Analysis of Factors Influencing Sales, Retention and Redemptions of Mutual Fund Units

September 2015 Study by Investor Economics for The Investment Funds Institute of Canada
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Introduction

This report presents the findings of a research project conducted by Investor Economics on behalf of The Investment Funds Institute of Canada (IFIC) to identify the factors driving investment fund sales and redemptions. Specific attention is paid to the question of whether or not the embedded advisor compensation models used in the Canadian mutual fund industry are influencing fund flows and advisor behaviour.

Over the past few years, a number of regulatory organizations and industry associations globally have conducted reviews of the costs borne by retail investors in order to purchase and hold various types of unitized investment products. These reviews have been conducted using both internal resources and external expertise.

In Canada, both the Canadian Securities Administrators (CSA) and The Investment Funds Institute of Canada (IFIC) have undertaken extensive research as part of their respective review processes. The results of these studies provided material advancements in the knowledge and understanding of the composition, structure and application of fees associated with both the distribution and holding of mutual fund units by members of the investing public.

This report builds on that knowledge base and has as its goal the exploration of the reasons underpinning the level of mutual fund flow activity—both sales and redemptions—at both the broader industry and at individual fund levels. The analysis leverages Investor Economics databases, both pre-existing, as well as the new ones which have been assembled to capture data relevant to this analysis. This report also makes use of anecdotal evidence to recognize and to comment on the impact of factors which cannot be directly measured at this stage, either as a result of lack of data or because of the qualitative nature of the factors.

This report seeks to answer the following:

- What are the key factors influencing the volume of sales and redemptions of mutual funds?
- What factors contribute to the investor and advisor choice of specific funds?
- Is the level of distributor/advisor compensation important? Does it act independently of other factors?

The findings of our analysis are presented in five sections:

- *Section 1* examines macro-economic and demographic factors beyond the mutual fund industry which exert influence on the volume of sales and redemptions of mutual funds at the industry and the fund asset class levels.
- *Section 2* provides an account of several internal mutual fund industry factors which impact flow activity in specific fund asset classes and funds, but which are
not related to fund investment performance or advisor compensation characteristics.

- **Section 3** drills down into the importance of relative investment returns to fund flows.
- **Section 4** features a statistical analysis based on a large dataset that comprises nine years of monthly data by fund, including assets, net flows, trailer fees, investment returns, and other related and relevant metrics and fund characteristics. The same dataset, which includes 59 companies and nearly $1.1 trillion in assets under administration at the end of 2014, is also extensively employed throughout the rest of the report to provide evidence on behalf of the arguments developed in the thematic sections listed above.
- **Section 5** focuses on the importance of the fund advisor compensation formula.
- **Section 6** explores those distribution channel trends that impact the advisor/distributor selection of mutual fund products and of specific mutual funds. Particular attention is paid to the evolution of the advisor compensation formulas and how the emerging trends might influence mutual fund flow volumes in the channels.

The appendix on page 75 contains definitions and the notes on the datasets used in the analysis.

**A Note on the Scope of the Analysis**

The scope of this report’s analysis is confined to mutual funds only and does not include competitive offerings, such as structured notes, discretionary platforms or segregated funds.

The flow activity into and out of individual mutual funds is a result of the complex interplay of a wide range of factors. The following list is an abridged version of the more than 40 factors we considered during our research for this study as significantly influencing the buying behaviour of mutual funds. The report focuses on those factors that are either directly measurable or which have been viewed as important to fund flows, as has been gleaned through Investor Economics’ observation of mutual fund industry trends and developments over the past 23 years.
Key Findings

Investor Economics has identified a range of factors that exert varying degrees of influence on mutual fund flow activity at the industry, asset class and specific fund levels. Many of these factors, along with sales and redemption patterns, can be measured directly, while others are more difficult to grasp due to data limitations.

A comprehensive set of matched transactional data, amplified with information regarding individual advisor practice, the composition of the advisor’s product shelf, individual client characteristics and client outcomes, would permit a definitive examination of the drivers of advisor and investor mutual fund purchasing and disposition decisions.

In the absence of such a dataset and the impracticality of its assembly, our research process focused on leveraging Investor Economics’ extensive mutual fund industry and distribution channel databanks to flesh out those factors that demonstrate the highest potential in explaining the directionality and volume of mutual fund sales and redemptions. The numerical analysis was augmented by an exploration of qualitative factors, made possible by our commitment to observing, measuring and synthesizing mutual fund industry trends over the past 23 years.

What matters most

Our analysis has revealed that no single factor can satisfactorily explain the volume of mutual fund sales and redemptions into a specific fund at a given point of time. Rather, mutual fund flow activity reflects the interplay of a large number of factors.

While no factor in isolation offers sufficient predictive value in terms of individual fund flows, three factors have been identified as significantly relevant to advancing the understanding of the volumes and the directionality of mutual fund sales and redemptions.

**Macro-economic and demographic factors** comprise a powerful backdrop to fund flow activity and can overpower all other factors. Historical evidence suggests that in the absence of supportive market and economic conditions, or addressable demand in the form of households with sufficient savings aspirations and capabilities, inflows into mutual funds fall off precipitously, erasing or significantly reducing the impact of fund-specific attributes and rendering fund company distribution strategies largely ineffective in generating new sales.

By shaping household risk preferences, macro-economic factors exert a decisive impact on the relative attractiveness of the mutual fund vehicle versus that of competing financial products, as well as on the asset class directionality of mutual fund inflows. The old mutual fund industry adage states that it is not possible to “sell against” specific
investor asset class preferences. As documented in this report, there is plentiful, fact-based evidence that this axiom still pertains.

**Individual fund investment return characteristics**, expressed both in absolute and relative terms, represent the single most valuable predictor of sales and redemptions at the individual fund level.

While excellence in investment performance cannot outdo weak macro-economic fundamentals or secure significant inflows in the absence of a well-executed distribution strategy, it can act as a strong support mechanism for amplifying fund sales, improving retention experience and broadening access to advice-givers’ shelves in a positive industry sales environment.

**Preferred access to distribution**, either via direct affiliation or strategic alliance, is another meaningful factor influencing the flow activity for funds. Again, access to distribution alone is not a guarantor of positive sales experience. Macro-economic demand factors and investment performance excellence form the basis of a positive client experience, which is essential to a long-term productive relationship between a distributor and their customer. When those factors are in place, however, our research found that fund companies with access to affiliated distributors have experienced, in aggregate, a consistently higher level of net flows than those without access to affiliated distribution.

**The importance of advisor compensation**

The examination of the relevance of advisor compensation to fund flow activity is complicated by the diverse advisor/sales representative compensation models employed within the various distribution channels. Depending on the distribution channel, the impact of modifying fund embedded-compensation features on advisor behaviour can be obscured by the fact that individual advisor compensation may be several steps removed from the revenue stream of the distributor and/or dealer. The examination is further complicated by the relatively low number of funds with embedded-compensation features that are meaningfully divergent from the industry median.
The statistical relationship between trailer levels and net flow volumes is not significant. Constructing a more restricted analytical scenario for funds sold through intermediary advice networks, and examining particular investment return characteristics, reveals the potential existence of a tenuous relationship between the level of ongoing trailer fee compensation paid by the fund company to the dealer and gross sales and redemption patterns. The relationship appears stronger in containing redemptions than it does in driving fund sales activity. The importance advisors and clients assign to the funds’ investment returns, however, supersedes the importance of the level of compensation in the sales process. This is demonstrated by the meaningful statistical relationship between relative and absolute investment returns and fund flow patterns.

Meanwhile, the shift to unbundled fee-based practice models and the diminishing reliance on the upfront sales commission payouts associated with deferred sales charge load sales in the intermediated advice channels, have continued to lessen the impact of embedded advisor compensation on fund flow activity.

**Other factors**

The report identifies additional factors influential in driving new fund sales and containing redemptions. Among these are factors such as the brand and/or asset manager’s recognized expertise in a given asset class or mandate and specific fund or fund wrap features; the importance of such characteristics oscillates with market and demographic cycles.
Section 1: An Overview of Macro-economic and Demographic Drivers of Mutual Fund Sales Activity

The following section examines macro-economic and demographic factors exerting influence on the volume of sales and redemptions of mutual funds at the industry aggregate and the fund asset class levels. The factors explored in this section include:

- Market sentiment
- Risk preferences
- Demographics, and its impact on investor preferences and needs
- Investor financial literacy, fund product awareness and recognition of benefits

Collectively, these factors, which reside both outside of the control of the mutual fund industry and of advisors and investors themselves, provide a powerful backdrop to fund flow activity and can easily overpower internal industry factors. Historical evidence from Investor Economics databases suggests that in the absence of supportive market and economic conditions, inflows into mutual funds fall off precipitously, erasing or significantly reducing the impact of fund-specific attributes and/or rendering fund company distribution strategies largely ineffective in generating new sales. The asset class directionality of mutual fund inflows also appears to be strongly influenced by capital market conditions and related investor risk preferences, which may lead investors to opt for other savings alternatives (such as deposits) or to gravitate toward fund asset classes with lower perceived risk exposure (such as fixed income funds).

Meanwhile, the demographic mix of the household population is yet another prominent factor influencing the demand for savings and investment products (including mutual funds), as well as the asset class preferences and needs of investors.

Our ongoing Canadian mutual fund industry research, conducted over the past 23 years, has consistently demonstrated that the relevance of the mutual fund investment mandate to the overarching macro-economic and demographic environment represents a critical aspect of driving sales inflows into specific funds. Conversely, achieving positive inflows is exceedingly challenging for funds in asset classes that are not aligned with the prevailing investor asset class and risk preferences, even when other, fund-specific attributes, such as relative investment returns or a generous advisor compensation formula, are in place.
Market Sentiment

There are, potentially, a myriad of factors that exert influence on the household propensity to save, to invest in different financial products, to favour one asset class versus another and to take on risk. Among these factors are the direction of capital markets; investment return expectations; interest rate levels; the perceived health of the economy and the employment market; and the likelihood of household income growth. Available data\(^1\) shows that when equity market returns falter, households are less likely to invest in funds and securities. The volume of new inflows of money directed into investment funds tends to decline during bear markets and to increase when market returns, among other factors listed in the previous paragraph, improve. Unstable and volatile equity markets often drive households to favour safety, leading to increases in the balances of deposit products; this tendency is generally verified even when interest rates sit at or below the level of expected inflation. Figure 1.1 shows the extent to which the direction of the markets seems to influence investing decisions.

**Figure 1.1. Long-term Mutual Fund Net Flows by Market Sentiment Category**
In millions of dollars

<table>
<thead>
<tr>
<th>Market sentiment category</th>
<th>1-year trailing S&amp;P/TSX composite return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bear</td>
<td>Negative</td>
</tr>
<tr>
<td>Positive</td>
<td>Greater than 0% and up to 10%</td>
</tr>
<tr>
<td>Bull</td>
<td>Greater than 10%</td>
</tr>
</tbody>
</table>

Figure 1.2 shows that the average volume of net flows into financial wealth (investible assets) in a positive market environment was 58% higher over the period than was the case during a negative market environment. The amount of money flowing into investment funds and securities nearly doubled when the market environment was favourable (from $28 billion to $54 billion).

Figure 1.2. Average Annual Net Flows into Financial Wealth (based on 18 years of data from 1996 to 2014)
In billions of dollars
Investor Financial Literacy, Fund Product Awareness and Recognition of Benefits

The relevancy of financial literacy as a driver of mutual fund flows lies in its potential to enhance households’ financial management capabilities, which can translate into a greater ability to generate savings.

Beyond baseline financial literacy, greater investor awareness of mutual fund products and their attributes can contribute to higher fund flows. In this context, while it remains unclear the level of awareness Canadians possess regarding investment funds, a recent survey\(^2\) found that 67\% of Canadians holding low-rate guaranteed deposit products were unwilling to consider investing in market-sensitive products due to the perceived risk associated with such investments; only 9\% indicated they were not aware of their options to do so.

Given the wide array of financial products available in Canada, these investor responses suggest that there may be a gap between what individuals believe is available to them in terms of investment product options and what is actually available. The survey results suggest a lack of understanding among Canadians investing exclusively in deposit products concerning the interaction between investment horizons, risk and product solutions available (mutual fund-based or not). As (and if) investor literacy initiatives contribute to narrow this knowledge gap in the future, the opportunity and addressable market for the mutual fund industry may expand considerably.

The size and reputation of the investment funds industry; the willingness of financial advisors to recommend investment fund-based products; advances in technology that make information about financial services and products readily available to investors; and numerous investment-literacy initiatives are all factors that, although difficult to measure, are likely to influence investment decisions and the probability of households committing their savings to one product versus another.

In Canada, a study\(^3\) found that 81\% of mutual fund owners are confident that mutual fund products will help them achieve their financial goals.

\(^2\) Survey sponsored by CIBC and conducted by Leger, February 2015
\(^3\) The Investment Funds Institute of Canada, Pollara, 2013
Risk Preferences

Investor risk preferences are affected by a number of variables, including market conditions and expectations; guaranteed returns in low-risk products, such as deposits; and by investors’ investment horizons. In a positive market environment, investors seem to be more likely to purchase investment products and they also appear to have a higher propensity to move up the risk/reward scale, increasing their equity asset allocations.

Figure 1.3 illustrates this point by tracing the recent trajectory of mutual fund equity net flows against the progress of two key equity market benchmarks: the S&P TSX (the Canadian equity index) and the S&P 500 (the U.S. equity index), expressed in Canadian dollars. With a few exceptions, equities were out of favour with investors and advisors during and after the market downturn.

Figure 1.3. Equity Mutual Fund Net Flows and Market Returns
Demographic Factors Drive Investor Preferences and Needs

The majority of households tend to accumulate financial assets throughout their lifetimes, but the growth of wealth is not always linear. At different life stages, the household capacity to save, the extent of their financial needs and the focus of their priorities change in fundamental ways, as does their demand for financial products and services. Investors’ propensity to take more risk varies not only with macro-economic circumstances, but also with age. At each life stage, however, individual household circumstances, expectations and resources are likely to play an important role in the decisions to invest in different products and asset classes.

The addressable market for mutual funds is directly impacted by the relative importance and absolute size of the three key household segments: borrowers, accumulators and retirees. (For detailed explanations of our segmentation methodology, please refer to the Appendix.) Figure 1.4 explores the importance of these segments to the Canadian household financial wallet and relates it to the importance of mutual funds therein.

