CARMIGNAC
RISK MANAGERS

This note has been written by Didier Saint Georges, Head of Portfolio Advisors and Member of the Strategic Investment Committee. When Didier decided to retire, he shared this personal testimonial to shed light from the inside on what fund management is about at Carmignac. Initially an internal document, we thought this would be of interest to those eager to understand the history of Carmignac, its unique investment style and culture.

Observations by a committed emissary

The prehistory

Edouard Carmignac was still an *agent de change* – one of France's few officially authorised stockbrokers – when he first recruited me in 1987. At the time, my whole career boiled down to three measly years as a financial analyst at Citibank. In 1989, Edouard left his brokerage house along with Eric Helderlé to found Carmignac Gestion, while I stayed on in what had become a booming trade after the financial Big Bang in the 1980s. By 2007, I was tired of stockbroking, which I'd been doing for eighteen years, first at JP Morgan, then at Merrill Lynch. At that point, Edouard called on me once again, though I was as unschooled in fund management and distribution as I had been in financial intermediation twenty years earlier.

So my career path was shaped in large part by the wagers made by Edouard. I was a lucky beneficiary of one of his key personality traits – a tendency to identify and exploit the potential in a situation instead of following a pre-established battle plan. Asset management turned out to offer the ideal setting for that trait to thrive. With Edouard's help, I got to discover the business from the inside over the past fourteen years, though like Napoleon's aide-de-camp, I never had any doubt about who was in charge.

"In theory, there is no difference between theory and practice. In practice, there is." – Yogi Berra

In a short book I wrote in 2007, I pointed out that active investment managers were quite presumptuous to assert they could consistently outperform passive investment managers, given that their assertion was belied by both theory and practice. In terms of theory, the economist Harry Markowitz, who won the Nobel Prize in the 1990s, argued that the efficiency of financial markets made them really hard to beat over the long term. In terms of practice too, plenty of statistical studies seemed to prove Markowitz right. The numbers showed that passively managed funds came out way ahead of actively managed funds over time, and that very few active managers could claim they beat market indices very often. Despite my position, Edouard was kind enough to agree to write a preface to my book. Perhaps that was because I suggested that a few fund managers might still be able to confound Markowitz's rule. It's precisely because it's so awfully hard to outperform the market that only a few active fund managers ever do. This reflects an unassailable paradox: if it were easy to beat the market, it would ultimately be impossible to do so, as hordes of active fund managers would rush in to seize opportunities (arbitraging the market) and would thereby cancel out those opportunities. So while active investing is a justifiable approach, by definition it can work only for a small minority of asset managers. This makes it not only a meritocratic practice, but also a fundamentally aristocratic one. I was most curious to find out how one could reach such noble standing. Edouard, meanwhile, had no doubt that the elitist nature of the business would work to his advantage. So I eagerly jumped in fourteen years ago to take part once again in the Carmignac adventure.

After being totally immersed in our investment style, I felt sure that the viewpoint I had put forward was right. But I also realised why the unique approach pursued at Carmignac enabled us to rise to the challenge of active fund management.

"But in fact, we are all collective beings." – Goethe

The first thing I witnessed is that, as expected, asset management involves a tremendous amount of work. It means delving deeper than the competition, thinking more soundly, so you can steal a march (though only a small one) on your peers, and preparing for the future before the consensus catches up with you. In the very few instances in which we got seriously bruised, I suspected it was in part because we had somewhat relaxed this no-nonsense, disciplined approach.

The next thing I learned was that effective sharing of ideas is the key to building a sturdy "conviction factory". That's what makes the emblematic Carmignac morning meetings so crucial.

Like King Arthur's companions, we assemble round a table to discuss how we can find the Holy Grail. At those meetings, Edouard spurs a process of productive contradiction among us knights. To paraphrase Karl Popper, the result is a climate of friendly-hostile debate. Things that previously escaped our awareness get uncovered; what seemed theoretically impossible turns out not to be. It's also at this stage that some of our cognitive biases are undone. For every idea, there is an effort to think of what might challenge it. Or, as Blaise Pascal famously said, even at the end of each truth we must add that we are bearing the opposite truth in mind.

