M E M O R A N D U M

DATE: September 20, 1974

TO: The Commission

FROM: The Division of Investment Management Regulation

SUBJECT: Portrayal of Performance for Mutual Funds and Variable Annuities.

NOVEL, UNIQUE OR COMPLEX ISSUES:

Should the Commission reverse its long-standing policy of not permitting any registered investment company to portray past investment results in sales literature in terms of a compound rate of total return (assuming all dividends and capital gains distributions are reinvested), recognizing that with appropriate safeguards to indicate variability such an approach can provide a meaningful basis for analysis and comparison of investment returns, risks and costs.[1]

RECOMMENDATIONS:

(1) That the Commission authorize the staff to publish for comment the attached Release which would propose an amendment to the Commission's Statement of Policy. It would add two new formats which would enable mutual funds and variable annuities to measure and portray investment results in terms of compound rates of total return.

(2) That whenever investment results of mutual fund or variable annuities are portrayed in terms of compound rates of total return:

(a) A bar graph presentation be required to adequately indicate variability in returns from year to year; and

(b) Chart I be required for variable annuity payout periods in order to indicate how annuity payments vary and to illustrate the effect of precrediting on annuity payments.

---

1 This memorandum should be distinguished from the Division's Memorandum on Variable Annuity Illustrations and Securities Act Release No. 8438, July 30, 1974, which dealt with the effects of costs on illustrative future investment returns. This memorandum is concerned with the portrayal of actual historical investment results of mutual funds and variable annuities.

SUMMARY:

To improve portrayal of investment returns, risks, and costs, we would add to the Statement of Policy five new charts of investment results using two basic formats -- a mountain chart and a bar graph. For mutual funds we propose to permit a mountain chart presentation of the total return (assuming all dividends and capital gains distributions are reinvested) and a bar graph of year-by-year and ten-year average total returns. For variable annuities, we propose two other charts to adapt these methods to the pay-in period of a variable annuity, and still a third chart to portray the results of the annuity payout period. All five charts show investment performance in terms of compound rates of total return (i.e., they combine dividend and capital gain distributions as well as changes in the value of the original shares into a single figure which is compounded over a ten-year period.)

Background - The Current Statement of Policy:

The current Statement of Policy sets forth the following requirements for measuring and portraying investment results:

(1) It permits the return due to net investment income to be measured in terms of a "yield rate" but prohibits the use of a compound rate of total return.

(2) It includes sample charts which show investment results only at year ends and thus it masks fluctuations during the year.

(3) It permits but does not require comparisons with market indices.

(4) It permits investment results to be shown over a minimum of ten years, or the life of the fund if shorter, or over any longer period up to the life of the fund, provided additional periods longer than ten years but less than the life of the fund are in multiples of five years. Thus it permits results to be portrayed over periods of 30 to 40 years, although economic conditions and the fund management may have changed considerably over these periods.

(5) It includes a mountain chart based on a linear scale which, as a result of compounding returns over extended periods, creates a ballooning effect on the results for later years.

How Our Proposals Would Change The Statement of Policy

The charts and tables currently permitted under the Statement of Policy would continue to be governed by the requirements listed above. However, on our proposed charts:

(1) Investment results would be measured in terms of compound rates of total return but the relative effects of income and appreciation on overall investment results would be shown separately.

(2) Investment results would be portrayed on a mountain chart on a year-by-year and on a market high to market low basis to indicate fluctuations during the year.

(3) A year-by-year comparison with the Standard and Poor's Composite Index of 500 Industrial Stocks would be included to provide an additional indication of risk by showing how the fluctuations in fund returns relate to market fluctuations.

(4) Investment results would be portrayed over a maximum of ten years, or the life of the fund if shorter, to provide a more meaningful basis for evaluating management and the risks involved.

(5) Mountain charts would give an accurate presentation of trends and variations in investment returns and eliminate the ballooning effect which results from compounding returns.