Figure 1.4. Canadian Households by Age Cohort—2014
Households in thousands, financial wealth in billions of dollars

<table>
<thead>
<tr>
<th></th>
<th>Number of households</th>
<th>Share of total households</th>
<th>Financial wealth</th>
<th>Share of financial wealth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrowers</td>
<td>5,803</td>
<td>37%</td>
<td>$548</td>
<td>15%</td>
</tr>
<tr>
<td>Accumulators</td>
<td>6,021</td>
<td>39%</td>
<td>1,814</td>
<td>50%</td>
</tr>
<tr>
<td>Dissavers</td>
<td>3,780</td>
<td>24%</td>
<td>1,243</td>
<td>34%</td>
</tr>
</tbody>
</table>

The ascendance of mutual funds into a prominent component of the Canadian household wallet during the 1990s closely parallels the transition of the populous baby-boomer generation into the accumulation phase of their financial household lifecycle (see Figure 1.5). Combined with the sustained bull market environment of that period, household demographics powered demand—and thus sales—for investment products, such as mutual funds.
Household demographics and its power to shape demand also exerts an impact on the asset class directionality of the mutual fund industry. As the waves of baby-boomer households reach retirement over the next 20 years, their asset class preferences are likely to shift toward income-producing, tax-optimized investments. This trend will be moderated by the continued need for growth in their retirement nest-eggs, exacerbated both by the increasing longevity and the generally higher debt burdens of this demographic cohort.
Risk Tolerance and Demographic Factors at Play

The examination of the asset class composition of mutual fund inflows over the past nine years illustrates the collective impact of market sentiment, risk tolerance and demographic factors.

The two equity market downturns of the 2000s decade prompted investors to shun risk. This trend, combined with the aging profile of the Canadian household population, has translated into accelerated demand for income-generating funds, particularly of the fixed income variety. Funds which pay regular distributions on a monthly or quarterly basis can be found across the full asset class gamut, including in fixed income categories, Canadian and foreign equities, balanced asset classes and fund of fund portfolios. As shown in Figure 1.6, income-oriented funds and portfolios account for a significant and growing share of industry assets and net flows.

Figure 1.6. Mutual Fund Assets and Net Flows: Income-generating Funds
In billions of dollars
Meanwhile, the wave of interest in income delivery, stimulated by the progression of the baby-boomer generation into retirement, has also intensified the demand for tax-optimization strategies. Figure 1.7 tracks the progress of one of the tax-efficiency strategies available to mutual fund investors: the corporate class structure. This structure allows investors to switch between funds in the same corporate class family without triggering a tax event.

Over our research period, corporate class funds have consistently captured a higher share of net flows than their share of assets. Prior to 2013, corporate class funds were even more popular with investors, as these products were able to use derivatives to reclassify income as capital gains, therefore providing higher after-tax distributions to investors. The desire for tax efficiency appeared to overwhelm other considerations, such as the level of the fund’s management expense ratio (MER). The MERs for the funds reclassifying interest income into capital gains were generally higher relative to their original fund comparators, reflecting the cost of the derivative strategy employed to achieve the reclassification objective.

Figure 1.7. Corporate Class Funds: Assets and Net Flows
In billions of dollars
Section 2: Impact of Select Internal Mutual Fund Industry Factors on Fund Flows

Section 2 examines select internal mutual fund industry factors which impact flow activity in specific fund asset classes, product structures and funds. The factors explored in this section are largely qualitative in nature; these were selected based on our view of their relevance to the discussion of what drives fund flow activity. This view has been shaped by our nearly quarter-century of researching the mutual industry. Other fund-specific factors, such as fund income delivery and tax-efficiency features, have already been addressed in Section 1.

Our research suggests that certain qualitative factors can add positive impetus to sales results for specific funds. Among these are:

- **The brand, manager and/or product recognition**: Historically, certain fund companies have been able to leverage their brand power, or a documented expertise in a particular investment mandate or asset class, to generate sales into specific funds. This “brand power”, however, has been highly dependent on the fund manager’s ability to sustain above-average investment returns and has been generally conditional on the asset class remaining in favour over a sustained period with investors and advisors.
- **Product positioning**: New funds with novel approaches, strategies or themes that resonate with investor needs often generate positive sales traction, despite untested strategies and absent investment return histories.
- **Marketing, wholesaling and client-servicing processes**: While not independent of macro-economic conditions, asset class directionality and other factors, excellence in these functions can translate into improved fund sales and retention experiences.

**Brand, Manager and Product Recognition**

At times, it seems as if a particular investment fund product is attractive to investors and advisors primarily due to the brand-name recognition of the fund company that manufactures the fund product. In some cases, the fund company brand is associated with an asset class that is in high demand; in others, the product’s acceptance is attributable to the perceived acumen of the asset management team or the historical success associated with the particular firm’s or asset manager’s investment approach. Cases in which the brand power seems to be a dominant driver of sales do not abound in the Canadian funds industry, but there are some examples of note in the 25-year history of our database, such as those of PIMCO or EdgePoint.
The Importance of the Fund Company or Asset Manager's Recognized Expertise in a Given Asset Class

Interconnected with the concept of brand power are those cases in which a company, or a fund family within a company, conveys expertise within a specific asset class. A common trait of the products offered by such “specialists” is a sustained track record of consistent outperformance in a given asset class’s investment return benchmarks and the achieving of superior relative investment return ratings against their peers in the same asset class.

Historically, the documented prowess in a particular asset class has proved to be a powerful magnet for new flows of money. This is particularly apparent with new funds. When a company that is well known for managing money in certain mandates introduces a new fund in the category, the product often attracts considerable inflows in a relatively short period of time. The power of both brand names and recognized investment expertise to attract new money, however, appears highly dependent on sustained above-average investment returns—and tends to be also contingent on the asset classes in which the expertise is believed to exist remaining in favour with investors and advisors alike.

Perception of Uniqueness of Fund Mandate or Fund Sub-advisor Expertise

Another aspect of fund company or fund product brand power is the issue of the perceived uniqueness of a fund’s mandate or its sub-advisor’s expertise.

The uniqueness of a fund’s mandate is generally associated with newer funds; the positive effects on new sales may not be enduring for any individual company due to the rapidity with which industry competitors tend to develop and launch funds with mandates that resonate with investors. A recent case illustrating this point is the surge in sales of fixed income funds with a floating-rate investment mandate. These products, which aim to generate income and mitigate interest-rate risk, were popular with investors and advisors in 2013 and 2014, when they generated a combined $4.4 billion in net flows. In 2012, 10 funds were offered with this mandate; in 2014, by contrast, the fund count increased to 30.

Unless a mandate is connected to a highly specific security selection approach by an asset manager, the impact of the singular appeal of a mandate for any individual firm tends to be short-lived. For the industry as a whole, however, new funds with novel approaches and strategies or themes that resonate with investor needs often generate positive sales traction, despite the fact that the strategies may be untested and the funds have no investment return history.
Marketing, Wholesaling and Client-servicing Support

While not directly measured in this study, it is generally acknowledged that the strength of marketing materials, investor and advisor tools, and client- and advisor-support services all have the potential to affect sales and redemption volumes. While excellence in these functions can influence sales volumes, it is unlikely that any single one of these factors is independent of a fund manufacturer’s brand power, product positioning and relevancy, nor would any of these factors likely supersede the importance of investment returns, either absolute or relative.

As documented in Investor Economics’ *Investment Product Wholesalers: A Review and Benchmarking Study*, published in September 2012, both the assets individual wholesalers supervised and the sales activity which they generated was higher for wholesalers in relatively large teams. As noted in the report (and as shown in Figure 2.1) “…On average, wholesalers in the less than 10 wholesaler group supervise 74% less mutual fund assets than the industry average… wholesalers in the 10 to 25 wholesaler group supervise 49% less mutual fund assets than the industry average”.

**Figure 2.1. Metrics per Wholesaler by Wholesaler Team Size**

<table>
<thead>
<tr>
<th></th>
<th>Average number of external wholesalers</th>
<th>Assets*</th>
<th>Gross sales</th>
<th>Redemptions</th>
<th>Net new money</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Industry</strong></td>
<td>20</td>
<td>$454,027</td>
<td>$109,706</td>
<td>$106,594</td>
<td>$3,112</td>
</tr>
<tr>
<td>&lt;10 Wholesalers</td>
<td>3</td>
<td>116,785</td>
<td>33,375</td>
<td>40,838</td>
<td>(7,463)</td>
</tr>
<tr>
<td>10 to 25 Wholesalers</td>
<td>15</td>
<td>233,116</td>
<td>64,276</td>
<td>51,789</td>
<td>12,487</td>
</tr>
<tr>
<td>25+ Wholesalers</td>
<td>35</td>
<td>575,838</td>
<td>136,331</td>
<td>134,578</td>
<td>1,753</td>
</tr>
</tbody>
</table>
Section 3: Impact of Fund Investment Returns on Fund Flow Activity

Section 3 examines the importance of relative investment returns on fund flows.

The available data demonstrates that investment returns, both absolute and relative to peers, along with other measurements associated with the return experience, such as standard deviation, exhibit a high degree of positive correlation with a fund's ability to generate and to maintain positive sales traction. The statistical model built for the purpose of this study confirms the meaningful statistical correlation between investment return characteristics and fund sales and redemptions.

Absolute Returns and Sales Momentum

The data shows that funds with positive absolute returns accounted for all the positive inflows (in aggregate). Figures 3.1a and 3.1b show the net flows into equity and balanced funds (including funds of funds), respectively, over the nine years from 2006 to 2014 by the one-year investment return at the time.

Figure 3.1a. Equity Mutual Fund Net Flows by One-year Investment Return
In billions of dollars, 2006 to 2014
While the investment return thresholds that generate positive sales traction for equity and balanced funds differ (return expectations for balanced funds appear to be lower), the data for both asset classes indicates that net redemptions are associated with negative absolute investment returns.
Relative Performance Ratings

Available data indicates that relative performance metrics that rank funds among their peers are also significantly correlated to inflows. Figure 3.2 shows the net flows of all funds by their three-year investment return quintiles. In aggregate, the bulk of the net flows are accounted for funds that rank in the fourth and fifth quintiles. This generally holds true when the analysis is run for individual asset classes, or with other popular relative performance metrics, such as Morningstar or Lipper Ratings.

Figure 3.2. Mutual Fund Net Flows by Three-year Investment Return Quintile – All Asset Classes
In billions of dollars, 2006 to 2014
Standard Deviation

The analyzed data suggests that a fund’s standard deviation, when compared against that of its peers, has a fairly high correlation to net flows; generally, the lower the standard deviation, the higher the net flows over a given period of time.

The example shown in Figure 3.3 includes 137 mutual funds in the U.S. equity category, as defined by the Canadian Investment Funds Standards Committee (CIFSC). This category has generated significant inflows in the last several years and the funds included in our sample accounted for nearly $58 billion in assets, as of March 2015.

Figure 3.3. Mutual Fund Assets and Net Flows by Three-year Standard Deviation – U.S. Equity Funds (CIFSC)
In billions of dollars, assets as of March 2015, three-year net flows through March 2015

The 137-fund sample size of Figure 3.3 is divided between those funds with a standard deviation below the average (84 funds in total, under an average of 8.91%) and those above. The funds with standard deviations below the average represented 61% of the fund count, but had a combined share of 67% of the assets for the group. The most significant observation is that this below-the-average cohort accounted for virtually all of the net flows generated by this group of funds over the previous three years. Results are similar when the analysis is done for other asset classes, particularly in the equity and balanced fund groups.
Section 4: Statistical Analysis

The main five sections of this report identify and provide extensive commentary and analysis on the factors influencing investment fund sales and redemptions. To understand the relative importance of some of these factors, we performed a regression analysis on the same dataset used throughout the report. Cognizant of the limitations of our dataset (and which is further explained below), we tested the results of the regression analysis with two methodologies.

Methodology

Modelling

The results reported in this section were obtained with the ordinary least squares (OLS) regression, clustering on asset classes. The starting point is the total fund universe comprised by our dataset. We then move to examine in detail specific product segments and groups of fund sponsors. Regressions were run on subsets, such as firms with low or high levels of vertical integration, stand-alone funds, mutual funds of funds or specific asset classes.

The key independent variable examined in this section is the trailer fee and its effect on net flows. Other variables included in the model are assets, investment returns, and season.

We tested the results in two ways:

- **The validity of net flows as an indicator of fund activity**: to test the results, the regressions were also run using the funds’ gross sales to redemptions ratio (a measure of the volume of gross sales respective to the volume of redemptions). Results were in line with the findings described in this section for the net flow variable.

- **The methodology**: in addition to the OLS model, we tested our results by running a fixed effects model using cluster-robust estimators. The issue we encountered is that the typical fixed effects model removes time-invariant individual differences, such as trailer fees. Due to the nature of the variables we measured—two of which are time-invariant—the fixed effect model could not estimate the seasonality variable and the trailer variable simultaneously. By making the model examine time effects, rather than individual effects, we managed to include the trailer variable, although we were obliged to abandon the seasonality variable. Irrespective of this, the fixed effects model was used as a test to confirm the result obtained with the OLS method. Upon running the fixed effects model, we arrived at the same conclusion.
Definitions of variables

Net flows: The model’s dependent variable is monthly net flows as a percentage of beginning assets, which is defined as the net value of gross sales minus net redemptions, plus transfers in, minus transfers out, divided by total net assets from the previous period. The net flows as a percentage of beginning assets represent the percentage growth of a fund’s assets in a given period of time due to sales activity, excluding market effect. Net flows are reported in basis points.

LASSETS: This is the natural log of total net assets for fund \( i \) at time \( t-1 \), and is included to both represent the size of the fund and as a control variable to reflect the fact that an equal dollar flow will have a larger percentage impact for smaller funds than larger funds.

\( X_{seasonQ1~Q4} \): This is the dummy variable that captures the seasonality effect that cycles in the mutual fund universe. Q1 is the first quarter of a given calendar year (i.e., January, February and March).

\( x_{perf 1~5} \): This is the investment return quintile dummy variable. The level of investment returns and net flows do not necessarily have a linear relationship. To examine the relationship between investment returns and net flows, we used relative fund ratings (quintiles) for one-year investment returns, and found through an analysis of variance (ANOVA and post hoc tests) that there were significant differences between investment return quintiles sufficient to justify this approach.

Trailer: Trailer fees represent the level of ongoing compensation paid by the fund to distributors in front-end load (or initial sales charge load options) or the indicative trailer fees listed by no load funds. Trailer fees are reported here as a continuous variable over time.

About the Dataset

The mutual fund data used in this part of the analysis includes funds that have been in existence for a minimum of 24 months. A filter excludes funds without sufficient investment return history and aims to remove any abnormal movements in net flows that can be associated with the launch of a new fund and the initial sales and marketing push that goes along it. The final step in the data-collection process was to identify outliers within the dataset and to correct for them. These outliers were typically the result of fund mergers; as such, this dataset does not include funds which merged over the period under consideration. In total, the dataset contains 40,536 monthly data points from 563 unique funds spanning six years. This data can be further segmented into 9,720 fund of fund data points and 30,816 stand-alone fund data points, over six separate asset classes and seven unique risk profiles.
Another caveat to consider is that the asset, sales, redemptions and net flows data reflects the totality of the funds’ metrics, which include share classes (such as those for fee-based accounts) that do not pay trailer fees. Over the last five years, assets in series without embedded trailers grew faster than the rest of the book of business (19% versus 8.3% compound average annual growth rate [CAGR], respectively) and accounted for 6% of industry assets at the end of 2014.

Finally, the trailers listed reflect the compensation paid with the front-end load sales option, but, given that the assets, sales, redemptions and net flows are for the totality of the funds, transactions in deferred sales load or low-load option (both with embedded sales commissions) are also included.

