ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 36

The use of past performance in investment advertising

September 2002

What this discussion paper is about

This discussion paper:

(a) describes the aim of our project on past performance (see **Section 1**);

(b) summarises ASIC's research on relevant topics, such as consumer behaviour, the value of performance information and current marketing practices (see **Sections 3-5**).

(b) describes regulatory approaches to past performance and marketing in Australia and overseas jurisdictions (see **Sections 6-7**); and

(d) outlines ASIC's conclusions and specific proposals (see **Sections 8-9**).

We are happy to consider any further issues and proposals you may wish to raise.

The proposals set out in this discussion paper are not final policy. We expect a final report will be produced in the first quarter of 2003.

Your feedback is invited

We are seeking your feedback on the questions we raise in this discussion paper by 15 November 2002.

Your comments

Comments are due by 15 November 2002 and should be sent to:

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Contact Robert Drake on 02 9911 2665 for more information about this discussion paper.

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Related publications available from ASIC:

- Paul Gerrans and Sheree St Clair, "Managed Fund Advertising – Preliminary Report"
- Funds Management Research Centre, "A Review of Research on the Past Performance of Managed Funds"

Executive summary

ASIC is conducting a review of how past performance information is used in investment advertising and marketing. The aims of this project are:

(a) to reduce the misleading or imbalanced use of past performance information;

(b) to improve standards so that past performance information is presented in a way that is meaningful, balanced and aids comparison; and

(c) to improve consumer understanding of what past performance figures mean and how they can be used appropriately in investment decisions.

The project covers all types of financial products and services where past performance information is used in advertising, although such advertising is most commonly used for managed funds. The project looks at general marketing material, not prospectuses or product disclosure statements. The focus is also on how performance information is presented for individual funds, not for asset classes.

This paper sets out our current thinking on the issues. We welcome input from interested groups and individuals on the issues set out in the Discussion Paper, including:

(a) examples of marketing material;

(b) background material on past performance;

(c) the range of problems identified; and

(d) the proposals for future action.

During the preparation of this Discussion Paper, we consulted a range of industry and consumer groups.

ASIC's concerns

If marketing material makes misleading or imbalanced use of past performance information:

(a) Consumers may make inappropriate investment decisions, resulting in lower returns or unintended risks. In particular, both consumers and funds will suffer if consumers are encouraged to switch money to whichever sector or fund is "yesterday's hero".

(b) Consumers may be given unrealistic expectations about the risk and return of investments.

(c) An undue emphasis on recent returns will undermine efforts to educate consumers about sound investment principles. For many asset classes, a long-term view is essential.

(d) Competition in the managed funds industry may be distorted with less emphasis given to factors such as fees, risk and long-term returns.

We do not propose limiting the legitimate use of past performance information. Investors are interested in past performance and, in context, the information can be useful.

Reviews of actual marketing material

To obtain a better understanding of how past performance information is used in marketing material:

(a) we sponsored an advertising survey by Edith Cowan University. The survey covered advertisements in investment magazines between 1997 and 2001;

(b) we undertook a snapshot survey of newspaper and magazine advertising in November 2001; and

(c) we reviewed recent marketing material that had come to our attention via complaints, industry liaison and routine monitoring.

The review of advertisements identified a range of issues such as:

(a) different ways in which the detail and format of presentation can lead to past performance information being potentially misleading;

(b) advertisements that either imply a link between past and future performance or rely on the knowledge that most readers will make such a link (many advertisements focus heavily on past performance and give few other relevant facts); and

(c) various examples of good practice where companies had taken specific steps to present past performance material in a balanced and informative way.

The first issue (details of presentation) involves potential breaches of consumer protection laws on misleading conduct.

The second and third issues raise questions of overall impression and balance. There are few legal precedents on whether implications from past performance would be judged to be misleading. However, such advertisements may undermine efforts to educate consumers about sound investment principles. In contrast, the good practice advertisements would contribute positively to consumer understanding.

Consumer behaviour

Research on consumer behaviour shows that consumers rely heavily on past performance when making investment decisions about managed funds. Anecdotal evidence suggests that advisers may also rely on past performance to a significant degree – partly in selecting funds and partly in justifying their selection to clients.

Reviews of academic research

We formed a Research Advisory Committee to summarise the relevant academic research on past performance. The Committee comprised four directors of the Funds Management Research Centre[1] and was chaired by Professor David Allen of Edith Cowan University, an international expert on the subject.

The key issue is how consumers can use past performance information when making decisions about managed funds. The Committee concluded that:

(a) Past performance information is likely to lead to incorrect conclusions unless factors such as fees and risk are taken into account.

(b) Good past performance seems to be, at best, a weak and unreliable predictor of future good performance over the medium to long term. Some studies have found no relationship at all between funds' past and future relative performance. Other studies have found a weak relationship, most commonly that poorly performing funds are slightly less likely to excel in the future.

(c) The academic studies represent a "best case scenario" of the predictive power of past performance, as they use risk-adjusted measures that are not available to individual consumers.

Existing regulation in Australia and other jurisdictions

This Discussion Paper reviews standards and regulation in Australia and overseas. In Australia, the key regulation for advertising is the general law on misleading and deceptive conduct. We have recently taken enforcement action against several companies where we were concerned that marketing material was misleading in its use of past performance.

[1] FMRC is a division of the Securities Research Centre of the Asia Pacific and involves researchers from a range of universities and other organizations.

Investment and Financial Services Association (IFSA) guidelines cover several aspects of past performance presentation, but do not deal with all the issues in detail. IFSA is currently reviewing its guidelines. A significant proportion of advertisements that raised concerns were from companies that are not IFSA members and therefore not bound by IFSA guidelines.

A review of overseas regulation reveals that past performance is seen as a significant issue in many developed countries. Most comparable jurisdictions have specific rules to prevent imbalanced or misleading use of past performance information. The UK is currently undertaking a major review of regulation in this area.

ASIC's proposals

This paper sets out two proposals to address the issues raised.

A. We propose issuing a Guide on the use of past performance information in promotional material.[2] The Guide would show how to best use past performance information in a way that:

(a) avoids potentially misleading (and therefore illegal) content;

(b) aids valid comparisons between investments;

(c) assists investors to make balanced and informed decisions about investing; and

(d) helps potential investors to apply sound principles of investing.

A draft Guide is included in Appendix 3.

B. We propose consumer education activities on past performance and related issues. If appropriate, we could participate in consumer education activities with other organisations.

Several options are specifically ruled out. We do not recommend banning the use of past performance information. The Guide only relates to advertising and other promotional activity, not mandatory product disclosure requirements.

This paper focuses on advertising and other promotional material, not prospectuses and product disclosure statements.

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[2] The Australian Competition and Consumer Commission (ACCC) has produced several editions of a more general publication on misleading advertising. This has helped industry to reduce uncertainty and avoid problems.

Feedback

Comments on this Discussion Paper are welcome, especially on the content of the proposed Guide. The closing date for comments is 15 November 2002. A final report is planned for release in early 2003.

1. Introduction

Project objectives

The Australian Securities and Investments Commission (ASIC) has a broad charter, among other things:

(a) to maintain, facilitate and improve the performance of the financial system;

(b) to promote the confident and informed participation of investors and consumers; and

(c) to administer relevant laws (such as the Corporations Act and laws against misleading conduct).[3]

Our project objectives on past performance and marketing are:

(a) to reduce the misleading use of past performance information;

(b) to improve standards so that past performance information used in the marketing of investments is meaningful, balanced and aids comparison; and

(c) to improve consumer understanding of what past performance figures mean and how they can be used appropriately in investment decisions.

The overall intended outcome is to give greater clarity to industry and see fewer problematic examples of advertising material.

Project processes

We announced the past performance project in early December 2001.

To help explore the issues, we formed a consultation group to ensure expert views were available. The group provided expert information on a range of issues and ensured a variety of perspectives were considered.

The consultation croup included a wide range of industry and consumer groups. We would like to thank the consultation group members for their valuable contribution.

Comments on this Discussion Paper paper are most welcome. The closing date for comments is 15 November 2002. A final report is planned for release in early 2003.

[3] ASIC Act, section 1.

2. Background

2.1 Scope of the project

While the issues raised by this Discussion Paper cannot be considered in isolation, the scope of the project is necessarily limited. The project focuses on:

(a) products and services related to market-linked investments, not mainstream deposit or credit products (where past performance is rarely an issue);

(b) information to retail investors, not wholesale investors;

(c) material on past performance which involves a selection or interpretation process, not raw information on its own (such as market reports); and

(d) references to past performance claims and related implications about future performance, but not stand-alone predictions about future performance.

