ESG Interview: Yves Choueifaty, president, TOBAM: "ESG factors are economic. The only difference/dilemma is between the short and long term"

Anti-benchmark, pro-ESG

HUGH WHEELAN

TOBAM – standing for 'Think Out Of The Box Asset Management' – is an independent, majority employee-owned, Paris-based asset management firm launched in 2005 by Yves Choueifaty, its president, a former head of Lehman Brothers Asset Management France and before that CEO of Crédit Lyonnais Asset Management.

It has two minority institutional shareholders: the California Public Employees' Retirement System (CalPERS) with an 8% stake, and Amundi, the French fund manager, with 12%. It manages over $9bn in its 'Anti-Benchmark' strategies in equities and fixed income via a team of 35 professionals based in Paris and New York.

Choueifaty, a highly respected investment professional, was one of the instigators of smart beta, but says TOBAM has stretched beyond the term today.

He may be anti-benchmark, but in other respects he is an actively 'pro' asset management chief: pro-sustainability in long-term investment, pro-environment, pro-human rights.

TOBAM has adopted the investment exclusions of the Norwegian Government Pension Fund, spent three years looking at ESG research in its statistical quant models, and is currently investing a lot of time in corporate governance. Choueifaty talks to ESG Magazine

You believe passive investment management is an oxymoron, why?
Passive management is the absence of management. It doesn't belong in the field of asset management. It's a utility business.

But don't passive managers sell themselves as utility businesses?
Nowadays yes. It was not the case a few years ago. It's worse than that though. Jack Bogle, the founder of Vanguard, had a formula that the market was the sum of a certain proportion of passive managers plus another proportion of active managers. By definition, a bear market would have the same performance as the benchmark. It means that the aggregation of all active managers will have the same performance as the benchmark. The next

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sentence that he usually says is dangerous because he deducts from this that active managers are useless. It says a lot about how little he understands about the economy. Why? It's not active managers that replicate the benchmarks, it benchmarks that replicate active managers.

What is the job of the aggregate asset manager? It cannot be to beat the benchmark. The job is to make the benchmark go up! If active managers allocate capital to companies that destroy value, the economy will suffer. If active managers allocate capital to companies that create value the economy will prosper. The role of active management is not to beat the benchmark – by definition, it cannot. But saying therefore 'active management is useless' is as bad as saying that the average racer in Indianapolis is very slow because on average he never beats the others' speed.

It's very important to understand that if you are a long-term investor, you should avoid passive management at any price because you drive the economy.

Isn't the problem here that active asset managers haven't really been using long-term performance measurement. They've all been driving performance against short-term benchmarks?

I kind of disagree with you. I can elaborate on that. I know some very good active managers – not many, I have to confess. They all have one common point: they never look at the benchmark. It is not sustainable to continue to increase the shares of passive management. Try to imagine capitalism without capital allocators, an economy driven by passive management. It does nothing.

Long-term investors need to remember what their utility function is. It's to pay pensions, not beat the benchmark. They need to drive the benchmarks up! We deal with sophisticated investors that understand that tracking error is not a measure of risk, but of conformity, and when you conform you destroy value. It's anti-conformity that creates value.

What do you think about the huge evolution of smart beta in asset management?

There are two kinds of people: the authors and the people copying the book. I can claim to be one of the authors because in 2005 very few

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people were talking about smart beta. Ten years ago when I was telling people "the benchmark is not efficient," they were surprised and sometimes sceptical. Nowadays it's mainstream and everyone is convinced the market cap weighted benchmark is not an efficient way to invest in the long term. But there is still a lot of confusion in the minds of many who believe benchmarks are inefficient because markets are inefficient. In fact, it's exactly the other way around. An efficient market is one you cannot forecast. If you cannot forecast there is only one thing you should do, diversify. The benchmark is not diversified. The problem of the benchmark is the lack of diversification not the lack of efficiency. Markets are difficult to forecast, so you should be diversifying.

There are three ways of investing and it's really about horizon.

First, if your investment horizon is short, you need to take a lot of care of liquidity, and the most liquid portfolio is the market cap weighted benchmark. But you pay a very expensive price for that because you always end up buying more of what is expensive than what is cheap. I estimate this cost at 400 basis points per annum.

The second step is that as soon as your investment horizon is longer you should move as far away from the liquid portfolio as possible by diversifying.

The third step is about positive alpha, if you are able to find somebody that can forecast – ie, buy cheap and sell expensive.

Are you suggesting that there is a question mark over the education of investors given the volumes of passive assets today?

It's a question of precision in the terms. Our industry is very often based on confusion. The biggest is between passive and neutral. Many people believe that when they are neutral they should buy the benchmark. No. The benchmark is not neutral: it's biased towards certain stocks at the peak of their prices.

Can you talk about the research process you apply at TOBAM?

A major area is theoretical research. We have been able to find 35 mathematical properties for our portfolio. One of them is that we have proven that our portfolio is an equilibrium portfolio. Let's imagine a planet where everybody would buy our portfolio! We have proof that this economy would be in equilibrium and be a growth economy. What is the economic definition of being a diversifier? It's to be an innovator. And the statistical definition of innovation is diversification. When you are an innovator you create something that does not exist yet, so you are a diversifier. You should weight your portfolio according to its diversification capability, which means how innovative it is.