The results presented below utilize the level of detail contained within this dataset by segmenting it in order to drill down and isolate the effects that distribution channel, product structure and asset class have on trailer fees and fund flows. To model the effect of trailer fees on sales data, it is important to make like-to-like comparisons. The structural differences between stand-alone funds and funds of funds and vertical integration are great enough to justify running regressions on each fund structure and not as part of the same dataset.

**Key Findings Regarding the Statistical Analysis**

The results of the regressions on each subset show that trailer fees have no significance on net flows for stand-alone funds, regardless of the firm’s access to affiliated distribution (level of vertical integration); no significant relationship on fund wraps in high vertically integrated firms; and a strong inverse relationship with net flows for fund wraps sponsored by firms with low degrees of vertical integration. According to the model:

- Despite having a negative coefficient, the relationship between trailer fees and net flows is not significant.
- The relationship between trailer fees and net flows is not significant for funds within highly vertically-integrated fund sponsors.
- The relationship between trailer fees and net flows is not significant for funds within low vertically-integrated firms.
- The relationship between trailer fees and net flows is not significant for stand-alone funds.
- Trailer fees have a significant inverse relationship with funds of funds.
Detailed Results

The total fund universe

In order to establish a base from which to direct further investigation, the regression was run on the total fund universe, the results of which are reported in Table I.

| Estimate | Std. Error | t value | Pr(>|t|) |
|----------|------------|---------|---------|
| (Intercept) | -6.66481 | 56.57649 | 0.1178 | 0.906225 |
| LASSETS | -20.62426 | 10.77901 | -1.9134 | 0.055707 |
| x_seasonQ1 | 26.21796 | 4.23987 | 6.1837 | 6.323e-10 *** |
| x_seasonQ2 | 7.98620 | 4.32943 | 1.8446 | 0.065098 |
| x_seasonQ3 | 0.54785 | 3.85643 | 0.1421 | 0.887033 |
| x_perf2 | 72.56049 | 25.24738 | 2.8740 | 0.004055 ** |
| x_perf3 | 94.25005 | 29.00082 | 3.2499 | 0.001155 ** |
| x_perf4 | 133.25604 | 30.92217 | 4.3094 | 1.641e-05 *** |
| x_perf5 | 182.48879 | 41.34795 | 4.4135 | 1.020e-05 *** |
| TRAILER | -8.58255 | 46.05490 | -0.1864 | 0.852168 |

The size of the fund (LASSETS) is only marginally significant, but its coefficient is negative, indicating smaller funds tend to experience larger inflows as a percentage of beginning assets than do larger funds.

The seasonality effect has a high degree of significance for the first quarter (Q1). The period, also known as RRSP season, is a time when Canadians are known to make decisions regarding investments. On average, a fund can expect a 26 bps increase in flows in Q1 for any given year. The effect seems to carry over into the second quarter (Q2) to some extent, but with a much weaker significance and coefficient value.

The investment returns results are in line with other findings in this report. The top quintile investment returns (x_perf5) is highly significant, with a considerable coefficient value associated with it. This relationship lessens for funds that fall into the fourth quintile, but is still highly significant. Results begin to taper off in quintiles two and three, but they still remain moderately significant.

Lastly, we can see that when examining the total fund universe, the trailer fee associated with a fund holds no significant relationship with net flows, according to our model. These results capture a very broad definition of the mutual fund market in Canada, and the next section aims to segment that market to adjust for both distribution channel and product structure types.
The vertical-integration factor

The results reported in Tables II and III group fund companies by the share of total assets that they hold in proprietary or affiliated distribution.

<table>
<thead>
<tr>
<th>TABLE II (low vertical integration)</th>
<th>TABLE III (high vertical integration)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimate</td>
<td>Std. Error</td>
</tr>
<tr>
<td>(Intercept)</td>
<td>119.1684</td>
</tr>
<tr>
<td>LASSETS</td>
<td>-35.6522</td>
</tr>
<tr>
<td>x_seasonQ1</td>
<td>19.9802</td>
</tr>
<tr>
<td>x_seasonQ2</td>
<td>6.9947</td>
</tr>
<tr>
<td>x_seasonQ3</td>
<td>5.2790</td>
</tr>
<tr>
<td>x_perf2</td>
<td>75.8124</td>
</tr>
<tr>
<td>x_perf3</td>
<td>105.6423</td>
</tr>
<tr>
<td>x_perf4</td>
<td>154.1313</td>
</tr>
<tr>
<td>TRAILER</td>
<td>-81.3288</td>
</tr>
</tbody>
</table>

Compared, codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1

Companies with low vertical integration are those which hold more than half of their assets under management with distributors unaffiliated with them. The strong majority of these companies are either independent fund providers (most of which have no access to affiliated distribution) or life insurers (most of which do have access to affiliated distribution). Excluded from this group are the banks, credit unions, direct sellers and the firm Investors Group, a fund provider that is highly vertically-integrated and which is virtually exclusive to its own distribution network. While the deposit-takers distribute approximately 18% of their funds’ assets under management through intermediated advice networks, our dataset is not sufficiently detailed to examine that element of their book of business. Highly vertically-integrated companies include the deposit-takers, Investors Group and a number of small direct sellers.

When the data is split by level of vertical integration, the results reveal some subtle differences between the two groups. For low vertically-integrated firms (Table II), the coefficient on the trailer has a negative sign; again, this indicates an adverse relationship with fund flows. It is not, however, significant in determining the level of net flows for a given fund. Seasonality factors, specifically those of the RRSP season, remain both positive and significant in determining fund flows, with the spring months in Q2 contributing slightly to fund flows, with a very weak level of significance.

Investment returns are again strongly related to fund flows, with the significance of that relationship only dipping in the lower quintiles (specifically, in the second quintile).

Highly vertically-integrated firms (Table III) show slightly different results. The relationship to RRSP season is stronger among firms with high vertical integration than for their low vertically-integrated counterparts. The coefficient value associated with the RRSP season variable is nearly double that of low vertically-integrated firms. Additionally, the second quarter holds no significance in terms of having any effect on fund flows for highly vertically-integrated firms.
Investment returns also have a visible relationship with net flows for highly vertically-integrated firms, the only exception being that funds in the fifth quintile do not experience a substantial increase in net flows as is the case with firms with low vertical integration. Finally, the relationship between trailer fees and net flows is not significant for the highly vertically-integrated firms.

Product type

Considering separately the results for fund wraps and stand-alone funds adds another important layer of detail to this analysis. The data reveals that fund wraps, defined here as asset allocation programs (unitized or not) which invest in underlying funds have been attracting considerably more net flows than have stand-alone funds (funds purchased on a one-on-one basis) over the last decade. At the end of 2014, fund wraps accounted for 33% of investment fund assets; this is up from 16% a decade ago. Economies of both scale and technology have made it possible for asset managers to deliver optimized asset allocation solutions to multiple client segments via fund wraps. Constant rebalancing and the relatively low minimum investments required make wrap programs an attractive proposition.

For fund wraps (Table IV), seasonality and investment returns are still the two main drivers of net flows. However, although Q1 shows the strong relationship that has appeared throughout this analysis, and Q2 remains insignificant, Q3 actually exhibits a negative relationship with fund flows, albeit at the weakest level of significance.

There is a moderate significance for trailer fees: in this instance, trailer fees have an inverse relationship with fund flows.

Stand-alone funds (Table V) account for the largest share of assets and number of records of the dataset at roughly 75%, so the fact that this table’s results mirror those of the results seen in the total fund universe is not unexpected. The seasonality variable displays nearly the same results as in Table I, where Q1 has a positive and significant relationship with flows, followed by Q2 capturing the tail end of the RRSP season.

Investment returns, however, is more varied a category in terms of significance. Here we see that fourth quintile investment returns hold a very significant relationship with
flows, while the fifth quintile maintains only a moderately significant relationship, although the quintile still has the greatest impact.

Again, the trailer variable turns out to have an insignificant relationship with stand-alone funds and fund flows.

Product type and vertical integration combined

Starting with the complete dataset, which includes all funds, the data has been narrowed into subsets that distinguish different fund structures (stand-alone and wrap) and access to affiliated distribution (high and low degrees of vertical integration). The structural differences between groups of funds and firms are great enough to justify running regressions on each, because by including all of the structures together as in the first regression model, the relationship between trailers and flows may have been diluted due to the various effects of different funds and firms.

The final four subsets of the data examined below are stand-alone funds sponsored by high vertically-integrated firms; stand-alone funds sponsored by low vertically-integrated firms; fund wraps sponsored by high vertically-integrated fund companies; and fund wraps sponsored by low vertically-integrated firms.

<table>
<thead>
<tr>
<th>Table - VI (High VI Stand-alone)</th>
<th>Table - VII (High VI Wraps)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Intercept) 22.6938 79.5980 0.2851 0.775568</td>
<td>(Intercept) -28.2202 122.6465 -0.2301 0.8180290</td>
</tr>
<tr>
<td>LASSETS -29.1608 17.0659 -1.6322 0.102652</td>
<td>LASSETS 3.6114 19.2797 0.1873 0.8534219</td>
</tr>
<tr>
<td>x_seasonQ1 26.2606 19.1438 2.5888 0.009640 **</td>
<td>x_seasonQ1 56.8651 3.8335 19.4510 &lt; 2.2e-16 ***</td>
</tr>
<tr>
<td>x_seasonQ2 11.7045 11.3089 1.0284 0.303763</td>
<td>x_seasonQ2 2.1363 3.4993 0.6326 0.5270398</td>
</tr>
<tr>
<td>x_seasonQ3 -3.5341 6.0874 -0.5806 0.561544</td>
<td>x_seasonQ3 -8.0607 5.6381 -1.4297 0.1528711</td>
</tr>
<tr>
<td>x_perf2 30.4638 38.0236 2.5112 0.012044 *</td>
<td>x_perf2 26.8651 14.7848 1.8161 0.070074 .</td>
</tr>
<tr>
<td>x_perf3 90.4638 36.0246 2.5112 0.012044 *</td>
<td>x_perf3 48.7718 21.0484 2.3078 0.0130502 **</td>
</tr>
<tr>
<td>x_perf4 123.8715 36.0795 2.5112 0.012044 *</td>
<td>x_perf4 47.5496 26.1822 1.8161 0.0694195 .</td>
</tr>
<tr>
<td>x_perf5 158.4508 53.7930 2.9463 0.003222 **</td>
<td>x_perf5 92.1640 19.3837 4.7170 2.464e-06 ***</td>
</tr>
<tr>
<td>TRAILER 17.2689 30.4477 0.5396 0.5941424</td>
<td>TRAILER -1.6861 16.0763 -0.1059 0.9158903</td>
</tr>
</tbody>
</table>

Signif. codes: 0 ‘***’ 0.001 ‘**’ 0.01 ‘*’ 0.05 ‘.’ 1

<table>
<thead>
<tr>
<th>Table - VIII (Low VI Stand-alone)</th>
<th>Table - IX (Low VI Wraps)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Intercept) -68.4651 139.7444 -0.4899 0.6241891</td>
<td>(Intercept) 787.2938 52.4143 15.0206 &lt; 2.2e-16 ***</td>
</tr>
<tr>
<td>LASSETS -8.3504 16.4777 -0.5068 0.6123230</td>
<td>LASSETS -104.3725 13.7607 7.5848 3.932e-14 ***</td>
</tr>
<tr>
<td>x_seasonQ1 17.0692 1.9317 8.8361 &lt; 2.2e-16 ***</td>
<td>x_seasonQ1 26.7178 10.2540 2.6056 0.0097818 **</td>
</tr>
<tr>
<td>x_seasonQ2 7.6875 4.6335 1.6591 0.0971081</td>
<td>x_seasonQ2 32.6178 10.2540 3.2056 0.0019821 ***</td>
</tr>
<tr>
<td>x_seasonQ3 7.0161 7.4056 1.3100 0.1902086</td>
<td>x_seasonQ3 -3.9057 7.3555 -1.2866 0.2021742</td>
</tr>
<tr>
<td>x_perf2 79.6966 37.5652 2.1216 0.0338034 **</td>
<td>x_perf2 26.8651 14.7848 1.8161 0.070074 .</td>
</tr>
<tr>
<td>x_perf3 105.4918 36.6663 2.8746 0.004219 **</td>
<td>x_perf3 67.8180 22.0760 3.0539 0.0022705 **</td>
</tr>
<tr>
<td>x_perf4 165.3344 44.1786 3.7424 0.0001829 ***</td>
<td>x_perf4 79.1640 25.3747 3.1398 0.0018197 **</td>
</tr>
<tr>
<td>x_perf5 231.4962 60.4161 3.8320 0.0002716 ***</td>
<td>x_perf5 104.5917 28.9862 3.6083 0.0003111 ***</td>
</tr>
<tr>
<td>TRAILER -74.9761 94.3615 -0.7946 0.4268792</td>
<td>TRAILER -244.9327 70.9380 -3.4518 0.0005614 ***</td>
</tr>
</tbody>
</table>

Signif. codes: 0 ‘***’ 0.001 ‘**’ 0.01 ‘*’ 0.05 ‘.’ 1
The results presented for highly vertically-integrated firms, stand-alone (Table - VI) shed some additional light on the investment returns quintile significance mentioned earlier when considering all stand-alone funds. It can be seen here that the fourth quintile holds the most significance in terms of investment returns, while for the low vertically-integrated firms in stand-alone funds (Table-VIII), the distribution of investment returns and significance conforms back to what was expected: the fifth quintile being the most significant and the largest impact, with significance-impact dropping from there.

The seasonality variable appears to conform to what could now be considered normal: seasonality is significant in Q1, with a spillover into Q2 for the low vertically-integrated firms (Table - VIII), but overall, this result is not unanticipated.

The trailer variable remains insignificant for both high and low vertically-integrated firms in stand-alone funds.

The regression for the fund wrap segment returns some interesting results for both high vertically-integrated firms (Table VII) and low vertically-integrated firms (Table IX). Beginning with fund wraps sponsored by highly vertically-integrated firms, Q1 plays a large role in fund net flows, returning the largest coefficient value for the seasonal variable among all the regressions.

The investment returns quintiles for high vertically-integrated firms’ fund wraps appear to be affected by an unspecified variable for which our model is not accounting and which is unique to high vertically-integrated firms—this variable may perhaps be the asset class differences between the portfolios. We see that the second and the fifth quintiles are both highly significant and are nearly as large as one another, while the third and fourth quintiles hold only a moderate to weak significance. Again, as mentioned above, this is an area for further research. The trailer variable holds no significance for fund wraps sponsored by high vertically-integrated firms.

Fund wraps for low vertically-integrated firms vary in terms of size and scope, compared to their high vertically-integrated counterparts. However, the Q1 seasonality effect still maintains significance, as well as does the performance quintile. The trailer variable for fund wraps sponsored by low vertically-integrated firms exhibits high significance, but with an inverse relationship.
Section 5: Impact of Advisor Compensation and Cost of Mutual Fund Ownership on Fund Flow Activity

Section 5 examines the importance of fund advisor compensation formulas and the cost of mutual fund ownership on fund flows.

