WOLFGANG FICKUS, CFA

MANAGING PORTFOLIO RISK AND RETURN
AIMING TO AVOID A KNOCKOUT

SUMMARY

- A crisis such as the Covid-19 pandemic is the ultimate litmus test for any portfolio risk management
- Financial services have long relied on standard risk models based on tested assumptions and past performance, according to which alpha generation is considered as an anomaly
- Comgest's way of managing risk and return is at odds with these models as we have a Darwinian approach to portfolio construction anchored in deep economic moats

Wolfgang Fickus, CFA
Product Specialist

It was boxer Mike Tyson's first defeat in his 38th professional fight[1]. He'd successfully defended his heavyweight title nine times. For nearly five years, Tyson had ruled heavyweight boxing with knockout after knockout and was widely regarded as being indestructible, even invincible. All of that changed on the night of 11 February 1990 in Tokyo when Tyson, and his mythical image, came crashing down. Challenger James "Buster" Douglas knocked Tyson down and out in the 10th round – capturing Tyson's championship belt and boxing history.

Just as no one saw Tyson's knockout coming, neither did Wall Street when Lehman Brothers, the venerable brokerage firm, filed for bankruptcy on 15 September 2008[2]. It was a collapse so unthinkable even the U.S. Federal Reserve didn't foresee it. In February 2008, Ben Bernanke, the Chair of the Federal Reserve, gave his semi-annual testimony before the U.S. Senate Banking Committee and noted that while there may be failures among smaller banks in the wake of the 2008 financial crisis, he "[didn't] anticipate any serious problems of that sort among the large internationally active banks …"[3]

Nevertheless, only a few months prior, Lehman's annual report for the 2007 financial year had offered 28 pages of elaboration on their risk management and business and geographical diversification, the "mother" of all risk reduction strategies. Their report noted "quantifiable risks using methodologies and models based on tested assumptions" and goes on to "measure the diversification benefit within our portfolio by historically simulating how the positions … would have behaved …".[4]

— **Are tested assumptions, based on past performance, a safe way to quantify risk?**

Tested assumptions and potential outcomes seemed a safe way to quantify risk for Lehman Brothers and as a bet on Tyson based on his glorious track record. However, both assumed that past performance was a good guide for the future. It simply wasn't – and isn't. Both wagers carried high levels of implicit risk. The global financial crisis became worse than the worst case scenario at that time. Tyson appeared invincible, until he wasn't. This is the paradox of risk management in financial markets.

The ultimate litmus test for any portfolio risk management is a crisis. If these risk tools fail, what's left? Is it even possible for a portfolio manager to get a grip on risk?

1 Smyth, Julie. 30 years after Mike Tyson fight, Buster Douglas is 'feeling good', The Chicago Tribune, 2-Feb-2020.
2 Sorkin, Andrew Ross, Lehman Files for Bankruptcy; Merrill Is Sold, The New York Times, 14-Sept-2008.
3 Banks should seek more capital: Bernanke, Reuters, 28-Feb-2008.
4 Lehman Brothers Holdings Inc., Form 10-K: Annual Report for the fiscal year ended 30 Nov 2007, SEC Archives, pgs. 69–70.

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COMGEST'S GRASP OF RISK

— **Comgest believes that understanding the companies' profitability characteristics is a far more effective way to understand the risk embedded in a portfolio.**

Rather than look at the probability distribution of historic share price returns, Comgest believes that understanding the companies' profitability characteristics is a far more effective way to understand the risk embedded in a portfolio. Our view of risk is at the fundamental company level, while standard industry risk models start from price volatility and covariance matrices, which are market-level inputs. In other words, we focus on what's happening in the business – not what's going on in the market – to understand risk.

— **Deep economic moats ought to protect a business – these are central to the profitability characteristics of our portfolio companies and to the risk embedded in our portfolios**

What we look for are deep economic moats that ought to protect a business – these are central to the profitability characteristics of our portfolio companies and to the risk embedded in our portfolios. They should protect the competitive advantage of the quality growth companies that we select and we believe they are key to shielding our portfolio companies from exogeneous events such as monetary shocks or economic crises.

