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SUMMARY OF THE STUDY

QUALITY OF KEY INVESTOR INFORMATION DOCUMENTS FOR INVESTMENT FUNDS

An analysis of the content of 40 key investor information documents from Austrian investment companies to determine whether they are complete and understandable

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1. Introduction

The features of investment products for small investors are increasingly complex and there is huge diversity of widely varying products based on securities, insurance and savings. It is factually impossible for consumers to gain an overview of the major aspects of a product from conventional promotional literature and prospectuses. For this reason, the AK demands that there be an "information leaflet" for all savings, insurance and investment products and that it be handed out to consumers in a timely fashion before they enter into the contract. Investment funds already have an information leaflet of this type that covers all key points of a fund. It has been mandatory since 2012 to hand out this key investor information document, or "KID" for short, to interested investors in a timely manner prior to their purchase of fund units. The KID is the first set of succinct information precisely defined by law. It is intended to enable investors to conduct a product comparison of investment funds prior to signing a contract. Content, format and structure are all stipulated, along with clear and understandable language.

The AK investigated whether Austrian investment companies have implemented the new provisions on key investor information documents and if so, how. The AK also determined whether the key investor information documents satisfy the requirements an information leaflet needs to meet.

The AK Study is divided into two parts or two lines of inquiry, which can be read separately:

Part 1: How complete are the key investor information documents?

This part of the study presents the analysis of 40 selected key investor information documents **from 10 Austrian investment companies**. The study team determined whether these documents did indeed contain the major points to be included (description of the fund and the investment company, objectives and investment policy, risk category and information on risk, recommended terms for holding investment, actual charges and information on charges, fund prices, additional information, charts) .

Part 2: How understandable are the key investor information documents?

The second part of the study presents the results of the analysis of how understandable the key investor information documents are. To this end, 20 KIDs were analysed and tested based on objective criteria such as sentence length, word length, and number of passive constructions. The study team applied the Hohenheim Index, which allows texts to be evaluated according to scales. In brief, the overall indicator provides information on whether or not a text is understandable. The AK also investigated the layout of the documents and its impact on the readability of information.

2. Results

2.1: How complete are the key investor information documents?

General remarks and flaws in the KID Regulation[1]

All 40 key investor information documents analysed had the legally prescribed length of (at most) two A4 pages. The content largely complied with the KID Regulation (headings, standard text passages, order of contents) but the analysis revealed **a few inaccuracies in formal specifications**, for example, an incorrect International Securities Identification Number (ISIN) or percentages missing in the bar chart.

However, the analysis also uncovered several **major informational deficits,** some of which resulted from insufficient provisions in the KID Regulation. All told, their effect was to make it largely difficult or impossible for the KID to serve its intended function of facilitating simpler comparison of investment funds prior to the signing of a contract.

In its present form, the KID is highly limited as a suitable tool for fund selection. As shown by experience – and by this analysis of 40 KIDs – **the investment companies devote most of the space in the KIDs to overly general explanations** without actually delving into the features of the investment fund. One main reason for the lack of

[1] COMMISSION REGULATION (EU) No. 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website, ABl L 176

concrete information is the **KID Regulation** itself. It prescribes myriad explanations and statements that have to be replicated word for word.

This shortcoming applies to the information to be given on performance but also on risk categories **not** covered by the synthetic risk and reward indicator. This information approach is hardly expedient from the standpoint of average investors. The KID Regulation contains too many provisions that are excessively “soft”, leaving leeway for interpretation on matters such as the inclusion of certain categories of risks (the Regulation qualifies inclusion as follows: *…where these are material).* There are too many statements the Regulation prescribes word for word and the KIDs subsequently incorporate formulaically. From the perspective of investors, the big disadvantage is that space is lost for concrete, specific information on the investment fund. This drawback was especially evident in the formulaic wording used for risk categories in the 40 KIDs. By contrast, the verbalization of volatility risk was altogether lacking although this risk is certainly worth mentioning.

Objectives and investment policy

The KIDs contained many phrases that were quite vague. There were also several striking incidents of contradictory explanations (for instance on derivatives). Many sentences raised questions, for example the passage noting that the fund undertakes a “*reasonable diversification of risk*”. There were a large number of vague formulations. Investors cannot glean any information from sentences such as these: *“Strives to achieve regular profits as an investment objective”* or *“Further, shares of other companies with business interests in Russia, in the reformed countries of Eastern Europe and in Turkey can be purchased*.”

The **information was especially sparse in KIDs for bond funds**: There was no indication as to whether the bonds were issued by corporations, governments or other parties. In addition, the 40 KIDs examined did not contain criteria crucial to the selection of assets. This shortcoming might be attributable in part to the KID Regulation itself, which relativizes the duty to provide information under “*Objectives and investment policy”* with these words: ***"so long as it is relevant.”***

Presentation of the risks and possible rewards

All 40 KIDs did depict the **volatility risk for the fund** with a seven-level synthetic risk and reward indicator as required, but this central risk was not further verbalised or elaborated upon. The required reason for a given categorisation was also almost always missing. Instead there were many risk statements describing the risks **theoretically** and rhetorically yet failing to refer concretely to the fund. The KIDs listed many different risk categories but the **wording they used was too formulaic and they failed to delve into risks specific to the fund**. The synthetic risk and reward indicator visualised the volatility risk by classifying volatility on a seven-level scale. The KID Regulation stipulates that additional risks **not** presentable on the scale be verbalised. This provision has the following consequence: Readers of the KID can probably hardly form an opinion about the **risk profile of a fund** if they have to **“mentally augment”** the vaguely **verbalised risks** to arrive at a quantifiable volatility risk.