Determining whether or not the level of compensation that fund companies pay to dealers, who subsequently compensate their advisors, influences fund flows is particularly complex. The complexity arises from differences in how distribution costs are embedded in mutual funds; the number and nature of channels through which funds are distributed; the number of advisor compensation models at work in those channels; and the variety of mutual fund product structures that are available. The picture is further convoluted by the relatively modest number of funds (relative to the overall mutual fund universe) that pay trailers above or below the industry median for asset classes, and the virtual absence of funds that pay non-median, upfront sales commission on deferred sales charge sales options.

The current section augments the statistical analysis presented in Section 4 by analyzing the available embedded advisor compensation datasets, including trailers and upfront sales commissions. The focus is on funds of low vertically-integrated fund manufacturers sold through intermediated advice channels, in which the direct-drive advisor compensation model creates the most direct route between the embedded fund compensation and the advisor compensation. (This topic is explored in greater detail in Section 6, which focuses on distribution factors and advisor compensation models.)

The analysis further attempts to identify specific situations where the impact of advisor compensation on fund flows might become more articulated. Examined scenarios include investigating whether funds that pay higher-than-median trailers sell well under any circumstances, including when their investment returns are below average for the same asset class or category; and whether higher-than-median trailers help funds shore up their retention experience at times when their weak relative investment returns and/or inopportune asset class positioning exert pressure on their redemption flows.

The current section should be read alongside Section 6, which illuminates the advisor compensation formulas and advisor practice models within different distribution channels.
Key Findings Regarding the Impact of Advisor Compensation on Fund Flow Activity

The analysis presented in this section suggests that the level of embedded trailers generally does not exhibit a meaningful relationship with fund net flows. As shown in previous sections, macro-economic and fund investment return characteristics appear to override advisor compensation formulas as the drivers of flows into fund categories and specific funds.

The examination of the additional specific scenarios outlined above confirmed that relative investment rankings overpower any trailer differences. There was no evidence that higher-than-median trailers positively impact fund flow volumes for funds with high relative investment return rankings (fifth quintile). However, higher-than-median trailers appeared to have a positive impact on fund sales and retention track records for funds with investment returns in the third quintile and below. In particular, funds with higher-than-median trailers with first- and second-quintile investment return ratings, while still remaining in net redemptions, generally exhibited a lower gap between gross sales and redemptions than did funds with lower trailers. Yet the analysis did not demonstrate any meaningful impact of the level of trailers on fund flow performance for funds downshifting from the fourth- and fifth-quintile investment return rankings.

The importance of embedded fund compensation on fund flows is being diluted by two well-entrenched industry trends. The first is the shift away from back-end load or deferred sales load options, which feature an embedded upfront sales commission payment to advisors. The second trend is the continued shift toward unbundled fee-based advisor models among advisors operating in the intermediated advice channels. This topic is explored in detail in Section 6.
Trailer Fees

The focus of this section is to review the importance of trailer fees in the sales of mutual funds through intermediated advice providers. Figure 5.1 shows the relative size of these conduits alongside the deposit-taker-owned, branch-based conduits and the direct-to-public channels. (The section on distribution channels delves further into the detailed characteristics of structure, shelf and compensation models within each channel.)

Figure 5.1. Mutual Fund Assets by Main Distribution Conduit
December 2014, in billions of dollars

The intermediated advice conduit includes two distinct distribution channels: the full-service brokerage and the financial advisor channels. The dealers in each channel are subject to one of two self-regulatory organizations (SROs); the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association (MFDA).
For the purpose of this section and for the issue of ongoing trailer compensation, the channels are treated in aggregate. The rationale for this combinatory view is that, in both channels, the fund shelf is predominantly open to a large number of fund manufacturers (including firms that may be affiliated to the distributor and to third-party fund providers). Additionally, the mutual fund companies catering to advisors in intermediated advice networks offer funds with different load options (discussed further ahead in this section) and trailer-fee levels, the result of which is that advisors in these channels control fund choices that will dictate both cost to customer and their own level of compensation. This is why the question of whether the level of ongoing trailing commissions drives sales is highly relevant to the intermediary advice distribution conduits.

For an important note on the composition of the data samples, please turn to the Appendix section.
Observations about funds available through intermediaries

**Figure 5.2** shows the number of products, assets and other key information for equity and balanced funds sponsored by firms with vertical integration lower than 50%—a universe that includes 1,211 products.

**Figure 5.2. Mutual Funds by Trailer Fees—Equity and Balanced Funds**
Fund companies with vertical-integration levels under 50% —December 2014

The majority of the funds in the sample (86%) paid trailer fees of 1% for front-end load options (or no load, if applicable) at the end of 2014. An additional 9% of the funds paid fees above 1%, while 5% of the products paid less than 1%. Relative to their share of fund counts, fund products that paid trailers lower than 1% accounted for a significantly higher share of assets. Products that paid trailers higher than 1% had a share of assets in line with their share of fund product counts. The group of funds that paid 1% accounted for 78% of assets at the end of 2014, well below their share of fund product counts.
The examination of aggregate sales and redemption trends over the nine-year period from 2006 to 2014 does not suggest the presence of a positive correlation between higher-than-median trailer level and sales or redemption volumes; in fact, the opposite is true. Funds with trailers of 1% accounted for more activity relative to their share of assets; funds with trailers higher than 1% had a relatively lower share of sales and redemptions. Funds with trailers lower than 1% had a share of sales higher than their share of assets, while their share of redemptions was lower. A significant difference between the three groups is apparent for redemption rates (annual redemptions as a percentage of average assets). The redemption rate of funds with trailer fees below 1% was lower (at 13%) than those of funds with trailers of 1% (at 15%); the highest redemption rate was observed for funds with trailers above 1%.

The redemption rate of funds with trailer fees higher than 1% oscillated considerably in the seven-year period depicted in Figure 5.3, and, more recently, has converged with the redemption rate of funds with 1% trailer fees. The redemption rate peaks in the period 2008 to 2010 are due to sharp changes in market valuations and also to the greater incidence of newer funds in the population of funds with trailers greater than 1%. The redemption rate of funds with 1% trailer fees has varied less than the other two groups over time; this is due to the larger number of funds, assets and redemption volumes associated with this option. The redemption rate of funds with trailer fees lower than 1% has trended lower since early 2011.

Figure 5.3. Redemption Rates of Mutual Funds by Trailer Fee
Fund companies with vertical-integration levels under 50%
Relative investment returns and fund flows: Low vertically-integrated fund companies

As explored in Section 3, investment return ratings appear to be a valid predictor of sales and redemption patterns, as shown in Figure 5.4. In the nine-year history of the examined dataset, gross sales tended to be higher for funds with higher quintile ratings for three-year ranges of investment returns. Redemptions surpassed the level of gross sales for funds populating the first to third quintiles, and were lower than the gross sales for the fourth and fifth quintiles (where the best-performing funds reside). In aggregate, funds within the fourth and fifth quintiles experienced positive inflows, while lower-rated funds were in net redemptions.

The chart shows data for equity and balanced funds sponsored by companies with low vertical-integration levels. As mentioned earlier in this section, these firms operate in distribution channels where the advisor compensation model creates the most direct link between the embedded fund compensation and the advisor’s compensation.

Figure 5.4. Gross Sales, Redemptions and Net Flows for Equity and Balanced Funds
Fund companies with vertical-integration levels under 50%, in millions of dollars

Figure 5.5 examines a subgroup of equity and balanced fund products, those with trailer fees higher than 1%. Their gross sales and redemption patterns suggest that funds that pay higher trailer fees are not immune to the power of investment return ratings. This group of funds was even more reliant on the highest rating (fifth quintile) than the total fund universe for firms with low levels of vertical integration.
Funds that pay trailers higher than 1% and rank in the third quintile, however, had positive aggregate inflows, while funds with lower trailers in the same quintile experienced substantial net redemptions. Another notable observation: while in net redemptions, the gap between gross sales and redemptions for funds with higher trailers in the first and second quintiles was lower than was the gap for funds paying 1% trailers. The redemption-to-gross sales ratio of funds that pay relatively high trailers for first and second quintile combined is 1.37, versus 2.25 for funds with 1% trailers.

The examined scenario suggests that, among companies with no or limited access to affiliated distribution, paying higher trailer fees has had a positive impact on gross sales and redemption patterns by attracting (or keeping) money into funds with average investment performance ratings (third quintile) and by ameliorating the negative retention experience of funds with low investment performance ratings (first and second quintiles).

The relationship between net flows and trailer fees does not supersede, however, investment return considerations. Furthermore, the regression analysis in Section 4 of this report shows that the relationship between trailer fees and net flows is insignificant in statistical terms.

Figure 5.6 shows the 12-month net flows, gross sales and redemptions for funds with a quintile rating of four or five and the same activity metrics for 12 months after the quintile rating fell to three or lower. In aggregate, funds moved from positive inflows...
when their quintile ratings were high to net redemptions when their ratings declined, irrespective of the trailer fees they paid.

**Figure 5.6. 12-month Sales Activity of Funds that Drop from Fourth or Fifth Quintile**

Gross sales, redemptions and net flows for selected equity and balanced funds

Fund companies with vertical-integration levels under 50%, in millions of dollars

Relative investment returns and fund flows – High vertically-integrated fund companies

When high vertically-integrated firms were subjected to the above analysis, no discernible difference was observed in the distribution of sales and flows between standard and high trailer funds. This is illustrated in Figures 5.7 and 5.8.
This suggests that trailers may be more relevant to gross flows in the intermediated distribution channels, where there is a direct link between trailer level and advisor payout, than in the high vertically-integrated firms, where the linkage is less direct.

**Figure 5.7. Gross Sales, Redemptions and Net Flows for Equity and Balanced Funds**
Fund companies with vertical-integration levels above 50%, in millions of dollars

**Figure 5.8. Gross Sales, Redemptions and Net Flows for Equity and Balanced Funds**
Fund companies with vertical-integration levels above 50%, in millions of dollars Funds with trailer fees >1%
Sales Commissions

In terms of sales commissions, funds can be divided in two broad groups, no load and load funds. No load funds are largely offered by highly vertically-integrated firms (mostly deposit-takers), but this group also includes a fast-growing segment: no load series of originally load funds, such as F-series for fee-based accounts. Load funds are offered in three varieties: front-end, back-end and low load option (for definitions, see the Appendix). All three load options are typically enabled on load funds by the fund manufacturer, leaving advisors and investors to select the most suitable option at the point of sale.

Figures 5.9a and 5.9b show the evolution of assets and net flows for load and no load funds. No load fund assets grew faster than load funds over the last decade; this can be attributed to the ongoing success of the deposit-takers in the funds business and the growth of fee-based accounts, particularly in the full-service brokerage channel—more on this will be discussed in the distribution section.

Figure 5.9a. Mutual Fund Assets by Load Structure
In billions of dollars
Figure 5.9b. Mutual Fund Net Flows by Load Structure
In billions of dollars

As it is the case with trailer fees, loads are particularly relevant to the intermediated advice sales forces (load funds are generally not available in bank branches). Figure 5.10 displays the recent net flow trends of mutual funds by load option.

The data shows that there has been a significant shift away from load options with back-end embedded commissions, while front-end load funds and no load share classes have gained ground.

Figure 5.10. Mutual Fund Net Flows by Load Option—Load Funds
In billions of dollars
Within front-end load funds and the load options with embedded commissions, two notable trends have unfolded in recent years:

- Data collected three years ago in the context of a report on the cost of ownership of mutual funds for IFIC showed that for 98% of all front-end load transactions, the load was waived (advisors were using this option as if the product was a no load fund). When a load was charged, it was typically 1% or lower (advisors can charge up to 5% in front-end load options).
- In the case of load funds with embedded commissions, there has been a pronounced shift away from back-end load funds into low-load funds (the former option has been in net redemptions over the last decade, while the latter has consistently attracted new money).

Some companies offer multiple low-load options (typically with a two- and three-year redemption schedule). A few fund providers pay a trailer fee in their low-load options that is at the same level as the trailer for front-end load funds (full trailer); most companies, however, pay a trailer lower in the low-load fund options than in front-end load funds. Our dataset does not have the level of granularity necessary to examine precisely which low-load options have been attracting more inflows.

The available data indicates that advisors have been moving away from options with high embedded commissions into either a) load options with lower embedded commissions; b) front-end load options that are largely used as no load funds, given that the commissions are generally waived; or c) no load share classes such as F-series, high net worth series or fund wraps with no loads.

The shift to fee-based compensation (embedded and not) and away from point-of-sale commissions is notable: if all mutual fund industry assets are taken into consideration, no load funds and front-end load options with waived fees accounted for 77% of industry assets at the end of 2014, a share that has been growing over time.
Impact of Management Fees, MERs and Total Cost of Ownership on Fund Flows

In Canada, a fund’s management expense ratio (MER) often equals the total cost of ownership—or comes close to it. MERs for the original series of most funds (more on series further ahead) are typically an all-inclusive metric that accounts for management fees, distributor compensation, operating expenses and taxes. Other expenses, such as point-of-sale commissions, account expenses or redemption fees, have a relatively low incidence.

Over the last decade, there has been significant downward pressure on mutual fund management fees. Some factors that have likely contributed to this include economies of scale that allow fund companies to lower their pricing; competitive pressures from low-cost products—such as ETFs—and platforms; the recurring attention given to the topic by the Canadian press; the increasing availability of literature and interactive tools (such as calculators), along with online/web-based services that compile fund information and make it readily available to investors and advisors; and more stringent regulatory standards on transparency, which have made cost information more prominent for investors.

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Figure 5.11 illustrates that the share of assets in funds with relatively lower MERs has increased over time. This shift in share is due to the fact that fund providers which offer funds with a lower cost of ownership have grown relatively faster over the last decade (highly vertically-integrated companies in particular). The substantial asset growth of these companies, however, including that of deposit-takers, cannot be directly and only explained by the fact that their funds, on average, have MERs lower than other firms with which they compete in the intermediated distribution channels, but rather by their distribution and product-positioning strategies.

Figure 5.11. Mutual Fund Assets by MER Level – Equity and Balanced Funds. A-series, Advisor-series and T-series
In billions of dollars
Section 6: Impact of Distribution Factors on Fund Flow Activity

Section 6 examines the importance of distribution factors on fund flows.

This section is based on inputs from Investor Economics’ detailed distribution channel research, particularly within the financial advisor (FA) and full-service brokerage (FSB) channels. The analysis focuses on shifts in the overall structure and characteristics of distribution channels, relying on longer-term movements in channel structure, asset mix and shifting advisor practice models to assess the impact that distribution factors have on fund flows.

In this analysis, we will provide a map of the distribution channels and advisors that deliver financial products and services, including mutual funds, to the Canadian retail financial wallet. The section presents mutual funds within the broader context of each distribution channel, the competitive product shelf, and the importance of vertical integration and access to advice-based distribution. The mixed universe of advisors across channels and their role as the engine of growth for mutual funds is examined, as are the compensation models that dictate practice economics for both advisors and firms.

These factors (competitive shelf, fund manufacturer access to distribution, the number of advisors and compensation models at work) dictate the relative importance of the embedded compensation structure of mutual funds within the practices of advisors in different channels and, in turn, the relative impact that those channels and their advisors have on overall fund flows.