This project focuses on advertising material but not prospectuses or Product Disclosure Statements. Formal disclosure documents have extensive content, so issues of balance and presentation are often different from advertisements. In addition, formal disclosure documents have more specific legislative requirements. ASIC has a number of Policy Statements that focus on prospectuses and Product Disclosure Statements.[4] However, some of the principles discussed in this Paper would also apply to formal disclosure documents.

2.2 What is the problem?

ASIC is concerned that retail investors are being misdirected by the way past performance is used inappropriately in marketing material, such as by:

(a) presenting past performance data in a way that leads to misleading impressions about actual past performance;

(b) giving the impression that past performance should be the main or sole factor in selecting an investment product or service;

(c) giving the impression that past absolute returns are a guide to future absolute returns; and

(d) presenting past performance data in isolation from the factors necessary for a meaningful comparison.

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[4] See ASIC Policy Statement 168 (on PDS's generally) and Policy Statement 170 (on forward looking statements).

The detriment that may arise from an over-emphasis on past performance or misleading impressions includes:

(a) inappropriate selection of investments by consumers with resultant reduced returns, inappropriate risk profiles and reduced savings;

(b) short-term "churning" or over-switching between funds by consumers in the attempt to chase high returns, causing significant increases in costs and, perversely, often having the opposite effect to that sought (it tends to result in a "buy high, sell low" pattern);

(c) insufficient attention by consumers to other elements of investments, such as fees, risk and qualitative factors on investment management capability;

(d) promoters with balanced advertising suffer as money flows to other companies which are prepared to use dubious advertising; and

(e) the inappropriate promotional material undermines efforts by industry, government and the media to educate consumers on sound principles of investing.

Overall, an industry characterised by information failure such as this does not fully compete on "value added". It will be less efficient and impose higher costs overall.

3. Consumer views on past performance

ASIC has examined available research on what use consumers make of past performance figures and how they choose a fund. We are aware that other research may have been commissioned by individual companies for marketing purposes. We would welcome any additional research material, even on a "commercial in confidence" basis.

Sweeney Research

Sweeney Research conducted research for IFSA in 2001.[5] The survey was primarily about fees, but included contextual issues as well. The quantitative part of the research involved a survey of 500 investors.

Investors were asked which factors (from a pre-determined list) were important in selecting a managed investment. Most common factors were:

98%	reputation of fund manager
96%	long-term performance of investment/fund
88%	risks associated with investment
86%	fees and charges
80%	range of investment product options
76%	recommendation from financial adviser
49%	awards or star rating
38%	short-term investment.

Investors were also asked which factor (from a pre-determined list) was the **most** important in selecting a managed investment. The results were:

54%	long-term performance of investment/fund
17%	risks associated with investment
14%	reputation of fund manager
5%	recommendation from financial adviser
4%	short-term investment
2%	fees and charges
1%	range of investment product options.

5 Sweeney Research, "Fees and Charges – the Final Frontier", presentation to IFSA Annual Conference, July 2001

Chartwell survey

An English survey in 2001 asked a total of 2000 investors about their top three reasons for choosing a fund.[6] Twenty possible options were offered.

Taking into account all three choices, the results were:

58%	performance (either the fund or the fund manager)
35%	risk profile
35%	charges
32%	media recommendation
20%	recommendations from their financial adviser.

UK Financial Services Authority (FSA) research

In January 2001, the FSA commissioned research to explore how consumers use and interpret past performance data in advertisements. The research also covered the views of advertisers[7] and found that:

(a) Many consumers were unable to interpret or compare performance claims in a meaningful way, and this leaves the way open for misunderstandings.

(b) Performance tended to be benchmarked against interest on bank or building society accounts.

(c) Much of the terminology was not well understood by a majority of consumers.

(d) Small print was universally disliked by both consumers and advertisers. Consumers thought it overwhelming and unintelligible; advertisers thought it was unread and ineffectual.

(e) Consumers did not think advertisements met the FSA's objectives of being fair, clear and not misleading.

(f) Advertisers often used ads to generate enquiries for the manager with one fund mentioned as the "bait". Advertisers believed that advertisements would generate fewer enquiries if they did not include performance figures.

(g) Advertisers felt that the rules had too many grey areas, and misdemeanours should be policed more.

[6] Chartwell Investment Management Ltd, Bath.

[7] "Past Performance in Advertising Research Report", The Research Business International Ltd 2001 (report prepared for FSA)

(h) Advertisers were aware of a wide range of tactics used to present performance information in the best possible light.

Conclusion

Overall, consumers seem to put heavy emphasis on past performance when making investment decisions.

To some extent, it is intuitive for consumers to think that past performance would be a good guide to future performance. In most other areas of human experience, past patterns tend to persist. In selecting investments, it is not surprising that consumers apply (or can be lead to apply) familiar concepts such as backing recent winners.

The UK focus groups suggest fund advertising is problematic for consumers' understanding. We are not aware of any research that shows the Australian situation is significantly different.

4. The relevance of past performance information

4.1 The context of consumer choices

There are thousands of managed funds in Australia. Investment advertisements are an attempt to influence the investment decisions of consumers and their advisers.

While consumers have diverse needs, they all face a similar investment decision (the exception is people who leave the investment decision entirely to their adviser). Consumers want to select one or more investments that maximise their net return, while fitting within the constraints of their preferences, (eg risk, liquidity). They do not have the time to read hundreds of prospectuses, so information from advertisements is one way of narrowing the search.

An increasing number of less experienced investors are now participating in the financial services via superannuation and other managed funds. Such investors may make more use of simple and readily available information to guide their decisions.

While consumers will vary in their individual preferences, the issues which will generally be relevant to some degree in selecting an asset mix, product and fund manager are:

(a) risk of capital loss;

(b) volatility of investment value over time; and

(c) time horizon before moving / withdrawing investment.

Most consumers will prefer an investment they can stay with for at least three to five years (except for cash management trusts and very active investors) for a combination of reasons:

(a) Many managed funds have an entry fee (eg 4%), so there is a substantial penalty for swapping fund managers frequently. Even without entry fees, funds typically have a 0.5% spread between entry and exit prices.

(b) Most consumers do not want the inconvenience of constantly monitoring fund performance, withdrawing money and making new investments.

(c) Most managed funds have an investment horizon of five years or more (less for capital stable / capital guaranteed products).

As stated above, consumers want to select investments that maximise their net return within the constraints of their preferences on risk and other factors. As time passes, investors have the opportunity to reassess whether their current choice remains the best one for the future.

Several factors create a "near enough is good enough" situation such as:

(a) Research of real life decision making suggests consumers tend to seek a "satisfactory outcome" rather than an "optimal outcome", given the time and cost involved in seeking perfection. Expectations vary, but most people would be content if their investment was among the *better performing* of the options available and the difference from the best was not large ("better performing" could mean upper half, upper quarter, etc).

(b) The time and cost of changing fund managers means a significant gap below optimum returns is tolerated.

In summary, it can be assumed that consumers use information from advertisements to assist their decision on products and fund managers which:

(a) fit their investment constraints; and

(b) are likely to deliver net returns that are among the "better performing" options over the next three to five years at least.

Sometimes consumers make the decision personally. At other times, consumers use the information to test their "level of comfort" with their adviser's recommendation.

4.2 Performance – returns and risk

"Past performance" is a broad term. Any discussion of it requires clarity on the following matters:

(a) on which aspect of performance is being measured (eg asset class, fund manager)

(b) on what the performance is measured against (eg asset class, peers, inflation, fund investment objective); and

(c) in what context (eg stage in economic cycle, risk, fees, duration).

Returns are only one dimension of performance. The other key dimension is risk or volatility.

Different ways of using return information

Return performance information can be presented in many different ways, such as:

(a) Return figures for a particular fund in isolation using % or $ figures (eg the XYZ fund returned 25% p.a. over the past five years);

(b) Returns compared to similar funds or to an index (eg the S&P 200 index). Superiority can be shown via top quartile performance, a top ranking or beating the average by a certain percentage;

(c) Funds sometimes compare themselves to a dissimilar investment category (eg comparing a property fund to an equity fund or a bank term deposit); and

(d) Performance of both returns and volatility compared to peers (eg scatter graph).

