

# **A Post-Implementation Review of The Impacts of The CRM2 Annual Costs and Performance Reports on Investment Fund Fees and Performance**

## **Executive Summary**

The CSA has undertaken research to examine the post-implementation impacts of the final phase of the Client Relationship Model (CRM2) amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (herein after the CRM2 annual costs and performance reports) on industry and investor behaviour.

The final amendments, which came into effect on July 15, 2016, were designed to ensure investors receive clear and complete annual disclosure of both the performance of their investments and of all fees associated with their accounts, including registrant compensation. The detailed findings of this research are presented in the following reports<sup>1</sup>:

- A Post-Implementation Review of The Impacts of The CRM2 Annual Costs and Performance Reports on Investment Fund Fees (*Fees Report*)
- A Post-Implementation Review of the Impacts of the CRM2 Annual Costs and Performance Reports on Investment Fund Performance (*Performance Report*)

This document provides a high-level summary of the research findings. *The findings presented in this executive summary and the research reports are the views of CSA staff and are for informational purposes only. As such, statements made in these documents do not represent the CSA's views of any official policy position.*

## **1 Purpose and Background of Research**

The increased disclosure of fees and performance brought about by the CRM2 amendments is expected to have enabled retail investors to make better investment decisions and promoted efficient markets. As a result, we hypothesize that this greater transparency has led to more competitive fund pricing and higher performance by investment funds.

To test our hypothesis, we undertook a study to examine whether the enhanced reporting of investment cost and performance led to changes in mutual fund and

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<sup>1</sup> The reports have benefited greatly from comments from internal and external peer reviewers. They include J. Ari Pandes, Haskayne School of Business, University of Calgary, and reviewers from The Investment Funds Institute of Canada (IFIC) and ISS MI Investor Economics. Any remaining errors of fact or interpretation are the sole responsibility of the authors.

exchange-traded fund (ETF) fees<sup>2</sup>, product creation, product distribution, and fund performance.

In particular, we asked:

1. Have investment fund managers (IFMs) lowered fees, specifically management expense ratios (MER) and management fees, and what is the extent of these changes?
2. Have product manufacturers and product distributors been shifting to products that are not captured by the new account costs and performance disclosures?
3. What have been the changes in product creation and distribution trends?
4. Has greater transparency about investment returns led to IFMs improving the risk-adjusted performance of their mutual funds and ETFs?

The research covers January 2013 to December 2020. This time period begins about 18 months before the first set of CRM2 amendments came into effect on July 15, 2014 (cost disclosures related to pre-trade disclosure of charges, and trade confirmation for debt securities). The 2013 start date gives us a baseline for the investment fund industry before the first set of CRM2 amendments were implemented. We hypothesize that the changes we are seeking to measure took place several years after the CRM2 annual costs and performance reports were fully implemented. Considering this, the study timeline extends to 2020 to account for this time lag, enabling us to more fully observe the extent of any changes. Our analysis groups the findings into three time periods: 2013 to 2020, which is the overall duration of our study period, the pre-implementation period of 2013 to 2016 and the post-implementation period of 2017 to 2020.

## **2 Summary of Research Findings by Research Question**

The research findings suggest that overall industry behaviour has been shifting in directions that are consistent with our hypothesis on the impact of the CRM2 regulations. This helps provide evidence that disclosure-based regulations may be an effective tool in changing industry and investor behaviour.

Our findings provide important directional trends (i.e., correlation rather than cause and effect outcomes). It is possible that other factors, which we could not practically account for in our analysis, also contributed to the changes we are highlighting.

We caution readers from drawing conclusions that the changes presented in this report were caused solely by the CRM2 annual costs and performance reports.