The relative importance of the embedded compensation structure of mutual funds in practice economics is not a static phenomenon. Distribution trends are emerging that are modifying the role of the embedded structure, to different degrees, across channels, most notably the shift to unbundled fee-based programs.
Key Findings Regarding Distribution Factors

The distribution factors that influence the sales and holdings of mutual funds fall into the following five categories:

- **Channel structure**: The delivery of financial wealth products and services occurs over a variety of distribution channels operating under a mix of regulatory regimes, business models and compensation models, all of which impact the relative importance of mutual funds in each channel.

- **Product shelf depth and architecture**: Open-architecture, full-service brokerage firms are significantly less dependent upon mutual funds (26% in funds) than are branch advisors (55% in funds) and financial advisors (95% in funds). Fund-specific compensation is less dominant in channels where product alternatives are readily available and used—as is the case in the FSB channel.

- **Vertical integration and access to distribution**: How ownership influences fund flows at the advisor practice level varies with the ownership model. Dealer ownership, either captive or affiliated, provides enhanced fund flows for the manufacturer through a restricted shelf or through beneficial access to advisors.

- **Advisors, practice profile and compensation models**: The Canadian advisor population is expansive, with almost 100,000 advisors who can advise on and deliver mutual funds to the investing public. Differences in average book of business per advisor across and within channels results in significant differences in practice models. Differences in advisor compensation models between and within channels amplify differences in practices and sales focus.

- **Shifting practice models modifying the impact of embedded compensation structure**: This shift has been underway across all types of firms in the FSB channel for a number of years and, to the extent that funds are gaining traction in these programs, the shift is modifying the impact of the embedded compensation structure on fund flows as advice fees are unbundled from the MER.
Channel/Distributor Factors
Distribution Channels—Classification

Over the past two decades, the investible financial wealth of Canadian households has quadrupled to more than $3.6 trillion. Over the same period, mutual fund assets have expanded 14-fold and have become a significant focus of expanding wealth management businesses, ranging from integrated financial services giants to independent distributors of financial products and advice services.

The roadmap that traces the distribution paths of retail financial products and services is a complex one. This is particularly true when it comes to assessing distribution capability, the capacity of channels and the myriad firms and advisors that populate them. Mutual fund flows play out across a diverse retail distribution landscape; before delving into specific delivery models and the changing shape of those models, it is important to establish a channel framework into which distributors fit. It is critical to determine how distributors align in terms of their relative importance to the financial wallet, to mutual funds in particular and to the delivery dynamics that are at work in each.

The Delivery Framework

The role that mutual funds play in each distribution channel is a reflection of an array of factors in effect, including: the type of delivery model; target client segments; historic and changing asset mix composition; and the strategic focus and direction of the firms in each channel. Part of this dynamic is reflected in the regulatory regimes in effect within each channel; it is important to recognize that not all channels are homogeneous in terms of regulatory status.

Figure 6.1 outlines four high-level categories of delivery into which seven key distribution channels fall: Direct, Branch, Intermediated and High Net Worth. The exhibit also indicates the primary registration/licensing platforms present in each channel. The Mutual Fund Dealers Association (MFDA) is the primary registration platform for delivery of mutual fund products in four of the seven distribution channels highlighted below, while Investment Industry Regulatory Organization of Canada (IIROC), through which the broadest range of investment products are delivered, is the only registration for two channels (full-service brokerage and online/discount brokerage). IIROC also has a presence in the branch advice, financial advisor and private wealth channels.
Figure 6.1. Delivery Categories, Distribution Channels and Regulatory Regime

**Distribution of Financial Wealth and Channel Focus on Funds**

Figure 6.2 displays the seven key distribution channels and provides the absolute size, in terms of the total financial wealth, held by retail investors in each channel. The relative share held by investment funds (ETFs are not included in this view of investment funds) against the backdrop of total financial wealth is also indicated. A more detailed view of the shelf will follow in this report.

Figure 6.2. Distribution Channels, Financial Wealth and the Relative Importance of Investment Funds
Total financial wealth assets at December 2014, in billions of dollars
The three leading advice channels, branch advice (BA), financial advisor (FA) and full-service brokerage (FSB), have similar absolute dollar volumes of mutual funds, but mutual funds represent different levels of importance to each channel in terms of share of assets under administration (AUA). By extension, the relative importance of mutual fund compensation to an advisor’s practice varies by distribution channel.

In terms of relative commitment to mutual funds, the FA channel leads the seven channels, both in terms of absolute dollars and by share of total assets, particularly when segregated funds are included. The share of mutual funds in the channel is diluted somewhat by non-dealer deposit holdings but, by any measure, the economics of the FA channel is more closely tied to fund compensation than can be said of other channels. With the bulk of assets in the branch delivery channels being made up of proprietary deposits, however, mutual funds are the dominant investment product in the channels.

The relative importance of mutual funds in the FSB channel is significantly lower than in BA and FA. Mutual funds appear in the private wealth management (PWM) channel, because several PIC firms have chosen to issue their pooled fund offerings pursuant to a prospectus, rather than offering memoranda. These products are priced as private pools and are used exclusively within the PWM channel. They are subject to demand and supply trends that strongly differ from those of mutual funds held in other distribution channels; consequently, we will not comment on this channel further.

Households will often use multiple channels. This is driven by their core banking requirements, as well as by their investment needs. In the case of the latter, this is a function of their existing financial wealth, as well as their attitudinal profile in terms of the household’s desire for advice and the form of advice best tailored to their needs. This is important to consider when assessing the nature and drivers of fund flows in each channel.
Product Availability—the Role of Shelf and Vertical Integration

This part of Section 6 will cover, in broad product category terms, the product shelves of each channel, highlighting the relative importance of mutual funds and, in turn, their relative contribution to dealers and to the practices of advisors in the advice channels.

A seven-year time frame, starting in 2007, was selected to examine relative growth rates and shifts in product shelf mix over time. This provides a range that encompasses the significant downturn in 2008, followed by the recovery, the market volatility and the relatively robust growth over the past two years. The asset totals align with the total financial wealth held in each channel identified in Figure 6.2.

Branch Delivery

Branch advice channel

The success of the transformative trend away from individual asset class-based fund sales toward pre-assembled advice solutions (covered in Section 1) is made apparent in Figure 6.3, as 75% of the channel’s growth between 2007 and 2014 arose from the expansion in mutual funds.

Figure 6.3. Product Mix—Branch Advice Advances on Growth in Mutual Funds
Assets and total financial wealth in billions of dollars, seven-year compound annual growth rate of assets to December 2014

<table>
<thead>
<tr>
<th>Branch advice</th>
<th>Dec 2007</th>
<th>Dec 2014</th>
<th>7-yr CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>120,841</td>
<td>163,236</td>
<td>4.4%</td>
</tr>
<tr>
<td>Investment funds (ex-ETFs)</td>
<td>123,513</td>
<td>245,074</td>
<td>10.3%</td>
</tr>
<tr>
<td>Directly held securities</td>
<td>11,917</td>
<td>9,169</td>
<td>-3.7%</td>
</tr>
<tr>
<td><strong>Total financial wealth</strong> (in $millions)</td>
<td>256,271</td>
<td>417,479</td>
<td>7.2%</td>
</tr>
</tbody>
</table>

The growth in mutual funds has come largely through proprietary solutions; mutual fund wrap products accounted for 88% of the branch advice mutual fund growth over the past two years.

The solutions focus in the channel reflects both opportunity and constraint. The large sales forces and extensive branch networks represent opportunity, but also a constraint in terms of how to ensure the uniformity of the customer experience that protects the brand across those large networks. The successful deposit-takers in the channel have been able to level the customer experience across their networks through the use of a structured sales process focused on pre-assembled advice solutions within broad risk management parameters.
Additionally, proprietary fund wraps both exclusive to the branch advice offer and falling into the high net worth fund wrap category are gaining in importance in the channel.

### Branch direct channel

On the branch direct side of branch delivery, growth in funds over the past seven years has increased fund penetration, but this growth has also significantly lagged the targeted offering of fund wraps in branch advice (see Figure 6.4). Fund wraps are beginning to come into their own in this aspect of branch delivery, representing half of all fund assets in branch direct by the end of 2014—this compares to over two thirds in branch advice.

**Figure 6.4. Product Mix—Branch Direct Skews to Deposits, Growth Favours Funds**

Assets and total financial wealth in billions of dollars, seven-year compound annual growth rate of assets to December 2014

<table>
<thead>
<tr>
<th>Branch direct</th>
<th>Dec 2007</th>
<th>Dec 2014</th>
<th>7-yr CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>500,893</td>
<td>608,041</td>
<td>2.8%</td>
</tr>
<tr>
<td>Investment funds (ex-ETFs)</td>
<td>86,094</td>
<td>132,488</td>
<td>6.4%</td>
</tr>
<tr>
<td>T-bills/savings bonds</td>
<td>9,670</td>
<td>16,249</td>
<td>7.7%</td>
</tr>
<tr>
<td><strong>Total financial wealth</strong> (in $millions)</td>
<td>596,657</td>
<td>756,778</td>
<td>3.5%</td>
</tr>
</tbody>
</table>

### Intermediated Delivery

**Financial advisor channel**

On the dealer side of the FA channel, just over $70 billion, or 20%, of total dealer assets are held on IIROC platforms. Of that $70 billion, over two thirds were held by dealers with a dual-platform option, MFDA and IIROC, the balance at IIROC-only firms in the FA channel. Growth on the FA IIROC platforms outpaced that of the FA MFDA platforms, largely as a result of the transfer dynamic that exists between the two.

For assets combined from both options, the mutual fund focus of the business has remained relatively static as investment fund assets (mutual funds and segregated funds) remained at over 90% of total dealer assets (see Figure 6.5); this is despite the stronger asset growth experienced on the IIROC platforms in the channel. By virtue of the dominance of mutual funds on the shelf of FA dealer firms, those firms and their advisors remain the most heavily tied to the embedded compensation model of funds.
Figure 6.5. The FA Dealers—MFDA and IIROC—Both Mutual Fund-centric
Assets and total financial wealth in billions of dollars, seven-year compound annual growth rate of assets to December 2014

<table>
<thead>
<tr>
<th>Financial advisor dealers</th>
<th>Dec 2007</th>
<th>Dec 2014</th>
<th>7-yr CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>7,883</td>
<td>5,826</td>
<td>-4.2%</td>
</tr>
<tr>
<td>Investment funds (ex-ETFs)</td>
<td>225,929</td>
<td>295,964</td>
<td>3.9%</td>
</tr>
<tr>
<td>Directly held securities</td>
<td>8,648</td>
<td>15,480</td>
<td>8.7%</td>
</tr>
<tr>
<td><strong>Total financial wealth</strong> (in $millions)</td>
<td>242,460</td>
<td>317,271</td>
<td>3.9%</td>
</tr>
</tbody>
</table>

Full-service brokerage channel

The product shelf in the full-service brokerage channel is the deepest across the wealth market. The size and nature of the channel reflects a long-term commitment to, and maturation around, that deep shelf and the higher-end wealth clients who seek a broader range of investment options and solutions that cannot, arguably, be provided by funds alone.

Mutual fund traction in the channel has improved over the past several years—largely, it would appear, at the expense of fixed income holdings (see Figure 6.6). This has been the case in both traditional, transaction-based accounts, as well as in fee-based programs, where F-series funds have become the norm, modifying the impact that the embedded compensation structure has had on overall fund sales and growth (see shift to fee-based further on in Section 6).

The bulk of the robust deposit growth has come from high interest savings accounts (HISAs)—those that clear through FundSERV. HISAs have provided a very competitive rate for clients’ cash balances and, unlike the spread earned by the firm on cash deposits, the embedded trailers paid on HISAs, while low, do go to the payout grid for advisors (see compensation models). A material portion of the growth in HISAs, however, has come through F-series.
Figure 6.6. Full-service Brokerage Channel—Funds Gain Traction on Crowded Shelf
Assets and total financial wealth in billions of dollars, seven-year compound annual
growth rate of assets to December 2014

<table>
<thead>
<tr>
<th>Full-service brokerage</th>
<th>Dec 2007</th>
<th>Dec 2014</th>
<th>7-yr CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>91,393</td>
<td>162,048</td>
<td>8.5%</td>
</tr>
<tr>
<td>Investment Funds (ex-ETFs)</td>
<td>167,709</td>
<td>263,481</td>
<td>6.7%</td>
</tr>
<tr>
<td>ETFs</td>
<td>8,903</td>
<td>43,534</td>
<td>25.4%</td>
</tr>
<tr>
<td>Equities</td>
<td>333,594</td>
<td>449,336</td>
<td>4.3%</td>
</tr>
<tr>
<td>Fixed-income</td>
<td>113,836</td>
<td>87,165</td>
<td>-3.7%</td>
</tr>
<tr>
<td><strong>Total financial wealth</strong></td>
<td>715,436</td>
<td>1,005,564</td>
<td>5.0%</td>
</tr>
</tbody>
</table>

Equity funds remain the backbone of the channel; if ETFs are included with equity funds, the mix was relatively unchanged over the timeframe—49% in 2014, versus 48% in 2007. The shelf at full-service brokerage firms remains deep, with a variety of marketable securities in the equity category—the revenue impacts from this category are highlighted later in this section. The rise of both investment funds and ETFs has been strong; together, they now account for 30% of all assets in the channel. ETFs have garnered attention as a substitute for mutual funds in the retail market, and particularly in the full-service brokerage channel where, operationally, sales are straightforward.

Solid growth in mutual funds, particularly through unbundled F-series in fee-based programs, relative to other asset categories, suggests a relationship with ETFs that is more commensal than substitutive (see Figure 6.7).

Figure 6.7. Recent Growth of Mutual Funds and ETFs in Full-service Brokerage
Two-year compound annual growth rate to December 2014

<table>
<thead>
<tr>
<th></th>
<th>AUA</th>
<th>ETFs</th>
<th>Mutual funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full-service brokerage</td>
<td>9.8%</td>
<td>32.4%</td>
<td>17.4%</td>
</tr>
<tr>
<td>Fee-based programs</td>
<td>22.9%</td>
<td>36.6%</td>
<td>33.8%</td>
</tr>
<tr>
<td>Transaction-based accounts</td>
<td>4.3%</td>
<td>26.6%</td>
<td>12.7%</td>
</tr>
</tbody>
</table>

In the transaction-based realm, ETFs have expanded more rapidly than mutual funds, despite the presence of a transparent commission structure for ETF transactions.
Direct Delivery

Online advice alternatives

The online/discount brokerage (ODB) channel is covered here as a point of comparison in terms of the shape and changes in a product shelf that is an alternative to the more traditional advice channels. For the ODB channel, the seven years to 2014 were a period of extensive growth, both in terms of assets and accounts for the channel (see Figure 6.8).