Economic moats have various origins and can come from size and economies of scale. For example, a retailer with more than US$500 billion in annual sales has teams of buyers that can demand lower prices from suppliers and benefit from lower per-unit distribution costs – resulting in lower consumer prices.

There are also moats based on intellectual property, such as a leading company in lithography equipment that has cutting-edge EUV (extreme ultraviolet) technology enabling the printing of ever smaller circuits on a semiconductor.

Brand recognition can sometimes provide a competitive advantage. We all know companies that can be easily identified thanks to their iconic brand name or logo. Nevertheless, brand awareness on its own – no matter what the sector – may not be enough to protect the competitive advantage and often needs to be combined with other distinguishing advantages, such as a distribution network that is difficult or expensive to replicate.

A network effect, wherein the value of a product or service usually goes up as more people use it, can also be an economic moat. This can be seen in the global dominance of certain search engines or social media platforms, a "winner-takes-all" market because the relevance of search results or communities is a function of the number of users, making it a self-reinforcing cycle. The same

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holds true for e-commerce where a handful of global e-commerce players dominate – the more consumers buy on these platforms, the more vendors they attract to the platform.

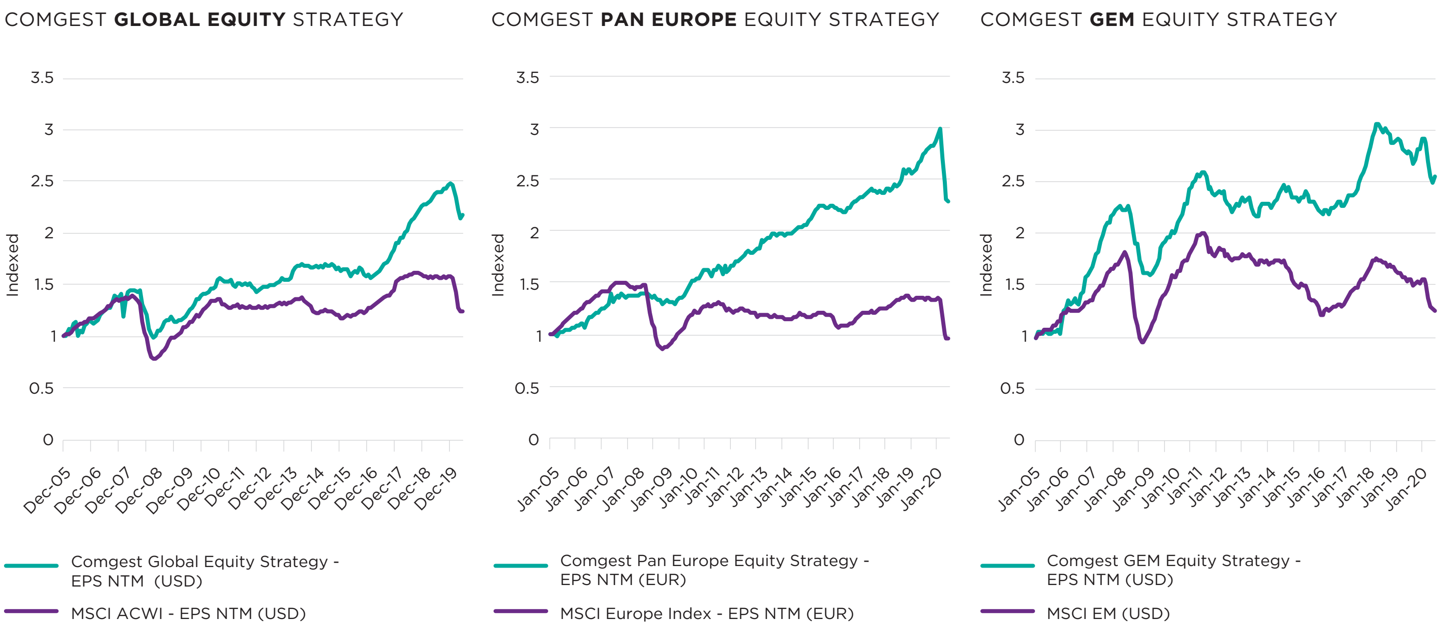
— **We believe deep economic moats allow companies to earn returns on their invested capital (ROIC) above their cost of capital for extended periods of time.**