<u>The Importance of Compound Rates of Total Return</u>:

Compound rates of total return provide a precise and easily understandable measure of the overall investment results of a fund because they put funds with differing approaches to investment on the same basis. They are the figures demanded and used by financial institutions and other professionals in analyzing and evaluating investment results. Compound rates of total return not only provide a precise measure of investment returns, but also facilitate more meaningful disclosures of risks and how risks relate to returns. In addition, they call attention to the importance of compounding a return over time and to the impact of small changes, such as changes in expenses, on the total results of an investment program. Because a total return presentation can provide a complete picture of almost all aspects of fund performance, it should permit greater investor understanding of investment results and more meaningful comparisons of different funds.

While we endorse a compound rate of total return as a more meaningful measure of investment results than interest or dividend yield, the charts we propose would also observe the traditional distinction between income and capital. They show the income and appreciation components of the total return and thus permit investors to see the variability of each and the relative effect of each on total return. Also, any presentation of a compound rate of total return would clearly indicate how the return varies over time. This is essential in order that investors not confuse the average return for a fund with the constant return associated with a fixed income security.

<u>Relationship of Our Recommendations to Mutual Fund Distribution</u>

The record developed during the hearings on mutual fund distribution clearly indicates the need to revise the Statement of Policy to provide more meaningful and accurate descriptions of investment results and to improve understanding of investment services offered by funds. We believe that in the long run such changes will also provide a basis for more effective price and product competition.

One objective of our program for modification of the mutual fund distribution system is to provide a regulatory framework which facilitates the transition to a distribution system based more on market demand than on the role of the salesman. If fund sales literature could provide a better means of transmitting information about fund investment results and services, there would be a greater possibility that it could help to achieve more economical and effective distribution. Insofar as this would make the salesman's job easier and less time-consuming, lower sales charges might be possible. To the extent that the information provided permits meaningful comparisons among funds, it could form a basis for greater competitive pressures to improve investment services and reduce costs, both of which could indirectly stimulate demand for funds.

Anne P. Jones	-50240
Lewis J. Mendelson	-50220
Samuel S. Stewart	-50233
Michael R. Virga	-50216
John P. Freeman	-

PRODUCT COMPETITION AND THE ROLE OF PERFORMANCE DATA

Submitted By

DIVISION OF
INVESTMENT MANAGEMENT REGULATION

AUGUST 1974

Table of Contents

List of Figures

I. What Can Be Accomplished By Improved Disclosure of Investment Results, Risks, and Costs?[1]

This memorandum recommends that five new charts be added to the Statement of Policy: two for mutual funds and three for variable annuities. Our purposes are to permit more informed investment decisions; to help strengthen the competitive structure of the fund industry; and to help make fund management more responsible.

A. A More Informed Investment Decision

Any program concerned with the marketing of mutual funds should take into account the lack of awareness of the mutual fund concept, the lack of comprehension of the investment management service, and the lack of understanding of the risks and rewards of a diversified equity investment. Greater imagination in presenting information on the mutual fund concept and the investment service provided by management can help in the first two areas. Investors

---

1 Much of the information and analysis contained in this memorandum was brought out during the Panel Discussion of Performance Measurement and the Statement of Policy held on March 16, 1973. (Tr. 1622-1817). Participants were:

DAVID BABSON: President, David Babson Company, an investment adviser with assets of $2 billion under management including $100 million in mutual funds.

JOHN BOGLE: Formerly, President, Wellington Management Company, which had assets of $4.2 billion under management at March, 1973, including $2.5 billion in mutual funds. Mr. Bogle was also the chairman of the NASD's Investment Companies Committee. He is now President of the Wellington Funds.

GERALD S. JEREMIAS: President of Empire Planning Corp., a retail distributor of mutual funds. Mr. Jeremias who has been involved in the retailing of mutual funds for the past twenty-three years and has trained and supervised several hundreds of mutual fund salesmen is the author of a 48 page study entitled "Mutual Funds in the New Market: Too Great a Risk?"