Figure 6.8. Online/Discount Brokerage Channel
Assets in billions of dollars, seven-year compound annual growth rate of assets to December 2014

<table>
<thead>
<tr>
<th>Online/discount brokerage</th>
<th>Dec 2007</th>
<th>Dec 2014</th>
<th>7-yr CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>22,944</td>
<td>61,275</td>
<td>15.1%</td>
</tr>
<tr>
<td>Investment Funds (ex-ETFs)</td>
<td>31,722</td>
<td>29,765</td>
<td>-0.9%</td>
</tr>
<tr>
<td>ETFs</td>
<td>5,944</td>
<td>25,317</td>
<td>23.0%</td>
</tr>
<tr>
<td>Directly held securities</td>
<td>119,178</td>
<td>208,309</td>
<td>8.3%</td>
</tr>
<tr>
<td><strong>Total financial wealth</strong></td>
<td><strong>179,788</strong></td>
<td><strong>324,665</strong></td>
<td><strong>8.8%</strong></td>
</tr>
</tbody>
</table>

The high cash/high equity-focused mix is indicative of the traditional active-trader cohort in the channel, but the concentration of activity, among a relatively low percentage of accounts in the channel, tells a different story. While the growth experienced in the channel over the past seven years attested to the rise of self-reliant consumer themes, getting those new clients both engaged and active has met with limited success.

Against that backdrop, mutual fund share of assets in the channel has eroded significantly, as total mutual fund assets are below the level they were seven years ago. This has happened despite the absence of trading commissions on sales or redemptions and despite the increased availability of reduced embedded trailer D-series funds.

Vertical Integration and Strategic Alliances

Scale and the importance of vertical integration in the financial advisor channel

A strong and growing complement of producing advisors is required in order to achieve the scale necessary for profitable growth across dealer firms in the advice-based distribution channels. The need for scale has triggered consolidation activity and has led to attrition in the FA channel with a 40-plus reduction in the number of MFDA firms in the past six years. The vertical integration of manufacturer and distributor, while not a panacea for the absence of scale, can help manufacturers—those owning distribution—
in capturing additional revenue streams through a greater presence on the shelf of those distributors and thus can improve the economics of owning distribution.

In its simplest form, vertical integration measures the share of a distributor’s total mutual fund base that is held by mutual funds of an affiliated or parent fund manufacturer. This occurs at integrated investment fund managers and dealers (as is the case with Investors Group and the deposit-takers) or where a manufacturer has bought and maintained independent distribution (as per CI Investments and Manulife Financial) and the independent dealer adds the owner’s funds to its shelf.

**Figure 6.9** provides a view across channels of the degree to which channel mutual fund assets reflect those manufactured by affiliates of the dealers in the channel.

**Figure 6.9. Channel and Shelf Dictate Varying Degrees of Vertical Integration**
Affiliated or proprietary fund share of total fund assets by channel

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*Includes only those firms owned by Big Six banks and deposit takers.*
With their focus on proprietary solutions, the two branch delivery channels are nearly fully integrated.

The year 2008 was followed by a period of increasing vertical integration among those FA dealer firms with affiliated manufacturing. Over the past three years, however, vertical integration experienced marginal declines across the channel. These channel results include Investors Group; excluding them from the calculation of affiliated fund penetration lowers the vertical integration in the channel to about 30%. Among the other top dealer firms in the channel, the decline in vertical integration over the past three years was, in part, due to consolidation activity that diluted the affiliated fund penetration on the shelves of acquiring dealers. Additionally, it is important to consider that in periods of positive markets, the shelf, in terms of fund manufacturers, tends to expand as demand becomes widespread and a larger number of advisors contribute to more varied sources of growth.

Vertical integration remains low among FSB firms due to the relatively low emphasis on mutual funds among bank-owned firms and a culture that has largely supported product independence from the bank.
Beyond formal affiliation

The growth in both product complexity and scrutiny on sales practices and value propositions may force even independent advisors to narrow their focus and their shelves; this scrutiny will heighten the importance of access to independent advisors and will potentially result in higher levels of vertical integration or some other form of affiliation. For example, there are strategic alliances that arise between independent dealers and manufacturers of mutual funds. Again, these relationships focus largely on access to the advisor and on building a favourable and lasting relationship between wholesaler and distributor/advisor. One of the more successful examples of this type of alliance in terms of penetration of the distributors’ mutual fund book was that of Sun Life Financial and CI Investments.

Key Findings Regarding Product Availability

- The mutual fund footprint on the shelf varies significantly between distribution channels, as does their role in overall distribution channel growth.
- Direct channels, notably online/discount brokerage, have seen mutual fund share erode significantly in the past seven years.
- Seventy-five percent of the branch advice channel's growth between 2007 and 2014 arose from the expansion in proprietary mutual funds.
- Product shelf depth and architecture:
  - Open-architecture FSB firms are far less dependent upon mutual funds (26% in funds) than are BA (55% in funds) and FA dealers (95%)—growth in the latter two distribution channels is driven by mutual funds.
  - Shelf architecture is largely closed within BA, and is focused on proprietary fund wrap solutions and on well-aligned sales processes—92% of funds in branch advice are proprietary, and funds in the branch direct channel are 99% proprietary.
  - Architecture in the FA channel is largely open, with few exceptions, and is focused on a broad range of fund manufacturers—almost 40% of mutual funds in the channel are affiliated (including those of Investors Group); this figure compares to only 12% of funds in the FSB channel, where the shelf is deeper and the scale is greater at the advisor level.
- Vertical integration and how ownership influences the affiliated distributor and success at the advisor practice level varies with the ownership model. Both dedicated and affiliated dealers (owned by, but not integrated with, the fund manager) typically benefit from deep-pocketed ownership and capital investment potential.
  - The group of mutual fund companies with access to proprietary or affiliated distributors have experienced, in aggregate, a consistently higher level of net flows than have companies without access to affiliated distribution.
Advisors, Compensation, Practice-based Trends and Economics

Advisor Factors
Despite the emergence of advice delivery in direct and online form, the advisor-based relationship remains the primary point of leverage on which financial services firms can build and maintain lasting relationships. Figure 6.10 highlights the expansive network of advisors, as well as the variability of where they are found from a channel perspective. Large differences in licensing, registration and proficiency are part of the varied landscape.

Figure 6.10. Advisors Present in Numbers in Many Delivery Models

The nature of advisors’ practices and the profile of those practices varies significantly from channel to channel as does their focus and reliance on mutual funds. The previous section underscored the broad differences in product shelf, from the depth of those shelves to how open the shelves are across the channels. Figure 6.11 provides an advisor lens into those shelves, looking at them in terms of the average book sizes that form the basis of the advisors’ practices in each channel.
The average size of an advisor’s book has a direct impact on the economics of the advisor’s practice and, by extension, the impact of the compensation structure. It is useful to examine not just the total average book size, but also each advisor cohort’s average mutual fund holding in those books of business.

### Average Book Dilution in the FA channel

The practice dichotomy between the FA and the FSB channel is striking. Among the FA dealers, however, there are a large number of dual-licensed advisors—those both registered to sell mutual funds, as well as being licensed to sell insurance products—who have not yet built out a mutual fund practice. While the overall financial wealth in the average top FA dealer books is still well below that of the FSB advisors, the average mutual fund book for those established FA advisors is slightly above that of the average FSB advisor.

Also affecting the size and nature of advisor practices are the many different compensation models that are at work across, and even within, distribution channels.

### The Compensation Models

All firms in advice channels generate revenue on their individual profit and loss (P&L) statements through the production and sales efforts of their advisors. That revenue is generated through the distribution of deposit and investment products and the provision of advisory services. It may be paid directly by the client to the distributor; by independent product manufacturers to a distributor; or it may reflect transfer pricing arrangements between affiliated business units in integrated financial services organizations.

<table>
<thead>
<tr>
<th>Channel</th>
<th>Total advisors</th>
<th>Total book per advisor</th>
<th>MF book per advisor*</th>
<th>Share of book in MF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch advice—total</td>
<td>13,100</td>
<td>$31.9</td>
<td>$18.7</td>
<td>59%</td>
</tr>
<tr>
<td>Top three leaders</td>
<td></td>
<td>$44.9</td>
<td>$30.2</td>
<td>67%</td>
</tr>
<tr>
<td>Financial advisor dealer—total</td>
<td>31,520</td>
<td>$9.9</td>
<td>$8.9</td>
<td>89%</td>
</tr>
<tr>
<td>Mutual fund dealers (MFDA)</td>
<td>29,804</td>
<td>$8.2</td>
<td>$7.7</td>
<td>95%</td>
</tr>
<tr>
<td>Investment dealers (IIROC)</td>
<td>1,716</td>
<td>$41.0</td>
<td>$28.6</td>
<td>70%</td>
</tr>
<tr>
<td>Full-service brokerage—total</td>
<td>10,185</td>
<td>$98.7</td>
<td>$24.7</td>
<td>25%</td>
</tr>
<tr>
<td>Big Six firms</td>
<td>6,364</td>
<td>$125.6</td>
<td>$27.4</td>
<td>22%</td>
</tr>
<tr>
<td>Other firms</td>
<td>3,821</td>
<td>$54.0</td>
<td>$20.2</td>
<td>37%</td>
</tr>
</tbody>
</table>

*excludes segregated funds
How this production translates into compensation for the advisors working at these firms is also highly varied across the channels and, to some extent, within the channels. Figure 6.12 provides a schematic view of the compensation model continuum that ranges from salaried to fully variable, direct-drive compensation.

**Figure 6.12. The Compensation Model Continuum**

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**Salaried models**

Salary and salary with various bonus formulations are the predominant models in the branch direct channel. The personnel under consideration here are customer-service representatives (CSRs) who are registered to sell mutual funds, but who are also tasked with a broad range of day-to-day banking responsibilities.

From a mutual fund perspective, these advisors are largely focused on the mass market clientele, those with typically much less than $100,000 in investible assets. Bonuses, where they exist, are often tied to broader performance-to-objectives branch measures. These can include balance growth objectives, new sales volumes, customer satisfaction scores or personal development targets. The key characteristic is that the bonuses are generally based on brown dollar awards that, in turn, help to determine the CSR’s potential share of a bonus pool that may be available for distribution across the deposit-takers’ branch networks.

**Base and variable compensation models**

The branch advice advisors typically have compensation models that have a higher base and a larger and more emphasized variable component than is available to their branch direct colleagues. Like their branch direct colleagues, however, these advisors operate within the banks’ existing branch networks and broader cost structures. The base compensation plus variable compensation model in this environment reduces the economic uncertainty for both the advisor and the firm, relative to a direct-drive compensation model. The model also limits the remuneration upside for the advisor, thereby improving the economics for the firm. There are several dealer firms in the FA channel operating under this model, as well.

The variable component, while sharing some characteristics of performance-to-objectives bonus measures, can also reflect direct participation in business results; for
example, via a percentage of incremental revenue growth and profitability associated with an assigned book of business. This model allows for greater control over the product shelf and sales process and, in the case of the banks, has helped shape the proprietary fund wrap solution approach and the desired uniform client experience objective.

There are specialized groups within some of the branch advice models tasked with bringing in new business and with handing off to the branch advice advisors. These individuals may operate in a fully direct-drive model that is based on the business they bring in and refer. The direct-drive models are, however, most typically found in the domain of intermediated advice—the FA and FSB firms.

**Direct-drive compensation models**

The direct-drive, fully variable models typically fall into two broad categories. We have notionally labeled these the employer/employee payout model and the independent payout model, based largely on differences in advisor payout and firm cost coverage. Payout reflects the percentage of the production that advisors generate that is paid out to them, with the firm keeping the balance.

In both cases, with the advisor assuming full responsibility for what they will earn, the firm typically has only limited control over practice-based decisions that the advisor will make, beyond the customary regulatory and compliance dictates. This is the big differentiator between FA and BA compensation models; in the former, the route from either individual product sale or broader asset management activity to exact financial compensation is readily apparent for both advisor and firm. For the latter, the outcome of specific activity is arguably clearer to the firm than to the advisor.

As a result of these characteristics, advisors in a direct-drive environment are generally free to choose the products and business approaches that fit best within their chosen practice model and which make the best sense economically for both them and their clients. The direct-drive model does work somewhat differently when attached to a dedicated sales force—this is more common in the insurance realm than in the mutual fund realm.

The top advisor payouts in the employer/employee payout model, the model dominant in the FSB channel, are in the 50-55% range. In this model, the firm covers many of the front-office costs, including occupancy, communications and technology, as well as the costs associated with some branch/practice support personnel, and the number of firm-paid sales associates depends on production hurdles at the branch and the advisor level.

By contrast, the independent payout model is a high payout/low expense recovery model from the advisor’s perspective. This means advisors typically receive a high payout on production, in the 80%-90% range, but are responsible for most or all the expenses arising from the running of their practices.
The independent model is dominant in the FA channel, but has some presence in the FSB channel. With FA advisors largely funding their own practices, dealers in that channel will allow large numbers of novice or small-practice advisors to register with them and attempt to establish and build a practice. This contributes to the dilution of the average book of business in the channel and to a high degree of turnover in the large numbers of advisors at the low end of the practice spectrum. Intuitively, it is these advisors who are in the early stages of establishing scale in their practice that would be most sensitive to specific product compensation structures and levels.

The models also dictate, in large part, the types of clients advisors are taking on. Advisors operating in an independent model are able to go lower into the mass affluent and into the mass market segments than in the employer-employee model, where the firm exerts more oversight on production per client and how advisors manage their capacity and overall production level. The further down the market the advisor goes, the more challenging become the economics of the practice.

The distribution of financial wealth and mutual funds by compensation model

Figure 6.13 provides a high-level view of how financial wealth, and mutual funds in particular, stack up across the different compensation models present across and within the branch direct, branch advice, financial advisor and full-service brokerage channels. Assets from the online discount brokerage, direct savings and funds and private wealth management channels are not included in the analysis, nor are the wealth assets from the dedicated, directly contracted and MGA insurance distributors. The latter two are similar to the independent dealer model in that a very high percentage of production is paid out to the advisor, with little or no cost support compensation structure.

Figure 6.13. How Compensation Models Play Out Across Financial Wealth and Investment Funds
Assets in billions of dollars
The four compensation models depicted in Figure 6.13 each contain assets from multiple distribution channels. Assets covered by each of the four main models break out as follows: 97% of the assets under the salary/bonus model ($757 billion) are driven through the BD direct channel, with the balance from BA; 95% of the assets in the base plus variable compensation model ($436 billion) are from the BA channel, with 5% from the FA channel; 91% of the assets under the employer/employee payout model ($954 billion) are in the FSB channel, with 9% in the FA channel; and 68% of the independent model assets ($347 billion) are from the FA channel, with 32% in the FSB channel. This does not capture the direct-drive individuals affiliated with the BA channel, as those assets are handed off to the BA advisors.

Just over 50% of the financial wealth held through the aforementioned channels is attached to direct-drive (all variable) compensation models, three quarters of which are in the employer/employee payout model. The latter is driven by the large brokerage firms focused on the high end of the market, in which two thirds of Canadian financial wealth currently resides. This is linked to the large average book size and control over the number of advisors and production levels in the full-service channel, relative to the FA channel.

