‘We believe that we are the only portfolio manager in the world which can say to its clients that we will never bet with their money.’

Yves Choueifaty
President and Chief Investment Officer, TOBAM

Q: What is the Anti-Benchmark?

The Anti-Benchmark is a portfolio which is extremely easy to define in any given market, whether it is UK, Japanese, emerging market, Swiss or Swedish equities. It is simply the most diversified portfolio you can build, being long-running and fully invested without leverage. The only focus of the Anti-Benchmark is diversification.

What does it mean to be diversified? It is simply the opposite of being biased. If you have a very strong bias towards US stocks or bank stocks or value stocks, you will not be able to say that you are diversified because you are exposed to a limited number of sources of risk. So a good way to summarise a diversified portfolio is one where you are trying to build a portfolio whose volatility is evenly provided by all the possible sources of risk. If I build such a portfolio, by definition you will not be able to tell me that I am biased; and if I am not biased that means that I am diversified.

Now diversification is not a well-defined concept. We all know how to measure volatility, tracking error, alpha, beta, gamma, delta, etc., but there is no measure for diversification. So we have introduced a measure of diversification for any given portfolio which has been patented in the US and Australia and will be patented very soon in Canada, Japan and some European countries. With this tool we can build a portfolio that maximises its diversification.

Q: What are the advantages of maximum diversification?

The chart shows the investable universe on a risk/return basis with the efficient frontier being the upper side of the red line. It is a well-established fact that whatever geography or time period you consider, the market-cap weighted benchmark is always far from the efficient frontier after two or three years. The first consequence of diversification will be risk reduction — the portfolio will move to the left on the chart as risk falls. What we also very strongly believe is that diversification will systematically increase the return, for two intuitive reasons.

First, the most diversified portfolio is one with real neutral risk allocation — we try to allocate the portfolio's volatility evenly to all the drivers of risk. It is very important to realise that if you describe your aim as capturing a risk premium, your job is about diversifying. Let me give you two real life examples. When you go to a casino, you will never be able to say that you have captured the risk premium from the casino even if you have made a winning bet. Only one person captures the risk premium from a casino: the owner, whose strategy is diversification. If you launch a casino with only one slot machine, you will go bankrupt.

Another example is provided by insurance companies: when I trained as an actuary, the first lesson came when the professor told us that the insurance company's job is never about trying to forecast. An insurance company's job is about pricing and diversifying the risks it covers.

It is the same in stock markets. If you build a portfolio which is different from the most diversified portfolio, you have made some bets, whether explicit or implicit, and as soon as you have made bets you have destroyed some risk premium. Depending on your success in forecasting, you will create wealth or destroy wealth — but in both cases you have paid back risk premium instead of receiving all the risk premium.

THE ANTI-BENCHMARK DEFINES AND MAXIMIZES DIVERSIFICATION

- The Anti-Benchmark delivers broad equity market exposure that provides superior performance with lower risk
- Backed up by empirical evidence and supported by academic theory
- Anti-Benchmark captures the full equity market risk premium
- We believe the higher returns result from better capturing of the risk premia

Source: TOBAM

The second intuitive reason why diversification will increase the return can be seen in the weighting of the sectors of the S&P 500. As stocks appreciate, the greater their weighting becomes in the index, and vice versa. So, for example, after the first oil shock, energy stocks rose and if you were following a market-cap weighted index, you would increase your allocation to energy stocks until the peak was reached — when the oil counter-shock happened, which was the worst day to be holding them. A market-cap weighted benchmark is not a neutral risk allocator; it is a biased risk allocator. And not only is it biased, those biases change over time — it is a dynamic risk allocator.

Q: So what is your investment strategy?

In a way, the Anti-Benchmark is not an investment strategy, but the absence of strategy. It is the agnostic portfolio, the neutral risk allocator, the only portfolio you should buy if you are not able to forecast. If you cannot forecast, you are left with no other decision than to diversify. We believe that we are the only portfolio manager in the world which can say to its clients that we are never going to deliver any alpha. We cannot deliver any alpha because we do not even have a strategy.

After six or nine months of investing with us, our clients stop asking whether the Anti-Benchmark outperformed or underperformed. They start asking whether the benchmark outperformed the Anti-Benchmark or underperformed it, because they realise that we do not make bets. Ours is a diversified portfolio, the most boring portfolio. The non-boring portfolios simply make enormous bets.

Q: When does the Anti-Benchmark underperform?

We underperform when the Benchmark outperforms us, because of the way the dynamic risk allocation of the benchmark is managed! The adverse scenario of the Anti-Benchmark is when the benchmark outperforms by winning the bets it is making and if that happens, and since the Benchmark is "buy and hold", the bets will simply grow.

At the end, the adverse scenario for the Anti-Benchmark is full concentration of the benchmark. ●