The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
E-mail: comments@osc.gov.on.ca

OSC Consultation Paper 81-737 – Opportunity to Improve Retail Investor Access to Long-Term Assets through Investment Fund Product Structures

Thank you for the opportunity to comment on this scheme.

<u>Summary</u>

This scheme will benefit the investment industry through high fees without providing commensurate benefits to investors.

<u>Comments from other interested parties</u>

I have read the submissions by Kenmar Associates, CARP, Tim Carter and Eva Krasa. They criticise the proposal and question whether there is any benefit to individual investors. In the event that the Ontario Government is determined to provide even more wealth to the investment industry by going ahead with the scheme, they recommend a number of essential improvements to the protection for smaller investors. I agree with their comments and will not waste your time by repeating them.

I am an expert recognised in both courts and the public domain. I have been investing in equities for myself and my family successfully for 50 years. I have high risk tolerance and I have the level of assets that I could reasonably afford to invest in these illiquid instruments. I would never do so. They will never provide value to overcome the large fees and liquidity problems. Most of the people who have the money to buy them are older, like me, and the risk of estate problems is alone enough for me as a financial planner to advise against them.

Instead of more comments supporting what you have already seen, let me discuss this proposal from a viewpoint of financial economic theory.

Financial Economic Theory and Illiquidity

A basic principle for investments is that broad diversification is required. It reduces risk without sacrificing the average return, since no-one can know which specific investments will prosper and which fail. Risk for a specific investment is thus measured by how much the investment will affect the risk of a diversified portfolio and how much return it will add.

The claim apparently is that there is a large liquidity premium hidden in these illiquid investments. The research is evidence is mixed, but in truth it is impossible to determine the liquidity premium on a risk-adjusted basis. The way a researcher does it is to adjust the return on the illiquid investment by using a benchmark portfolio. As Roll showed conclusively in 1978, this result is always ambiguous because there is no universal portfolio of all investment assets. Choosing different perfectly reasonable benchmarks will give different results. You cannot unambiguously conclude that any specific asset or portfolio outperforms on a risk-adjusted basis. Academic researchers carefully avoid admitting this because it takes away a major part of their research.

Does the illiquid asset reduce the risk of the portfolio enough to justify the high fees? This question is also unanswerable because the illiquid assets are not traded and hence we can't unambiguously measure their correlation with the broad market index, which itself ambiguous. We can discuss the basis of the assets and perhaps conclude they are particularly valuable because they are negatively correlated with the rest of portfolio, a claim often made for holding gold. As long as the illiquid asset is not perfectly correlated with the rest of say a broad market portfolio, adding some illiquid asset will reduce risk a small amount. But to justify the high fees that reduce the expected return, the correlation must be low or negative.

What are possible illiquid assets? Let me posit four big ones:

- Real estate. Since the investor almost certainly already has personal real estate, and could buy REITs already, an illiquid portfolio of real estate will not help reduce overall portfolio risk.
- Infrastructure. This has a low market risk and therefore is probably not correlated highly with a market portfolio. It might justify the fees, but we observe that the big pension funds have already figured this out and so anyone in one of the large funds, including CPP, already implicitly holds infrastructure.
- A portfolio of high risk personal loans. Do I need to mention the crash of 2008-09? These loans are not highly correlated with each other, but they are strongly correlated with the general economy and hence with any market portfolio. They would likely increase the risk when added to a market portfolio. Plus they provide the creator of the portfolio with a large incentive to cheat on the risk profile and loan approval process.
- Farmland. I don’t think we have any idea how to deal with the complex issues this creates, including the need to protect farmland from urban encroachment. Some provinces already prevent further foreign ownership of farmland.

The claimed benefits of making these illiquid assets available to small investors are therefore largely illusory, and the various problems and risks that others have already written about are not overcome by some promised great return or risk reduction.

The sensible way to achieve the objective is twofold. First, create a broader requirement for Canadians to have employer pensions. The CPP expansion was a good idea, but we need more because so many Canadians now have only CPP and OAS in the future and they must save more to achieve long retirement goals. The Australian Superannuation system is one example. The second part is already in place. The huge pools in the pension plans like CPP, Ontario Teachers PP and OMERS are already heavily invested in illiquid assets. They have the expert staff to assess them properly, the scale to handle the illiquidity and the scale to benefit from the diversification, all at a much lower cost to the investors.

Chris Robinson PhD CFP$_{\text{retired™}}$ CPA,CA
Professor Emeritus of Finance and Senior Scholar, York University
Fellow of FP Canada