From a consumer's or adviser's perspective, returns should not be considered in isolation. Depending on the circumstances, an incorrect impression can be created by a failure to take account of:

- fees;
- volatilty and risk of capital loss;
- time period for investor;
- stage in the economic cycle (overall or for the particular asset class); and
- taxation implications.

Relevance of risk

In considering the issue of fund performance, a brief explanation of “risk” is useful. Research shows consumers view risk (especially risk of capital loss) as a very important issue.

The investment market is based on a trade-off between risk and return. Informed investors will only invest in higher risk investments if, on average, they deliver higher returns. The most common element of risk is volatility, commonly measured by "standard deviation". Within most asset classes, the most volatile fund will have a standard deviation at least twice as high as the least volatile fund.

However, most consumers only have a vague concept of risk. The issue is becoming more complex with the emergence of derivatives and specialist funds.

The measurement of risk is discussed in more detail in Appendix 1.

4.3 Research on relevance of past performance

There are numerous academic studies on issues related to past performance of managed funds.

To get the benefit of this research, ASIC formed a Research Advisory Committee, comprising leading Australian academics in this field. The Committee comprised:

- Professor David Allen, Department of Finance, Edith Cowan University (Convenor)
- Professor Robert Faff, Faculty of Business and Economics, Monash University
- Professor Tim Brailsford, School of Business, University of Queensland
- Associate Professor Ron Bird, School of Business, University of Technology, Sydney.

We commissioned a review on research relevant to the "persistence" of past performance for retail managed funds. The central research question is: "What do common measures of a fund's past performance tell consumers about its likely future performance?" Professor Allen prepared this report, in consultation with other members of the Research Advisory Committee.

The aim of the research is to explore the *context* in which past performance information is relevant and the *extent* to which it can be used as a guide for investment decisions.

The full review is available on the Internet at www.asic.gov.au[8].

Summary of academic research

The review looked at the research methodologies and conclusions of a wide range of academic research studies:

(a) Research studies have to take account of typical consumer circumstances. Most consumers would want to hold a fund for several years at least. Swapping funds can incur significant transaction costs. Therefore, fee structures and time horizons are important factors.

[8] It is linked from the media release on the release of the Discussion Paper.

(b) The research methodology is complicated as studies need to take account of:

   (i) the differing level of risk for different funds and different asset classes;

   (ii) some funds (generally poor performing funds) are terminated during the period studied, skewing the results ("survivorship bias"). The median returns for funds surviving the whole period may be higher than for funds existing at any point in time;

   (iii) different performance measures are possible (eg against a benchmark, compared to peers, etc); and

   (iv) different time periods can be used for comparison.

(c) If a comparison of raw returns involves funds with significantly different risk levels, then a performance comparison which ignores risk will be invalid. If not adjusted for risk, a degree of persistence could just reflect that, on average, higher risk products show higher returns. This is why almost all academic studies go on to compare risk-adjusted returns.

(d) Overall, about 100 studies from the past 20 years were considered directly relevant to the research question. The review considered a dozen studies of performance using Australian data. The majority of studies examined US funds and some UK funds. Most studies looked at equity funds. The wide range of studies from the US, the UK and Australia covered various time periods, used a range of techniques and sometimes reached different conclusions. The Australian studies are broadly consistent with the pattern of overseas research.

The research review showed that some general conclusions can be drawn from the academic literature.

(a) Good past performance seems to be, at best, a weak and unreliable predictor of future good performance over the medium to long term. About half the studies found no correlation at all between good past and good future performance.

(b) Where persistence was found, this was more frequently in the shorter-term, (one to two years) than in the longer term. The longer-term comparison may be more relevant to the typical periods over which consumers hold managed funds.

(c) Where persistence was found, studies came to inconsistent conclusions about which time periods (historical and future) were correlated. The general pattern appears to be symmetrical. Short term past performance is only correlated with short-term future performance. Longer term future performance is only correlated (if at all) with longer term past performance.

(d) Where persistence was found, the "out-performance" margin tended to be small. Where studies found persistence, some specifically reported that frequent swapping to best performing funds would not be an effective strategy, due to the cost of swapping.

(e) More studies seem to find that bad past performance increased the probability of future bad performance.

(f) Performance comparisons can be quite misleading if not done properly. Returns are only meaningful if adjusted for risk/volatility or used to compare "like with like".

(g) Most academic studies look for persistence in risk-adjusted returns. These use complicated mathematical techniques beyond the reach of retail consumers and most financial planners. Therefore most academic studies measure the potential value of past performance information in the hands of experts, not ordinary consumers looking at advertisements.

There are plausible explanations for conclusions about the low persistence of past performance:

(a) Fund managers constantly strive to match the performance of competitors. If one firm is outperforming its peers, others will try to copy its methods and/or headhunt its staff.

(b) The future value of investments is extremely hard to predict accurately, so a significant part of a fund's performance (compared to its peers) may be random luck.

(c) The methods which work best in one set of market conditions will not work best at other times. For example, value and growth style managers tend to excel at different times. However, it is hard for a consumer to predict the likely market conditions over the next few years.

(d) The findings are consistent with other research which shows that it is hard for fund managers to consistently outperform the relevant benchmark.

These findings are not necessarily bad news. They suggest that funds are fairly efficient in getting access to information and copying successful techniques. The findings also suggest the market is fairly efficient in that funds which consistently give poor returns are less likely to survive.

For consumers, the findings show how difficult it is to predict which funds will do best in the future. They suggest consumers need more understanding about *why* funds are performing the way they do (ie volatility, style, economic cycles). The past performance measures currently available to consumers are generally provided without the context necessary to make them meaningful.

Research houses can use the more complicated mathematical techniques which may have greater predictive value. Even these are no crystal ball.

4.4 Fund performance and advertising

A recent US study explored the usefulness of fund advertisements as an information source for potential investors.

Jain and Wu[9] examined 294 US equity mutual funds that had advertised in *Barron's* and *Money* magazines from July 1994 through June 1996. All advertisements mentioned 1,3, 5 and 10-year performance, as required by SEC guidelines. The researchers found that the funds that chose to advertise had superior performance in the year prior to the advertisement date. On average, the advertised funds outperformed comparable funds by 6 percentage points. Average returns at the time were around 20% pa.

Not surprisingly, the study found that advertised funds attracted about 20% more capital in the post-advertisement period than comparable funds.

However, in the year after the advertisement, the average advertised funds had inferior performance. On average, the funds <u>under-performed</u> comparable funds by 0.8%.

The authors conclude:

> "The current practice in mutual fund advertisements emphasises past performance. Our results show that past performance is not associated with future results. It seems the emphasis on past performance in advertisements is misplaced."

Paul Gerrons at Edith Cowan University is conducting a parallel study looking at Australian fund advertising. The results will be available later in 2002.

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[9] P. Jain & J. Wu, "Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows", *Journal of Finance*, Vol 55, No 2, April 2000.

5. Current practices in marketing

5.1 ASIC's advertising survey

ASIC conducted a small advertising survey to get a "snapshot" of current marketing practice. This looked at newspapers Australia-wide for a week in early December 2001. It also looked at magazines in August and November 2001 – magazines likely to be read by potential investors and magazines aimed at financial advisers.

The survey revealed 43 different advertisements which had references to past performance (ignoring duplicate advertisements in different publications). These came from 27 different companies. About 60% of advertisements were in magazines likely to be read by potential investors. About 40% of advertisements were in magazines aimed at financial advisers.

ASIC also reviewed recent marketing material that had come to our attention via complaints, industry liaison and routine monitoring.

5.2 Edith Cowan University survey

Paul Gerrans and Sheree St Clair at Edith Cowan University are conducting research on the past performance and advertising of managed funds. As it relates to ASIC's past performance project, ASIC has provided partial financial sponsorship to assist the project.

A report on the first part of the research and copies of the advertisements have been provided to ASIC.

The details of the ECU study are as follows:

(a) Publications surveyed had a readership interested in investment (*Money Magazine, Shares, BRW, Personal Investor, Investment Adviser)*.

(b) The period covered was 1997–2001.

(c) The survey recorded advertisements which mentioned specific managed funds. The 507 advertisements referred to 270 unique managed funds.

(d) The research included a qualitative assessment of the advertisements.

The second part of the research (due late 2002) will include a quantitative assessment of advertised funds, comparing relative performance of funds before and after advertising.

The results of the survey can be summarised as follows:

(a) The use of return figures in managed fund advertisements is extremely common (70% of advertisements).