However, it isn't easy to corroborate with facts the oft-repeated mantra that teamwork is what ensures that the whole will be greater than the sum of its parts. That's because the process through which opposing views ultimately enrich our collective outlook absorbs a lot of energy. Even as you defend your own convictions, you need to stay open to fresh ideas generated in what can at times be an electric atmosphere. That requires a unique skillset: you have to able both to catch the ball on the rebound and to go the distance on a mountaineering expedition. As with a constantly fanned fire in a fireplace, only the best-quality hardwood will keep burning beyond the early combustion stage. So at Carmignac perhaps more than elsewhere, when you get involved with asset management, you know it's going to be exhausting work. But just as in mountaineering, exhaustion is a way to live life to the fullest. And if our Table isn't exactly round, it's probably because Edouard is gifted not only with a brilliant capacity for questioning, but also with uncommon endurance.

"The instant of decision is madness." – Kierkegaard

Intuition often wiggles its way into asset management, and for a long time that made me suspicious. I agree with what Daniel Kahneman wrote in his great book *Thinking, Fast and Slow.* I tend to view intuition in many cases as a lazy way out of the necessary process of deliberation, a convenient way to sidestep the tough job of thinking things through by falling back on a hunch or gut feeling – whereas such shortcuts are brimming with the most insidious psychological biases (which, Kahneman shows, are invariably unconscious).

And yet over the years, my monomaniacal rationalism has been shaken by instances in which mere logical reasoning wasn't up to the task of beating the market. Huge streams of available data – economic, financial and non-financial, political and technical – form the nuts and bolts of investment analysis. But they contain at least as much noise as useful information, if not more. Distilling what matters from this welter of events and numbers, and correctly sorting out what's essential – even as tonnes of conflicting information clamour daily for attention on our computer screens – is a daunting challenge. The quest for ultimate knowledge never ends. Despite our best efforts, the information we glean is incomplete and only partially reliable. But sooner or later, a fund manager has to reach a decision, whatever the uncertainties. So once all lines of reasoning have been aired, intuition necessarily kicks in. Some day perhaps, artificial intelligence may enable us to get past this limitation (and when it does, it may bring us back to Markowitz's contention that tracker funds are the only game in town). But until then, active investing can't rely on logical thinking alone. Intellectual purity will never be enough to generate above-market returns. You also need to take a strong whiff of reality.

This already leads us to the notions of *character* and *talent* required to succeed in active investing, as asset managers must first excel in rational thinking. Only then can they transcend it, boldly going past the logical inferences suggested by a line of reasoning that may be flawless, but is still insufficient. More on this later.

"Vision without execution is hallucination." – Thomas Edison

Furthermore, while predicting changes in economic metrics like a company's earnings or a country's GDP growth calls for objective analysis, estimating future prices for financial assets – and by extension upcoming market movements – has nothing to do with uncovering previously inaccessible absolute truth, as in Plato's world of Ideas. It's rather about anticipating how your projections – assuming they prove accurate – will be reflected in the market prices arrived at by the consensus. Investing is always a question of trying to pre-empt the market. But the market always has the final say.

When you make such projections in the hope that they will pay off later on, the primary difficulty is assessing to what extent acting on a conviction that you judge will be valid in the long run can offset the cost of being wrong in the short run. The answer lies somewhere in the mysterious, elusive space between two extremes: on the one side, the dogmatic convictions typical of pure value investing, however costly they may be, where fund managers defiantly proclaim they are right and the market is wrong; and on the other, devout momentum investing, where fund managers dispense with conviction and merely defer to existing market trends.

In practice, then, you need to evaluate your overall investment approach against your current "reading" of the market, to figure out whether the market seems ready to endorse your views soon. Or not. The first signs of such endorsement can make you more self-confident about following your convictions. In contrast, if the market votes against you, you're likely to postpone or drop an approach altogether that may have been sensible and attractive, but turns out to be a losing proposition.

"This great world is a mirror in which we must look at ourselves to recognise ourselves from the proper angle." – Michel de Montaigne

The first pitfall in the interactive process between conviction and market response is that it can easily lead you to drag your feet, given that the market doesn't usually deliver a clear and conclusive verdict. Fund managers may find themselves wavering for quite a while, alternately adjusting their holdings in one direction and then the other. I've often heard Edouard warn his fund managers about that pitfall. He draws an analogy with a gardener who constantly prunes what he's planted in the hope of giving it the desired artistic shape, but who winds up with nothing but scrawny, stunted shrubs. In conviction-based investing, as long as you're right about the forest, you can afford to be wrong about this or that tree.

The second pitfall is that if you look hard enough for technical evidence to support your views, you'll eventually find it – even when the evidence doesn't really exist – due to the well-known *confirmation bias* that underlies all the cognitive biases affecting us to varying degrees. There's an almost irresistible inclination to favour information that supports our beliefs and to ignore any data that might disprove them. We all unconsciously tend to view things the way we'd like them to be. And even the most seasoned fund managers run the risk of falling prey to confirmation bias.

