



## Friday Morning Coffee

### Nr. 63 — The Trinity of Investment Risk Management

At ECP, we internally produce weekly investment risk reports to keep a tight grip on the underlying risk factors of our portfolios. They go further than what is legally required by the UCITS regulation in terms of risk management and are structured around the following three main pillars, we internally call the trinity of investment risk :

1. Valuation risk of our holdings
2. Earnings risk of the companies we are invested in
3. Liquidity risk on the individual names in the portfolio and the portfolio overall

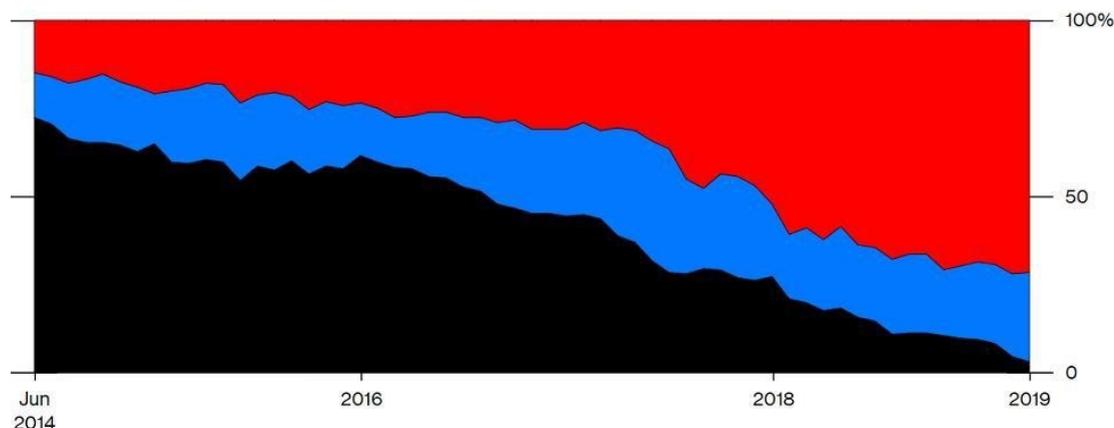
We have been commenting many times on the first 2 pillars. Valuation risk appears low with European equities being an unloved asset class and our value approach out of favor. Our portfolio trades currently at a record margin of safety approaching 40% compared to our aggregated estimated fair value of the companies we hold. In the meantime, we think that earnings risk is also relatively low as we focus on quality companies with strong balance sheets able to generate strong cash flows and we do not believe Europe is risking an imminent earnings recession. In this morning coffee, we therefore focus on the third pillar: liquidity risk.

There have been three high profile cases recently of asset managers facing unforeseen pressure on their products due to sudden, high redemptions by their investors. Of the three, namely GAM, Woodford and now H2O, Woodford is probably the one closest to our hearts because of his reputation and tenure as an equity stock picker not only in his own boutique but also long before at Invesco. His example shows to us that even seasoned investment professionals have a risk of getting caught in a liquidity trap as they adapt to changing market conditions. The below graph from Morningstar summarizes in our opinion very well what happened to Woodford's flagship product :

#### Woodford Equity Income Fund Allocation

By size of company

■ Large-cap ■ Mid-cap ■ Small- and micro-cap



Data: Morningstar

The following note gives the opinion of the Investment team at the time of the publication. Please refer to important notice at the end of the document.

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Over the last 5 years, the manager found more and more investment opportunities in the illiquid parts of the market. Due to the sheer size of a fund with 3.5 bn GBP in AUM the mismatch between the investment horizon of the investors (daily liquidity) and the long term investment horizon of Woodford (investing in illiquid assets with high upside potential over time) became extreme and resulted into a situation where Woodford became a forced seller to meet redemptions that ultimately led to the decision to close the fund to stop further outflows.

Our European product also offers daily liquidity to our investors. It is a flex-cap strategy allowing us to invest in both small and large companies provided we find undervalued earning power. The similarities however stop there. We are not holding any non-listed assets. We have also learned from the bitter experience of 2008 and fully understand how toxic a combination of high AUM's and lowly liquid investments can become in extreme market conditions like a financial crisis. At ECP, the understanding of liquidity risk is an integral part of our DNA and our investment process. Mitigation of this risk is being done by capping the size of the strategy at 1 bn EUR and avoiding stocks with insufficient trading volume. According to Bloomberg, it would take 11411 days to liquidate all the positions in the Woodford Equity Income Fund. At ECP, we can liquidate more than 95% of our portfolio in less than one day. This certainly cannot be considered as an illiquid investment even in extreme situations.

I wish you a nice weekend,

**Léon Kirch, CFA**  
*Partner & Chief Investment Officer*  
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