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TOBAM – DIVERSIFICATION, DIVERSIFICATION, DIVERSIFICATION …

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For Paris-based **TOBAM**, whose founder Yves Choueifaty we had the pleasure of sitting down with in Toronto recently, the corresponding mantra could well be Diversification, Diversification, Diversification… and, more Diversification.

What does TOBAM seek to bring to the table in a world where “Passive does not equal Neutral”? Respectively one where beyond passive, “Smart Beta” or “Factor” based strategies increasingly are crowding the product shelf? Answer: the “Undiversifiable” portfolio.

Bottom line – It was probably high time we had a mathematician solve for “diversification”. As with TOBAM, this now appears to be “chose faite”, the question could be – will investors grab onto the diversification factor, one which come 2017 could arguably become increasingly useful?

What we know in the Smart Beta field, is that the enticement of Yield, and the premise of getting lower volatility, have both had a very significant gravitational pull to them for investors. As proper diversification is a key tenet of portfolio construction, will it resonate with them and correspondingly, attract significant assets? And if diversification alone doesn’t do it for them, will knowing that SRI filters are also part of the recipe be what clenches the deal? (TOBAM commingled equity funds’investment universes are filtered based upon the Norges Bank Investment Management SRI recommendations).

In Canada, Mackenzie Investments has launched 5 TOBAM based ETFs (2 in June when it joined the ranks of Canadian ETFs providers, 3 more since) created to help protect a portfolio from equity market biases, sector concentration and unmanaged risks. By increasing diversification and reducing biases, these equity ETFs seek to enhance risk-adjusted returns for investors.

The ETFs are managed through a partnership with TOBAM, a France based independent asset manager. The goal of the investment strategy at TOBAM is to achieve the optimal beta through diversification and to spread risk evenly throughout the portfolio. Mackenzie’s Maximum Diversification ETF’s replicate and track proprietary indices provided by TOBAM’s Maximum Diversification Index Series.

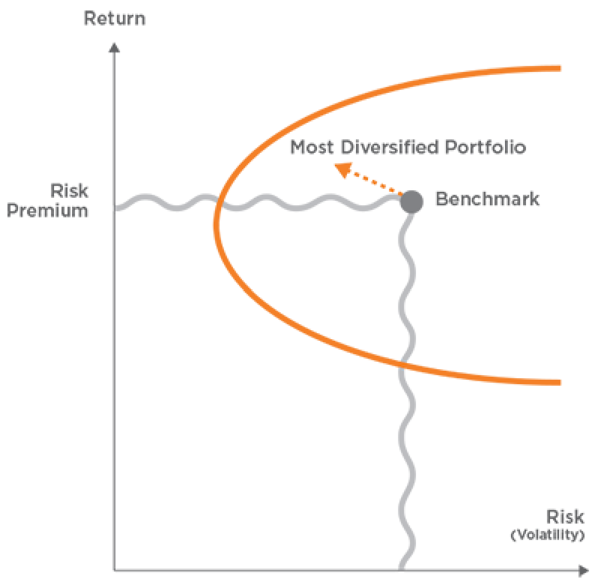
TOBAM was among the founders of the “Smart-Beta” movement in 2005. The firm has been awarded twice in 2015 for its pioneering role in the foundation of the alternative/smart beta movement, as well as more recently being recognized as “European Asset manager of the Year” by Funds Europe Awards in London.

TOBAM uses an innovative methodology to select and weight individual stocks to significantly reduce correlations between holdings. The strategy is based on Mr. Choueifaty's development of a formal measure of diversification, Diversification Ratio. While we know that diversification is a good way to manage risk as it reduces volatility and enhances the risk-adjusted returns, the problem was that there has not been a universally agreed mathematical measure of diversification. TOBAM's research led to defining a mathematical measure, the Diversification Ratio, which provides TOBAM with a systematic approach for building well diversified portfolios.

The theory is that this approach will result in the most neutral possible portfolio, taking no bets on style or valuation – focusing instead on "capturing the full equity market risk premium". Mr. Choueifaty notes that he may be the only portfolio manager who does not make any predictions about the future or whether or not a stock is valued properly. He may be the only active manager that is not looking to add 'alpha'.

TOBAM's objective is to maximize diversification in order to capture the risk premium of an asset class, in other words, to provide the optimal 'beta'. He notes that while many managers focus on capturing 'alpha' to contribute to performance, less attention may be dedicated to improving 'beta' which often provides the major contribution to performance, and to risk.

TOBAM believes the error with passive investing is that more money is constantly being allocated to overvalued stocks, those with the largest weights in the market. Hence, ***Passive does not equal Neutral.*** Active portfolio managers generally adhere to an investing strategy/style, such as growth, value or momentum. To invest in one of these styles is to assume that the investment trends will continue to provide positive returns, and that the manager will continue to select the best holdings to benefit from those trends, which may or may not be correct. Getting these bets right can be very challenging, particularly in the current environment. TOBAM's strategy differentiates itself in that the managers are not making any assumptions or forecasts about future returns or which strategies/styles will outperform and which ones will underperform. The key goal is to maximize and provide the optimal 'beta', thereby enhancing returns and reducing volatility over a market cycle.