The reason that deep economic moats are so important for Comgest is that we believe they allow companies to earn returns on their invested capital (ROIC) above their cost of capital for extended periods of time. With a buy and hold approach to such "moat-protected" companies, our goal is to enable our portfolios to benefit from the compounding power of their earnings growth over the long term.

— **These moats can also provide protection in times of crisis.**

Another added value of economic moats is that they can provide protection in times of crisis. When demand shrinks in volume, strong companies can defend high operating margins, compared to peers, thanks to superior pricing power. This results in lower earnings volatility, as shown by *figure 1* in the charts for our strategies.

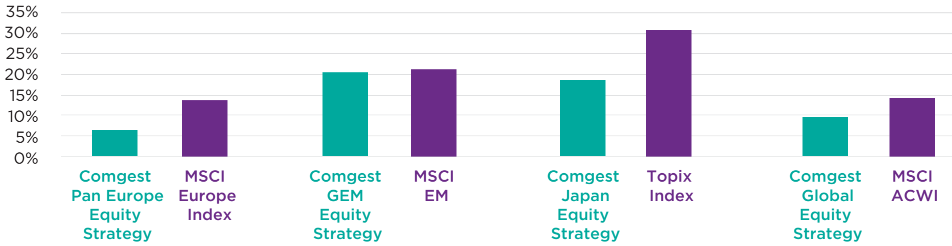
Figure 1. EPS of Comgest's equity strategies versus comparative indices



Source: Factset / Comgest, data as of 30-Jun-2020. Indices are used for comparison purposes only. Comgest's strategy performance is that achieved by a pooled investment vehicle which has been managed in accordance with the strategy discussed since inception. Indices: MSCI Europe Index; MSCI Emerging Markets (EM) Index; MSCI AC World Index (ACWI); and Topix Index.

As quality growth investors with an investment horizon of three to five years, Comgest views fundamental risk as any factor that could impact our long-term earnings expectations. For us, dealing with "uncertainty" therefore means minimising the potential divergence in realised versus expected earnings. Focusing on robust businesses well defended by sustainable competitive advantages is one way to reduce such forecasting errors. *Figure* 2 offers an analysis of our core strategies and their comparative indices showing that the absolute deviation of realised earnings per share (EPS) at the end of each calendar year, versus initial calendar year expectations, is considerably lower for our portfolio holdings than for stocks of the relative indices.

Figure 2. Deviation of realised EPS versus initial calendar year EPS forecast (2005–2020)[5]

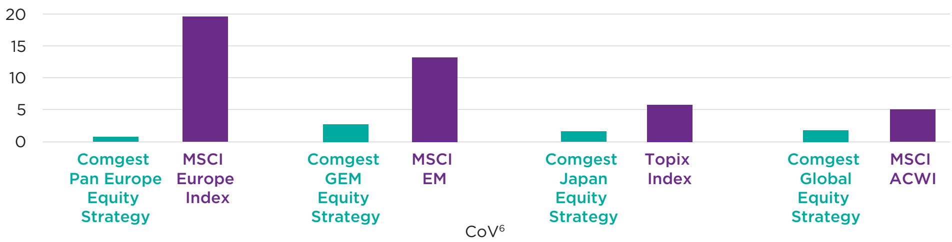


Source: Factset / Comgest, data as of 30-Jun-2020. Indices are used for comparison purposes only. Comgest's strategy performance is that achieved by a pooled investment vehicle which has been managed in accordance with the strategy discussed since inception. Indices: MSCI Europe Index; MSCI Emerging Markets (EM) Index; MSCI AC World Index (ACWI); and Topix Index.

