing fund. This fund would look attractive in such a KII document. An approach to measuring mean returns that is much better rooted in the academic literature is reliance on mean returns on asset classes that are estimated over (very) long periods. Combination can be thought of where e.g. average performance over a 25 year period is to be reported and the return on the asset class as a whole is to be used for years where the product had not been introduced. As a side effect such an approach also solves problems with new products where no past performance data are available.

Smaller comments:

- The KII documents should not be limited to pre-contractual information, because the characteristics of many structured products that contain derivatives can change drastically over their life cycle. A simply guarantee product e.g. can at one stage in their life cycle have risk characteristics that are equivalent to stocks but can easily become equivalent to a term deposit. A practical solution might be to post up-dated KII documents on a web-site of the provider whenever significant changes in risk characteristics have occurred.
- Guaranteed products and other non-linear products can easily be incorporated in the same scales that are used for linear products if the focus in the legislation is on quantiles of the return distribution, and not e.g. just on the mean and standard deviation of that distribution. The separate scales that are referred to on page 64 of the document will not be necessary.