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CEO Yves Choueifaty: Pushing Smart Beta's Boundaries

By Timothy Bourgaize Murray

Yves Choueifaty was at the forefront of the smart beta revolution well before it spread across the asset management industry. From Paris, the CEO tells Tim Bourgaize Murray how a twist of fortune pushed his firm, Tobam, to rapid independence, and why technical acumen has always been central to the burgeoning asset management house's success. Photos by Thierry Chantegret

After World War II, the French aerospace industry was in ruins. Marcel Dassault, one of Yves Choueifaty's inspirations, rapidly brought it back to health.
An engineer by training, Dassault developed a new model of jet fighter—the *Mirage*—that became ubiquitous in the post-war era not only for its sturdiness but also for its aesthetics, and its designer was dogged in his willingness to go anywhere to sell it.

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"A good plane must be a beautiful plane," he was known to say. One quality was indistinguishable from the other.

Choueifaty often quotes that sentiment when describing his vision for Tobam—the $9 billion Paris-based asset manager that he founded shortly before the financial crisis and which, like the Mirage, has emerged from the ashes of dark years to help redefine asset management. Along the way, the firm's Anti-Benchmark diversification strategy—its singular focus—has proven a progenitor of the broader "smart beta" rise, which in 2015 is sweeping in many of the world's largest buy-side firms.

But Choueifaty tells *Waters* that it takes more than a contrarian-turned-conventional idea to rope in top institutional investors. So how did a tiny French manager convince CalPERS (the California Public Employees' Retirement System) to take a minority stake in the business, and sign up many of the largest public and corporate pensions in Europe as clients? It is as much about looking right—and operating beautifully—as being right, he says.

And technologically, that dedication has reaped rare and unique dividends of its own for this firm nestled just a short walk from the Arc de Triomphe.

Trial by Fire

Choueifaty's mindset is not that of your typical CEO. When he left his role as Credit Lyonnais' head of asset management in 2005, he tried to be "very methodological" in figuring out the next step. Things got fairly philosophical.

"My friends suggested I venture out on my own, but there are enough managers already, I thought. So I remember thinking about what the social role of an asset manager should be in society—to be the link between savings and labor, reinvesting in the economy," he says. "And if you think about that, you arrive relatively quickly at the problem of diversification. We realized everyone talks about it, but it's not well defined. So, first of all, we wanted to define a measure. All of this started with maths."

Once Choueifaty had a beat on a thesis, the next step was gathering some seed money, and it turns out there was serious interest in his concept. Lehman Brothers signed an incubation agreement with Tobam in early 2006, which would provide some infrastructure, middle-office provision, and real estate for three years, after which the bank would sell its share and the firm would spin-off. Of course, it was Lehman—*not* the start-up manager—that failed to survive that 36-month term. But Tobam's design, to operate mostly independently from the beginning with an internally built software platform, helped it survive.

Unperturbed, Choueifaty moved the middle-office responsibility to Tobam's fund administrator, and just as important, began accumulating frequent flyer miles. "The most important loss for us [from the Lehman collapse] was our distribution, but by 2008 everything else was ready," Choueifaty explains. "For us, there were two steps: first, prove that the most demanding clients in the world would give us money, and second, build partnerships."

Fast-forward and Amundi, the French asset manager and fund distributor, now holds a 12 percent share in Tobam and has bolstered the firm's reach in the Middle East and Asia. CalPERS is staked at 8 percent, with Tobam's staff owning the rest. Trial by fire, it seems, worked pretty well.

Defining 'Smart'

So, just what is smart beta, why is it gaining the attention of mainstays like State Street and BlackRock, and how did Tobam arrive so early? In the simplest sense, smart beta products are a reaction to institutional investors' need for risk-adjusted returns, balanced with their desire to avoid the hefty fees traditionally demanded for active management. Beyond that, though, things tend to vary.

"There are plenty of strategies that qualify themselves as smart beta, and like groups of anything, they're very different," Choueifaty explains. "If you think about it, many lack commonalities except that each has that one thing: the argument that a market capitalization-weighted benchmark is a ‘dumb’ beta. By their nature, these benchmarks systematically over-allocate to overvalued assets, and though it’s changing for the better, our industry is quite poisoned with two confusions.

"First, it should be understood that passive management is very far away from neutral," he says. "Passive management, by definition using market cap-weighted benchmarks is extremely biased to certain stocks, and biases at the worst moment. The second is around the term ‘efficient.’ We hear that benchmarks are inefficient because markets are inefficient when it’s exactly the opposite—an efficient market is actually hard to predict. This is why, with our products, we strictly stay away from correlation.”

The challenge, then, is managing the complicated analysis and deep digging that goes into building a portfolio that is perfectly uncorrelated. In short, this involves growing the ratio of its parts’ weighted-average volatility to the portfolio’s volatility overall as much as possible. And it is here that the “smart” comes in, the CEO explains.

34 Properties

Of its 36 employees, Tobam has 15 researchers dedicated to its strategy, and through years of work, Choueifaty and his team have coined 34 different mathematical properties around their theory of portfolio construction, most of which come under the banner of, “emphasize correlation, not weighting.” A very simple example from the CEO: if 2.5 percent of the portfolio is Toyota stock, but the remaining 97.5 percent is in no way correlated to the auto industry, you’re less exposed to certain volatilities—oil shocks, for instance—than if that share were only 1 percent but with a high level of correlation in a significant part of the remaining portfolio.
Figuring that out is the rub. A series of sophisticated tools, such as plesiochronous estimators, are used to tease out correlations around subtle issues like trading time-zone difference, and a portfolio management application is needed to keep all of the resulting models organized. But Choueifaty argues that it’s worth the effort.