— As fundamental stock pickers we also want to reduce variability of realised earnings growth over time.

As fundamental stock pickers we also want to reduce variability of realised earnings growth over time. We search for holdings that we believe will have stable, annual double-digit EPS growth over five years instead of those with more volatile annual EPS growth. That is what we mean when we talk about strong visibility. Strong economic moats support this dynamic and reduce the volatility of earnings growth over time. *Figure* 3 shows that the variability of realised EPS growth for our oldest strategies has been substantially below their comparative indices.

Figure 3. Volatility of realised earnings growth (2005–2020)[6]



Source: Factset / Comgest, data as of 30-Jun-2020. Indices are used for comparison purposes only. Comgest's strategy performance is that achieved by a pooled investment vehicle which has been managed in accordance with the strategy discussed since inception. Indices: MSCI Europe Index; MSCI Emerging Markets (EM) Index; MSCI AC World Index (ACWI); and Topix Index.

[5] Average absolute difference between realised EPS and initial calendar year EPS forecast (for FY2005–2020).
[6] Measured as the coefficient of variation ("CoV", which is: standard deviation / mean annualised realised EPS growth) for FY2005–2020.

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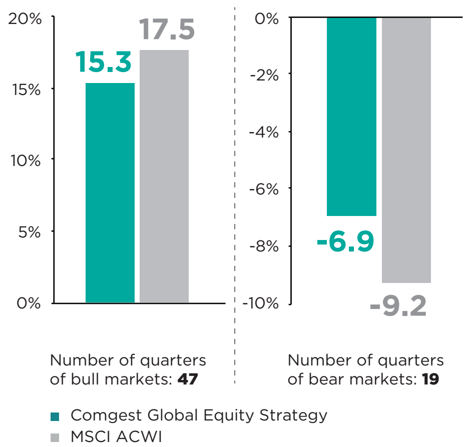
Comgest's deep dive into every security aims to give us a thorough understanding of the risks embedded in the fundamentals of our portfolio holdings. As illustrated in *figure 4*, we believe that our approach has worked as shown by our portfolios' consistently low drawdowns during bear markets – the statistical result of our fundamental risk control.

Figure 4. Bull/Bear Market Comparisons of Core Comgest Strategies

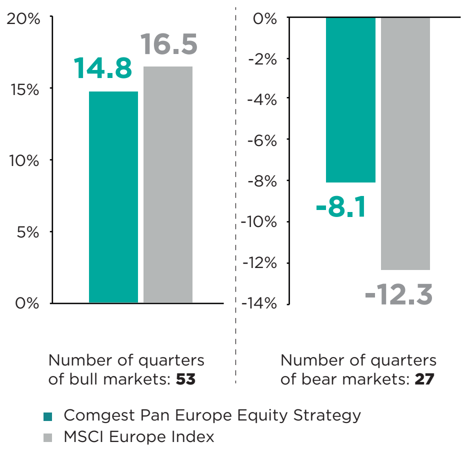
COMGEST **GLOBAL EQUITY** STRATEGY PERFORMANCE (NET)

Bull Market (l.) and Bear Market (r.) Performance
(annualised since inception)



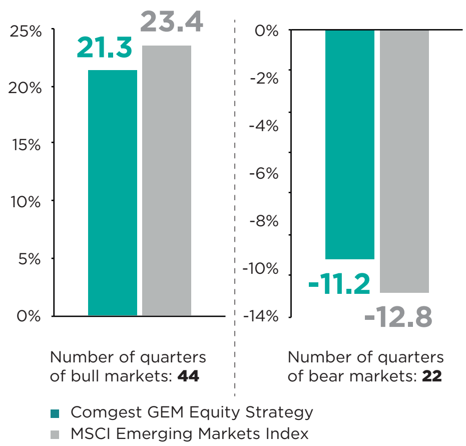
COMGEST **PAN EUROPE** EQUITY STRATEGY PERFORMANCE (NET)