(b) However, information on risk – the other key dimension of performance – is rare (about 1%). During the survey period it was only found in publications aimed at advisers.

(c) There is a strong focus on recent short-term returns. Of the advertisements where only one historical measure was used, 57% had figures for the past year only. This was despite funds being on average seven years old.

(d) Despite the limitations of absolute returns for judging the performance of a fund manager, they are used frequently. Where returns are mentioned, only 58% of advertisements provide comparative information (eg with a benchmark or peers).

(e) Advertisers exercise significant discretion as to which benchmark to use with wide variation in practice.

(f) Funds are sometimes compared with dissimilar investments without any acknowledgement of relevant differences such as risk.

(g) Some advertisements show shortcomings in presentation. These cover a variety of details, but the effect is that advertisements lack important information and in some cases may be actively misleading.

(h) A number of problems were evident where new funds used performance data from some other source ("hypothetical" past performance).

The survey also noted that ratings and awards were increasingly mentioned in advertisements.

5.3 Issues arising in marketing material

The marketing material reviewed reveals a wide range of issues about how past performance is used. The following sections give examples on the key issues raised by the marketing material. These are generic examples, as the aim is to focus on the issue rather than the particular company.

Some of the issues relate to whether the manner of presentation constitutes "misleading conduct" under the ASIC Act or the Corporations Act.

Other issues relate to whether advertisements may give an imbalanced impression or omit information necessary for consumers to make a balanced comparison.

The scan also reveals examples of good practice. Some companies have taken specific steps to make meaningful comparisons.

Issues raised by marketing material include:

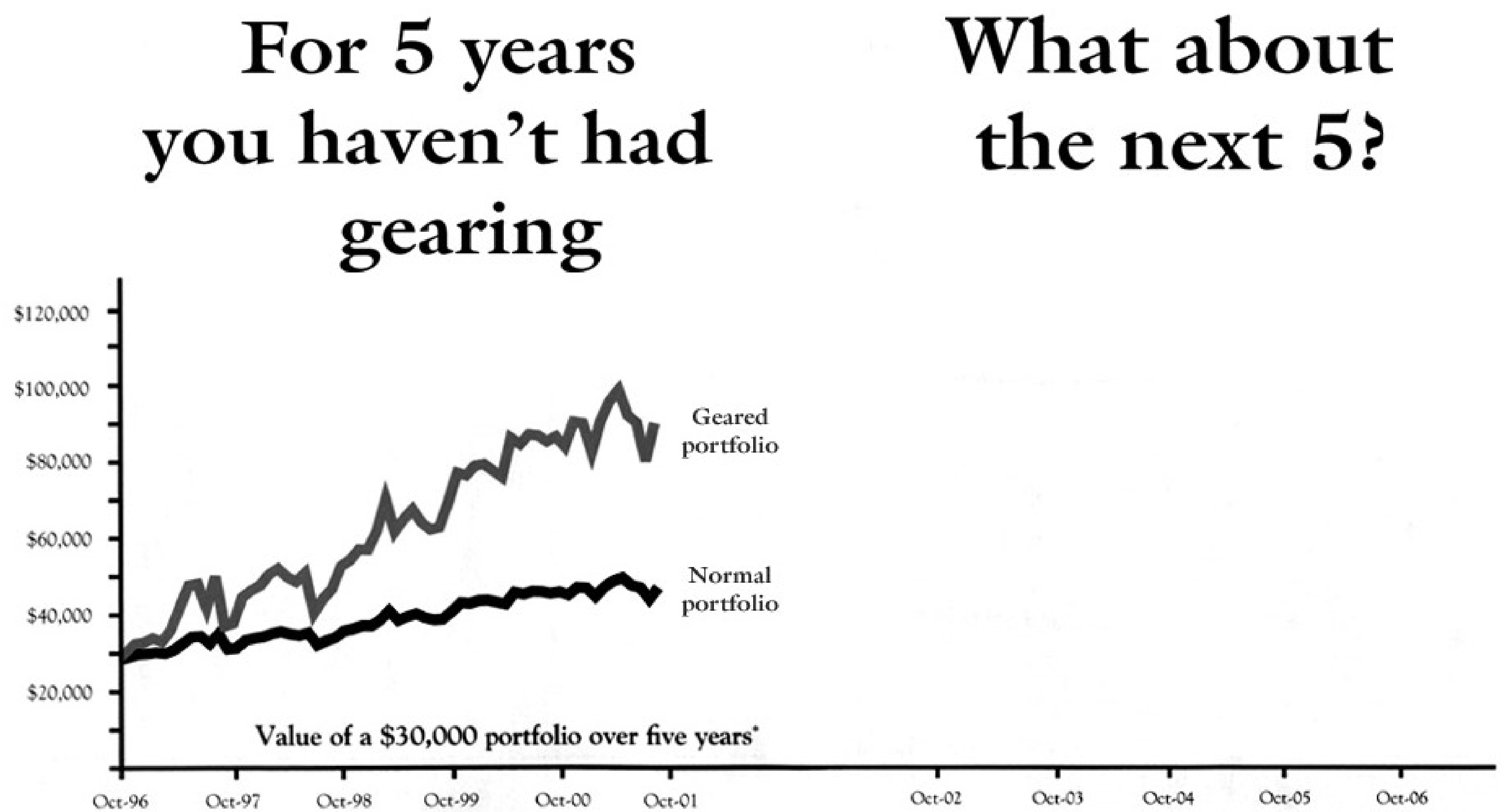
- implied link between past and future performance (including from the prominence given to past performance figures)
- promoting spectacular but atypical returns through the selective choice of periods.
- the construction of 'hypothetical' past performance figures for new funds;
- disclaimers about future performance.
- prominence and readability of small print
- returns from inappropriate or unspecified time periods
- calculation of return figures
- comparisons with related and unrelated indexes
- information on volatility and other risks
- impact on financial advice.

Issue 1: Implied link between past and future performance

A widespread problem is where an impression is created about future performance, but only through implication.

The most common instance is where a reference is made to past performance, but no direct comparison is made. It is left up to the consumer to use the information to make a comparison, but the information provided is likely to lead to an invalid comparison.

An upward trend is often implied in text. In a graph the impression is even more striking. A graph may suggest a pattern merely because of the time period selected (eg a sustained bull market).



This chart reveals the huge advantage you could have gained by using borrowed money to buy shares.

*Historical investment performance is not necessarily indicative of future returns.

Some promotions use specific scenarios to imply a pattern of growth.

> **WANT TO BE RICH?**
>
> **INCREASE YOUR WEALTH WITH XYZ**
>
> Dear Mr Bloggs,
>
> Wouldn't you like to stop hearing about other people's successful investments and enjoy that success for yourself?
>
> The XYZ Fund is one way that you could choose to increase your wealth through investments. If you'd invested $10,000 in this fund in January 1994, then invested just $200 each month, by December 2000 your investment would have grown to more than $60,000.*
>
> You too could be enjoying performance like this.
>
> ETC
>
> * Past performance is no indicator of future performance.

Some advertisements blur the distinction between past and future performance by using present continuous tense in their wording rather than past tense. For example:

> *Get a tax-effective income in a Fund that outperforms the benchmark.*

Issue 2: Promoting spectacular but atypical returns

Advertising managers seem tempted to base advertisements around whichever fund has the best short- to medium-term returns.

62% return?

It pays to get into South America

XYZ South American Fund

1 year

62% XYZ South America Fund

############################# 37% South American Share Index

2 years (pa)

############################### 40% XYZ South America Fund

#################### 26% South American Share Index

If your client is not in South America, then the XYZ South America Fund is the perfect way to get there and grow. With a one year return of 62% and a ranking of 1st place for both 1 and 2 year returns amongst South American funds, the XYZ South America Fund is a valuable investment vehicle for high growth.

Some fund managers appear to choose between their suite of funds and only advertise the fund or funds with spectacular returns.

Funds can go from being the best performing in the sector to the worst performing within 12 months. The broad principle is that what can go up quickly can also go down quickly, but these advertisements make no mention of volatility.

Issue 3: Past performance claims for new funds

It is not rare for new funds to advertise past performance. The practice of simulating historical performance for a new entity seems unique to financial services. A particular problem arises where it is not obvious that the advertised fund is new.

