Diversification Dashboard – 31.01.2014

TOBAM's Diversification Ratio (DR)[1] measures to what extent a portfolio is diversified. The DR2 (square of the diversification ratio) measures the number of effective degrees of freedom to which a portfolio is exposed. As the table shows, the "broad market" indices leave diversification on the table. In addition to a snapshot of each market's DR², the table shows the DR² of a well-diversified portfolio, and the fraction of available diversification used by the index.

	DR² - Index diversification	*DR² - Maximum diversification*	*% diversification used by index*
MSCI Australia	2.59	4.72	*54.9%*
MSCI Japan	2.02	4.87	*41.5%*
MSCI UK	2.88	5.24	*54.8%*
MSCI Pacific ex-Japan	2.68	6.44	*41.6%*
MSCI EMU	2.64	7.86	*33.6%*
MSCI Canada	4.69	9.41	*49.9%*
MSCI Emerging	4.93	9.55	*51.6%*
MSCI US	3.36	9.66	*34.8%*
MSCI World	5.01	18.71	*26.8%*
MSCI All Countries World	5.51	22.75	*24.2%*

January briefs.

- 2013, was a strong year for equity markets, in which the AB flagship strategies have been able to outperform during this bull market. In January 2014, markets are witnessing a general sense of profit taking. In this backdrop of widespread negative returns, AB strategies are providing protection across all regions with general outperformance as well.

- We have contributed to a report on 'Smart Beta Investing' in the form of a roundtable discussion.

Please find in the next pages the comments of TOBAM's President, Yves Choueifaty, during the roundtable debate.

[1] TOBAM's Diversification Ratio measures a portfolio's or index's diversification. It is supported by original research and is based on a mathematical definition of diversification. TOBAM's "Anti-Benchmark" Most Diversified Portfolio® maximizes this Diversification Ratio. Maximizing diversification within a universe of securities provides a result closer to the true market risk premium from that universe. "Maximum Diversification®" and "MaxDiv®" are registered trademarks of TOBAM.

Where do these strategies sit on the passive to active spectrum?

Moderator:
Hubert Danso, Vice Chairman & Chief Executive Officer, Africa Investor Group

Panellists:
Yves Choueifaty, President and CIO, TOBAM
EW
IH

Hubert Danso: How do you define a smart beta investment strategy and its relationship to fundamental indexation?

Yves Choueifaty: In order to answer properly this question it's important to go back to the definition of what is beta. Originally, beta is a measure of how much you access the systematic risk premium available in a given market. We know need to define what is the systematic risk premium, it is the return of the un-diversifiable portfolio. Most of the smart beta approaches emerged from the observation that the current representation of beta by the industry, which is the market capitalization weighted benchmark, is failing to achieve two objectives. The first objective is to be close to the efficient frontier ex-post and the second is to be truly diversified.

The market cap weighted benchmark has failed to meet those two criteria and as a result there is a growing demand for a smarter way to access the equity risk premium. In my mind a smart beta investment strategy is a strategy which should be systematic and try to resolve the 2 issues with the market cap weighted benchmark: the fact that it is not efficient ex-post and its enormous lack of diversification (hugely biased at the worst moment towards GM(1970), Oil Companies"(late 70s), IT stocks(1999), then Financials and Apple more recently) .

In terms of the second part of the question, fundamental indexation is simply one of the smart beta approaches amongst a handful of ways that have been produced by practitioners.

Hubert: Is smart beta more than just a rebalancing rule for market cap pricing?

Yves: A concept which is often mentioned in conjunction with rebalancing is security selection. Here maybe I should mention that a smart beta strategy should be a holding scheme and not a trading scheme.

When talking to asset owners or to portfolio managers, as opposed to traders, it's important to understand that it is by holding a position that one earns the risk premium. It's not by trading securities that the risk premium is captured.

A common point for most smart beta approaches is that, as far as I know, they are all based on portfolio construction methodologies rather than on trading schemes.

I completely agree with IH on the fact that when opposed to market cap-weighted benchmarks which are buy and hold, rebalancing in smart beta is crucial. However, I don't think it's true to classify smart beta as just a rebalancing rule. In fact smart beta is a portfolio construction approach and whilst one of the merits of this is that rebalancing is needed from time to time, it is completely wrong to imagine smart beta is simply or just about that.

