Guidance note on risk indicators and description of managed funds

November 2015

About this guidance note

This guidance note is for managers and supervisors of managed funds.

It gives guidance on how to calculate risk indicators, when to update a PDS, how to describe a fund's volatility, and in certain cases how to name your fund.

About FMA guidance

Our guidance:

- explains when and how we will exercise specific powers under legislation
- explains how we interpret the law
- describes the principles underlying our approach
- gives practical examples about how to meet obligations.

Guidance notes: provide guidance on a topic or topic theme. Typically we will seek industry feedback via a public consultation paper, or more targeted consultation before we release a guidance note.

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

You might also like to check the reports and papers on our website. For example, our monitoring reports describe actual practice we are seeing and our comments on this.

Document history

This version was issued in November 2015 and is based on legislation and regulations as at the date of issue.

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About this guidance

1. This guidance note is primarily for managers and supervisors of managed funds. It gives guidance on the disclosure of risks associated with your fund and our expectations of your product disclosure statement (PDS), Disclose register entry, or fund update when you:
    a. calculate and present the risk indicator
    b. update a PDS when there is a change in the risk category
    c. describe your fund's volatility
    d. name your fund.

Background

2. Information on the risk and volatility of returns are important disclosure elements for managed funds under the Financial Markets Conduct Act 2013 (FMC Act) and the Financial Markets Conduct Regulations 2014 (the regulations). Managers are required to include information on the risk in the PDS[1], as an entry in the Disclose register when the PDS is lodged[2], in each fund update[3] and in the corresponding Disclose register update.[4]
3. Market participants initially asked for guidance on how to calculate the risk indicator. The consultation on the proposed guidance identified several other information needs. Submitters wanted to know when a change in the risk indicator meant they needed to update the PDS. We also found that investors could be confused by how managers described the risk indicator and named their funds. Inappropriate descriptions of the fund's volatility could also undermine the benefits of the risk indicator while certain fund names could mislead investors as to the potential risk of a fund.
4. As a result of the consultation, this guidance addresses how to approach calculating the risk indicator, how to describe risk categories, when to update the PDS, and how to approach naming conventions for funds.
5. We will specify the format and presentation of the risk indicator in more detail when we provide a template for fund updates. We expect to develop a fund update template once regulatory changes (related to PDS options that incorporate a fund update) have been made in 2016. Managers who must provide a fund update under the FMC Act before that time should set out the information as prescribed in the regulations. All presentations of risk indicator in the PDS, fund update or Disclose, should be consistent, and meet what the law requires. If you have concerns about your fund update, contact us to discuss your proposed approach.

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[1] Clause 25-29 of schedule 4 of the FMC Regulations
[2] Clause 53(1)(c)(ii) of schedule 4 of the FMC Regulations
[3] Clause 58(1) of schedule 4 of the FMC Regulations
[4] Clause 54(1)(a)(i) schedule 4 of the FMC Regulations

Your obligations related to risk indicators

FMC requirements

6. The purpose of a risk indicator is to provide investors with a simple tool that shows the historical volatility of returns of the fund. The risk indicator is intended to help investors make decisions, enabling them to compare the volatility between various managed investment scheme (MIS) products.
7. Schedule 4 of the regulations (schedule 4) shows what's required for how the risk indicator diagram should look[5], how the indicator should be calculated[6], and when alternative methods must be used to determine risk indicators.[7]
8. This part of the guidance focuses on the methodology for calculating the risk indicator. You must calculate a risk indicator that is relevant for your fund, using different approaches for different situations. The methodologies are listed below.
   a. A general methodology for calculating the volatility for a managed fund using the standard deviation for past changes in weekly or monthly returns (clause 6 methodology):
      i for funds with a performance history of at least five years, the calculation is based on the latest five years of fund returns (full history funds)[8]
      ii for funds that do not have a sufficient return history (short history funds), either because their investment policy is now significantly different, or because the fund is less than five years old, the calculation is based partly on fund returns, and partly on the returns of a relevant market index (index).[9]
   b. Alternative methodology for calculating volatility when the clause 6 methodology results in an inappropriate risk indicator. This applies when a risk indicator calculated using the clause 6 methodology is likely to mislead or deceive investors. The risk indicator calculated by an alternative method must accurately reflect the future volatility of the fund.[10]
9. The New Zealand legislative requirements for risk indicators are based on guidelines produced by the Committee of European Securities Regulators (CESR) for the calculation of a 'synthetic risk and reward indicator' for key disclosure documents (CESR Guidelines). [11] The CESR has now been replaced by the European Securities and Markets Authority (ESMA). The intention is that the CESR Guidelines will become enforceable technical standards for the European Union. The CESR Guidelines are available here: https://www.esma.europa.eu/document/guidelines-methodology-calculation-synthetic-risk-and-reward-indicator-in-key-investor