How to save for retirement

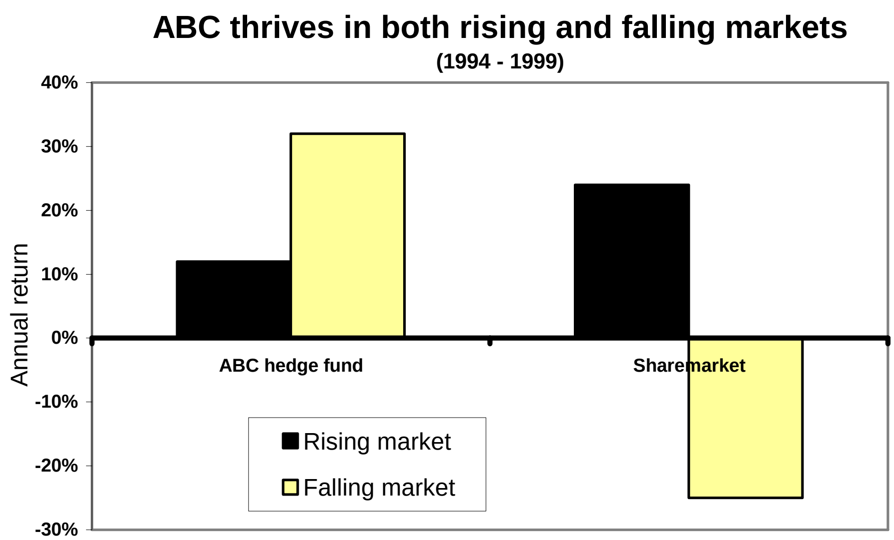
You want to invest wisely for a comfortable retirement. But how do you know which are the best funds? Consider a fund manager that has achieved high returns in the past. Returns such as the ABC Fund, which has averaged 24.7% p.a. over the last 5 years.*

* These are indicative returns based on the XYZ Growth Fund five-year returns to 1 April 2001. Past performance is not indicative of future performance.

In an example like this, the ABC fund is new, but it is attempting to copy the performance of the XYZ fund, which has been operating for many years.

It is unlikely many consumers would understand the industry term "indicative returns". Many consumers would not notice the distinction from actual returns.

A similar type of advertisement focuses on the investment strategy to give a strong implication of future performance, but gives little prominence to the fact that the Fund is new and poor disclosure about the reliability of simulated returns.



The ABC Fund can deliver an impressive return on your investment – whether the market is rising or falling. The graph shows that the ABC Fund is even more profitable in months where the Australian stock market is falling.

Research shows that in the 5 year period from January 1994 to December 1999 the QRS Fund would have achieved returns of 17.8%*.

* Past returns are no guarantee of future performance. The returns of the ABC Fund have been calculated using the actual trading results of the EFG Pty Ltd, adjusted for fees, tax, interest rates. The ABC Fund has not yet traded.

Issue 4: Disclaimers about future performance

Advertisements use a range of warnings about future performance including:

"Past performance is not indicative or a guarantee of future performance."

"Past performance is not indicative of future performance."

"Past performance is not a reliable indicator of future performance. You should not rely on past performance to make investment decisions."

These warnings are almost universally given low prominence. In many cases, the warning is contradicted by the overall message of the ad.

The warnings appear to be included to meet a formal requirement or as an attempt to avoid liability for future poor performance, rather than a genuine attempt to inform consumers.

Issue 5: Prominence and readability of small print

There are many examples of small print in advertisements.

The following example, reproduced in its original size, is an extract from an advertisement from a major fund manager:

** For the year ended 30 April 2001 Performance returns may vary. Past performance is not necessarily indicative of future performance. Performance was calculated on redemption prices (net of expenses) assuming income distributions were reinvested.*

Problems with fine print can include:

- small print size
- dense block of text
- use of capitals only, which reduces readability
- poor reproduction, especially in newspapers
- many investors are older people who, on average, have more eyesight problems (the print size takes no account of their needs).

The second broad issue is prominence. If important information is put in fine print, many readers would not read it. The use of small print sends the message that the information is unimportant. This is exacerbated where important consumer information is combined with less important information.

Issue 6: Returns from inappropriate or unspecified time periods

Promoters have a degree of discretion about which time period they select for past performance. An imbalanced impression may be created by selecting a period which shows the best past performance.

At the height of a boom in particular markets (technology, SE Asia, US stockmarket), promoters have tended to advertise recent returns (eg one or two years). When recent performance is low, promoters have tended to advertise longer term returns (eg five years or life of fund).

Similarly, a misleading impression can be created by quoting fund performance from a very short period (eg three months).

For example, a fund manager had a scrolling banner on its website indicating its new hedge fund had "Year To Date return of 37.72% annualised". When the website was observed, the fund had been operating for 10 weeks.

Some advertisements gave returns for periods which were quite out of date (eg ending six months previously).

For example, one advertisement showed a fund's performance compared to the benchmark for the year to September 2000, but it was published five months later in February 2001. Another advertisement showed that a fund was rated first over five years to February 1999, but this was published nine months later in November.

Sometimes the period is shown in the body of the advertisement; sometimes it is only revealed in the fine print. Where either the fund or market returns have changed materially since the figures were produced, such out-of-date figures could be misleading. Non-current figures also increase the opportunity to select the time period with the best performance figures.

Some advertisements give a performance figure "since inception" or for "life of fund", but don't say how long this period is. In some instances it may be over ten years, in other cases it may be a matter of months.

Issue 7: Calculation of return figures

IFSA Standard No 6 sets certain requirements for the treatment of fees in performance information. Where performance is compared to an index (eg ASX 300), no fees need to be deducted. However, when fund performance is shown in isolation or compared to another fund, ongoing fees are deducted from returns but initial fees are not.

The Australian Shareholders Association has raised the issue of whether entry and exit fees should be deducted from all percentage return figures, regardless of the period.

The omission of entry fees is understandable when showing investment performance over a short period or where the information may relate to ongoing investors. In addition, there is no method for incorporating entry fees that would not be misleading for some investment scenarios. The issue of whether entry fees should be separately disclosed is important but outside the scope of this paper.

However, the omission of entry fees from returns is likely to be misleading when dollar returns are presented, especially for "life of fund". Dollar returns are a specific scenario for a new investor (not an on-going investor) and entry fees will generally be applicable. Entry fees are a significant factor as they have a cumulative effect over time.

Some advertisements convey past performance information by using a specific scenario, such as:

> If you had placed $10,000 in the JKL fund in 1984,
> it would be worth $760,000 today.*
>
> *Entry and exit fees are not taken into account.

Where the fund has an entry or exit fee, the current "value" of the investment will be incorrect. For example, if the fund has a 4% entry fee, a $10,000 investment would be worth about $730,00 now, not $760,000. The advertisement could have presented an accurate increase in dollar terms over period without undermining comparability or the overall message.

Some of the most unusual forms of return calculations were observed in the marketing for share advice newsletters. These calculate investment "returns" assuming the advice had been followed.

Promotions for stock market newsletters demonstrated some unique practices in reporting past performance. The following are quotes from various promotions:

> "XYZ is one of Australia's most successful stock market newsletters, with 81.1% of our completed recommendations being profitable since inception."
>
> "We have a superior annualised rate of return on profitable recommendations of 206.1%."
>
> "Successful recommendations have averaged 20.6% returns."
>
> "Returns on 144 share trades:
> *Gross Return = 1,897.6%*
> *Average Return = 13.2%*
> *Gross Annualised Return on Profits = 15,521%*
> *Average Annualised Return on the 112 Profits = 138.6%"*
>
> *"Please note that annualised returns are only calculated for profits... as for losses, they are irrelevant, as it is impossible to lose more than 100% of your money, whereas you can make more than 100% on your money."*

These advertisements raise the issue of whether it is misleading to calculate a return based on profitable recommendations but excluding losses. As some of the trades are for periods as short as two weeks, the issue of whether it is appropriate to annualise such short-term trading results arises. Concepts such as a "Gross Annualised Return" would not be meaningful to many investors.

Issue 8: Information on volatility and other risks

Advertisements for a volatile or speculative investment could be misleading if they mention past performance without adequately mentioning risk.

