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FACE TO FACE

Tobam: 'I promise to deliver zero alpha'

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Yves Choueifaty is a man on a mission. His yearbook photo, from the high school he attended in Beirut, was captioned: "If he's going to be successful, he'll continue providing us with antidemonstration of mathematical theorems".

Three decades later, he still has that combination of contrariness and obsessive devotion to his subject, but he has moved on, a little bit, from maths to asset management. He believes the industry has a mission to improve the world.

Unfortunately, he also believes the industry is going down the wrong path with its emphasis on active managers beating the benchmark and investors pouring money into passive management.

"The role of the active manager is not to beat the S&P. It is to make the S&P go up," he says. If they are doing their job as capital allocators correctly, the index will rise as returns on capital are optimised. "If we resign this role, the S&P would go to zero, because that is the end of capitalism."

Passive investment, he declares, "is the perfect oxymoron", because it incorporates all the biases of the active managers, creating not a neutral portfolio but one that reinforces the bets in other portfolios.

In Mr Choueifaty's view, passive managers are misleading their clients, because the portfolios they oversee are not neutral but dynamic asset allocators, inevitably putting more money with the most overvalued stocks.

His antidote to this is "the anti-benchmark", an indexing idea he developed in opposition to the more mainstream capitalisation-weighted benchmark. Tobam, the company he set up to exploit this idea, is focused exclusively on running funds tracking proprietary anti-benchmark indices.

Most stock market indices are weighted according to the capitalisation of the constituent companies — the bigger the company, the larger its value in the index. In recent years, fundamentally weighted indices have become popular, as they weight their constituents according to other company metrics, such as profit, free cash flow or sales. As passive investment, which replicates the cap-weighted index, has grown in popularity, these alternative indices, known as smartbeta indices, have attracted significant assets.

In a world where smart beta is the latest trend, Tobam's anti-benchmark seems like an inevitable idea.

The anti-benchmark is based on Mr Choueifaty's development of a formal measure of diversification. While it is generally agreed that diversification is a good way to manage risk, there is no universally agreed mathematical measure of it.

Mr Choueifaty developed such a measure and used it to create an index of maximum diversification. The theory is that this is the most neutral possible portfolio, taking no bets on style or valuation.

In theory at least, it should outperform the cap-weighted index representing the same market, because it avoids taking large bets in overvalued companies and overweights companies where investors have failed to recognise value.

For this reason, Mr Choueifaty eschews the term smart beta. "I believe there is no smart beta, but there is one dumb beta [the cap weighted benchmark]. What we are trying to access is the true beta [the source of the equity risk premium]" he says.

"I am the only portfolio manager who will promise to deliver zero alpha."

Although in most cases, investors are looking for managers they believe will deliver alpha, Tobam's offer has attracted more than $9bn and is growing.

It has been a long road to get here, though.

In 2006, Mr Choueifaty set up what was to become Tobam as part of Lehman Brothers Asset Management. Luckily for him and his team, Lehman was to act as an incubator, with a plan to spin off the unit after three years, in 2009. This meant that when disaster hit in September 2008 and "unfortunately Lehman Brothers spun off from us", Tobam was ready to escape the clutches of the receivers by accelerating its departure slightly.

A couple of years later, Calpers, North America's largest pension fund, took an interest, making a small allocation to the funds and taking Tobam into its manager development programme. Now, after graduation from that programme, Calpers has an 8 per cent stake in the company and the original $150m mandate has grown to $1bn.

Eighty per cent of Tobam is employee owned. All employees of a certain tenure (not excluding administrative staff) have the option to buy shares, and so far none has declined. The remaining 12 per cent was bought by Amundi in 2012, as part of a strategic alliance giving Tobam access to the French fund house's distribution network.

This is important because Tobam's sales team does not exist. Demonstrating the company's priorities, almost half of its 36-strong team work in research. There are three strands for the 15 people in the research team to focus on: elaborating the mathematical properties of the diversification measurement; working out how best to implement it; and looking at how well it will work in other markets and asset classes.

This kind of research resource is necessary because, in the view of Mr Choueifaty, the son of a surgeon and an anaesthetist, asset management is at the stage of development that medicine was at in the Middle Ages. "It is entirely empirical. You see the symptoms, so that is what you treat."

He is careful to say he does not wish to sound dismissive of other asset managers, but he has no qualms about voicing excoriating criticism of so-called passive management tracking cap-weighted benchmarks. "Passive is completely toxic."

"There are two ways to extract risk and reward from markets," says Mr Choueifaty. "First, to assess the possibility of arbitrage, to see mispricing and take advantage." This is traditional active management. "Second, to extract the value of employees of the underlying companies." This is the beta he is trying to capture. Although traditional passive managers would claim to be doing the same thing, he thinks they are actually interfering with the process of capital allocation by reinforcing any mispricing already present.

He says: "The benchmark has a property that I don't have: It is the sum of all portfolios, and it shows what is expensive. That is still useful, but not in order to be replicated."

Topam

Founded **2005**

Assets under management **$8.8bn** (as of March 31 2015)

Employees **35**

Headquarters **Paris**

Ownership **80% employees, 12% Amundi, 8% Calpers**

CV

Born *1967*

Education *1992* Master's degree in statistics, actuarial studies, finance and artificial intelligence, ENSAE

Career *1992-98* Development of structured products, Credit Lyonnais Asset Management

1998-2000 Head of financial engineering and quantitative investment management, CLAM

2000-06 Chief investment officer, then chief executive, CLAM

2006 to present Founder and president, TOBAM