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[5] Clause 5 of schedule 4 of the FMC Regulations
[6] Clause 6-7 of schedule 4 of the FMC Regulations
[7] Clause 8 of schedule 4 of the FMC Regulations
[8] Clause 6(1) of schedule 4 of the FMC Regulations
[9] Clause 6(2) of schedule 4 of the FMC Regulations
[10] Clause 8 of schedule 4 of the FMC Regulations
[11] CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document, Committee of European Securities Regulators, 1 July 2010, CESR/10-673

Clause 6 methodology will apply to most managed funds

10. The risk indicator must be based on annualised standard deviations, calculated using the change in week-to-week returns or (if not available) month-to-month returns over five years. This is essentially a measure of how volatile the returns have been over the relevant period. The more a fund's actual weekly or monthly return differs from the average weekly or monthly return, the higher the standard deviation, and the higher the volatility. This clause 6 methodology will result in a reasonable indication of volatility for most managed funds. You must use this method unless it results in an indicator that is likely to mislead or deceive investors.

11. The CESR Guidelines are useful to help you meet the regulations' requirements. They provide additional details for managers, including setting a standard deviation formula and defining the variables that will produce a risk indicator required by the clause 6[12] methodology. The CESR Guidelines show a diagram[13] that meets the requirements and descriptions of the risk indicator diagram required by clause 5 of schedule 4 of the regulations. The CESR Guidelines[14] also use the same risk categories listed by the regulations (from 1-7) to determine a fund's volatility, or risk. We expect you to use the CESR Guidelines to meet your requirements.

12. You must adjust your risk indicator calculations when the fund is not a full history fund or when there is insufficient relevant performance history for calculating five years of returns. To do so, you need to identify an index that is appropriate for assessing the type of assets relevant to the fund. This index needs to either be widely recognised or used, or administered by a person not connected with the scheme.[15] The index returns are then used as a proxy for the returns of the short history fund, given its lack of performance history, or to reflect a period of significant difference in investment policy.[16]

13. Although the CESR Guidelines have different requirements for the choice of index, they are useful for their detailed description of the reasons and methods behind the 'short history adjustments'.[17]

You have an obligation to assess whether the clause 6 methodology will work for your fund and if not, to choose a reasonable alternative methodology when calculating your risk indicator.

If clause 6 methodology is likely to mislead, use an alternative

14. If the nature of your managed fund is such that the clause 6 methodology is likely to result in a misleading or deceptive risk indicator, you must use a method that you consider will produce a risk indicator that accurately reflects the potential future volatility of the fund.[18] In other words, you have an obligation to assess whether the clause 6 methodology will work for your fund and if not, to choose a reasonable alternative methodology when calculating your risk indicator.

15. The regulations do not prescribe alternative methodologies if the clause 6 methodology is not appropriate for your fund. In contrast, the CESR Guidelines do provide specific alternative methodologies for certain categories of fund. We

[12] Clause 6(1)(a) of schedule 4 of the FMC Regulations and the CESR Guidelines (box 1), page 5
[13] CESR Guidelines (Box 1), page 5
[14] Clause 6(1)(b) of schedule 4 of the FMC Regulations and the CESR Guidelines (box 2) page 7
[15] Clause 61 of schedule 4 of the FMC Regulations
[16] Clause 5(2) of schedule 4 of the FMC Regulations and the CESR Guidelines (box 4), page 9
[17] CESR Guidelines (Box 4), page 9
[18] Clause 8 of schedule 4 of the FMC Regulations

recommend you use the Guidelines as a resource when you are looking for a reasonable method to calculate the risk indicator if your fund is one of the identified categories.