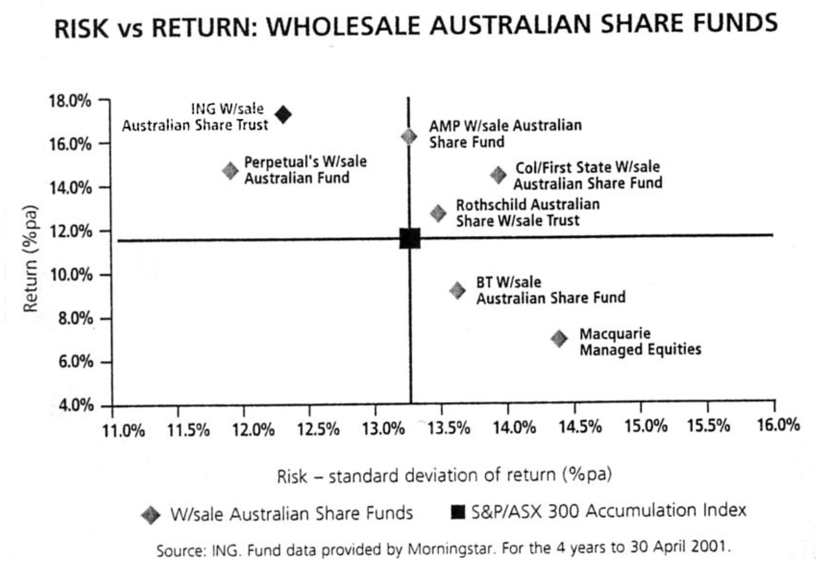
Advertisements may also give a misleading impression about the level of risk. For example, an advertisement may compare returns of one fund with returns from a different asset class without disclosing the difference in risk.

> If you're not getting 8.0% you must be losing interest.
> Invest with the ABC mortgage trust and you'll enjoy a secure return that's better than bank interest.

Another example is advertisements that feature high returns but do not disclose that the investment carries a significant foreign exchange risk. In recent cases, the high returns were partly due to the foreign exchange volatility but the advertised returns were from a period when the foreign exchange movement was favourable.

Few advertisements make reference to volatility as well as returns. Volatility information is more common in publications aimed at advisers but rare in publications aimed at retail investors.

Sometimes the information is presented as a scatter graph, sometimes as figures. The most common theme is "our fund has achieved higher returns with volatility no higher than our peers". The following is an example of a scatter graph.



We have observed different measures of volatility being used. Most presentations use % standard deviation per year, but the Morningstar database appears to use % standard deviation per month. Some use figures from just one year, others use a longer and more illuminating period.

Issue 9: Comparison with an index

Some funds compare their performance against an index which they have created themselves. This is understandable for multi-sector funds, as there is no standard benchmark. However, it does leave open the potential to create a benchmark which gives the most favourable comparison. There is no standard methodology for how to create such a benchmark (such as using the funds strategic asset allocation ranges).

Issue 10: Impact on financial advice

Some of the advertisements were in publications directed to consumers; some were in publications directed to financial advisers.

The "pitch" in some advertisements suggests promoters are trying to influence both what advisers think clients want to hear (in terms of past performance) and what clients think their advisers should be advising them.

Anecdotal evidence raises the question of whether consumers' over-reliance on past performance is affecting the financial advice they receive (eg about managed funds). Research houses and dealer groups might feel some pressure to tailor recommended product lists to fit consumers' misapprehension that an investment must have a good past record to be a credible prospect for good future performance.

In this project, ASIC is not exploring the issue of how much weight is given to past performance when professional advisers objectively rate funds or other investments. However, we are interested in whether objective selection is distorted by subjective factors that may be ill-informed.

Advisers play an important role in educating their clients and advising on sound investment principles.

5.4 Examples of good practice

The preceding discussion should not lead to a conclusion that all promotions using past performance information are problematic. Some advertisements have aspects that provide balanced and valuable information for potential investors such as:

- long-term comparisons of asset classes;
- reporting investment performance for a long period;
- comparing returns with peers or an index;
- backing up claims about sustained out-performance with relevant data;
- giving qualitative as well as quantitative data to show the factors contributing to past performance; and
- giving information about volatility.

5.5 ASIC enforcement action

Where ASIC has become aware of cases where past performance information has been presented in a clearly misleading way, enforcement action has been taken.

For example, in December 2001 we accepted an enforceable undertaking from a major fund manager. We were concerned that its print and television advertisements did not adequately disclose that the past performance figures quoted were hypothetical and in some cases may have been misleading.

In several instances, ASIC has required that prospectuses be amended where hypothetical past performance claims may have been misleading. In several other less serious cases, we have raised issues informally. The companies concerned have acted promptly to address our concerns.

ASIC also has several matters at the investigation stage where past performance information in promotional material may have been misleading.

6. Existing regulation and standards in Australia

6.1 Legal requirements

The main legal requirements governing advertising are the various provisions about misleading or deceptive conduct in the ASIC Act and the Corporations Act. ASIC Act provisions include:

> s12DA (1) A person must not … engage in conduct in relation to financial services that is misleading or deceptive or is likely to mislead or deceive.
>
> s12DB (1) A person must not … in connection with the possible supply of financial services…:
> (c) represent that services have … performance characteristics, uses or benefits that they do not have.
>
> s12DF(1): A person must not … engage in conduct that is liable to mislead the public as to the nature, the characteristics, the suitability for their purpose or the quantity of any financial services.
>
> Note: Sections 12DB and 12DF are strict liability offences. In lay terms, this means that the person's intention in publishing is not a defence.

Similar provisions about misleading conduct are in the Corporations Act covering formal disclosure documents (such as PDS's).[10] The Corporations Act also has provisions about the link between promotions and related PDS's.[11]

Holders of an Australian Financial Services Licence also have a broad obligation to ensure that financial services are provided efficiently, honestly and fairly.[12]

Some guidance to the interpretation of misleading conduct is available from case law. Most of the relevant cases involve the parallel provisions in the Trade Practices Act. Key cases include:

Energizer Australia v Gillette Australia[13] - particular hazards of comparative advertising; ineffective qualifiers.

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[10] Corporations Act, ss1041F-1041H.
[11] eg Corporations Act s734, s1018A.
[12] Corporations Act, s912A(1) (a)
[13] (2001) FCA 1887

TPC v QDSV[14] and ACCC v Target Australia[15] on the use and size of fine print, and fine print which qualifies the main message.

ACCC v Nissan[16] – Non-actual examples and use of the disclaimer "for illustrative purposes only".

CRW v Sneddon[17] – advertisement can be misleading even if corrected before any sale occurs.

ACCC v Dell Computers[18] - on the need for the price disclosed to be the full price.

GIO v AMP Insurance[19] where is was accepted that a marketing document could be misleading, notwithstanding that it accompanied a formal disclosure document that was unobjectionable.

6.2 ASIC policies on disclosure

ASIC Policy Statement PS 168 includes:

(a) a broad policy guidance on preparing Product Disclosure Statements; and

(b) Good Disclosure Principles.

It states that this guidance may also be relevant to other disclosure that consumers may receive (ie disclosure which is not in a PDS).

The Good Disclosure Principles are:

- disclosure must be timely;
- disclosure must be relevant and complete;
- disclosure must be clear, concise and effective;
- important information should catch the consumer's attention;
- where possible, the PDS should be based on a format that has been consumer tested;
- where possible, the PDS should contain information that has been personalised for the consumer; and
- disclosure should make it easier for consumers to compare financial products.

[14] (1995) 128 ALR 551
[15] FCA 25 June 2001
[16] (1998) ATPR para 1-428
[17] (1972) 72 AR (NSW) 17
[18] (2002) FCA 847
[19] (1998) 29 ACSR 584

Most of these principles also apply to marketing material.

ASIC Practice Note 60 is on updating and correcting prospectuses and product disclosure statements. This has considerable detail on when past performance information should be updated.

ASIC Policy Statement 170 is on forward looking statements.

6.3 Industry standards and guidelines

The Investment and Financial Services Association has issued several relevant standards and guidelines.[20]

IFSA Guidance Note No 1 "Australian Investment Performance Standards"

This is a voluntary standard for the presentation of information to wholesale clients. It is based on the generic "Global Investment Performance Standard".

While the standards are voluntary, there is strong pressure to comply from asset management consultants who advise wholesale clients (eg superannuation funds).

The standard requires extensive disclosure of performance on a standardised basis.

IFSA Standard No 6.00 "Product Performance – Calculation and Presentation of Returns"

This is a voluntary standard for the presentation of information to retail clients. It has much less detail and fewer requirements than the Australian Investment Performance Standards.

IFSA Standard No 10.00 "Promotional Statements and Advertising"

This standard was issued in December 2000. Compliance is required for new advertising material created after 1 July 2001. Existing non-complying material should be phased out by June 2002.

