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Manager interview: Has this man found the key to maximum diversification?

By **Shunil Roy-Chaudhuri** / 19 Jun, 2017 at 14:24

Yves Choueifaty, chief executive of Paris-based asset manager Tobam, believes in Harry Markowitz's formulation of modern portfolio theory. Markowitz showed portfolio returns could be boosted by holding combinations of assets that were not perfectly positively correlated. For Markowitz, an efficient portfolio is one where, for a given level of risk, no additional diversification can improve returns.

But Choueifaty does not agree with the subsequent theory, sometimes called mutual fund theorem, that the most efficient portfolios are market index portfolios or, as we call them today, index trackers. Instead, Tobam's fund range embodies his innovative ideas on effective diversification.

You are not seeking to outperform an index through alpha, as active fund managers do, nor are you tracking an index, as traditional passive funds do. You are not even trying to identify specific attractive passive factors, as smart beta funds seek to do.

Instead, you want to achieve a more effective, or a truer, means of diversification, which you describe as your maximum diversification approach. What is this more effective means of diversification?

In order to build a well-diversified portfolio, we try to build a portfolio composed of the stocks that are the least correlated as possible to one another. The idea is to avoid any bias.

We have mathematically proven our portfolio has the same exposure to all kinds of bias. By doing that we properly build an unbiased portfolio: the most diversified portfolio.

What sort of biases?

We are talking about any kind of biases. In order to imagine our portfolio you need to imagine a sphere. Our portfolios are truly unbiased, whatever way you look at them. From a style point of view, a sector point of view or any other points of view, you should not be able to identify bias.

My understanding of your 2008 paper in the Journal of Portfolio Management is you are seeking to maximise what you call the diversification ratio of your portfolios. Your paper suggests this happens when the average volatility of the individual stocks in the portfolio is significantly higher than the volatility of the portfolio as a whole. But how do you assess volatilities on a forward-looking basis?

We don’t look at the future. I am probably one of the rare portfolio managers in the world who lacks a crystal ball. If I had a crystal ball I would not diversify.

Most of the other managers claim they have a crystal ball. This is why they dare to be biased. We look at past correlations and past volatility. We are mostly driven by correlations.

Could you give me some examples of historic non-correlation and how you try to project that into the future?

Let's consider three well-known US stocks: Bank of America, Bank of New York and Boeing. I ask four questions about those stocks.

First, which one will have the highest performance in 2020? You don't know for sure. Second, which will have the highest volatility in 2020? You don't know. Third, what will be the correlation between Bank of America and Bank of New York in 2020? This you also don't know because correlations are unstable.

Fourth, among those three stocks, which two will be the most correlated stocks in 2020. You will probably feel comfortable telling me Bank of America and Bank of New York will be more correlated than Boeing and Bank of America. You will probably be right because, over the past 25 years, there has not been a single year in which Bank of America and Bank of New York has been less correlated than Bank of America and Boeing.

What I am saying is it is extremely likely Bank of America and Boeing will contribute to a more diversified portfolio than Bank of America and Bank of New York. This shows how stable the diversification characteristics of a portfolio are across time.

You seek true beta rather than the biased beta of the asset management industry. What is true beta?

A good way to understand what beta and alpha are is to say when you are insightful you have an alpha. If your insights are good you will have a positive alpha, and if your insights are bad you will have a negative alpha.

As soon as you build a biased portfolio you are an alpha provider, whether this alpha is positive or negative.

I often say I am the least insightful portfolio manager in the world. If I was insightful I would not diversify. But if I'm not insightful and if I'm building the most diversified portfolio, maybe I am the true beta provider.

In an article last year you said, on average, active managers could not beat the benchmark as they were the benchmark. By contrast, you have devised Tobam's anti-benchmark strategy. How do we judge the performance of your funds if there is no benchmark?

There are two ways to judge the performance of my fund: from an absolute point of view and from a relative point of view. From an absolute point of view, [you can] judge my performance by checking that I am effectively not driven by a small number of drivers.

If my fund's performance was mostly correlated to one sector I would not be diversified. If my fund's performance was correlated to only one style I would not be diversified. This will not happen as I run well-diversified portfolios.

From a relative point of view, [it is about beating] the benchmark and I have beaten the benchmark if you look at the past.

Why? Because the benchmark only allocates to what is fashionable, to what is already expensive.

By systematically doing that, the benchmark will generate a negative alpha when compared to a well-diversified portfolio.

What Tobam funds are available in the UK?

We have one main product: a Ucits Sicav. All its compartments are available for UK investors: from global equities to UK equities, and from US equities to Japanese equities, Canadian equities and European equities. We also have a fixed income range, including US credits and global high yield.

The Tobam Most Diversified Portfolio UK Equity Sicav sits towards the bottom end of our Citywire performance tables. Why is this?

If you look at our funds since inception, we have strong outperformance versus a market cap weighted benchmark. But across the past 12 or 24 months we have underperformed the benchmark.