Bull Market (l.) and Bear Market (r.) Performance
(annualised since inception)



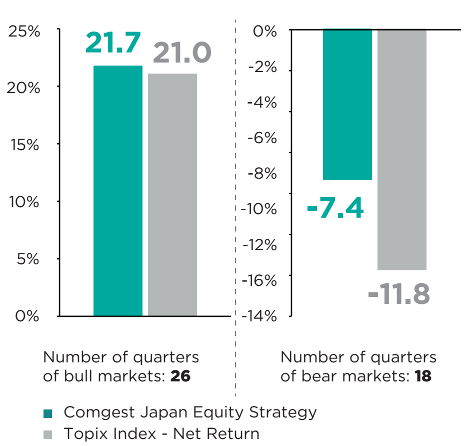
COMGEST **GEM** EQUITY STRATEGY PERFORMANCE (NET)

Bull Market (l.) and Bear Market (r.) Performance
(annualised since inception)



COMGEST **JAPAN** EQUITY STRATEGY PERFORMANCE (NET)

Bull Market (l.) and Bear Market (r.) Performance
(annualised since 01/07/2009*)



Source: Factset / Comgest, data as of 30-Jun-2020. *Current team commenced management of the Japan strategy as of 01-Jul-2009. Indices are used for comparison purposes only. Comgest's strategy performance is that achieved by a pooled investment vehicle which has been managed in accordance with the strategy discussed since inception. Indices: MSCI Europe Index; MSCI Emerging Markets (EM) Index; MSCI AC World Index (ACWI); and Topix Index.

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RISK, RETURN AND PORTFOLIO CONSTRUCTION

— Comgest's financial and extra-financial search processes for such quality growth companies provides a natural filter that determines the construction of our portfolios.

Comgest's financial and extra-financial search processes for such quality growth companies provides a natural filter that determines the construction of our portfolios. Part of the process, as previously noted, is finding those companies with protective economic moats that can help us practically manage portfolio risk. In theory, deep moats are simple. In practice, we believe businesses that benefit from strong and sustainable competitive advantages are rare. Comgest's long-term on-the-ground research efforts have helped us to find such hidden gems around the world. We believe that a concentrated portfolio with a few of these high-conviction quality growth companies is the best way to garner their unique compounding power.

Concentration around companies that we know very well is also a way for us to avoid the ultimate investment risk: absolute loss of capital. This is why Comgest's investment philosophy focuses on the in-depth accumulation of knowledge about a company, which helps us to identify its risks. Our continuous and on-the-ground research gives us the opportunity to obtain more profound company and market insights than just reviewing financial statements or publications. We believe this knowledge capital makes us extremely sensitive to any business changes and is essential to building a portfolio in a risk averse way.

The concentration of our portfolios also determines the meticulous nature of our portfolio construction, which can be described in terms of "antifragile tinkering", as coined by Nassim Nicholas Taleb.[7] Antifragile tinkering offers an experience-based methodology to deal with uncertainty. This trial-and-error process aims to create a system that actually gets better or improves when exposed to shock or stress.[8] Resilient systems resist shocks but remain the same. Antifragile systems get better or improve when exposed to stress. Antifragile tinkering, however, is not random. In any trial, potential error costs must be kept low and potential benefits must be maximised. If you can quickly adapt and learn from mistakes, then you have the opportunity to take advantage of the asymmetry of the costs and benefits.

[7] Taleb, Nassim Nicolas. Antifragile: Things That Gain from Disorder, Random House (1st edition, 27-Nov-2012), 544 pgs.

[8] Liberto, Daniel. Anti-Fragility, Investopedia, 29-Jul-2019. A similar, well-known phenomenon has been observed in medicine, i.e. Wolff's Law, which describes how human bones become stronger in response to external stressors.