Specific provisions relevant to past performance include the following (not exhaustive):

(a) Sufficient prominence and legibility in font and size in general layout must be given to any qualifications or conditions or disclaimers.

[20] see http://www.ifsa.com.au

(b) When making references to investment performance, the methodology must be in compliance with IFSA Standard No 6.00 "*Product Performance – Calculation and Presentation of Returns*".

(c) In all statements which quote performance, footnotes are required to note that future performance of the financial product or service is not guaranteed.

(d) Any performance projections must be accompanied by the major assumptions used for the calculation of these projections;

(e) Where a financial product / investment option has been operating for less than the performance period disclosed, the experience of assets managed according to the same investment objectives and guidelines may be used to represent the performance of the financial product / investment option for the periods for which actual performance is not available, provided the basis of the indicative performance shown is clearly disclosed.

Other standards and guidelines

The Alternative Investment Management Association (AIMA) represents managers of hedge funds and similar investments. AIMA has indicated it is preparing a standard for its members. This standard will include broad provisions on misleading promotions and performance calculation issues.

Comments on industry standards and guidelines

Industry standards can be useful in encouraging good practice and offering guidance about legal compliance. However, the current role of IFSA guidelines and standards in relation to investment marketing needs to be seen in context:

(a) While IFSA members include the major fund managers, a significant number of industry participants are not IFSA members (eg mortgage trust operators) and therefore may not comply with IFSA standards.

(b) The standards and guidelines are voluntary. ASIC will be seeking information on the monitoring and enforcement mechanisms for the standards.

(c) The documents represent the industry's view of appropriate conduct. The documents do not refer to a broader consultation process (in contrast, for example, to the current Banking Code of Practice).

(d) In the standards for retail consumers and marketing, a range of issues are only covered in broad terms. Communication with wholesale clients is covered in much more detail.

7. Regulatory approaches in other jurisdictions

Most overseas jurisdictions have specific rules to try to ensure past performance information is presented in a balanced way.

ASIC has reviewed overseas regulatory approaches to past performance issues, including in

- United Kingdom
- USA
- Canada
- Malaysia
- Hong Kong
- New Zealand
- The Committee of European Securities Regulators (CESR).

Some interesting requirements from overseas jurisdictions are outlined below. Some apply to prospectuses as well as advertisements.

- comparisons of returns must clearly explain all factors necessary to make the comparison fair and which affect the conclusion (Canada, USA, Malaysia);
- an advertisement using past performance must not be selective so as to exaggerate the success or disguise the lack of success of unit trusts under the management company's portfolio (Singapore);
- "hypothetical" past returns are banned (Canada, Hong Kong, Malaysia, CESR);
- message required to the effect that " past performance will not necessarily be repeated" (UK, Canada, USA, Hong Kong, Singapore, Malaysia);
- returns must be given for standard periods (eg 3, 5, 10 years) where the fund has existed that long; additional periods are allowed (UK, USA, Canada, Hong Kong);
- any performance rankings must be over the same standardised periods (Canada, USA);

- returns for standardied periods must be up to date (eg no more than 45 –90 days old) (Canada, Malaysia, Hong Kong);
- general requirement for type sizes to be adequate (UK, Malaysia) or a specified minimum size (Canada);
- a benchmark can only be used if it is widely recognised (Canada);
- advertisements must have the prior approval of the regulator (Hong Kong);
- rankings should not be published for periods of less than one year (Malaysia);
- the use of performance figures in broadcast advertisements is discouraged (Hong Kong);
- prospectuses must show year-by-year returns (and best and worst quarter) to give an indication of volatility (USA);
- past performance information in a prospectus must include a comparison with the relevant benchmark (Canada).

The International Organisation of Securities Commissions (IOSCO) recently produced a survey "Performance Presentations Standards for Collective Investment Schemes" in member countries.[21] The survey covered both prospectuses and advertisements. For example, 13 out of 18 developed countries surveyed require standardised periods of performance in advertisements. IOSCO is considering issuing best practice guidelines on the issue.

The Financial Services Authority (FSA) in the UK is in the midst of a review of past performance information and marketing. In 2000, FSA released a Task Force report on the issue. In April 2002, the FSA released proposals to change rules on the subject.[22] These would mainly clarify the existing financial promotion rules on past performance, and the overall requirement that promotions be "clear, fair and not misleading".

The main proposals are:

(a) past performance should no longer be the predominant message in an advertisement;

(b) past performance should not be presented in any way that links it to the future performance of a product;

(c) the past performance warning should be included in the main text of the advertisement, not buried in the small print; and

[21] http://www.iosco.org/download/pdf/no_130.pdf
[22] http://www.fsa.gov.uk/pubs/press/2002/035.html

(d) the use of hypothetical past performance should be significantly restricted.

The FSA is still exploring several aspects of how past performance information is communicated to consumers. These include:

(a) researching a method for communicating the risk of a fund relative to others in the same or a similar sector and relative to other forms of investment (such as cash); and

(b) developing a model to indicate performance, price and risk in a simple (possibly symbol-based) and effective way in advertisements.

The Committee of European Securities Regulators has also recently issued proposals for harmonisation of retail business rules across Europe.[23] These proposals include issues about how information is presented to potential investors.

We will continue to monitor international developments.

[23] http:// www.europefesco.org/documents/standards/01-014d.pdf

8. Conclusions

ASIC is conducting this review because we are concerned that some past performance information is being presented in a way that is potentially misleading and/or imbalanced. Such information causes several problems, such as:

(a) Consumers may be given unrealistic expectations about the risk and return of investments. Both consumers and funds will suffer if consumers are encouraged to switch money to whichever sector or fund is "yesterday's hero".

(b) Consumers may make inappropriate investment decisions, resulting in lower returns or unintended risks.

(c) Competition in the managed funds industry may be distorted, with less emphasis given to factors such as fees, risk and long-term returns.

Misleading or imbalanced information will undermine efforts to educate consumers about sound investment principles.

The common decision facing investors and their advisers is to select managed funds which maximise their net returns but are within their personal preferences for risk, flexibility, etc.

Academic research shows that information available to consumers about a fund's past returns gives little guide to the fund's future performance. Firstly, short-term past performance information gives little indication of long-term future performance. Secondly, both risk and return have to be considered to form a valid picture. The exception is that a very poor past record suggests a fund is less likely to be above average in the future.

The low predictive value of past performance does not fit with the impression held by most investors (and perhaps many advisers). This is not surprising as the low relevance of past performance is "counter-intuitive". It goes against human experience in almost every other aspect of life where past performance is a strong guide to future performance (though rarely a guarantee).

Overall, the use of past performance information is a matter of balance.

Past performance information can be of some use to consumers and their advisers in making investment decisions, but only if:

(a) accurately presented;

(b) used in conjunction with other information; and

(c) put in context.

A review of advertising showed a range of questionable practices (some positively misleading, some merely below good practice):

(a) Many advertisements either implied a link between past and future performance or relied on the knowledge that most readers will (mistakenly) make a strong link. Many of these advertisements focused heavily on recent past performance and gave few other relevant facts.

(b) Many advertisements emphasised past returns but gave no information on risk, fees, etc. Often only short-term returns were given, even where funds had a longer history.

(c) Some advertisements made selective and sensational use of past performance figures and so undermined attempts to educate the public about sound investment principles.

The review also showed examples of excellent presentation. Some companies show long-term performance, explain risk, create achievable expectations and don't rely on fine print.

A review of overseas regulation reveals that past performance is seen as a significant issue in many developed countries. Most jurisdictions have specific rules to prevent the imbalanced or misleading use of past performance information. The UK is currently undertaking a major review of regulation in this area and has proposed tightening rules significantly.

9. ASIC's proposals

9.1 Proposal 1: ASIC Guide on the use of past performance in promotional material

We propose issuing a Guide on the use of past performance information in investment advertising. A draft Guide is contained in Appendix 3 for consultation.

The Guide shows how to best use past performance information in a way that:

(a) avoids potentially misleading (and therefore illegal) content;

(b) aids valid comparisons between investments;

(c) assists investors to make balanced, informed decisions about investing; and

(d) helps potential investors to learn sound principles of investing.

The document covers issues of legal compliance as well as describing good practice standards.

The Guide only relates to advertising. It does not set standards for formal product disclosure documents as these are a very different format and are subject to specific additional laws.

The guidelines flow directly from the problems outlined earlier in the paper. Issues covered in the Guide include:

(a) methods of presenting past performance information;

(b) hypothetical past performance;

(c) inclusion of balancing information; and

(d) information on risk.