The Anti-Benchmark® strategy is designed to create portfolios proposing to lie closer to the ex-post efficient frontier than the market cap portfolio over a market cycle. Anti-Benchmark® portfolios access the available risk *premium in a risk efficient manner and are intending to typically enhance performance vs. the benchmark by 3%-5% p.a. via greater diversification for equity portfolios, while also reducing volatility by 20-30% per annum over a market cycle. For credit portfolios, the strategy endeavours to outperform the benchmark by 1-2% per annum with less volatility as well*

Source: TOBAM

The crux of the strategy is that holding a large number of assets does not necessarily mean the portfolio is optimally diversified, rather, it is that the portfolio must be exposed to a diversified number of sources of risk for optimal diversification. While a portfolio with 500 holdings may at first appear well diversified, if all 500 stocks are highly correlated to the price of oil, that portfolio is not very well diversified. TOBAM's unique approach and formula seeks to maximize diversification of the portfolio by reducing the correlation of the various holdings.

Table 1 shows the top holdings of Mackenzie's Maximum Diversification Canada Index (MCK), alongside that of the iShares S&P/TSX 60 (XIU).

Table 1: Top Holdings, October 31, 2016

Constellation Software	3.2%	Royal Bank	8.6%
Canadian Tire	3.1%	Toronto Dominion Bank	7.8%
CGI Group	3.1%	Bank of Nova Scotia	6.0%
Shaw Communications	3.0%	Suncor	4.6%
Saputo	3.0%	Canadian National Railway	4.5%
Intact Financial	3.0%	Bank of Montreal	3.8%
TransCanada	3.0%	Enbridge	3.7%
Turquoise Hill Resources	2.9%	BCE	3.7%
Alimentation Couche-Tard	2.9%	TransCanada	3.4%
RioCan Real Estate	2.8%	Canadian Natural Resources	3.2%

At the sector level, the difference in exposure to financials and energy is notable. Not surprisingly, XIU, which replicates the S&P/TSX 60, has significantly higher financials and energy weights, at 39.2% and 21.1% respectively. In contrast, MKC's exposure to these sectors is significantly lower, at 22.2% and 9.1% respectively (**the offsets are significantly greater consumer, technology, and telecom exposures**).

In addition to MKC, Mackenzie also offers other Maximum Diversification ETFs:

- Mackenzie Maximum Diversification All-World Developed Index ETF (MWD),
- Mackenzie Maximum Diversification All-World Developed Ex-North America Index (MXU),
- Mackenzie Maximum Diversification Developed Europe Index (MEU),
- and Mackenzie Maximum Diversification U.S. Index (MUS).

"Smart Beta" in Canada:

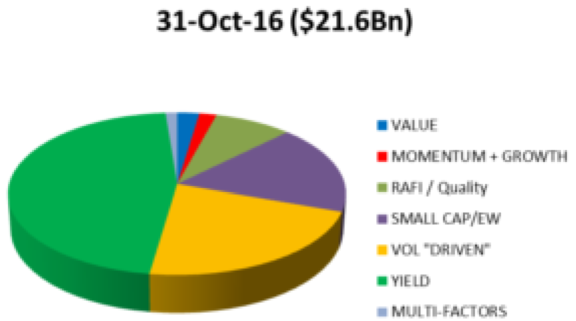
In the ETF World, when looking to invest in stocks, aside from traditional pure passive indexing, investors are faced with an ever expanding array of choices – most notably in the fast growing "Smart Beta" product shelf.

Checking-in on the uptake of “Smart Beta” in Canada, “Smart Beta” solutions have been growing at close to twice the pace of the overall ETF space (47.3% y/o/y to Oct 31, 2016 for smart beta, vs 24.8% for the overall product group), with Smart Beta AUM of some $21.6 Billion corresponding or close to 1/3 of overall equity AUM in the Canadian ETFs space).

A look across the traditional factors identified by MSCI Inc. :

- Value,
- Momentum,
- Size,
- Quality,
- Yield,
- and finally Volatility (low and min)

also including the more recently introduced Multi-Factors category, shows a category dominated by Yield, Volatility, and Size in Canada (though size here is a misnomer, in that including Equal Weight here overlooks the fact that equally weighting across US sectors such as Healthcare, and Banking, doesn’t exactly get one close to a pure “size” effect), claiming the bulk of the Assets, and therefore growth generated in recent years:



ETFs providing “Factor”, or “Multi-Factor” solutions provide ready access to desired / desirable investment attributes, which over time have proven to produce a risk premia for investors. The challenge, or issue? Factors can be in, or out of favor, and could spend lengthy periods in the “underperforming” category, testing investors’ patience in the process. In addition, it isn’t inconceivable that factors with long track records of delivering a risk premia could, on occasion, become the object of “crowded trades” subsequently translating into – worse case scenario – subpar returns…

Caroline Escott and Yves Rebetez