The practical examination of 40 selected key investor information documents revealed that a large number of risk categories were listed and that some of the indicated risks went beyond the risk categories explicitly named in the KID Regulation. The risk categories in the KIDs examined in the study raise more questions than they give answers, however. Here are a few examples: The KID Regulation requires that *operational risks* must be indicated but only *"where these are material"*. When investors read the cryptic information that *"risks* [could occur] *in connection with the management of assets"*, they ask themselves what the concrete management risk might be for this particular fund. If an investment fund provider mentions *"price risk"*, the question arises as to how it differs from volatility risk, which by definition must be shown on the seven-level risk and reward scale. According to the Regulation, risks **not** captured by the synthetic risk and reward indicator must be included.

Another striking aspect was that the risk presentation (under *Risk and reward profile*) **devoted the most space to risks *not captured by the indicator***, thereby undermining the meaningfulness of the indicator, visually and substantively. A similar weakness was that many equity funds were given a risk and reward rating of 7, but this (highest) volatility risk was elaborated upon neither under *Objectives and investment policy* nor anywhere else in the two-page document except in the scale of the synthetic risk and reward indicator. Information on the highest risk (and the potentially highest reward) appeared in the document but was not elaborated upon anywhere. Instead a number of risks not covered by the risk and reward profile were explained. **Contradictory impressions** also arose for funds with a relatively low risk rating. The risk information that was verbalized was very extensive in scope. In taking up so much space, it overshadowed the risk indicator in the bar chart.

Presentation of charges

Entry and exit charges were indeed indicated as maximum values as required in the KID Regulation but were **not** included in the presentation of performance. Moreover, 32 of 40 KIDs contained the unclear formulation: "*Transaction costs are not part of ongoing charges.*" Four of the 40 KIDs had this incomprehensible or non-assessable sentence: "*Transaction costs are **partially** included.*" In addition, not a single KID contained a concrete figure for transaction costs. The provisions in the **KID Regulation are insufficiently binding** on this point. Portfolio transaction costs must be indicated (as per "*Objectives and investment policy*") "…*where the impact of portfolio transaction costs on returns is likely to be material due to the strategy adopted by the UCITS..."* This provision gives quite a bit of leeway to the producer of the KID or the investment company.

Moreover, there were remarks that contributed little, especially the one that transaction costs were ***partially*** included. When reading sentences like these, investors are left with a justifiable question: How high are the transaction costs and what impact do they have on returns?
All 40 KIDs indicated entry and exit charges (usually indicating they are 0), but for the good of investors, there should be at least a representative calculation showing the concrete impact entry and exit charges have on returns. Moreover, **there is no indication anywhere** that the bank might impose **custodian charges**.

Past performance

The **presentation of past performance is not ideal.** The bar charts used in the 40 KIDs to depict past performance as specified in the KID Regulation lacked bench-

marks for the indicated percentages. Moreover, font sizes were illegible in some cases and the scale selected varied greatly. As a result, **it was hardly possible to make a comparison, particularly a direct visual one**.
Another point of criticism is that there was no basis of reference for any percentages. The Regulation only stipulated that a label be added to each bar "*indicating the return in percentage that was achieved"*. In other words, readers were unclear on the reference value (base value, benchmark) for the past performance indicated.

Apart from the above objections to the appearance of the charts in many of the KIDs (scaling), the presentation of *past performance* (as a bar chart) **lacks discriminatory power** also because the **entry charges (and any exit charges) are not incorporated in the calculation**. The KID Regulation is obviously too vague in this respect too: The provision stipulates that the bar chart be supplemented by a statement indicating "*briefly which charges and fees have been included or excluded from the calculation of past performance."* This is not sufficiently binding and ultimately results in not (all) costs being included in performance. In summary, the term "*return*" can also be considered too vague. It does **not** refer to an investor's return because it does not include the exit charges but also other possible costs of a securities deposit account that can be incurred.

Recommended term for holding the investment

The recommended term for holding units in the UCITS required by the KID Regulation **has no visible correlation for investors with the risk categories**. One example by way of illustration: For the funds with a risk rating of 3, the recommended term for holding units was 3 to 8 years. A fund rated 7, the highest risk category, had a shorter recommended term (7 years) than two funds rated 4 and 5 (each with a recommended term of 8 years). That means the principle of the higher the risk the longer the (recommended) holding term was not in evidence. One KID contained no information about the recommended term for holding units.

2.2: How understandable are the key investor information documents?

As stipulated in the KID Regulation, the language in the key investor information documents themselves must be clear, succinct and comprehensible. Jargon should be avoided and technical terms should be dispensed with wherever everyday words can be used instead.

