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Paris firm takes anti-benchmark approach to indexing

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It's a well known fact of financial life that active investment management is a waste of time and clients' money. Investment managers as a group just can't beat the market.

Sure, fund managers and brokers may talk a good line about how well you'll do in their funds, or with the stock picks of their firm's hotshot analysts. But modern portfolio theory, bolstered by real world evidence, has found that money managers as a group underperform the market over time. Even if managers deliver market-beating returns for a while before the inevitable reversion to the mean, you've still got to pay their fees, eating into your profits.

If you believe that active management is fool's gold – attractive at first glance but ultimately worthless – it makes sense to consider the profusion of index funds, many of them available through exchange-traded ETFs, now on the market. These funds have given up on the idea of besting the index and are content to mindlessly match the market's return by buying the exact basket of the stocks in the index they're tracking.

The attraction: Investors don't have to pay the hefty fees of active managers and over time will do just as well or as poorly as the index, minus, of course, the modest charges for running the fund.

But there is also a glaring weakness in these index funds, a kind of congenital brain defect in an otherwise well born idea. Most major indexes are capitalization weighted, so as a company's overall market value rises, the indexers are forced to load up on more of its shares.

The modern poster boy for this phenomenon is Apple Inc., the world's most valuable company, which now makes up nearly 20 per cent of the Nasdaq 100. Back at the turn of the century, when Nortel was a darling of the tech boom, it amounted to about 30 per cent of the Canadian market. We all remember what happened next.

Buying companies in proportion to their market values means that indexing leads to a portfolio that loads up with the hottest names at precisely the worst time – just when they're at their most expensive. Meanwhile, undervalued and bargain-priced investments are under owned, just when they are at their cheapest.

It's this drawback that has prompted a little known Paris-based firm, Tobam Core Investments, and its president Yves Choueifaty, to make the rounds on Bay Street, arguing that there are particularly glaring weaknesses in the concentrated index weightings of stocks in the MSCI Daily index for Canada. Mr. Choueifaty, a mathematician by trade, says profits

are to be made exploiting the index structure, through what he's dubbing an "anti-benchmark Canada equity strategy" that he created last year.

Like all good market crunchers, Mr. Choueifaty has done some backward calculations on how his portfolio would have performed and found that since December, 2000, it would have had an annualized return of 9.7 per cent, more than double the 4.2 per cent of the index. "In the Canadian market, there is a lot of room for diversification," Mr. Choueifaty observes. "Almost all the volatility of the benchmark is coming from three different sources of risk, which are financials, materials and energy."

He's built a Canadian portfolio that aims to achieve maximum diversification while sidestepping stocks that traditional indexing overweights. The 10 top names in his portfolio are worth a look because they're good companies in their own right: Bell Aliant Inc. (5.9 per cent weighting), BCE Inc. (5.6), TMX Group Ltd.(4.9) Telus Corp. (4.7), Empire Co. Ltd. (4.3) CI Financial Corp. (4), Intact Financial Corp. (4), Fairfax Financial Holdings Ltd.(4), Pembina Pipeline Corp.(3.9) and Metro Inc. (3.7).

It's hard for retail investors to avoid capitalization-weighted ETFs, but there are a few offerings, such as Blackstone's iShares RAFI index funds, that weight their holdings according to such factors as book value and gross dividend payments, to avoid the negative impact of investing by market value.

Tobam caters only to institutions, and so far has about $30-million invested in its Canadian anti-benchmark and nearly $3-billion in similar funds on other international market indexes. Institutions seem to be buying into the concept. Pension fund giant CalPERs has taken a minority ownership stake in Tobam, and the firm's assets under management rose 41 per cent last year and are on track for a 60 per cent gain this year.