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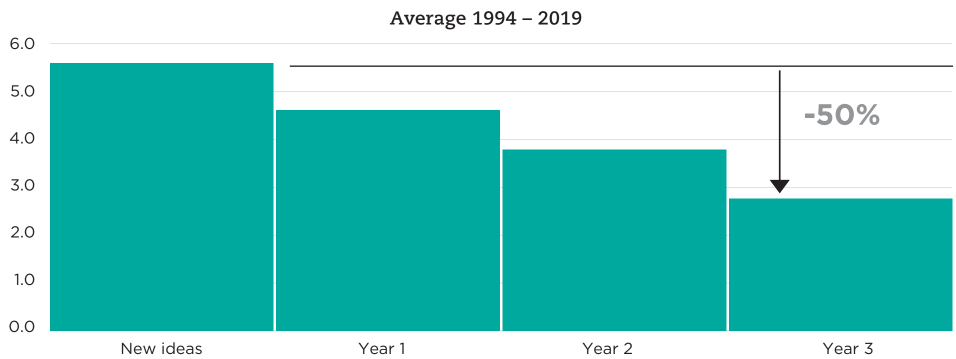
This asymmetry of cost and benefit is how our portfolio managers think about portfolio risk and return. Their mindsets are forged by one of the main prerogatives of money management – the skewness of returns.[9] This is illustrated by the following example: if you lose 50% on your investment, you need to double it to recoup your losses. Therefore, limiting losses in the portfolio construction process is the prerequisite needed to compound strong portfolio returns over time while also efficiently dealing with risk in equity markets.

We can illustrate antifragile tinkering looking at the portfolio construction of our European large cap strategy. *Figure* 5 shows the average annual number of new holdings ("ideas") introduced to the portfolio over the past 25 years and the evolution of those positions following their initial purchase. After four years, only 50% of the new ideas were kept in the portfolio and the rest were dropped.

Figure 5. Number of new ideas kept in Comgest's Pan-Europe Equity portfolio over 4 years

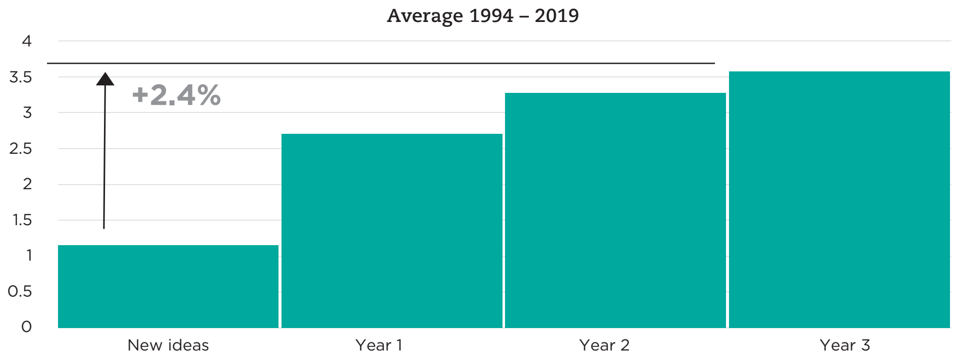


Source: Factset / Comgest, data as of 30-Dec-2019. Comgest's strategy performance is that achieved by a pooled investment vehicle which has been managed in accordance with the strategy discussed since inception.

With regard to the ideas kept in the portfolio, *figure* 6 demonstrates the evolution of the average weight of each position, which tripled from 1.2% (Year 1) to 3.6% (Year 4).

[9] Further information on the skewness of returns can be found in the Comgest paper, "An Approach to Risk" (2014), available upon request.

Figure 6. Antifragile tinkering: Average weight of position in years 1 – 4 following introduction to Comgest's Pan Europe Equity portfolio



Source: Factset / Comgest, data as of 30-Dec-2019. Comgest's strategy performance is that achieved by a pooled investment vehicle which has been managed in accordance with the strategy discussed since inception.