The purpose of key investor information documents is to explain the product to investors in an understandable way. The analysis showed that KIDs (still) miss the mark in terms of readability and comprehensible text.

- None of the documents analysed can be classified as comprehensible. On average, the documents had a value of **6.02** on the Hohenheim Index[2], **somewhat**

[2] The Hohenheim Index measures the degree to which texts are formally understandable based on various readability formulas and other criteria important to a text being understandable. The scale for the Hohenheim Index ranges from 0 (very difficult to

more than half of the desired value. The desired value for documents of this kind is 10. The best KID scored 8.12 and the worst, 4.26.

- The sentences are much too long in general. Readers have a harder time understanding long sentences. A limit also suggested in the CESR Guidelines stipulated 25 words per sentence[3]. Altogether, **one in every ten sentences** had more than 25 words and was therefore too long and difficult to read. The longest sentence had a remarkable 93 words! A further example:

  > "In reference to the fund regulations approved by the FMA, it is noted that for [redacted] securities or money market instruments from the following issuers may be purchased in an amount equivalent to more than 35% of the fund assets provided the fund assets are invested in at least six different issues, whereby the investment in one and the same issue is not allowed to exceed 30% of the total fund assets: Federal Republic of Germany, French Republic, Republic of Austria, Kingdom of the Netherlands."

- In addition, the sentences are too **convoluted.** Additional nested constructions increase the complexity even more.
- **Technical terms and foreign words** occur too frequently in the documents. Technical language should be largely avoided in the KIDs. According to the Investment Fund Act [4] readers should be able to understand the KIDs without resorting to further documents. "Hedged", "denominated", "asset allocation" or "maturity segment" are hardly terms that interested investors can understand.
- **Monster words** comprising more than 17 characters occur frequently. Many could be reworded. Examples are: Due diligence violations (in german: Sorgfaltspflichtverletzungen), investment possibilities (in german: Veranlagungsmöglichkeiten) or payment obligation (in german: Auszahlungsverpflichtung).
- In all cases, the **font used is too small** and therefore very difficult to read. In 18 of 20 cases it is only 8pt. This problem becomes all the worse if the document also has just one column.
- Most documents contain far too many passive constructions. On average, **one in every three sentences** is written in the passive voice. This is not a criterion for a text to be understandable per se, but passive sentences create distance with the reader and seem impersonal.
- Several documents were well structured, utilising multiple columns, paragraphs and enumerations. Many of the KIDs examined seemed quite unstructured, however.
- The number of characters varied substantially among the documents, a fact all the more surprising considering that the length of document is limited to two pages. It is interesting in any case that several documents managed to produce under-

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understand) to 20 (very easy to understand). Dissertations are usually 4 on this scale whereas simple newspaper articles can be 18.

[3] Source: CESR's guide to clear language and layout for the Key Investor Information document, http://www.esma.europa.eu/system/files/10_1320.pdf

[4] § 135.2.2 Investment Fund Act (InvFG): "The investor must be able to understand these essential elements without having to resort to additional documents to do so."

standable information using only a few words. T**he four KIDs with the best values** on the Hohenheim Index **had relatively fewer characters on the whole**.

3. Demands from the Chamber of Labour

- Provide **consumer-oriented numbers to present past performance**; in particular, use representative examples (with amounts in euros) and include the entry and exit charges in the calculations.
- **Indicate complete costs** including the costs for active fund management and transaction costs and show how costs reduce returns.
- Develop logical **standards for** (recommended) **terms for holding** units in the UCITS and give further explanations (or reasons) in the KID for these holding terms.
- **Be specific about individual risks** and how they might affect the value of the fund. Verbalise the volatility risk in addition to providing the synthetic risk and reward indicator.
- **Give clear, understandable information on the use of derivatives** and the risk associated with them. Clearly state when derivatives are used for hedging or as an “active investment instrument” and if the latter is the case, indicate what impact this has on the reward and risk.
- Implement more fully the specifications in the KID Regulation as regards readability and understandable text in the KIDs. **Render the text more comprehensible** with shorter sentences, bigger font sizes, active voice (i.e. avoid passive constructions), use two-column text and improve layout with enumeration, columns, paragraphs, and highlighting.
- **No abbreviations, no jargon, no foreign words:** There is too much jargon and unclear language in general. For one thing, there are too many abbreviations (VT, A, T, PKG) and sentences that provide no information. In some cases, it is unclear to which fund category a fund belongs despite two A4 pages covered with fine print. “Investment fund”, diversification or other frequently used, seemingly self-evident terms should also be explained. Technical language and foreign words should be replaced with terms that are generally understandable. It could also be helpful to add a glossary to the KID.
- Instead of awkward formulations, use more **graphic design elements**; in particular visualise the “Objectives and investment policy” with **pie charts** that make the composition and orientation of a fund (as regards instruments, sectors, countries) evident at a glance. Another desirable step would be to indicate the three largest securities in each category (equities, bonds, funds, derivatives, cash deposits), the three securities with the greatest volatility including their share in the fund assets.