*The grid provides additional control*

The payout an advisor receives from production in the direct-drive models is generally determined through a grid. Grid payout is determined by some form of the advisors’ 12-month trailing production (the formula varies) and the volume, or ticket size, of current production coming into the grid—the higher the trailing 12-month production and the larger the ticket size, the higher the payout.

Within the employer/employee payout model, advisor payouts from the grid may favour certain types of production, or rather the type of production may trump the volume coming into the grid. For example, production from a fee-based program or from a life insurance policy may be paid out at a higher rate than an equity trade commission of the same size (trailing 12-month advisor production being otherwise equal). For many firms, however, a dollar in production is treated the same across all sources. Firms with a high penetration of fee-based business typically do not treat that production any differently than transaction-based production.

Trailers may also receive special treatment on the grid, regardless of the dollar amount coming in at any given time. While trailer amount may vary by fund, once the trailer reaches the grid, all are treated the same way on that grid, irrespective of the fund manufacturer.
The effectiveness of differential grid treatment in the independent payout model is limited because of the already high payout level. The nature of operating a fully independent model limits the firms’ ability to direct the advisor’s mix of business and/or practice model. Of the assets held by FA dealers, 80% fall into the independent payout model compensation structure.

Overall, the independent model plays a disproportionate role in the distribution of mutual funds relative to financial wealth; the model accounts for almost 30% of the mutual funds held across these channels represented in Figure 6.13, but only 14% of financial wealth. Across the independent models, mutual funds make up almost three quarters of the assets administered. The inclusion of several full-service brokerage firms in the independent payout model category lowers the mutual fund footprint on financial wealth relative to that shown earlier.

The advisor-practice profiles and the compensation models align with the nature of advisors’ practice, their target client segments and the economics of the business. These factors also influence the extent to which advisors may consider a shift in their practice model.

**Advisor Factors—Fee-based Focus Drives Changes in the Nature of Production and Compensation**

Arguably, the most significant advisor practice trend influencing the impact of embedded compensation of mutual funds has been the move to fee-based programs. As fee-based programs grow and, with them, the volume of F-series funds, the linkage between fund flows and trailers is eroding. In this discussion, ‘fee-based programs’ refers to specific programs or platforms where there is an ongoing fee accrued on the assets that are considered part of the program.

These programs typically have a tiered fee that is based on asset level; there are generally maximum/minimum fee ranges for the tiers within which advisors can set the fee. The fees may be asset class-based, or blended (a single fee, regardless of asset class). In most cases, the approach unbundles the cost of advice from mutual funds held in the programs. In some cases, however, an A-series mutual fund may be considered part of the program, but the program fee is not charged on the fund assets as the trailer is still collected. This allows the client to maximize the assets in the program relative to tiered pricing, but ensures that assets are not double-billed.
Figure 6.14 shows the movement to fee-based practices in the full-service brokerage channel. At the end of 2014, assets in unbundled fee-based programs were at $353 billion, or 35% of total assets in the FSB channel; this was up from 19% seven years earlier.

**Figure 6.14. Fee-based Programs Drawing Assets From Transaction-based Practices**

Assets and total financial wealth in billions of dollars, seven-year compound annual growth rate of assets to December 2014

<table>
<thead>
<tr>
<th>Full-service brokerage</th>
<th>Dec 2007</th>
<th>Dec 2014</th>
<th>7-yr growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets in fee-based programs</td>
<td>138,248</td>
<td>353,258</td>
<td>14.3%</td>
</tr>
<tr>
<td>Assets outside fee-based programs</td>
<td>577,188</td>
<td>652,305</td>
<td>1.8%</td>
</tr>
<tr>
<td>Total financial wealth (in $millions)</td>
<td>715,436</td>
<td>1,005,564</td>
<td>5.0%</td>
</tr>
</tbody>
</table>

The move to fee-based programs within the FSB channel has been widespread. While the Big Six firms have an edge, with 38% of assets in fee-based programs, the Other firms (those other than the bank-owned Big Six) have gained significant ground and currently sit at 27%, up from only 8% seven years ago. The transition in the channel has played out across firms utilizing both types of compensation payout models (employer/employee and independent) and is growing even among long-term, transaction-based firms and practices.

The move to fee-based is in part supported by the scale of the full-service advisors’ practice and the historic nature of the shelf. The lower emphasis placed on mutual funds in the channel has limited the impact of shifting away from the embedded compensation model of funds for many advisors.

The shift has been underway for many years, but gained momentum in the wake of the 2008-2009 market decline. Undoubtedly, advisors and their firms are attracted to the recurring monthly revenue of fee-based programs, even if it means sacrificing the upside of transaction–based revenue during strong markets. Additionally, fee-based programs appear to better align the interests of the client and the advisor and, in so doing, fee-based programs dispose of the tendency for clients to second-guess their advisor’s recommendations. This is often cited as a significant efficiency gain in practice management.

The tiered fee-based structure may also encourage clients to consolidate assets and can provide more flexibility in terms of relationship pricing. The latter assertion was more evident when considering firms and advisors with larger mutual fund footprints, ones in which the embedded trailer model essentially forces a “one size fits all” fee, based on the prevailing trailer.
The divide in fee-based transition focus

The four programs benefitting from the transition to fee-based are non-discretionary fee-based brokerage (FBB) programs; discretionary advisor managed (AM) programs; discretionary separately managed wraps (SMWs), including both separately managed account (SMA) and unified managed account (UMA) structures; and discretionary in-house managed wrap (IHMW) programs.

The pace of fee-based transition across these programs is evident in Figure 6.15, which provides the absolute sizes and the seven-year compound annual growth rates of each program. These fee-based programs split along one key practice dimension, advisor control: control over the direction of the investment management function and control over cost to customer. On one side of the fee-based shelf are programs in which the investment management function is considered to be advisor-directed; on the other side are those programs that are largely focused on delivery of packaged or sponsor-directed investment management solutions.

Figure 6.15. Fee-based Program Growth Favours Advisor-centric Programs as Discretionary Gains Traction
2014 assets in billions of dollars, seven-year compound annual growth rate of assets to December 2014

<table>
<thead>
<tr>
<th>FSB Fee-based programs</th>
<th>Dec 2007</th>
<th>Dec 2014</th>
<th>7-yr growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fee-based brokerage</td>
<td>72,661</td>
<td>180,396</td>
<td>13.9%</td>
</tr>
<tr>
<td>Advisor Managed</td>
<td>26,905</td>
<td>118,924</td>
<td>23.7%</td>
</tr>
<tr>
<td>Separately Managed Wraps</td>
<td>29,828</td>
<td>41,735</td>
<td>4.9%</td>
</tr>
<tr>
<td>In-house Managed Wraps</td>
<td>8,854</td>
<td>12,204</td>
<td>4.7%</td>
</tr>
<tr>
<td><strong>Total financial wealth (in $millions)</strong></td>
<td>138,248</td>
<td>353,258</td>
<td>14.3%</td>
</tr>
</tbody>
</table>

Asset growth along this divide has dramatically favoured advisor-centric programs, which have grown from 72% to 85% of fee-based program assets over the past seven years. The biggest shift in share has been in AM programs moving from 19% to 34%; this has been at the expense of SMWs.

The mutual fund penetration in fee-based programs was traditionally lower than it was for the channel as a whole. In the past several years, however, mutual funds have gained traction within fee-based programs, most notably in the largest program; fee-based brokerage (see Figure 6.16). This highlights that growth has been strongest for funds, in an environment largely absent of embedded trailers.
Figure 6.16. Mutual Funds Gaining Traction in FSB Fee-based Programs
Mutual fund assets in billions of dollars, share as a percentage of total program assets

Fee-based expansion in financial advisor channel has been slow, but has gained speed

As is evident in the product shelf analysis, the FA channel represents advisor and practice dynamics that are very different from the FSB channel; this should be considered when assessing a move to an unbundled fee-based practice. Since 2007, market forces have not only impacted mutual fund flows and asset class distributions, but have also led to gradual changes in the way in which mutual funds are priced and the methods by which the advisors selling funds are compensated. As a result, a re-evaluation of the practice options in the channel, including unbundled fee-based programs, is currently unfolding.
Change in the FA practice model

The decline in the overall importance of deferred sales charge (DSC) or back-end load funds, among load fund options represents a significant practice-based change in the FA channel. In addition to the move away from DSC fund sales, there has been a trend toward greater pricing flexibility in the form of multiple series funds, paving the way for unbundled fee-based programs, as well as providing the basis for a negotiated fee agreement between high net worth clients and advisors at the individual fund level.

The emergence of unbundled fee-based programs in the FA dealer channel has been slow (see Figure 6.17). The results highlight the practice differences between the FA and FSB channels, where the shift to fee-based in the former reflects a move from an embedded asset-based fee to a transparent unbundled asset-based fee, while the latter reflects a move from a transparent transaction-based commission structure to a transparent unbundled asset-based fee.

Figure 6.17. Fee-based Transition Slower in Financial Advisor Channel

Assets in billions of dollars, fee-based asset share of total dealer assets

The unbundled options in FA channel are largely restricted to non-discretionary fee-based programs; on the FA-MFDA platforms, they would be mostly mutual fund-based, except in some cases where cash and deposits can be held.
The deeper product shelf potential of the FA-IIROC option has not resulted in advisors abandoning their mutual fund roots. There has, however, been a partial move to equities, including ETFs (see Figure 6.18). The presence of lower-cost alternatives to F-series, and even to HNW F-series, adds an important differentiating aspect to the fee-based value proposition which advisors can present to their clients.

Figure 6.18. Move to FA-IIROC Brings Moderate Shift from Funds to Equities/ETFs
Assets in billions of dollars

<table>
<thead>
<tr>
<th>Asset mix</th>
<th>FA-IIROC</th>
<th>FA-MFDA</th>
<th>FA-total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>3.2%</td>
<td>1.7%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>69.8%</td>
<td>93.1%</td>
<td>87.9%</td>
</tr>
<tr>
<td>Segregated funds</td>
<td>7.6%</td>
<td>4.7%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Equity/ETFs</td>
<td>17.7%</td>
<td>-</td>
<td>4.0%</td>
</tr>
<tr>
<td>Other</td>
<td>1.8%</td>
<td>0.5%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Total AUA</td>
<td>$70.3</td>
<td>$247.0</td>
<td>$317.3</td>
</tr>
</tbody>
</table>

The opening of the mutual fund dealer shelf to ETFs via a broader, industry-level solution could arguably provide additional incentive for the move to an unbundled fee-based practice there, as well. Product shelf and a clear difference in how the cost of advice is applied, such as via transaction-based versus fee-based, appears to be a key catalyst for advisors to shift to an unbundled, fee-based practice.

Fee-based is emerging in the branch advice channel, but this is not completely new

More recently, the availability of the fee-based program structure à la FSB has begun to emerge in the branch advice channel, offering the ability to hold F-series funds and, likely, deposits. However, as discussed for FSB and FA, minimums for these and MM-PPS (see below) are also high—in the $200,000-plus range.

A form of the unbundled fee-based approach, however, has existed in the branch advice channel for many years through CIBC Imperial Service’s Multi Manager Personal Portfolio Service (MM-PPS). The MM-PPS offering has provided customers with prospectus-issued pools with very low management expense ratios and a fee charged to the client outside the pool/fund structure. While not an open architecture fee-based platform, it did and does unbundle the fee from the pools’ embedded expense ratios.

With changes potentially coming in ETF operational barriers, it will be interesting to see what will emerge on the unbundled fee-based stage. Currently, despite two BA models operating on IIROC platforms, the asset focus has remained on proprietary fund wraps/high end fund wraps.
Key Findings Regarding Advisors, Practice and Channel Economics

- Advisors, practice profile and compensation models: The Canadian advisor population is expansive—over 140,000 advisors in total, of whom almost 100,000 can advise on and sell mutual funds.
  o The differences in average book size across channels results in significant differences in practice models. Compensation model differences between and within channels amplify differences in practices and product sales focus between channels.
  o The intermediated advice channel firms operate primarily direct-drive payout models which vary in terms of the level of payout to advisor. Advisors in the full-service brokerage channel typically have many branch costs covered by the firm, but have a lower payout than those in the financial advisor channel, where advisors cover the bulk of their branch costs.
  o Economics of the FSB model forces a focus on established producing advisors (average advisor book size: $99 million), while the FA channel has lower barriers to entry and far greater numbers of advisors—this results in the low average book size and challenging practice economics for many advisors (average advisor book size: $10 million).
  o Dealers and advisors operating under an independent payout model account for 14% of the total financial wealth across the BA, FA and FSB channels, but account for 30% of the mutual funds held across those channels.

- Practice models shifting from transaction-based to fee-based models: This shift has been underway across all types of firms in the FSB channel for a number of years.
  o Among FSB firms, the fee-based versus transaction-based shift poses clear differences to both advisor and client in this channel. Thirty-five percent of total assets are now in fee-based programs, up from 19% seven years earlier. A further shift is now forming within fee-based—from non-discretionary to discretionary.
  o For small-book advisors operating under an independent model, in which DSC remains prevalent, the 5% embedded payment on DSC is economically difficult to yield; fee-based platforms are uneconomical for dealers operating in the client’s name.
  o Product shelf depth and a clear difference in how the cost of advice is applied, i.e., transaction-based versus fee-based, appear to be key factors supportive of an advisor shifting to an unbundled fee-based practice.
Appendix

Methodology and definitions

The Dataset

Our dataset comprises nine years of data by mutual funds, including assets at the end of the month and gross sales, redemptions, transfers in and out and net flows for each fund.

Part of the analysis focuses on fund providers with a level of vertical integration lower than 50%; that is, mutual fund companies that have more than half of their assets under management with distributors not affiliated with them. The strong majority of these companies are either independent fund providers (most of which have no access to affiliated distribution) or life insurers (most of which do have access to affiliated distribution). The focus is on their equity and balanced funds (including funds of funds), given the large number of products, their substantial asset and net flows and their uniform trailer and commission levels. Excluded from this group are the banks, credit unions, direct sellers and Investors Group, a fund provider that is highly vertically-integrated and which is virtually exclusive to its own distribution network.

While the deposit-takers distribute approximately 18% of their funds’ assets under management through intermediated advice networks, our dataset is not sufficiently detailed to examine that element of their book of business. When relevant and possible, commentary is provided about the deposit-takers’ business with intermediaries, the conclusions of which are derived from data sourced and aggregated at the company level.

As explained in the methodology of the statistical analysis, the asset, sales, redemptions and net flows data reflects the totality of the firms’ funds, which include share classes (such as those for fee-based accounts) that do not pay trailer fees.

*Our analysis assumes that all the funds’ sales and redemption activity in the dataset are subject to the trailer fees paid by front-end load options (the higher available trailer) and that all the activity is generated in advice-distribution conduits.*

In our view, the data available does not account for all the relevant variables needed for an exhaustive and conclusive analysis. Missing are the split of sales and redemptions by load option and by fund series. Part of the sales are conducted using the front-load sales option (the one that pays the highest trailer fees and generally has no point-of-sales commissions), but also part of the sales make use of back-end (or deferred sales charge, DSC) and low load (short-DSC) options; for those two options, trailer fees are significantly lower—typically half—than for front-end load options. Similarly, while our dataset does not break out sales and redemptions by series of funds, aggregate industry information shows that series for fee-based accounts (that pay no trailers) and
high net worth series (that often pay reduced trailers) are growing rapidly for some of the best-selling mutual fund providers. Finally, not all the sales and redemptions are generated by investors in advice relationships; it is likely that the vast majority of the funds in our sample experience some level of activity in the online-discount brokerage channel and, potentially, through other direct-to-public conduits.

