

Make Diversification your Beta

Yves Choueifaty, President and Founder of TOBAM, explains why concepts such as “smart beta” or “neutral portfolio” require clear definitions and how the Maximum Diversification® approach answers the need for beta.



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What is your definition of Smart Beta? What makes a beta smart?

TOBAM is one of the founders of what has been called by the industry the “Smart Beta” movement since 2005. I do not like the expression smart beta since it lacks clear definition and, as a mathematician, I do not like undefined terminology.

So, what is smart beta? Originally, beta is a measure of how much you access the systematic risk premium available in a given market. Secondly, what is the systematic risk premium? It is the return of the undiversifiable portfolio.

Most of the smart beta approaches emerged from the observation that the current representation of beta by the industry, which is the market capitalisation-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.

The common thread of mainstream smart beta approaches and their providers is the recognition that market cap-weighted indices are not the optimal solution for investors. In that sense, “Smart beta” approaches are smart or at least “smarter” than the traditional benchmarks.

What defines truly a smart beta approach, I believe, is its capacity to deliver an equilibrium portfolio.

Risk Factor investing, for example, is contradictory with the notion of equilibrium since betting on a factor for pricing or strategic reasons remains an arbitrage. This is as far as the similarities go in the smart beta world.

TOBAM is the founder and unique provider of the Maximum Diversification® approach and Anti-Benchmark® strategy. What makes your approach unique?

The core investment philosophy of TOBAM is to harness diversification to optimally capture risk premium of an asset class. At TOBAM we don't know if we are “smart” but we believe that we provide the Beta.

Our conviction is that the inefficiency of the market cap-weighted strategy arises from insufficient diversification. TOBAM's patented Maximum Diversification® approach is designed to maximise the degree of diversification when selecting the weighting of assets in the portfolio allocation process. TOBAM's proprietary measure of diversification, the Diversification Ratio®, is maximised to produce a portfolio designed to access risk premium evenly from all the independent risk factors available in the market at any given time.

The Anti-Benchmark® portfolios generated by this approach aim at providing greater returns than market cap-weighted benchmarks over a market cycle, while these portfolios typically also have significantly lower volatilities than the market cap-weighted benchmarks.

What is your position in the current debate about the passive versus active management?

“Passive”... “management”. This is the perfect example of an oxymoron. How can you be passive and manage? How can you manage and be passive?

In my mind passive has nothing to do with asset management, it is literally a custody job.

The passive/active dilemma is hiding another much more crucial dilemma. We often tend to assume that a passive portfolio (i.e., following the benchmark) is a neutral portfolio. This is absolutely false. You can be passive, but you definitely are not neutral, implementing a neutral risk allocation. The market cap-weighted benchmarks are hugely biased and completely failing to allocate their risk neutrally across the risk drivers.

Smart beta approaches are active by design. To remain the Most Diversified Portfolio®, for instance, you need to stay active, in order to remain neutral. Being a systematic asset manager, we are systematically active.

Does that mean that the end is near for traditional benchmarks?

I believe that benchmarks have a role to play in the asset management industry. They are representative of the market; they are the sum of all speculation and, as such, provide information for asset managers and investors. They are a very useful tool for the finance industry but they need to remain an output.

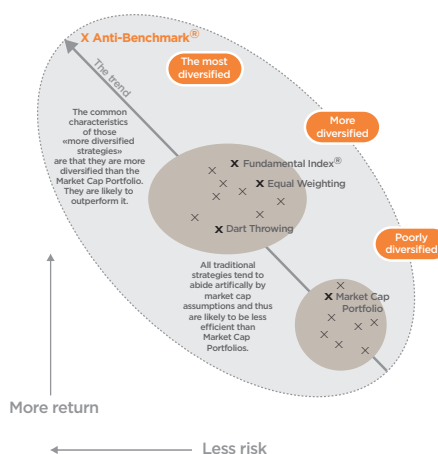
The tendency over the last 20 years to use market cap-weighted benchmarks as inputs that some asset managers take as a strategy reference to follow is highly inefficient and potentially destructive for the global economy, as it diverts core asset managers from their fundamental role in the latter.

How would you then define the role of core asset managers for the global economy?

The job of core asset managers within the overall wealth creation process is to re-invest savings into the economy to create wealth for investors through growth and development. Importantly, the real source of wealth is not the “skills” of portfolio managers, but the “skills” of employees working in the companies in which savings are invested, labour, in other words. It is labour, through improved innovation, productivity and corporate governance, that creates wealth for the investor. This is especially true in the case of equity holdings.

The fundamental role of core asset managers is to act as a link between savings and labour and ensure the risks savers are taking are rewarded as well as possible. To achieve this as purely as possible, it is critical to protect investors' core portfolios against all kinds of speculation.

By definition, a Maximum Diversification® approach intrinsically promotes firms that stand out in terms of innovation, efficiency and strong governance. It is these characteristics that progressively contribute to the creation of growth, wealth and improve the overall well-being of society.



Anti-Benchmark® is an active, systematic, comprehensive solution that aims to:

- Create the most diversified portfolio®
- Deliver outperformance across market cycles
- Capture the full risk premium available for a given asset class.

TOBAM *
CORE INVESTMENTS

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