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<sup>2</sup> Our study is focused on the management expense ratio (MER) and management fees because the MER is an ongoing cost levied annually, and the components of the MER are relatively consistent across asset classes for the same (mutual fund) series type. The MER consists of the management fee paid to the fund's investment manager, trailing commissions paid investment advisors and/or dealers, operating expenses and taxes. For more information, see <https://www.getsmarteraboutmoney.ca/learning-path/mutual-funds-segregated-funds/mutual-fund-fees/>

**Research question 1: Have investment fund managers (IFMs) lowered fees, specifically MERs and management fees, and what are the extent of these changes?**

*There were declines in the asset-weighted average MERs and management fees, for both mutual funds and ETFs, during our study period, and the extent of these changes varied by investment fund type and fund characteristics.<sup>3,4</sup>*

**Mutual Funds**

*i. 2013-2020 Findings*

Overall, the asset-weighted average MER declined by 38 basis points (or 19%) over 2013-2020 for our study sample, and between 13 and 49 basis points, or between 6% and 30%, across the main fund characteristics examined.<sup>5</sup> The size of the asset-weighted average management fee declines was smaller, at 29 basis points for the overall study sample and ranged from 6 to 39 basis points across the main fund characteristics, or between 4% and 32%.

*ii. Pre-implementation (2013-2016) and Post-implementation (2017-2020) Findings*

Changes in the asset-weighted average MERs and management fees were generally greater during the post-implementation period than the pre-implementation period. Declines in the asset-weighted average MERs and management fees across the fund characteristics examined ranged from 3 to 19 basis points, or 2% to 15%, for both time periods.

Both shifts in the distribution of assets towards mutual fund series with lower fees, and reductions in series' MERs and management fee rates, contributed to lowering the asset-weighted average MERs and management fees.<sup>6</sup>

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<sup>3</sup> Asset-weighting the average MER or management fee is a way to calculate the average fee paid by investors which gives more weight to the fees charged by investment funds that manage more assets. We use this measure as it better reflects the average fees paid by investors than a simple average.

<sup>4</sup> Our analysis of fees examined the changes in MER and management fees across the following fund characteristics: asset class, fund product type (mutual funds only), fund investment strategy, IFM firm type, and series/class type.

<sup>5</sup> The analysis in the body of the report focuses on fund characteristics that account for the majority of mutual fund and ETF assets.

<sup>6</sup> Series with all levels MER/management fee rates saw both increases and decreases in their asset shares during our study period. However, on average, asset shares of series with lower MER/management fee rates grew more than asset shares of series with higher MER/management fee rates, and this contributed to lowering the asset-weighted average fees.

However, shifts in the distribution of assets had a larger effect than reductions in MER/management fee rates in lowering the aggregate asset-weighted average MERs/management fees for both time periods.

## **ETFs**

### *i. 2013-2020 Findings*

ETFs, compared to mutual funds, had smaller declines in their asset-weighted average MERs and management fees during our study period. This finding was anticipated since the MERs and management fees for most ETFs started from a lower baseline level. This is primarily because the majority of ETF assets are invested in funds that employ a passively managed investing strategy.

By the end of our study period in 2020, the asset-weighted average MER for our study sample had declined by 8 basis points (or 21%) from 2013 levels, and between 6 and 11 basis points or between 12% and 34%, depending on the fund characteristic examined. The decrease in the overall asset-weighted average management fee was 7 basis points (22%) between 2013 and 2020. Across the main fund characteristics, the declines in asset-weighted averages ranged from 3 to 10 basis points, or 5% to 34%.

### *ii. Pre-implementation (2013-2016) and Post-implementation (2017-2020) Findings*

Changes in the asset-weighted average MERs and management fees during both the pre- and post-implementation periods ranged from +1 to -8 basis points or +1% to -19% across the fund characteristics examined. There were no strong directional trends in the asset-weighted average MER/management fee declines by fund characteristics. Both changes in the distribution of assets and reductions in MERs and management fee rates had a broadly similar contribution to lowering the asset-weighted average fees, in both the pre- and post- implementation periods.<sup>7</sup>

<p><b>Research question 2: Have product manufacturers and product distributors been shifting to products that are not captured by the new account costs and performance disclosures?</b></p>
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*Our analysis of Canadian household discretionary financial assets did not show a trend of discretionary financial assets moving towards products not captured by the CRM2 annual costs and performance report requirements.<sup>8</sup>*

Between 2013 and 2020, the share of discretionary financial assets held in deposits remained stable at 27%. Meanwhile, the share of assets in non-investment fund securities increased slightly, from 25% to 26%, and the share of assets in

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<sup>7</sup> Ibid.