In many cases, the proposals are modelled on provisions from other jurisdictions. However, the proposals are more liberal than the UK proposals, and less prescriptive than the US and Canadian regulations.

We have considered whether we might offer examples of "acceptable" or "unacceptable" advertisements as part of our guidance. We concluded we could not make effective use of examples in most instances as most provisions depend on context. In addition, examples could cover only a small proportion of the possible advertising scenarios.

The Guide covers some issues in more detail than others. More detail is provided on particularly problematic issues or where more specific guidance is possible. Other issues are addressed by broad principles.

We will take account of the legal guidelines when looking at potential misleading conduct under the ASIC Act and the Corporations Act.

Industry associations may enforce good practice guidelines by incorporating them in self-regulatory standards. Industry dispute resolution schemes could take account of both legal and good practice guidelines when assessing individual complaints.

Your feedback: Proposal 1

Q1.11 The Guide serves two distinct functions. It gives ASIC's view on how the broad **legal requirement** about misleading conduct applies in specific situations. It also sets out **good practice standards** to encourage investment promotions that are balanced and informative for potential investors. Are these functions useful and appropriate in an ASIC Guide? If not, how could the objectives be better achieved?

Q1.2 The Guide is written in a generic style. It is intended to apply to all financial products and services where past performance is used in promotions. It is intended to apply to all communication media and technologies. Are there any particular circumstances where aspects of the Guide may not be appropriate? If so, in what circumstances and how could this be remedied?

Q1.3 The Guide attempts to outline key factors that need to be considered when assessing whether a promotion is misleading. Are there instances where the Guide omits important factors, includes irrelevant factors or gives an inaccurate picture of what may constitute misleading conduct?

Q1.4 Do the Guide provisions cause practical problems for industry? If so, what are they and how can they be overcome while still protecting the interests of consumers?

Q1.5 Part 7 of the Guide encourages a balance between past performance and other factors in promotions. Would such a practice be beneficial for potential investors? Could such a practice be implemented in practice?

Q1.6 Sections 8.2.3 and 8.2.4 of the Guide discuss the best wording for a warning that past performance will not necessarily be repeated. Are there better (or equally appropriate) wordings to convey this message?

Q1.7 Section 9.3 of the Guide proposes that all promotions should disclose a five-year return (or period since commencement if less than five years), in addition to any other performance figures. Cash funds are excluded from this provision. Are there other specific situations where a five-year return figure would not be relevant?

Q1.8 Section 10.4 of the Guide attempts to be more specific about acceptable delays in updating performance figures. Are there circumstances where it would not be possible to incorporate performance data within three months of the end of a performance measurement period?

Q1.9 In Part 11 of the Guide a clear distinction emerges between two types of non-actual past performance ("indicative" vs "hypothetical" past performance). The cumulative effect of Part 11 is that "indicative" past performance can be used in a non-misleading way, but "hypothetical" past performance has a very high risk of being misleading in promotional material for a retail audience and should not be used.
Does this represent appropriate guidance and good practice?

Q1.10 Section 11.2.2 highlights the need for a non-misleading term for "non-actual" past performance. The most commonly used term at present is "indicative" past performance, but may confuse some audience members (eg "indicative of what?"). What is the best term to describe non-actual performance data?

Q1.11 Section 12.2 of the Guide sets, as a good practice standard, that returns should be net of fees to the greatest extent practicable. This would generally mean deducting all fees except entry and exit fees.
Are there any particular situations where the use of net returns is impractical or undesirable?

Q1.12 Part 14 of the Guide makes some preliminary suggestions about good practice in communicating information about risk. Are there any additional or alternative practices that ought to be included?

9.2 Proposal 2: Consumer education

We propose conducting consumer education activities on the past performance issue. Where appropriate, this could be done in conjunction with other organisations.

ASIC recently announced it would produce a calculator on its website to show the impact of fees and fund earnings on net returns.

Future education topics could include:

- understanding past performance in context
- understanding risk and volatility

Q2.1 We are interested in any suggestions for consumer education activity on past performance. We are also interested in information about complementary consumer education activity that other organisations are planning.

9.3 Options not considered

Several options are specifically ruled out:

- We do not recommend banning the use of past performance information.
- We do not propose pre-vetting advertisements.

9.4 Regulatory and financial impacts

We have considered the likely regulatory and financial impact of the proposals in this paper. To ensure that we have achieved an appropriate balance, we are also developing a Regulatory and Financial Impact Statement (RIS). In order for us to fully assess the financial and regulatory impact of our proposals, we invite you to consider possible options that would achieve our objectives, comment on the impact that these policy proposals might have, and in particular, give consideration to the costs and benefits of these proposals.

Any comments that we receive will be taken into account when preparing our final RIS.

A more detailed explanation of the RIS process is contained in Appendix 2.

Appendix 1. Measurement of risk

Promotions for managed funds (both advertising and Product Disclosure Documents) rarely give any measurement of risk. Some give broad statements about where the investment lies on the risk continuum.

A few advertisements have started showing the performance of a fund (versus competitors) on a volatility / returns graph. However, this is only done for the funds where the comparison is favourable (eg when returns are high and volatility is low or average).

In researching the issue, it became apparent that information on volatility is not readily available to potential investors in Australia. This contrasts with public databases in the US which provide extensive comparison and commentary on risk.

Range of Volatility within broad categories – United States
(standard deviation % per annum)

Fund category	Least volatile fund (%)	Most volatile fund (%)
Bonds	2.4	10.8
Property	11.3	23.2
International equities	9.1	32.9
Small cap funds	12.9	61.7
Aggressive growth funds	4.7	69.4

In the US, there are funds which have a standard deviation of over 100% p.a. over three years.[24] For example, the following is the pattern of returns for the ProFunds UltraOTC Investment Fund.

Year	1998	1999	2000	2001
Annual return	+185%	+232%	-76%	-69%

The average return of around 70% over four years hides the extreme volatility.

[24] For example, Nicholas Applegate Growth Equity Funds

Appendix 2. Regulatory and financial impact

We have considered the likely regulatory and financial impact of the proposals in this paper. Based on the information that we currently have, we believe that our proposals strike an appropriate balance between facilitating financial services activity and investor protection. To ensure that we have achieved an appropriate balance, we are also developing a Regulatory and Financial Impact Statement (RIS).

The RIS will address the following seven key elements:

1 Issue / problem

This will discuss the nature and magnitude of the problem.

2 Objective(s) / analysis of the problem

The objective(s), or the outcome sought in relation to the identified issue / problem, will be addressed.

3 Options / solutions

This will identify all the alternative options that could achieve the objective(s) stated above for dealing with the issue being considered (eg no specific action, ASIC guidance, self regulation and co-regulation, compliance and enforcement strategies).

4 Impact analysis (costs and benefits) of each option

Impact analysis will include:

(a) analysis of the benefits and costs of the options, including any restriction on competition for different persons affected;

(b) identification of persons or bodies affected by the problem; and those that will be affected by the solutions or options identified (ie investment promoters; competitors, consumers and government);

(c) a consideration of how each of the proposed options will affect existing law, regulations or policies;

(d) identification and categorization of the expected impacts of the proposed options as likely benefits or likely costs against each of the persons/bodies identified as likely to be affected;

We will try to quantify these effects where possible (for example, will there be any restriction on competition as a result of the proposed regulation?)

Costs to business affected by a regulatory initiative might include: administrative costs; complying with new regulatory standards; delays etc.

Costs to consumers affected could also include higher prices for products and services or reduced utility of goods and services.

(e) benefits of the options will also be identified (even where they are not quantifiable); and

(f) the data sources used and assumptions made in making these assessments will be identified.

5 Consultation

The consultation undertaken in the policy process will be detailed.

6 Conclusions and recommended option

The preferred option(s) will be given, and reasons why.

7 Implementation and review

This will discuss how the proposed option will be administered, implemented, or enforced.

In order for us to fully assess the financial and regulatory impact of our proposals, we invite you to consider possible options that would achieve our objectives, comment on the impact that these policy proposals might have, and in particular, give consideration to the costs and benefits of these proposals. Where possible, we are seeking both quantitative and qualitative data.

Any comments that we receive will be taken into account when preparing our final RIS.

Appendix 3. Draft Guide

DRAFT FOR CONSULTATION

ASIC Guide on
the Use of Past Performance
in Promotional Material

September 2002