— **Our carefully selected "quality" companies go through a Darwinian "survival of the fittest" selection to remain in a Comgest portfolio.**

These two charts demonstrate that even our carefully selected "quality" companies go through a Darwinian "survival of the fittest" selection to remain in a Comgest portfolio. Weak companies that did not live up to our expectations were gradually removed from the portfolio to keep error costs low. Strong companies that consistently met our high expectations became sizeable positions to maximize the compounding of their long-term positive returns.

When clients ask us about the models and theories behind our risk management and portfolio construction process, they sometimes refer to scientific procedures and models as their understanding of how to efficiently deal with uncertainty and to quantify risk. We respond to such questions by noting that we believe that these practices can sometimes be misleading – creating an illusion that everything is under control as highlighted by the cases of Tyson and Lehman Brothers. While Comgest portfolio managers are strong advocates of investment discipline and the importance of a rigorous process [10], they are also convinced that this process should not be automatically or uniformly applied. In other words, our portfolio managers adopt an antifragile tinkering approach rather than a purely scientific approach as described earlier in this paper.

Constructing an antifragile portfolio – stock by stock – is reminiscent of the medieval stone construction of Gothic cathedrals. Comgest's challenge is to construct portfolios with companies that deliver double-digit EPS growth over a long-term investment horizon to our clients. The challenge in building Gothic

[10] For further information on Comgest's investment process: https://www.comgest.com/en/our-business/our-investment-strategy/process

cathedrals was to maximize the height and verticality of the nave. At the time, limited technology existed to enable the building of complex vaulting at significant heights.[11] The construction of a cathedral was the work of artisans, primarily based on experience. That these cathedrals are still standing after centuries demonstrates the robustness of their composition. Similarly, our portfolio managers endeavour to build high-conviction portfolios that can withstand crises and be sustainable over the long-term.

GENERATING ALPHA

— **Alpha generation is considered a market anomaly within standard industry risk and return models.**

The key value proposition that Comgest offers to our clients is alpha generation. So why then is alpha generation considered to be a market anomaly within the standard risk and return models based on efficient market theories used extensively by the financial industry?

— **A substantial portion of the portfolio returns that Comgest generates are linked to company-specific returns, not the market return, the excess of which is referred to as "alpha".**

Comgest invests with an unconstrained risk and return mindset, which can be seen in our concentrated portfolios. As a result, a substantial part of the portfolio returns that we generate are linked to company-specific returns, not the market return. This excess return is referred to as "alpha" and is what our portfolio managers target in their meticulous portfolio construction. Alpha can only be generated by actively managed portfolios such as our buy and hold approach, for example, which is the essence of being bottom-up, long-only investors. With over 30 years of experience, Comgest's long-term performance of our strategies, while not indicative of future performance, offers insight into how we've consistently generated alpha over time.

[11] St. Peter's Cathedral in Beauvais holds the record for the highest vault at 48m – over half the length of a football pitch. Nevertheless, the nave collapsed several times while the roof was being built.

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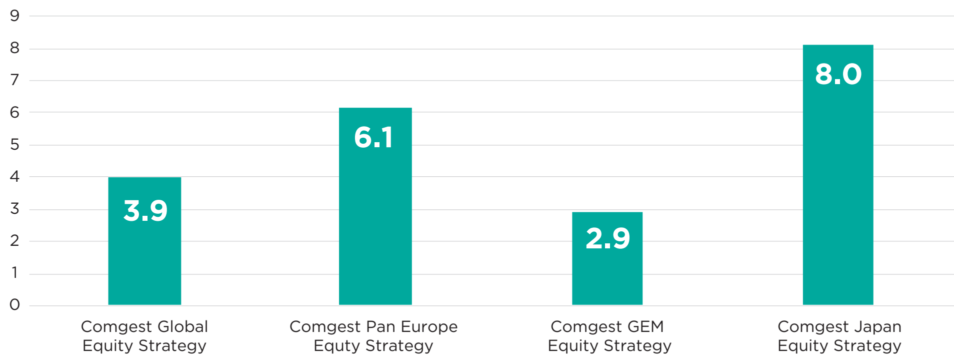
Figure 7. Annualised alpha [12] of Comgest strategies 30-Nov-2003 to 30-Jun-2020 [13])



Source: Factset / Comgest, data as of 30-Jun-2020. Comgest strategy performance is achieved by a pooled investment vehicle that has been managed in accordance with the respective strategy discussed since inception.

