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TACKLING THE 'UNKNOWN UNKNOWNS': HOW ACTIVE MANAGERS MANAGE UNFORESEEN RISKS

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- Active managers are better positioned than passive managers to guard against and react to unforeseen risks, such as the Covid-19 crisis
- During the financial crisis this flexibility helped active managers to outperform
- Those active managers who can recognise and control their behavioural biases are better positioned to outperform

Reports that say that something hasn't happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones."

So said Donald Rumsfeld in answer to a question at a news briefing in 2002. His words prompted an immediate reaction worldwide. Some ridiculed the-then United States Secretary of Defence for his awkward turn of phrase; others argued that his use of the concept of "unknown unknowns" was apt and perceptive.

However, Rumsfeld did not coin the idea of thinking about risk in this way. Rather, it was formulated in the 1920s and is commonly used by national security and intelligence officials in the United States, as well as inside NASA.[1]

Moreover, never does the expression seem more relevant than on today's social, economic and political rollercoaster. Unforeseen (and unforeseeable) risks are ever present, from unexpected referendum and election results to natural disasters and terrorist attacks – and global pandemics. Investment managers therefore face a challenging task. Not only must they avoid falling victim to foreseeable risks, but they must also mitigate risks that come entirely out of the blue.

[1] In 1921, the economist Frank Knight, in his book "Risk, Uncertainty and Profit", distinguished uncertainty, an unmeasurable risk as he termed it, or an unknown unknown in Rumsfeld-speak, from one that is measurable – a known unknown. Even, today an unmeasurable risk is termed Knightian uncertainty.

Yet this is one of the ways that active managers prove their worth. While passive funds by their very nature slavishly follow the markets in which they invest both lower and higher, active managers can act to limit losses and make the most of opportunities. The evidence is that many have done so, particularly during market dislocations and episodes of fundamental regime change, characterised by periods of high volatility and highly dispersed stock returns.[2] Under such conditions even quality companies with strong fundamentals can suffer. Perhaps unsurprisingly, at such times index tracker funds and their closet tracking counterparts suffer the most. Take the global financial crisis of 2008 and its immediate aftermath when active management came into its own. In the first half of 2009, 70% of active equity managers in the US, that most price efficient of markets, outperformed the S&P 500, gross of fees.[3]

QUANTIFYING THE UNKNOWN

Talented active managers, operating within a robust risk management framework, not only manage the known and more readily quantified risks. They also manage those that are not so straightforward to calibrate and forecast. In seeking to mitigate downside risk, they take a 360-degree view of their holdings, constantly evaluating the geopolitical landscape, macroeconomic outlook, industry dynamics, company-specific events, as well as those all-important regulatory, environmental, social and corporate governance factors. All of these variables are woven into the intricate tapestry of a company’s prospects – and what could hit its share price.

A good fund manager will also take an informed view of the extent to which the overall portfolio is exposed to any one risk or to risks that will likely go unrewarded.

Of course, managers’ attitudes to and perceptions of risk will differ, not least when it comes to applying their chosen investment style. For example, a contrarian investment manager will seek out stocks, irrespective of sector and without reference to a benchmark, that have fallen out of favour, which they believe to be under-priced. By contrast, momentum investors will seek to identify stocks which have recently performed well and look set to continue rising in a self-perpetuating manner. So, where momentum investors see headwinds, contrarian managers may see opportunity – and vice versa.

Therefore investors should be prepared to probe active managers’ investment philosophies and processes to ensure they have genuine conviction in an approach that is consistently applied through thick and thin.

Responding to such questions, managers should be able to explain clearly why an idea is in their portfolio, the wider process for generating ideas and the extent to which the process is subject to genuine challenge. Additionally, they will be able to describe how adverse shifts within the social, economic and political landscape could impact the companies in the portfolio. If enough due diligence underpins an investment decision, a manager will be able to clear-headedly evaluate whether the investment case remains intact when a paradigm shift and the associated risks appear on the horizon.

[2] Tobias Moskowitz. “Discussion: ‘Mutual Fund Performance: An Empirical Decomposition into Stock-Picking Talent, Style, Transactions Costs and Expenses.” Journal of Finance, vol.55, no.4 August 2000: 1695-1703; Robert Kosowski. “Do Mutual Funds Perform When It Matters Most to Investors? US Mutual Fund Performance and Risk in Recessions and Expansions”. Working paper, Imperial College Business School. August 2006.
[3] Empirical Research Partners 8 October (2009).

OVERCOMING BEHAVIOURAL BIAS

It is easy to buy into a compelling story when a company is doing well. It is much more difficult to identify the moment to sell. That’s why when it comes to active management, clear-headedness is everything.

Many behavioural biases, both conscious and unconscious, can skew a fund manager’s rationale, leaving investors vulnerable to unnecessary and undesirable risks. A fund manager could simply be a trend follower, subconsciously creating and extrapolating patterns and trends from unconnected events, without ever investigating the underlying reasons for an apparent trend.

Likewise, a manager could fall victim to confirmation bias, only seeking out evidence that reaffirms their world view and dismissing any arguments to the contrary. They might overestimate their skill and ability following a period of prolonged outperformance, failing to listen to colleagues with opposing views and excessively turning over their portfolio in the misplaced belief they have a significant information advantage. They could become emotionally attached to particular companies and wedded to outdated forecasts, neglecting to adequately consider the impact of potentially adverse events. Then there are those managers who, anchored to the price paid for a loss making stock, simply run their losses.

In fact, there are endless behavioural pitfalls for managers to fall into. Thankfully, there are two ways in which investors can establish whether their manager is compromised behaviourally. The first is to question the manager about their philosophy and process, in much the same way as detailed earlier. However, additionally, the manager should be able to clearly articulate how they recognise and control the cognitive errors to which it is all too easy to systematically succumb.

The second is to look for a certain attitude. That displayed by the world’s top sports people is instructive. Top tennis player Serena Williams convincingly won the Australian Open in 2015. Afterwards, her coach, Patrick Mouratoglou, said: “She can improve a lot. Her game at the net can improve and the transition from the baseline to the net can be improved a lot. Her swing volley can be better; she sometimes hesitates to move forward….”[4]

With that, Serena was back on the practice court the following day to further refine her game.

Likewise, the best investment managers are never complacent. Instead, they remain humble and determined to learn from their past experiences. According to Jeremy Beckwith, Morningstar’s Director of Research, the very best fund managers “are passionate and single-minded about investing. They show humility and realise that at least one-third of their decisions are going to be wrong. The successful ones want to learn when they are wrong and when to cut their losses.”

CONCLUSION

Truly talented fund managers never succumb to blaming events seemingly outside of their control for poor performance – even major event-driven crises such as the current Covid-19 crisis. Rather, they work harder to overcome such hurdles, listening to a wide range of views, inviting challenge and working closely with others to refine their process so as to retain that all-important edge. They realise that by doing so, they are maximising their chances of not only guarding against the known, knowns and known, unknowns but also of not falling victim to the potentially calamitous effects of those bolts from the blue, the unknown unknowns, constantly and inconspicuously lurking overhead.

[4] Reproduced from: Elizabeth Pfeuti. Uncoachable: Underperformance, egos and asset management’s most obvious structural flaw. ai.com. 11 September 2015.

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