“Building a portfolio this way is actually much more stable, whereas when you simply buy a benchmark, you’re already over-weighing what’s gone up,” he says. “If you’re buying the S&P500, the only rationale is a bet that full concentration—an eventual ‘S&P1’—will ultimately happen. If you don’t focus on diversification, you’re implicitly saying that you have a crystal ball.”

In the Cockpit

Surprisingly, though perhaps owing to his experience, Choueifaty says handling all this on a technical level isn't actually a huge lift. The bigger focus, instead, has always been on honing the firm's ability to interface with clients, market participants, and regulators in a single platform, much like a larger firm would.

"We have a rule," he says. "No spreadsheet can be used to communicate with the outside world more than twice. For me, it's as if they're biodegradable: the more you use them, the more they break down."

That's especially so as Tobam continues to expand to new geographies, and win a greater percentage of existing clients' invested money—with a push that has more than tripled its assets under management in the past two years. Diversification, according to the CEO, shouldn't be a constituent piece of the puzzle, but rather central to an institution's core investments. "You can be bullish on some other risk factor—fundamental value or low or high volatility—and you should implement that in a satellite, as you might a hedge fund allocation, but always be diversified," he argues.

Interaction of Styles

One way the firm has succeeded in that drive is to examine clients' full portfolio holdings and help frame exactly how Tobam's strategy would fit into the broader picture, assessing the interaction of investment styles.

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The result harkens back to Choueifaty's interest in flying. Pilot, the firm's Java-based proprietary portfolio management system, was built early in Tobam's life to provide decision support to both its managers and its compliance personnel. "You need a tool in the service of your organization, rather than making the organization serve several different tools," Choueifaty says. "In retrospect, I'm glad we made that investment, having something that was very scalable and that could be used for performance reporting and reactivity for investors, just the same as it could be used to vet order flow or risk report to regulators."

Many in the industry will be familiar with Pilot—though they may know it by a different name. In 2012, Tobam's technology work handsomely paid off, quite literally, when technology giant SunGard acquired the software from the firm and commoditized it. After further enhancements, it exists today as Asset Arena 360, a widely-used portfolio management system for boutique managers.

Unfinished Business

Having gone from an incubator to center stage in only a few short years, what does Choueifaty see in store for Tobam? Well, in a way, his answer is simple … almost too simple for a thoughtful Frenchman: it's much more of the same.

“We really are all about beta; we’re not an alpha provider,” he says. “We’ll let them figure out which risk factor is cheap and which is expensive. We don’t do that, and actually, that’s why we’ve built what we have. Beta is a field that is extremely deep whether in its theory, implementation, or generalization. Pretty radical theoretical research produced those 34 properties; implementation is really how to compute those and potential market impacts of them, and then generalization, which is how we can use equities findings and apply those to other asset classes. We look at all three.”

To the last point, the firm recently started porting its strategy to US credit with a new sub-fund. But there is not any wide swing or additional array of new offerings coming any time soon. As Choueifaty puts it, there is still smart beta work to do. And in an era when every firm wants to be a multistrat, this too shows a contrarian spirit—the same one that got Tobam to where it is.

“We were preaching in the desert at the beginning,” he says. “Having breakfast with the CEO of one the largest US asset managers the other week, he asked me what the future of active versus passive management would be, and I told him ‘passive’ is such a bizarre description—it shouldn’t even be in the same conversation, because it isn’t asset management at all. I still believe benchmarks have a role in the asset management industry: they are representative of the market; they are the sum of all speculations, and, as such, may provide information for asset managers and investors. They may in fact tell the industry what is expensive and what is not."

What’s dangerous is when an output like market-cap weighting becomes the input.
"A dog following its own tail doesn’t get very far, and I’ve said as much to regulators: People aren’t really abiding by their fiduciary duties when they do that. It’s not criminal, but it’s toxic for investors and for the economy," he continues. "We’re finally moving in the right direction. Everyone agrees now with what was even impossible to say ten years ago, when they would’ve laughed at you."

As for smart beta becoming the next great thing, Choueifaty points to the firm’s growth in assets as reason not to worry about its new and often behemoth competition, once again citing the beauty of Tobam’s mature operation as a differentiator.

“Maybe we’re not done yet,” he blinks.

Fundamental Data
Name: Yves Choueifaty
Title: President and founder of Tobam
Degree/university: 1992 graduate from ENSAE in statistics, actuarial studies, finance and artificial intelligence
Number of Staff: 36
Personal Hobbies: Chess, scuba diving, skiing and tennis
Biggest Personal Achievement: Three marvelous kids and a wonderful wife

Link: http://www.waterstechnology.com/waters/feature/2415187/ceo-yves-choueifaty-pushing-smart-betas-boundaries?utm_medium=email&utm_term=&utm_content=CEO%20Yves%20Choueifaty%3A%20Pushing%20Smart%20Beta%27s%20Boundaries&utm_campaign=WT.Daily_RL.EU.A.U&utm_source=WT.DCM.Editors_Updates&im_mfcid=9398148