In modern portfolio theory – the basis for standard risk and portfolio management tools – the alpha that we generate is considered a market anomaly or statistical error.[14] In those models, portfolio risk and return are solely a function of market risk/return. Consistent alpha generation over time does not have a place in those models.

— **Comgest's style of investing generates returns and aims to take risks away from the market risk and return.**

So what is Comgest's answer to the conundrum of risk and return management in equity markets? The fact is that Comgest's style of investing generates returns and takes risks away from the market risk and return. As such, using standard industry risk models starting from market level-inputs such as price volatility and covariance matrices, which look at what is going on in the market to quantify risk does not make sense for us, even in theory. As outliers in the industry, understanding the fundamentals of our investee companies therefore is and will remain our approach to risk management.

[12] Alpha is defined as follows: where: α = Alpha, ß = Beta, x_i = Portfolio return for period i, y_i = Benchmark return for period i

$$\alpha = \frac{1}{n}\sum_{i=1}^{n} x_i - ß\,\frac{1}{n}\sum_{i=1}^{n} y_i$$

[13] For Comgest's Japan Equity Strategy, the annualised alpha refers to the period 30-Jun-2009 to 30-Jun-2020 when the quality growth investment style was implemented by a new investment team. Comgest's strategy performance is that achieved by a pooled investment vehicle which has been managed in accordance with the strategy discussed since inception.

[14] In single-index & multi-index models, this statistical error value has an expected value of 0, so that the equilibrium model works. Hence, alpha does not exist in the single or multi-index model. See: Elton, Edwin J. et al., Modern Portfolio Theory and Investment Analysis, Wiley (9th Ed. 2014), pp. 101, 135.

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AVOIDING THE KNOCKOUT

"Everybody has a plan until they get punched in the face," was Mike Tyson's response to a journalist who asked if he was worried about his fight with Evander Holyfield in November 1996.[15] Having a plan is theory, while getting punched in the face is reality. In financial markets, standard industry risk models and theories still dominate. These risk and return models can create the illusion that everything is "theoretically" under control – until an unforeseen black swan event[16], as was the case with Lehman Brothers and the Covid-19 pandemic. The world and the interconnections of market forces can simply be too complex for models and theories.

— **Comgest's approach to managing portfolio risk and return is embedded in the real-world value creation of our investee companies.**

Comgest's approach to managing portfolio risk and return, on the other hand, is embedded in the real-world value creation of our investee companies. Deep economic moats can protect our clients' wealth in the midst of a crisis. We believe this gives us a better grip on risk than standard industry risk models, which are full of pitfalls. Comgest's approach combines on the ground research with experienced-based portfolio construction. We generate returns, the alpha of our portfolios, that do not have a place in traditional financial theories. As seen during the global financial crisis and the Covid-19 pandemic, these industry risk models can clearly fail to deliver in the case of Black Swan events. In contrast, the systematic low downside capture of Comgest's portfolios proves that we have successfully avoided the knockouts.

Wolfgang Fickus, CFA
Product Specialist

Wolfgang Fickus is a graduate of the University of Cologne (Germany) with a degree in business administration (Diplom-Kaufmann) and studied at the London Business School. He also holds a CEMS Master's in international management and is a CFA® charterholder. Wolfgang began his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000, he moved to WestLB where he worked as an analyst for European technology stocks before becoming the Head of Mid- and Small Cap Research in 2005. Wolfgang joined Comgest in September 2012 and is a Product Specialist.

[15] Tyson, Mike, "Mike Tyson explains one of his most famous quotes", The Sun-Sentinel, 9-Nov-2012.
[16] https://www.investopedia.com/terms/b/blackswan.asp

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