How can you measure that?

Statistical correlation. Let's look at three companies: two banks and one pharma. The two banks think very similarly and the pharma is very different. One way to invest could be to hold a third of each. That's fine, but you are not really diversified because you have roughly 66% banks and 33% pharma. As a result of minimising correlation you might obtain 50-25-25. This is the portfolio that maximises the risk ratio. It's correlation as a statistical measure that tells you how different one thing is from another.

Decarbonise as you drive

YVES CHOUEIFATY IS AS INTERESTED in practical solutions to climate change as the issue itself. He chairs WeNow, a French tech start-up, providing a practical and simple way for drivers to offset their real-time CO_2 emissions.

A tracking device called a 'WeNow box' is installed in a vehicle to monitor 'in real time' the level of CO_2 being produced through three data points: acceleration, deceleration and evenness of speed. The data is collated and presented simultaneously to the drivers via an app on their phones and to the WeNow project. The data can then be used to neutralise and reduce CO_2 emissions in two related ways.

First, a cost assigned to carbon emissions is voluntarily collected from the driver (€12 to €19 per ton of CO_2 emitted). This sum is then passed on to support a project designated by the user in a developing country that will 'offset' the equivalent amount of CO_2.

Second, the app raises users' awareness on how they can reduce their carbon contribution by providing analytics on journeys and driving, and offering 'tips' to avoid inefficiencies and improve performance. WeNow believes an overall reduction in fuel consumption of 5–15% is feasible. Over time, the cost of subscribing to the project will be offset by fuel savings. The logic behind the project is that the actual location of CO_2 production or removal from a global temperature viewpoint is immaterial. What matters is the net level of emissions, which has continued to grow year on year.

Projects supported by WeNow range from providing wind farms in India to reforesting mountain regions in Colombia. Through supporting these projects the aim is also to help the social, economic and environmental development of the host country through jobs, education and infrastructure. A recent report by Imperial College London and the International Carbon Reduction and Offset Alliance (ICROA) demonstrated that the benefits of offsetting go beyond simply addressing CO_2 levels. They estimate that every ton of carbon removed results in social, economic and environmental benefits to the host country worth approximately $664.

WeNow: www.wenow.com/en/wenow-drive-carbon-free/

You are doing a lot of work on ESG research. Why?

Because our investors are long term. What they want is to have a portfolio that is sustainable; meaning compatible with the long term. We're very motivated by this work. In my mind it's purely economic. If I want to sustain something economically over the long term I need to look at ESG characteristics in my portfolio, although the three letters E-S-G are shorthand really. We have done a lot of research on this, especially in the last three years to look at ESG at both the firm and portfolio level. Let's talk about the firm first. TOBAM offsets systematically 130–150% of its carbon emissions. I think I'm the only CEO on this planet that can say that every time I take the plane that it's good for the planet because I offset 150%.

How do you offset?

We write a cheque to NGOs that plant trees that capture the CO_2. We also took another major step at the firm level. When we launched our first emerging market portfolio we decided to systematically give 7.5% of our fees to human rights NGOs.

Because you believe good human, social and labour rights lead to long-term economic growth?

Absolutely. I have no doubts human rights will win in the end because it is an efficient structure from an economic point of view in encouraging innovation.

Couldn't you argue that the other way round with the continued evolution of China with a poor human rights record?

The question you have to ask is: are human rights improving in China? I think they are, especially over the medium to long term. The trend is positive.

Does this human rights 'mission' have any advantage in attracting/retaining employees?

According to a survey we've done, at least 75% of our staff thought it was a real plus in terms of working for us.

How do you see the evolution of ESG?

Very often when I meet with ESG experts, I disagree with them because they tell me there are economic factors – and ESG. No! ESG factors are economic. The only difference/dilemma is between the short and long term.

Talk about the ESG research you've done at the portfolio level.

After three years, I have to confess that the results have not been entirely encouraging. First of all, we were looking for rational and coherent information. We subscribed to an ESG data provider. But the coherence of the data we received was not good, to say the least. We are now beginning to address the problem differently by going back to first principles. What is my job? It is to be a professional shareholder. Therefore, there are two things that I should do. First is that I should be happy with the stocks I own and the second is that I need to make sure that I am well represented in the governance of these entities.

My role as a shareholder is not to judge management decisions. That is the role of the board. I am putting more attention on the 'G' in terms of board oversight. If the board is working well it will take care of the E and the S.

Is that because statistically you see better governance data or is it more instinctive?

Statistically I have seen no significance in E and S data, and 'some' significance in G data, but not a lot. I think things can be improved if looked at in a more objective way. I think most issues are problems, ultimately, of governance. What is the perfect board for me? It's the most diversified one, with men, women, young and old people, experts, environmentally or legally aware people.

But what is the meaning of diversification here? 50-50 men/women?

Diversification doesn't mean equality in numbers, it means not 'unique'.

How do you think ESG data could be involved in investment decisions?

It needs to evolve. I'm sure it will increase in importance in the decision-making process but the quality of the data must improve. For the moment it's not objective. There are too many opinions and contradictions.