PAUL JOHNSTON: Vice President of Wiesenberger Services, Inc. Mr. Johnston is in charge of the production of a dozen Wiesenberger publications, one of which "Investment Companies", is one of the main sources of information concerning mutual funds.

A. MICHAEL LIPPER: President of Lipper Analytical Services of Steiner, Rouse & Co. Mr. Lipper is a Chartered Financial Analyst with thirteen years of securities analytical experience.

could obtain a better understanding of the risks and rewards of a diversified equity investment through analysis and comparisons of past investment results.

If investors were provided with information which would facilitate meaningful analysis and comparisons, they would be better able to select a fund which could best meet their investment needs.[1] It is possible to obtain at least a partial understanding of the relative effect of the various factors which influence overall fund performance by studying past investment results -- the risk as well as well as the return -- in relation to stock market trends and movements, the fund's objective (i.e., the relative emphasis on current income or capital appreciation) and the performance of other funds.[2] This kind of information could provide some basis for understanding and evaluating the investment service provided by the fund.

The three factors which influence the record of a mutual fund are the performance of the stock market, the fund's objective and the ability of its management. Mr. Bogle analyzed them as follows:

> "One is the performance of the stock market. That is the overpowering force that affects the record of an equity oriented fund. . . The second factor is the fund's objective, is it more or less aggressive, more or less risky than the stock market generally, and third is the ability of the fund's management.
>
> The performance of the stock market I think we can all agree is not predictable. I would say relative performance (with respect to the market) in the light of funds that have had good past records, is in fact predictable. In other words you can't prove this, I think, with statistics but it is my general impression that funds that have performed better than the market consistent with their risk characteristics over a period of time are more or less likely to do so in the future."[3]

Providing information about investment results does not automatically guarantee selection of the "right" fund but the goal should be to provide the investor with enough information so that he can reasonably make the right decision.

> "One thing that I think we have got to be very careful about, I don't think that we can design a measuring media with such brilliance that it will automatically direct the investor to the right fund. We have to permit the investor the same luxury as we do some individual securities and that is the luxury of

---

1 One proposition that all witnesses agreed upon during the panel discussion on Performance and Statement of Policy was that investment results could not and should not be projected to imply the future results.

2 The daily valuation of the funds portfolios, the net asset value per share calculation and redemption at net asset value make possible a precise measurement of the investment return and complete and accurate disclosure of investment results.

3 Tr. 1665.

> being wrong. All we have to do -- all that we should do is provide him with enough information that he could reasonably make the right decision."[1]

B Strengthening the Competitive Structure

The Department of Justice found the funds inefficient in providing the public with information about their merits and suggested that improving the presentation of fund investment results could be expected to result in adequate sales.[2]

The importance of disclosing the relationship between costs and performance was brought out by Dr. Irwin Friend, Mellon Professor of Finance at the Wharton School of Finance and Commerce in his book "Mutual Funds and Other Institutional Investors."[3] Professor Friend saw this kind of disclosure as an alternative to the repeal of Section 22(d).

> "Competition in this industry has not served its traditional function of reducing price to the purchaser. . . .
>
> "More effective price competition might be achieved by either removing the retail price maintenance provisions of Section 22(d) of the Investment Company Act or providing potential investors with more complete disclosure.[4]
>
> "If potential investors were provided with full disclosure, they would be aware of the performance and costs of the fund offered to them compared with the broad alternatives, including other load funds, no-load funds, and closed-end investment companies (the latter frequently selling at a discount). However, it is difficult to conceive of Congress enacting this type of disclosure.

---

1 Testimony of A. Michael Lipper, tr. 1673.

2 Tr. 2022-23.

3 "Mutual Funds and Other Institutional Investors", A Twentieth Century Fund Study, McGraw-Hill, 1970.

4 Id. at 104.