<sup>8</sup> [Investor Economics](#) defines discretionary financial assets as financial assets where households hold the decision-making power with regards to the deployment of these monies into specific investment vehicles.

investment funds increased from 28% to 32%. For investment funds, the 4 percentage point share increase was the result of growing market shares for mutual funds and ETFs.

**Research question 3: What have been the changes in product creation and distribution trends, generally?**

*Five notable changes in product creation and distribution occurred during our study period. Unless otherwise noted, the findings and figures discussed below are for the overall industry and are not only for our study sample.*

*i. Increasing Popularity of Fund-of-Funds Products*

The continued popularity of fund wrap programs contributed to a rise in the number of fund-of-funds products, for both mutual funds and ETFs<sup>9</sup>. This was evident in the shift of assets away from stand-alone funds to fund-of-funds products. In 2013, 26% of mutual fund assets were in fund-of-funds products and by 2020 this figure had increased to 37%. One of the largest ETF manufacturers introduced ETF-of-ETFs products in early 2018. By December 2020, ETF-of-ETFs products accounted for \$6 billion or 2% of the total industry ETF assets.

*ii. Growth of the ETF Market, and Actively Managed and Strategic/Smart Beta ETFs*

Growth of the ETF market was evident during our study period, and the growth rate for ETFs substantially surpassed the growth rate for mutual funds. Between 2013 and 2020, the annual growth in the number of ETFs was 17% while it was 2% for mutual funds.

Within ETF creation, one of the most significant changes that occurred during our study period was the rise of actively managed and strategic beta ETFs.<sup>10</sup> Near the start of our study period, actively managed and strategic beta ETFs accounted for 23% and 17% of the number of ETFs according to data from Investor Economics. By December 2020, their respective share rose to 43% and 21%. The rise in the number of strategic beta ETFs did not lead to a corresponding rise in ETF assets in that category of funds. In contrast, the share of ETF assets in actively managed

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<sup>9</sup> [Investor Economics](#) defines fund wrap programs as those that use investment funds as building blocks. These can include segregated funds of funds, mutual funds of funds, packaged fund wraps and high-end fund wraps.

<sup>10</sup> Strategic beta ETFs are funds that apply rules to a basket of securities (often represented by an index) to target companies that demonstrate specific “factors” such as value, momentum, or growth. Strategic beta ETFs are also known by other names such as smart beta or alternative beta. There is no universally accepted view as to whether strategic beta ETFs are passively managed investment funds or actively managed investment funds. For the purpose of our research, we have classified strategic beta ETFs as passively managed funds because they focus on a specific basket of securities often represented by indices.

ETFs increased from 9% at the start of our study period, to 24% by the end of our study period.

iii. *Continued Growth in Fee-Based Mutual Fund Series*

Within the mutual fund market, the shift from commission-based to fee-based series was pronounced during our study period. Between 2013 and 2020, the number of fee-based series increased by 186%, from 2,592 to 7,404. In comparison, the number of commission-based “A-series,” which is the “core” mutual fund series, increased by 103% from 2,887, in 2013, to 5,880, in 2020.

Looking at our study sample, we found that 6% of mutual fund assets were in fee-based series at the start of our study period in 2013. This figure increased to 27% by the end of our study period in 2020. The growth and shift of assets into fee-based series corresponded with declining assets in commission-based A-series. In 2013, 75% of our study sample assets were in A-series and by 2020 this figure had declined to 58%.

iv. *Rise of Funds with an ESG Mandate*

A product creation trend that occurred towards the end of our study period was the rise of and demand for funds with an environmental, social, and governance (ESG) mandate. There were 49 mutual funds with an ESG mandate in 2013 and these funds had assets of \$5.1 billion. By 2020, the number of mutual funds with an ESG mandate almost doubled to 97 funds. The number of ETFs with an ESG mandate grew from 10 in 2018, to 50 by 2020. Despite the significant increase in the number of funds with an ESG mandate, their share of total industry assets is small. In 2020, funds with an ESG mandate accounted for around 1% of total industry assets within the mutual fund and ETF markets, respectively.