Getting your signals crossed

One way to avoid confirmation bias is to base your market analysis on strict, totally objective protocols. Rather than seeking confirmation for the results of fundamental analysis, you try to establish correlations between past or expected events and market behaviour. You limit yourself to identifying signals and chart-patterns in market movements and then inferring that they are likely to repeat themselves.

The strange upshot of this strict discipline is that by ignoring causality (apart from the psychological postulate that behaviours tend to repeat themselves) and focusing solely on analogy, "chartists" purposely forgo any attempt to understand. A specific chart formation – for example, a moving-average crossover, a head and shoulders pattern or a double top – supposedly sends out a clear message. So instead of trying to interpret market movements in context, chartists voluntary submit to the tyranny of the sign, or rather signal.

Still, they can pride themselves on making the right call in some cases, because when their technical analysis is subscribed to by the many, it becomes a self-fulfilling prophecy. As Deng Xiaoping put it, it doesn't matter whether a cat is black or white, as long as it catches mice.

But in broader terms, my impression is that technical analysis boils down to the highly unambitious choice of abdicating your responsibility to think. Based on the assumption that most observers will have the same interpretation of a given signal, such analysis is unlikely on its own to offer a serious path to long-term outperformance.

This means that investors should mainly use technical analysis they way physicists use experimentation – as a way of checking the extent to which practice validates theory. So it seems we have no other alternative than to maintain a safe distance from blind belief in market signals, while at the same time steering clear of the cognitive bias trap. In other words, we need to exercise our freedom in a disciplined manner. Instead of merely trusting signals, we have to draw out their meaning.

"Art is born of constraint." – André Gide

Active investing is therefore a lot like playing a piece of music: it requires a subtle combination of discipline and freedom. Another analogy is with mountaineering. You need to have a sense of the space round you while still watching where you step, to confront the paradox of exercising freedom in a very uncertain, constraining environment. You have to check your narrative against the facts – yet without assuming that they necessarily reflect reality more accurately than your narrative. "Listen to the market", only to question it even more effectively. Striking that difficult balance between intellect and

sensitivity, between rigour and instinct, requires a quality that is elusive, unfathomable and yet essential – a quality that extends well beyond technique and that you'd really have to call talent.
Now art, by definition, is created by a small minority. Just as with athletes, musicians, painters, sculptors and architects, it's when you combine audacity with discipline, when you're serious about what you do without taking yourself too seriously, when you manage to be at once profound and light-hearted, that you can come up with the right move that makes all the difference. And if that right move happens at a critical juncture, the talent behind it will produce a splendidly nonconformist investment style.

"There is a crack in everything, that's how the light gets in." – Leonard Cohen

This brings us back to the issue of investment decisions.
The humility that comes from hearing all the arguments brings you to the Archimedean point from which you can feel cocky enough to decide all alone when the time is ripe. And as we've seen, such an impetuous move always involves taking a risk when there is little certainty. As in medicine, an active investment approach is often threatened with failure, and even more often comes face to face with it. It's been estimated that the best fund managers make the right call only about 60% of the time. Markowitz still casts a long shadow.
Failure is caused by mistakes, but also by chance, which even handedly distributes strokes of good luck and bad luck. So failure is an integral part of active investment. It takes a lot of character to accept it, and a lot of intelligence to draw valuable lessons from it for the future.
But all failures are not created equal. The frequency distribution for long-term market returns doesn't follow some normal distribution, much less one that would be conveniently symmetrical on both sides of the mean. In fact, it sometimes contains outliers or extreme outcomes that are very far from historical averages, whether due to a financial crisis, a pandemic or some other as yet unknown factor. It may take just a few months for such events to wipe out years of positive returns – not to mention all the savings that clients have entrusted an asset manager with. So such events are of paramount importance, and Carmignac owes a large part of its reputation to the number of times the company has triumphed over financial crises.
But our ability to thrive over time has also drawn sustenance from how we manage risk.
Essayist Nassim Taleb popularised what he calls the "Lindy effect", which posits that, in the case of anything that doesn't have "an unavoidable expiration date", the longer it's already been in existence, the longer its remaining life expectancy will be. (The Rolling Stones will still be listened to 60 years down the line, whereas the biggest hit of this past summer probably won't be a few weeks from now. Likewise, Beethoven will still be listened to in 200 years, and the Bible will still be read in 2,000.)