16. The CESR Guidelines set out four alternative methodologies for funds that may require adjustments to the risk indicator calculation because of the nature of the fund.

    a. Absolute return funds[19]: funds managed according to investment policies or strategies based on a variable allocation of the portfolio of the fund across asset classes. They have constraints of a predetermined risk limit.

    b. Total return funds[20]: funds managed according to investment policies or strategies focused on certain reward objectives by participating (through flexible investment) in different financial asset classes.

    c. Life cycle funds[21]: funds managed according to investment policies or strategies. Over time, their portfolio allocation might shift from equity to fixed-income assets, based on some pre-determined rules, or as a target maturity date approaches.

    d. Structured funds[22]: managed funds that provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or when price changes provide gains, or when the financial assets, indices or reference portfolios change.

17. In our view, the CESR's methodologies are appropriate alternatives for calculating risk indicators for funds in the identified categories. We expect managers of these funds to use the CESR Guidelines when they need alternative methods to calculate a risk indicator of the fund. Risk indicators that are widely used and based on the same methodology will provide investors with a consistent comparison between funds.

Calculating risk indicators when prescribed or identified methodologies are likely to mislead

18. It is possible that you might not be able to find an acceptable risk indicator for your particular fund from the methodologies set out in the regulations and the CESR Guidelines. All the methodologies may result in a misleading or deceptive risk indicator. This could happen if your fund is not a typical market fund, or is not one of those identified for a CESR methodology. In some cases, the methodologies might be unacceptable even if your fund fits what's anticipated by the regulations or specified in the CESR Guidelines.

[19] CESR Guidelines (Box 5), page 10
[20] CESR Guidelines (Box 6), page 11
[21] CESR Guidelines (Box 7), page 12
[22] CESR Guidelines (Box 8), page 13

19. In every case, your overriding obligation under the legislation is to choose a risk indicator that reflects the potential future volatility of the fund. If the clause 6 methodology and the CESR alternative methodologies do not work for your fund, you must use a different method to calculate your fund's volatility. If you have concerns about the methodology to use or the resulting calculations, it is important to talk to us to present and explain your proposals. We will be happy to discuss the issues and options for you.

Describing the volatility of managed funds

20. After a fund's annualised standard deviation has been calculated, the fund is then allocated into one of seven risk categories. Each category has a prescribed numerical value which may be used to indicate the fund's volatility risk. You may also describe the numerical risk value in words. However there is no obligation to do so.
21. Neither the Act, nor the regulations have prescribed wordings for risk indicators. In our view, different descriptions for the same risk category may be confusing and misleading for investors. To help investors understanding, and to facilitate comparisons between funds, we have developed a set of standardised descriptions for each risk category. We do not require you to describe a fund's volatility risk in words, but whenever you choose to use words we would expect you to use the descriptions set out in the table below.
22. For example, a fund with a risk indicator of 4 could include a description in its Key Information Summary (KIS) saying 'this fund has a medium to high level of volatility'. You risk misleading investors if you use any other terms to describe the fund's volatility.

We do not require you to describe a fund's volatility risk in words, but whenever you choose to use words we would expect you to use the descriptions set out in the table below.

Risk category	Annualised standard deviation[23]	Description of volatility
1	0% to less than 0.5%	very low
2	0.5% or more, but less than 2%	low
3	2% or more, but less than 5%	low to medium
4	5% or more, but less than 10%	medium to high
5	10% or more, but less than 15%	high
6	15% or more, but less than 25%	very high
7	25% or more	extremely high

[23] Clause 6(1)(b) of schedule 4 of the FMC Regulations

Updating a PDS for a change in risk category

23. You must not offer, or continue to offer, interests in a fund if the PDS's information has become false or misleading, or is likely to mislead.[24] A change in the risk category of the fund is, on its own, unlikely to cause the PDS to be misleading. One reason for this is the regulations anticipate that the risk indicator may change. The PDS must contain language saying: '*While risk indicators are usually relatively stable, they do shift from time to time. You can see the most-recent risk indicator in the latest fund update for this fund.*[25]

24. Although not every change in the risk indicator will require a change to the PDS, there may be situations where the change in the risk indicator is significant. This would make the information in the PDS potentially misleading. The PDS needs to be updated before further interests in the fund are issued. In our view, a PDS should be updated when there has been a sustained or significant change from the risk indicator stated in the PDS. While we cannot give exhaustive guidance on the types of changes which may occur, we would expect you to update a PDS to incorporate the new risk indicator if one or more of the following circumstances happen.

A change in the risk category of the fund is, on its own, unlikely to cause the PDS to be misleading. In our view, a PDS should be updated when there has been a sustained or significant change from the risk indicator stated in the PDS.

