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Portfolio Strategy

The art of risk management

In the first of a three part series, Didier Saint-Georges, managing director and member of the investment committee at Carmignac, takes a closer look at why managing 'unknown' risks may be far easier than trying to predict them

Didier Saint-Georges

Asset managers and entrepreneurs have one thing in common: the odds are stacked against them. A simple look at the average returns of actively-managed funds, or the failure rates of start-ups, reveals just how self-assured asset managers and entrepreneurs have to be. They take such bold steps because they believe that the future, with all its uncertainty, contains not only perils and challenges, but also – and for those very reasons – lucrative opportunities, provided they can figure out how to navigate the associated risks. Knowing which risks to take is the most difficult thing about investing in financial markets, just as it is about starting a new business. But risk-taking is what both asset management and entrepreneurship are all about.

Yet newspapers often claim that investors don't like uncertainty – are they wrong? Yes and no. While some journalists may not necessarily be aware of the difference between risk and uncertainty, US economist Frank Knight explained it as far back as the 1920s. He defined risk as an uncertainty that can be quantified. Whereas uncertainty has to do with pure chance, risk relates to probabilities, which can be measured. And if you can measure an uncertainty, then you can deal with it and put a price tag on it – so that you can subsequently buy, sell or even insure against it. Investors don't like uncertainty unless they can turn it into a risk that can be managed.

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Strategies

The catch is that stockmarket uncertainty cannot be easily tamed into a quantifiable, benign risk. Investors must map out strategies using probabilities that are unreliable more often than not. Earnings estimates and economic data come with a margin of error, which could in itself be erroneous. Economics describes the past, not the present; we find out only in the next quarter how much an economy grew in this one. And even these figures can be revised many times over. Managing risk therefore means navigating a world of possible outcomes where actual figures are elusive.

Market risk sometimes takes a more dramatic turn. From a long-term perspective, the trend in stockmarkets is undeniably upwards. The MSCI World index has gained 380% over the past 30 years. So it would make sense to bet that stockmarkets will continue to rise, since throughout history economies have been growing most of the time (there have been only 11 recessions in the US since 1945). And stockmarkets tend to follow GDP growth over the long term.

But most of the time is not all of the time, and the difference can cost investors dearly. It is easy – very easy – to lose a fortune in the markets. When events suddenly prove the consensus wrong, the adjustment to what should be the 'right' market prices can be brutal. That is what happens when asset-price bubbles pop.

Investors who take a stoic approach, with their eyes firmly fixed on the long term, are not making the best choice. That is because such an approach exposes them to sharp market downturns, which can considerably handicap wealth creation over time. If we look at the S&P 500 over the past 20 years, its five worst-performing months (out of a total of 240), have together deprived the index of half its gains. And today, 25 years after Japan's stockmarket bubble burst, the Nikkei index is still 50% lower than where it was at the end of 1989.

Effectively managing the risk of such major events is therefore essential to generating adequate long-term returns. Fortunately, these kinds of events are rare. But for this very reason, they slip past analysts' statistical models, meaning they will catch investors by surprise. What is more, the trend reversal when investors suddenly realise the consensus got it wrong sometimes turns out to be nothing more than a broad change of opinion – which could change again.

Black swans

False alerts and wild gyrations are hallmarks of stockmarket behaviour. And 2016 was a case in point. Three major political events – the Brexit vote, the US presidential election and Italy's referendum on constitutional reform – which shook the markets in rapid succession, illustrated how fickle investors can be. On three separate occasions, for a few hours, or even a few minutes, they seemed certain of one outcome and the ensuing new risks – only to rapidly change their minds.

A solution to effectively manage these 'black swans', to use the expression coined by Nassim Taleb, could thus lie in a change in tactic: in lieu of focusing on managing 'unknown' risks by trying to predict them, a more effective approach could be to create the conditions to successfully handle them as they materialise. Contrary to popular opinion, managing these 'unknown' risks is far easier than trying to predict them.

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TOTAL RETURNS (MONTH END as of 12/31/2015)	Fund %	Index %	IA sector avg %
1 Month	0.64	0.52	-0.44
Year to Date	15.95	7.26	4.46
1 Year	15.95	7.26	4.46
3 Years Annualised	-	-	-
5 Years Annualised	-	-	-
10 Years Annualised	-	-	-
Since inception (annualized if >1y)	16.87	13.90	11.87

Past performance is no guarantee of future results.

Top 10 Holdings Fund – U.S. Equity Leaders	**%**
Amazon.Com Inc.	6.9
Facebook Inc-A	5.8
Visa Inc-Class A Shares	5.3
Cisco Systems	5.2
Oracle Corp	4.7
Monster Beverage	4.3
Alibaba Group Hldg Adr	4.0
Qualcomm Inc	3.8
Coca Cola (The)	3.7
Procter & Gamble Co/The	3.4

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