

# **Financial Economists Roundtable**

## **Statement on Risk Disclosure by Mutual Funds**

**September 18, 1996**

### **The Need for Information about Mutual Fund Risks**

The growth in the U.S. mutual fund industry in recent years has been explosive. Individuals invest in such funds directly and through retirement funds such as 401(k) plans. With broader use comes the need for investors and their advisors to have more and better information concerning the nature of the investments these funds undertake. To help achieve this goal, in March 1995 the U.S. Securities and Exchange Commission (SEC) issued a Concept Release and Request for Comments on "Improving Descriptions of Risk by Mutual Funds and Other Investment Companies". Interest was great - 3,600 individual investors submitted comment letters and the Investment Company Institute (an industry trade association) surveyed an additional 600 fund shareholders on the subject.

In May 1996, Arthur Levitt, the Chairman of the Commission, stated that "... at least for the time being, we do not need to mandate a specific risk measure..." but that funds would be asked to select names more closely related to their investment practice and that a bar graph showing historic annual returns should be included in a fund's prospectus, along with "...a brief, plain English risk summary."

### **Financial Economists Roundtable Views and Recommendations**

At its annual meeting in July, 1996, the Financial Economists Roundtable examined the issue of mutual fund disclosure and reached the following conclusions:

1. Current disclosure practices in the mutual fund industry are inadequate. Investors and their advisors need more information to help them assess the risks associated with investment in mutual funds.
2. Since the impact of a single mutual fund on an investor's overall financial situation may be complex, a one-dimensional measure is often inadequate. For this reason, fund risk disclosure should go beyond the reporting of historic return variability. Investors and their advisors need information that can enable them to assess sources of future risk; in many cases, history may not be the best guide to the future.
3. To better communicate the sources of risk associated with mutual fund investments, fund managers should provide estimates of the principal risk factors that are likely to influence fund returns in the future. Specifically, fund managers should describe and quantify the expected relationship between their fund's future returns and relevant security market indexes as well as the likely extent of divergence of their returns from

such indexes and the probable sources of such divergence. In subsequent periods, actual fund returns should be compared with the portfolio of market indexes previously selected by a fund. It is important that fund managers both provide estimates of exposures to key risk factors in advance and subsequently report returns relative to those same exposures.

4. Management predictions of future actions and outcomes are, of necessity, subject to error. Thus the SEC must provide an adequate safe harbor for such predictions so that managers can provide honest estimates without fear of later litigation.

5. We hope that individual investors and sponsors of retirement plans that use mutual funds will demand that fund managers provide the above information, thereby avoiding the constraints and costs of mandated disclosure.

### **The Need for Disclosure of Future Risk**

The Roundtable concurs with the SEC's conclusion that disclosure of a specific risk measure need not be mandated. However, the Roundtable believes that investors and their advisors need more information to help them assess the risks of mutual funds and other investment companies.

By its very nature, risk concerns the uncertain future. While investors know (or can know) what happened to a fund's returns in the past, their primary need is to predict the likely range of a fund's returns in the future. The greater is this range, the more risky are a fund's prospects.

Investments in funds are risky because they are exposed to economic forces or factors for which the future is uncertain. Some of these are unique to individual funds, but many are common to many funds. Thus, a U.S. stock fund will typically move to a greater or lesser extent with the overall U.S. stock market. A fund's risk depends on how closely its return is coupled with given indexes, the riskiness of each index, and how closely the indexes tend to move together.

A fund manager can communicate the nature of exposures to major risk factors of this sort by specifying a portfolio of security market indexes that, averaged over the next two to four years, is likely to have exposures similar to those of the fund. Thus, a growth stock fund might specify that a U.S. growth stock index would be an appropriate benchmark for this purpose. Another fund might select a combination of indexes, with 5% in a money market index, 75% in a value stock index, and 20% in a non-U.S. stock index. The Roundtable recommends that each fund manager provide a well-defined index or portfolio of indexes so that investors can be informed of the fund's likely future exposures to major sectors of the security markets.

Since disclosures of this nature will, of necessity, describe management's intentions and predictions concerning future actions and outcomes, the SEC should provide an adequate

safe harbor by specific reference under Rule 175 so that funds can provide honest best estimates without fear of later shareholder litigation.