v. *Rise of Online Advisers*

A new direct to investor/consumer distribution channel emerged in 2014 with the launch of four online advice platforms – Wealthsimple, Wealth Bar, NestWealth, and Questwealth Portfolios. These platforms provide retail investors with access to discretionary asset management services with no or low account size minimum requirements. These platforms invest client assets primarily in ETFs, and to a lesser extent in mutual funds, other redeemable investment funds, cash, and cash equivalents.<sup>11</sup> By the end of 2020, 22 online advisers operated in Canada. These firms had an estimated \$10 billion in assets under management, which is equivalent to about 4% of the industry total assets for ETFs.

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<sup>11</sup> Redeemable investment funds generally allow investors to purchase or redeem securities of mutual funds on demand for a price representing a proportionate interest of the fund’s net assets. Mutual funds are the main type of redeemable investment fund.

**Research question 4: Has greater transparency about investment returns led to investment fund managers improving the risk-adjusted performance of their mutual funds and ETFs?**

*On balance, we find that the risk-adjusted performance relative to our model's benchmark for both mutual funds and ETFs, while remaining negative for the whole study period, improved in the years after the client statements, annual costs and performance reports were implemented.<sup>12</sup>*

Our research findings are based on a fund sample representing approximately 62% of mutual funds and ETFs in the Canadian market, as measured by assets under management (AUM) in December 2020.

We use total return and risk-adjusted return, also known as alpha, as measures of fund performance, and report results based on gross returns (i.e., returns before fees and expenses).<sup>13</sup>

*i) 2013 to 2020 Findings*

The annualized average gross total returns between 2013 and 2020, for our study sample, were 7.1% for mutual funds and 7.9% for ETFs. Accounting for fund risks, we found that the mean gross alphas relative to our model benchmarks were -3.5% for mutual funds and -2% for ETFs. These negative alphas imply that, on average, the total returns are lower than what would be implied by our chosen benchmark used to account for fund risks.<sup>14</sup>

*ii) Pre-implementation (2013-2016) and Post-implementation (2017-2020) Findings*

Comparing the performance findings for the pre- and post-implementation periods, we found that the risk-adjusted returns relative to our model benchmarks improved during the post-implementation period, even though they continued to remain negative. For mutual funds, the annualized average gross alpha was -5%, between 2013 and 2016, and -2.2% between 2017 to 2020. The ETF findings were -4.8% for the pre-implementation period and -0.6% for the post-implementation period.

Our research also analyzed whether there were differences in fund performance by the following fund characteristics: asset class, investing strategy, product type, and

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<sup>12</sup> Note that risk-adjusted performance is measured relative to our chosen benchmarks based on the Fama and French (2015) model. Negative risk-adjusted performance of a fund indicates that the fund underperformed the benchmarks used to account for the fund risks in the model we have applied. It is important to highlight that a negative risk-adjusted return does not imply that investors incurred losses from investing in the fund during our sample period.

<sup>13</sup> Gross performance allows the analysis of funds' performance to be independent of their fees and expenses, which are analyzed separately in a companion report entitled *A Post-Implementation Review of the Impacts of the CRM2 Annual Costs and Performance Reports on Investment Fund Fees*. We have also assessed net performance and obtained qualitatively similar conclusions (results available upon request).

<sup>14</sup> See footnote 11 for some information on our chosen benchmark.

IFM type. The findings by fund characteristics directionally mirrored the overall findings but the annualized average gross total return and risk-adjusted return varied by fund characteristics.

There were no uniform directional trends for the gross total returns when we compared the pre- and post-implementation results. Between these two time periods, returns increased for some fund characteristics and decreased for others. The gross total returns ranged from 1% to 10.8% for mutual funds, and 1.4% to 11.2% for ETFs.