Hubert: Is the notion of selection something that is quite widely used within the context of this rebalancing idea?

Yves: As soon as you define a beta as a way to access the systematic risk premium then the approach can't be about selecting specific stocks, you cannot build a smart beta approach which would be theoretically and fundamentally sound if it is based on a selection process. A smart beta approach should in fact be a portfolio construction methodology. What you want to hold is a portfolio with some specified characteristics rather than building a set of stocks on which, you believe, a specific event will happen.

Hubert: One of the reasons that smart beta is attractive is because it contains elements of both passive and active management- how successful is this blend in delivering on objectives and protecting against market volatility?

Yves: It has been quite successful. These new approaches are gathering momentum and for our clients it has been a proven success in meeting their objectives; we have roughly doubled our assets under management last year from USD 2.8bn to USD 5.6bn.

Being active and passive is not always well defined. At its roots, 'passive' means that you don't need to trade and being 'active' means that you need to trade. By definition the passive strategy is the market cap weighted benchmark; you buy it once and you are supposed to hold it and to reinvest the dividends. Any adjustment is done only marginally.

Actually, any other type of strategy should be qualified as active as soon as rebalancing occurs as part of the investment process. Hence, by design smart beta approaches are active. But then again they are systematic. In our view, this is why there is confusion between them and passive approaches; they are systematically active but not passive.

The passive/active dilemma is hiding another much more crucial dilemma: Do you want to be Neutral or Biased? The market cap weighted benchmark is passive but hugely biased and absolutely failing to allocate its risk neutrally across the risk drivers.

Very often, it is accepted that when you are neutral you should buy the benchmark when, in fact, the benchmark is hugely biased! A market cap weighted portfolio is not a neutral portfolio but rather a hugely biased portfolio which is passive. Some smart beta approaches are trying to build a neutral risk allocation, a neutral portfolio, and needs to stay active in order to stay neutral.

EW: Can you explain what you mean by neutral?

Yves: Neutral means that you believe that risk is relatively evenly rewarded across the universe. You don't have a speculative view. Having a speculative view would mean that I believe in a specific risk factor outperforming in the future.

Imagine you buy the index at a moment in which it is highly concentrated in techno stocks. What would be the justification from a risk return point of view? The only way to justify that from a risk and return perspective is to be more bullish on the bias, factor or style that you are over risk-weighting. The market cap weighted benchmark is not neutral. You have implicit speculations when you buy the benchmark. If you buy the NASDAQ at the end of 2012 you are investing about 17% of your portfolio in Apple whether you like it not. If you have 17% of your portfolio in Apple it means that you are more bullish on Apple than on any other stock at a moment when Apple has already substantially outperformed. This is clearly not a neutral position to hold.

Hubert: How diversified are the strategies that sit underneath the 'smart beta umbrella'?

Yves: I believe that most of them have in fact a common source of excess return versus the benchmark which is that they are, in fact, more diversified than the benchmark. I would categorise smart beta approaches, from the point of view of diversification, into two categories; those who have diversification as a side effect of their portfolio construction methodology and those who have diversification as an explicit goal.

Most of the smart beta authors agree on two aspects. Firstly they acknowledge that the market cap weighted benchmarks are not an efficient way to invest in the medium and long-term. Secondly, they believe that they have discovered why the market cap weighted benchmark is not efficient.

In fact the real problem with the market cap weighted benchmark is that you are buying unwanted biases and from this conclusion you have two sets of smart beta approaches.

The first set believes they would be able to identify better biases than the market cap weighted benchmark. Typically 'Minimum Variance' is biased towards low volatility stocks, which is probably a better bias to have than the unwanted biases of the market cap weighted benchmark. Another example is 'Fundamental Indexation' that is biased towards value and small caps.

The second set includes those who are not trying to identify a better bias but instead trying to build an unbiased portfolio.

This second group aims at building the most diversified strategies. While the first group would be more diversified than the benchmark, it will still be less diversified than the second group.

For more information

TOBAM is an asset management company offering innovative investment capabilities whose aim is to maximize diversification. TOBAM's flagship Anti-Benchmark® strategies, supported by original research and a mathematical definition of diversification, provide clients with diversified core equity exposure, both globally and in domestic markets. The company manages over $5.6 billion via its Anti-Benchmark strategies for institutional clients worldwide. Its team includes twenty four financial professionals.

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