Investors must ultimately be responsible for understanding or making predictions about the risks associated with major market sectors, as well as the extent to which sectors are likely to move with one another. Much of this information is common to many funds and thus can be most efficiently provided to investors by third parties such as financial planners and database providers. In contrast, the manager of a mutual fund is in the best possible position to predict his or her intended future investment strategy and to choose a benchmark portfolio of indexes that best describes that strategy.

In some respects this proposal resembles the SEC requirement that each fund compare its historic returns with those of a broad-based index, preferably one provided by a third-party. However, there are three major differences. First, in many cases, funds can provide better information if they use narrow-based indices. Second, where relevant, funds should use portfolios of indexes. Third, and most importantly, a fund should select a benchmark of indexes representative of future investment strategy whether or not this benchmark was representative of the fund's past strategy.

Many narrow-based indices could be used for this purpose. Some examples are:

- Cash equivalents (for example, short-term U.S. Treasury Bills)
- Intermediate-term government bonds
- Long-term government bonds
- Corporate bonds
- Mortgage-related securities
- Large value stocks
- Large growth stocks
- Medium-capitalized stocks
- Small-capitalized stocks
- Non-US Bonds
- European stocks
- Pacific stocks
- Emerging Market stocks

There is at least one index readily and cheaply available for each of these, and many are already tracked by index mutual funds.

### **Risk not Related to Principal Factors**

Not all risk arises from exposures to major factors. A fund's returns will typically be more risky than those of its selected portfolio of indexes, for one or both of two possible reasons. First, the fund may concentrate its holdings within a sector and hence be less

diversified than the corresponding security index. Second, it may rotate its holdings around the long-term average positions represented in the portfolio of indexes.

While it would be useful to formally quantify the non-factor risk arising from one or both of these activities, this may be difficult to do with precision. However, fund managers should provide a narrative account of the likely divergence of their fund's returns from those of the selected portfolio of indexes and the extent to which such divergence is likely to be due to (1) concentrated holdings and (2) rotation among asset classes.

## **Performance Evaluation**

The Roundtable recommends that subsequent disclosures by funds provide historical comparisons of returns with the returns that could have been obtained had investments in the selected portfolio of indexes been made instead. Thus, in all subsequent periods, the fund's returns would be compared with returns on the portfolio of indexes selected by the fund management in advance of that period. To emphasize the risk arising from its operations, the fund should show the difference between its return and that of a portfolio of indexes for each year for which the information is available.

## **Reporting Historic Variability**

In many instances the total variation in a fund's returns may not adequately measure its risk for a specific investor. A fully relevant measure of risk will take into account all the investor's assets and liabilities. For example, an investor making payments on a fixed-rate mortgage will view the sensitivity of a bond fund to change in interest rates differently than will an investor with no such liabilities. Similarly, an investor with existing holdings in a U.S. stock fund will be more concerned with the sensitivity of a stock fund to changes in the level of the U.S. stock market than will one with only holdings in other countries. It is for these reasons that the Roundtable has advocated a focus on the exposures of funds to principal risk factors.

Despite these caveats, the historic variability of returns still provides useful information for many investors. Thus, the Roundtable does not oppose the presentation of information on historic returns for the benchmark portfolio of indexes selected by a fund for the forthcoming period. However, it advocates that any chart based on the previous returns on such a portfolio show the difference in the portfolio's return each year from the average portfolio return over the years portrayed in the chart. Such a presentation emphasizes the effects of risk rather than on historic average returns. Both theory and empirical evidence indicate that history is a much better predictor of future risk than of future average return.

## **The Need for more Information on Portfolio Holdings**

These recommendations are not intended to minimize the importance of third-party studies of past mutual fund performance. Such analyses require high-quality data, some of which can only be provided by fund management. There is one area in particular where the data provided by mutual funds is deficient for this purpose. Funds are now required to report their portfolio holdings after-the-fact once every six months, on a delayed basis to protect proprietary information. To increase the usefulness of studies of mutual fund performance, analysts should ultimately have access to monthly portfolio holdings. To facilitate this, the Roundtable recommends that the SEC mandate that funds include holdings at the end of each of the prior six months when filing their bi-annual reports.

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