Strategically Speaking TOBAM

Life on planet TOBAM

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Quantitative asset managers aren't particularly noted for prioritising ESG matters, and sure enough Parisian boutique TOBAM pursues an investment methodology, dubbed 'Maximum Diversification' or 'Anti-Benchmark', that is based on the idea that it doesn't pay to make any judgement about the future prospects of a company or stock.

But TOBAM signed up to the UNPRI in 2010, commits a substantial part of its Emerging Markets Equity fund revenues to Amnesty International and offsets 125% of its carbon footprint. And, more profoundly, its company agnosticism is right at the heart of president and CIO Yves Choueifaty's idea of TOBAM's social role: he argues that it redirects the emphasis away from the skills of portfolio managers and back to where it should be – linking savings and labour.

Choueifaty invites us to imagine two planets. On one, every investor is buying minimum variance; on the other, everyone buys maximum diversification. "On the first planet every CEO will aim to reduce the volatility of cash flows to attract capital from investors," says Choueifaty. "In a way, they will buy T-Bills instead of building factories or spending on research and development – and the planet's economy will become sterile. On the other planet, every CEO will want his company to add diversification to investors' portfolios. What's the only way to diversify within an economy? To innovate, and focus completely on what you do better than anyone else. The result: a fertile, growing economy."

TOBAM lives up to this ideal. It outsources marketing and distribution; and also its entire middle office (to CACEIS). In investment strategy it does just one thing – 'Maximum Diversification' – across Global, US, European, Pacific ex-Japan, Emerging Market, Japan, UK, and French equities.

That process creates the portfolio of stocks from a given universe that maximises what Choueifaty calls the diversification ratio: the ratio of the portfolio's weighted average volatility to its overall volatility.

Choueifaty recalls one of his first assignments as a young quant. A client's consultant measured the performance of the manager he worked for against 'The Most Likely Portfolio' – which Choueifaty was tasked with identifying. It turned out to be the equally-weighted portfolio. Choueifaty was intrigued at the idea of measuring managers, not against the sum of the portfolios actually in existence (the market-cap index), but against the sum of all the portfolios that could potentially exist.

Maximum Diversification takes the idea a step further by creating a portfolio that equally-weights not all of the stocks in the universe, but all of the sources of risk; it gives the biggest weights to the most diversifying stocks and is more correlated with the stocks it excludes than with any of the stocks it holds. Worried because your TOBAM portfolio doesn't contain Apple? Don't be: its absence means the portfolio already contains all the 'Apple risk' it needs.

As befits someone who has had to sell such a quanty concept, Choueifaty has a gift for analogies. This time he describes two houses by the sea. The one nearest the sea looks likely to collapse. A "speculator" would buy the other house in anticipation of a nice sea view and some price appreciation. But an "investor" would buy both.

YVES CHOUEIFATY
- 2009: President and CIO, TOBAM
- 2006: Head of Lehman Brothers Quantitative Asset Management Europe
- 2005: President and founder, TOBAM
- 2000: CIO and later CEO, Credit Lyonnais Asset Management

TOBAM
- AuM: $2.5bn
- 2012: Amundi becomes minority shareholder, distribution partner
- 2011: LA office opens, CalPERS becomes minority shareholder
- 2010: Amsterdam office opens
- 2008-09: Business bought out of Lehman Brothers, re-named TOBAM
- 2006: TOBAM becomes part of Lehman Brothers Quantitative Asset Management
- 2005: TOBAM founded in Paris

"An investor believes that the price of the building at risk of collapse must reflect that likelihood of collapse," he explains. "As it's so cheap, why not buy it just in case it doesn't collapse? Then the investor needs to allocate risk. He would pay much more for the sound building than for the one in danger of collapse, in order to equalise his exposure to the risk that one or both – or neither – of the buildings collapses."

In other words, the market is efficient (that is, impossible to forecast), and the only sensible response is to perfectly diversify exposure to its risks. That is a bracing corrective to the fashionable dismissal of the idea of efficient markets. Choueifaty's labelling of everything else as 'speculation' also challenges the view – exemplified in the recent review of UK equity markets by John Kay – that proper investment involves concentrated portfolios based on detailed bottom-up fundamental research.

Choueifaty can show impressive risk-adjusted returns. But does Maximum Diversification also extract something like the true risk premium from its markets? Take its emerging markets product, launched in June 2011. The volatility of the MSCI Emerging Markets index is dominated by financials, energy and materials risks that are, in turn, driven by global cyclicality: it is almost 75% correlated with the MSCI World index. TOBAM's portfolio equally weights these risks with all the others available from the EM universe – and shows a 59% correlation with MSCI World. Choueifaty also relates how TOBAM created mock portfolios that first gave bigger weights to companies with more letters in their names and then reversed the process They all outperformed the cap-weighted benchmarks.

"I can think of no other explanation than the benefit of diversification," says Choueifaty. "That is why the starting point of any conversation with potential clients is to say that their core portfolio should be properly diversified."

This is the key argument in Choueifaty's attempt to position Maximum Diversification against other iterations of 'smart beta' like minimum variance and fundamental indexation. All agree that the cap-weighted portfolio generates unwanted biases, but while others plump for 'better' biases, Choueifaty believes that ultimately this is just another species of speculation whose benefits are really due to diversification.

This is a brave marketing strategy, given TOBAM's explicit intention to target the world's "most demanding" and "emblematic" institutional investors. It would have been much easier to sell these investors a modest slice of a 'smart beta' satellite, rather than stake a claim on billions in core allocations. It hasn't always been easy. Intermediaries find it tricky to fit a process aiming for total style-neutrality into 'style boxes'. Moreover, Choueifaty has openly published the mechanics of the diversification ratio, which is now patented, and that is one reason TOBAM partnered with FTSE to share revenues from eight maximum diversification indices.

"We always thought that there was a chance that the very largest investors could decide to try this internally rather than allocating $10bn to TOBAM, but that they would respect our intellectual property by buying an index if one was available," he explains.

So far so good. Assets under management went from $600m (€465m) when TOBAM became independent, to $2.5bn by mid-2012. The Netherlands is its biggest market, including major names like De Eendragt. Switzerland comes next, including the Swiss Post Pension Fund (which increased its original 2008 allocation by 50% in 2010). In Sweden TOBAM works with two of the AP funds, one of which seeded its emerging markets product. At home, it counts the largest health insurer, two top-15 life companies and ERAFP as clients. It also manages money for a top-15 UK pension fund and a top-15 Finnish pension fund.

It added to this impressive position in Europe with a big vote of confidence from CalPERS in 2011. Selected by the pension giant's manager development programme, it picked up a $150m global equities mandate, and CalPERS bought a 17.5% stake in the business.

TOBAM is now looking to consolidate that position with a new US office headed by ex-Analytic Investors portfolio manager Steve Sapra, and already counts two other public pension funds and a university endowment as clients. Most recently, it entered into a distribution partnership with Amundi with a view to accessing its clients, especially in EMEA. Amundi bought a 5% stake from CalPERS, and a further 12.5% from TOBAM, leaving Choueifaty and partners with 70%.

All in all, it has been an impressive three-and-a-half years. But, for Choueifaty, the story is only just beginning. "Phase one was about establishing TOBAM's credibility with the most demanding investors in the world," he says. "Phase two will be about leveraging that credibility."

Maybe Planet TOBAM wasn't just an analogy, after all.