Risk indicator has moved by two categories

25. We would expect you to update a PDS if a fund's risk category has moved by two or more categories in one direction. For example where the risk indicator has moved from category 3 (low to medium risk) to category 5 (high risk).

Risk indicator moves as a result of a change in investment policy

26. We would expect you to update a PDS if a fund's risk category changes as a result of a change to the underlying investment policy of the fund. By this we are referring to a change in the long-term policy of the fund as described in the Statement of Investment Policy and Objectives (SIPO).

Risk indicator is consistently inconsistent with PDS

27. We would expect you to update a PDS if the latest risk indicator for a fund demonstrates a consistent change away from the indicator stated in the PDS. To decide if a change represents a consistent change depends on whether the fund is required to produce quarterly or annual fund updates.

28. Where a fund is required to provide quarterly fund updates (under regulation 56(1) of the regulations) we recommend a PDS is updated where:

    a. the risk indicator shown in the PDS has been inconsistent with the indicator stated in two consecutive quarterly fund updates

    b. the risk indicator shown in the PDS has been inconsistent with the fund's risk category for the majority of the weekly or monthly data reference points during the period covered by the two quarterly updates

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[24] Section 82 of the FMC Act
[25] Clause 26(2)(c) of schedule 4 of the FMC Regulations

You must ensure your funds' names are not misleading.

Naming conventions for funds

29. The Act requires that managers refrain from engaging in conduct which may be misleading, deceptive or likely to mislead or deceive. Managers should exercise care when using terms which will have a particular connotation to investors, and ensure that fund characteristics are consistent with the representations inherent in the fund's name. In particular, managers should ensure that they do not call a fund by a name which misrepresents:

    a. the fund's risk category or risk volatility, or

    b. the types of products that the fund may invest in.

30. We do not propose to mandate specific names for funds or to prescribe requirements on the types of names that funds might use. When there is already a consistent market approach for certain names, you should take extra care to ensure your fund is in line with market practice.

31. The table below has a summary of some of the features we would generally expect to see for some common fund names.

Defensive	Funds using the word 'defensive' in their name would be expected to have a low risk investment strategy and hold a significant majority of low risk assets (such as bank deposits and fixed interest investments). Funds may hold some growth assets, but we would generally not expect this to represent more than 10% of their value.
Conservative	Funds using the word 'conservative' in their name would usually be expected to have a medium to low risk investment strategy with a higher proportion of their funds in income assets. Funds would generally be expected to hold between 10% and 35% of their value in growth assets.
Balanced	Funds using the word 'balanced' in their name would usually be expected to have a medium risk investment strategy. A more equal split between income and growth assets would be expected, with growth assets generally representing 35% to 63% of the fund's value.
Growth	Funds using the word 'growth' in their name would usually be expected to hold a majority of their value (between 63% and 90%) in growth assets. Funds would be expected to have a higher risk investment strategy.
Aggressive or High Growth	Funds using the word 'aggressive' or 'high growth' in their name would usually be expected to hold a significant majority of their value in growth assets. We would generally not expect more than 10% of their value to be income assets.

32. You must ensure your funds' names are not misleading. We cannot give definitive guidance on all names and circumstances that might be misleading, but we would be happy to hear from managers if they have any concerns about their naming conventions. We will continue to monitor market trends in this area and issue further guidance on fund names if necessary.

Terms used

CESR	Committee of European Securities Regulators CESR provided technical advice on securities markets to the European Commission until it was replaced by the ESMA as the European regulatory authority
Disclose register	The register of offers of financial products and the register for managed investment schemes, see http://www.business.govt.nz/disclose
ESMA	European Securities and Markets Authority is the regulator for the EU that has a role similar to the FMA's role in New Zealand
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
Fund update	A fund update prepared under regs 55-74 of the FMC Regulations
Manager	Manager of a registered managed investment scheme, and in the case of a restricted scheme, the trustees of that scheme
MIS	A managed investment scheme that is registered on the MIS register and defined in section 9 of the FMC Act
PDS	Product Disclosure Statement for a regulated offer as defined in section 41 of the FMC Act
Regulations	Financial Markets Conduct Regulations 2014
Risk indicator	The value calculated under clauses 5-8 of schedule 4 of the FMC Regulations
Synthetic risk and reward indicator (SRRI)	The term used in the CESR Guidelines that is equivalent to the term risk indicator in New Zealand legislation
Supervisor	Supervisor of managed investment schemes as defined in section 6(1) of the FMC Act

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