Underlying this prognostic rule is the observation that the best gauge of the resilience of a model, organism or phenomenon is how well it has stood the test of time. It's by coming through crises that a system reveals how robust, or even how "antifragile" it is – in other words, the extent to which it can not only withstand shocks, but also come out of them stronger than before. Well, Carmignac's management of market crises for over thirty years now has quite clearly made this an antifragile outfit.
In 2017, I wrote a 30-page internal memo titled *The Difficult and Solitary Art of Risk Management.* In my paper, I explained that risk management is more about adopting the right culture than using the right technique. If you lack that greater relationship to risk, raw data and calculations will soon team up against judgement and responsibility towards your clients. I argued that such a culture involves embracing the uncertainty inherent in financial markets – you have to know what the risks are to be able to spot them – mainly so that you can identify the risks *you don't want to take.* I went on to say that you should then be confident about acting when there is no way of anticipating what's next.
To return to my analogy between asset management and mountaineering, it's worth recalling that the most experienced guides obviously pass on knowledge and technique, but more to the point, they impart values. The first of these is courage, which Vladimir Jankélévitch described as the virtue of beginnings, the virtue that makes all others possible. Then comes commitment and above all responsibility. Investing is always a question of responsibility.

Noblesse oblige

So active investing, as practised at Carmignac, draws its inspiration from a kind of aristocratic ethic, with its emphasis on excellence as much as on performance. The underlying rationale is to ensure that that ethic works in the interest of the many. Our clients entrust us fully with their savings, and that trust creates a binding obligation.
Our obligation is not only to manage their investments, but also to faithfully represent our mission. This is about more than providing transparency – where one may say everything without showing anything and generates information rather than knowledge, let alone buy-in from others. It's also about more than eloquence – often a way of embellishing the truth. As I see it, representing what a fund house stands for is more like translating. The aim is to be true to the perspective, spirit and style of the original, while making sure nothing gets "lost in translation".
One of my fondest memories from these past fourteen years was of an investment advisor I worked with, and who has since become a friend. After one of my presentations, he came up and said, "Your talks are uplifting." The beauty of that memory is that the forecasts I had just outlined for financial markets were fairly bleak. But that investment advisor relished our unique style and the vision we have of our job. He understood that we were committed to our mission, body and soul. Because we

acknowledged our shortcomings, but didn't opt out of our responsibility or ambition, we earned his trust. From then on, he went out of his way to impress upon his clients that Carmignac was, and would continue to be, a rampart against impersonal, mass-produced asset management, standing in opposition to the narrator's remark in Proust's *Remembrance of Things Past* that "The instinct of imitation and the lack of courage govern societies as well as crowds".

I've always found it exhilarating to translate the complexities of asset management into simple terms, to convey the relevance of macroeconomic analysis or the hidden ideas underlying portfolio construction. Engaging in this educational work, side by side with my fellow Investment Committee members, fund managers, analysts, product specialists and marketing people, has been a never-ending source of joy for me. But our role also consists of shifting the people we talk to away from a day-to-day focus on raw data and helping them gain a better understanding of the deeper issues. When we converse with our clients, we act as emissaries who convey a vision of asset management.

"A leader is someone who needs others." – Paul Valéry

Our demanding cult of freedom is more than just a powerful performance driver; it has also enabled Carmignac to attract top managers for thirty years now because they find themselves in an ideal environment for expressing their talent. For that reason, the difficulty inherent in active investing shouldn't be considered an obstacle for Carmignac. The opposite is true. The past fourteen years have confirmed in practice that our approach to asset management is fully equipped to meet the challenge of long-term active investing.

In broader terms, Edouard and Eric, later joined by Maxime and Christophe, are continually adjusting our whole organisation to a changing environment. Their watchful attitude, which includes a large dose of anticipation, also involves regularly invigorating our teams with fresh talent that can draw on our past to help build our future. That goes for all our departments and offices, in Paris and across Europe. The feverish activity deployed by all our people is a key ingredient of our success. But it also enables us to maintain our ability to derive a unique, and increasingly potent dynamic from the kinds of ordeals that will inevitably crop up in the next thirty years.

Nassim Taleb would no doubt term the Carmignac approach intrinsically "Lindy-compatible".

I would add that this virtue also draws sustenance from our shared passion for successfully waged struggles.

In the words of Baudelaire, the worst vice is *ennui,* or apathetic boredom.