Most of the analysis is based on a sample of funds in the equity and balanced asset classes for the fund companies primarily using the intermediary distribution channels as their main route to reach investors (the IIROC- and MFDA-licensed advisors in full-service brokerage and financial advisory distribution conduits). In these distribution channels, there is generally a direct link between the level of trailer fees a mutual fund pays and the advisor/distributor payout—the subject of payout in the deposit-takers’ branch networks is also explored in that section.

**Mutual Fund Load Options**

Our analyses use the following terminology: *No load* funds are largely—albeit not exclusively—sponsored by deposit-takers; this group also includes fund series and pools sponsored by non-deposit-takers that are no load (generally, these series also have no embedded advisor compensation, such as F-series). The *load fund* world is subdivided into *front-end, back-end and low-load*. The *front-end* load option, also known as the initial sales charge (ISC), allows advisors to negotiate an upfront sales commission with the investor within a prescribed range (typically between zero and 5% of the amount invested). The *back-end* load, or deferred sales charge (DSC), is an option in which the fund sponsor pays the advisor a sales commission at the point of sale—typically 5% of the amount invested. Back-end load fund units are generally subject to a redemption fee over a schedule of six years, although most companies now allow 10% of the investment to be redeemed without penalty each year. The *low-load* option is a variation on the back-end load theme: The option features a shorter redemption schedule (two to three years) and a lower upfront advisor commission, customarily at 2% or 3%. A number of no load series of original load funds also exist and are growing rapidly (this includes F-series, and certain high net worth series and pools).

The timing and the level of the ongoing compensation—the so-called trailing commissions or trailer fees—that are paid by the fund company to distributors/advisors will vary depending on the load option selected. For certain load/provider/fund series combinations, no trailer commissions are paid. In the case of no load and front-end load funds, the accrual and payment of ongoing compensation to distributors/advisors typically commences at the time of the investment, and is established at roughly twice the level of back-end load funds (for example, 1% for equities for front-end load funds versus 0.5% for back-end load funds). Back-end and low-load options generally halve the trailer fee during the redemption schedule, although selected fund companies pay full (i.e. identical to the front-end load level) trailer fees in their low-load options from the first year.
Mutual Fund Multi-series

Fund companies have introduced three main share classes, each with distinct pricing, targeting particular client segments and distribution opportunities:

- **F-series:** for fee-based accounts. These series do not pay trailer fees, as distributor compensation is charged at the account level. Some fund providers have introduced F-series with a lower management fee for accounts with higher balances (more on F-series in the distribution section of this report). A total of 78 fund companies offered F-series as of December 2014 in 2,204 funds.
- **HNW-series:** for high net worth (HNW) accounts. These series are reserved for accounts with a high minimum investment (typically $100,000, but sometimes lower). A total of 55 companies offered HNW-series at the end of 2014.
- **D-series:** for self-directed investors operating in the online/discount or other direct platforms. These series have a significantly reduced trailer. A total of 12 companies currently offer D-series, but most of these companies have introduced this option recently, which is why assets in D-series account for only about 1% of the industry total.
  - Availability of D-series in the online/discount platform (OD) is also varied. Some OD firms have enabled virtually all D-series from all fund providers, and, in at least one platform, if a fund is available in series D, that series is the default option presented to investors. In some OD platforms, however, only a limited number of D-series are available to investors.

Assets in these distinctly priced series have been growing faster than the rest of the asset base in recent years. At the end of 2014, series F, HNW and D accounted for 22% of industry assets, up from 8.1% in 2004.

Market Environment Classification

To analyze the impact of the capital market directionality in fund sales and redemption, the market environment was classified into three categories: “bear” (for periods when the one-year return of the S&P TSX was negative); positive (the one-year return was single-digit and positive); and “bull” (the one-year return was double-digit and positive). While the categories are somewhat arbitrary—there is no industry standard that precisely defines bear or bull markets—dubbing “bull” periods as those during which average investment returns are above 10% annually seems sound, given that 10% or greater annual investment returns are just ahead of the 35-year average investment return of the Canadian equity index of 8.9%.

We repeated the analysis with different thresholds for the market sentiment categories and the “lag” of the net flows after the investment returns materialized and, while the amount of net flows into each period changed to some extent, the conclusion remained
unaltered: The available data shows that, in general, households direct a greater amount of new money into investment funds when the market environment is positive. This is likely driven by two main factors: a) the relatively positive economic environment and investment market return expectations; b) the economy tended to be healthier during positive market cycles and the level of employment and income were higher; these factors created the underlying conditions for the availability of higher volumes of savings available to be directed toward investment.

**Household Segmentation Data**

In the context of *Investor Economics’ WealthMINE* (a service based on household segmentation data), households are divided by age in three financial life stages:

- **Borrowers**: from the beginning of their economic life until their mid-40s. This period is characterized by the imperative to borrow and to repay debt. The main financial objective in the archetypal household is to borrow to build real assets (residential real estate), to save for post-secondary education and to pay for all the expenses customarily associated with raising a young family. Wealth accumulation is generally minimal in this life stage and is often not a high priority. In most income brackets, it is difficult to achieve, given competing priorities, and is generally limited to specific objectives, such as savings set aside for education, or major purchases and expenditures.

- **Accumulators**: from their late 40s until retirement. This is the age range during which many households typically begin to accumulate more financial assets. The debt repayment obligations and expenditures associated with the previous life stage fade and incomes tend to be higher (most individuals will reach their career summits in this life stage). Investors in this life stage can often afford taking on investment risk, particularly if they are still relatively far from retirement. Households that may have not saved enough for retirement are faced with the choice of assuming more risk in their investment portfolio or working longer to achieve their financial objectives.

- **Dissavers (or retirees)**: typically past age 65. As households move out of the workforce (be it at once or progressively), their financial needs often change considerably when compared to the previous life stages; their focus shifts from accumulation to payout and capital preservation. Legacy planning and tax efficiency are concepts that resonate loudly with this group. On average, retiree households are the demographic segment with the highest financial assets across all segments. Both in terms of assets and headcount, retirees have been (and given demographic trends are expected to remain) the fastest-growing demographic segment.
Distribution Channels

Direct delivery

Direct delivery has traditionally been comprised of the online/discount brokerage channel, 18 member firms all under the regulatory purview of IIROC, and the aggregate of various direct-to-client investment fund managers and virtual savings/banking offerings. The direct delivery channels are evolving and the scope of financial products and services available to investors through web-based platforms is widening. The introduction of technology-driven platforms has broadened the reach of financial advice, allowing firms to develop online solutions designed to tap into attitudinal elements typical of, but not exclusive to, a younger demographic segment of the investing public.

Several new online, advice-based business models have been launched in Canada by firms registered as portfolio managers with various provincial securities commissions. These will gradually appear in the online savings and direct funds channel, but in addition, online/discount brokerage firms have also introduced new, automated online wealth solutions to their shelves, expanding their presence beyond the purely self-reliant investors and traders.

Branch delivery

Branch delivery, the domain of deposit-takers (including credit unions), is, from a financial wealth perspective, split into two distinct components: branch direct (BD) and branch advice (BA). There are differences among the large deposit-takers with respect to the involvement of their branch direct sales forces in the sales process and the advice-giving prevalent with proprietary mutual funds and fund wraps. Branch direct, however, is primarily focused on day-to-day banking and savings needs.

Branch advice, by comparison, represents the deposit-takers’ best efforts in terms of the planning and investment offering to the mass affluent household segment, a segment defined via an entry point, generally at the $100,000 mark, in investible assets. The channel represents a competitive intrusion into the target-market territory of the FA channel and those FSB firms which continue to focus on the middle of the mass affluent market segments.

The value proposition in BA has expanded from an original strategy to retain deposit-takers’ clients to one of deepening the capture of their share of wallet. The approach has been to engage the client in investments, with a focus on proprietary funds and pre-assembled advice solutions. In the BA channel, both TD and CIBC compete from IIROC platforms.
Intermediated delivery

The intermediated delivery category is split between the financial advisor (FA) channel and the full-service brokerage (FSB) channel. Both channels, for the most part, share a strong entrepreneurial culture founded on a direct-drive advisor compensation model—advisors only earn a portion of what they produce. As a result of this, many of the business aspects of an advisor’s practice, outside of compliance and regulatory requirements, are controlled largely by the advisor.

While the FSB channel has increasingly targeted its services toward high net worth clients, the channel is viewed through its role as an advice/sales intermediary, its relatively open product shelf and a range of practice models that underscore a strong entrepreneurial culture. It is distinguished from both the financial advisor private investment counselors in the private wealth channel by its open architecture and its full range of product and service options. These typically include broadly focused, transaction-based practices, as well as fee-based practices that include both non-discretionary and discretionary programs.

Within the FA channel, the variety of distribution and practice models is worth noting. The distributors in the channel reflect a range of financial service businesses, as well as firm and advisor registration or licensing regimes. Several firms operating in the FA channel have opted to provide their mutual fund advisors with an alternative platform option; registration through IIROC and the use of a securities dealer platform. From a wealth-product perspective, the dealer firms are responsible for the majority of the assets in the channel. Several mutual fund dealers operate only in Quebec under the sole registration of L'Autorité des marchés financiers (AMF).

The channel is also home to insurance-only licensed distributors, through which life insurance wealth products contribute to the total financial wealth in the channel. Additionally, pure deposit brokers and scholarship plan dealers ply their trades within the FA channel.

High Net Worth Delivery

High net worth delivery is focused on the wealthiest Canadian households. Such wealth commands attention and these investors are generally guided toward discretionary money management, traditionally in the private investment counsel (PIC) business, but increasingly through discretionary brokers in the FSB channel. The channel also encompasses the deposit- and lending-focused private banking business of the deposit-takers and the assets held through the private trust business. This channel is not a focus of this report.
Online advice alternatives

Investment support propositions are emerging in the ODB channel and beyond. BMO InvestorLine’s AdviceDirect continues to operate under an IIROC exemption to provide recommended portfolios and subsequent notifications to clients when rebalancing of securities is required.

Other, more passive, approaches, such as exchange-traded fund (ETF) portfolio options with automatic rebalancing, have emerged as well. Canadian ShareOwner's Model Portfolio Service and National Bank Direct Brokerage’s InvestCube are two such examples. Notably, neither of these services provides investors with any guidance as to which portfolio is most suitable for their needs. This leaves them in the realm of self-directed investors who have long-term investment objectives and little time or desire to approach those objectives from an individual, security-picking perspective.

Robo-advice

Other online ETF and unitized wealth offerings are now available under formats generally termed “robo-advice”. Six firms are currently registered as portfolio managers, with various provincial securities commissions, to provide advice primarily through an online algorithm that performs needs assessment and recommends a portfolio without human intervention, at least initially. In Canada, an advising representative registered to the portfolio management firm assesses the veracity of the recommendation for each client and must be available to address questions, if the client so desires.

The portfolios are structured to be well-diversified, with relatively low management expense ratios (MERs) in the range of 15 to 40 basis points (bps), which is in addition to the management fee charged by the firm. Client accounts generally hold between six to 12 securities. Exposures tend to be to broad asset class groupings, with several of the firms we interviewed acknowledging the inclusion of non-traditional asset classes to provide further diversification, such as real estate and gold.

Most of the online advice firms generally design their portfolios around ETF products. While the majority of products used are passively-managed, there are a few actively-managed ETFs with higher MERs sprinkled into the mix.

Fee-based Programs

Fee-based programs are split between advisor-centric and sponsor-centric and come in non-discretionary and discretionary varieties.
Advisor-centric Programs

**Non-discretionary fee-based brokerage (FBB) programs** are advice-based programs in which clients are required to approve all transactions in the program. Using an open architecture concept, FBBs provide investors with a scaled number of trades for a fee, based on the assets held in the account. The fees are calculated as an asset class-based fee or a single blended fee, irrespective of the portfolio composition. Examples include RBC Investments Advisor and BMO Nesbitt Burns Meridian.

**Advisor managed (AM)** are full-service brokerage programs in which the individual advisor/broker is qualified through both the firm and IIROC to provide discretionary management for clients—provided a discretionary account agreement is entered into with the client. The advisor is required to have either a CIM or a CFA, as well as meeting certain experience and practice management requirements (for example, a minimum number of years in business and an established track record managing assets on a discretionary basis). Examples of AM programs include RBC Dominion Securities Private Investment Management.

Sponsor-centric Programs: Discretionary Wraps

We categorize fee-based discretionary wraps into two categories: **separately managed wraps (SMW)** and **in-house managed wraps (IHMWs)**.

Our view of SMWs includes the traditional separately managed accounts (SMAs), in which specific mandates, managed primarily by third-party investment management firms, are set up as individual accounts to which clients have separate title to the underlying securities flowing through each mandate/account.

The **unified managed account (UMA)** programs are included, for asset-tracking purposes, within the SMW category together with SMAs. However, UMAs and SMAs are distinct in several ways. Separately managed accounts, as well as mutual fund wrap programs, evolved from individual, product-focused solutions. Meanwhile, the UMA developed as a platform solution intended to deliver separate accounts and other fee-based vehicles in a single package able to address the broader investment needs of the individual client. A single platform structure, such as UMA, would therefore provide greater operational efficiency in terms of asset management, tax efficiency, reporting and clarity for clients.
The range of other vehicles that can be held alongside the separate account models in a UMA is highly varied. UMAs may include advised sleeves, which are similar to an FBB program, as well as possess the ability to hold individual mutual funds, mutual fund wraps, ETFs or individual mandates made up of mutual funds and ETFs (as can SMAs). The structures of the three UMAs currently available in Canada and of those on the drawing board all vary to a considerable extent in terms of what can be included beyond multiple separate account models.

The IHMW is principally the domain of the Big Six firms, where affiliated, well-established asset management groups can provide in-house management of a select range of investment mandates or models. These programs are typically available at a somewhat lower cost point per mandate and have a shorter model shelf than is available through the SMWs. Like the mandates on the SMA and UMA shelf, the IHMW mandates provide clients with title to individual securities in separate accounts.

Mutual fund wraps (MFW) are also part of the broader managed asset continuum, but are not part of the discretionary wrap group, and, if held on their own, do not necessarily reflect the unbundled fee structure inherent in the fee-based program structures. MFWs are certainly present in the full-service brokerage channel, but are not nearly as prevalent in Canada as they are in the U.S. among broker/dealer firms. These programs include everything from unitized fund-of-fund products to high-end fund wrap products, which can include packages of individual mutual fund products, sometimes positioned as pools. Unless available as an F-series fund and held within one of the fee-based program structures, these products carry embedded trailers.
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Analysis of Factors Influencing Sales, Retention and Redemptions of Mutual Fund Units is published by Investor Economics, a division of Strategic Insight, an Asset International Company

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