

French boutique chief debunks three major investment myths

By Terri-Ann Williams 24 Aug, 2017

TOBAM's Yves Choueifaty delves into the most common investment misconceptions around smart beta and portfolio construction.

Debunking investment myths

The investment management industry relies on foundations and pillars which strongly influence beliefs and decision making. But how are investors influenced by the decisions they make, and how should investment professionals avoid being sucked in by the biggest investment myths around?

In this gallery, Yves Choueifaty, founder of anti-benchmark boutique TOBAM, debunks four investment myths which often catch investors out. Choueifaty highlights the common misconceptions in consensus thinking which are either flawed, or not well defined and can often lead to misunderstandings.

Myth 1: we know how to define 'efficiency'

Choueifaty said the term 'efficient' can be used in two different contexts – an efficient portfolio and an efficient market. 'An efficient portfolio is a portfolio that is close to the efficient frontier ex-post, meaning a portfolio, delivering a consistent level of returns given the level of risk.

'Whereas an 'efficient market' is a market in which all current and historic information, is taken into account in asset prices. In efficient markets, it is quite difficult to forecast the direction of a securities' prices in the future. Looking at the financial markets, if an investor believes that forecasting is difficult and expects ex-ante risk to be rewarded, then the most efficient portfolio for an investor to own is the non-diversifiable portfolio.'

However, Choueifaty said the issue with market cap-weighted benchmarks is not that markets are inefficient, but that investors should consider the issue the other way around. 'Markets are difficult to forecast, they are quite efficient. The real problem is the lack of diversification of market cap-weighted benchmarks.'

Myth 2: Look at your holdings

How do portfolio managers define exposure to risk? Choueifaty said the common response of ‘check your holdings’ is not the best solution.

‘To mitigate stock-specific risk, many investors choose to allocate portfolio holdings over as broad a selection of stocks as possible and/or simply keep portfolio allocations close to those of the market capitalisation benchmark. However, both practices may lead to overexposure to stock-specific risk factors.

‘If the investor wants to know how much his portfolio is exposed to oil price variations, he would first compute the portfolio’s correlations to the variations of the price of oil – instead of counting the barrels of oil in the portfolio.’

Choueifaty also said if an investor wants to know how much his portfolio is exposed to the variations in, for example, Toyota’s stock price, saying the portfolio holds 2.5% of its market share is just not enough.

‘Combining this 2.5% with the remaining 97.5% stocks – that are not correlated to Toyota – your portfolio’s exposure to Toyota is actually lower than if you held only 1% in Toyota, but the remaining 99% were highly correlated to Toyota.

‘The investor should instead calculate the correlation between his/her portfolio and Toyota. Generally, a portfolio’s true exposure to any given phenomena (or source of risk) is measured by the portfolio’s correlation to this source of risk, whether this source of risk is the price of oil, inflation... or the price of Toyota.’

Choueifaty said what matters is not the weight of a stock or a sector in the portfolio, but the portfolio’s correlation to the risk factor it presents.



Myth 3: Risk factor investing belongs to smart beta

In 2005 and 2006, a handful of pioneers in the asset management industry started a new initiative, later defined as the smart beta initiative. However, as time has

progressed, Choueifaty said a number of strategies have been launched under the 'smart beta' banner which actually vary in their ability to deliver 'pure beta'.

'One of the most notable changes has been the proliferation of 'factor-based' investment strategies in the space – leading to confusions and even contradictions. As such, we believe there is a fundamental contradiction in the following sentence: risk factor investing belongs to smart beta.

'Firstly, there is 'smart beta' probably because there is a 'dumb beta', and this must be the market cap weighted index. As a matter of fact, buying an approach that systematically consists into increasing one's exposure to a typical risk driver - the more expensive this risk driver gets everything else being equal - is 'smart' in only one case: if the investor believes for example in the case of the S&P 500 that the S&P 500 index will disappear and become the S&P1, meaning at the end of the day, concentration will win.'

In a second instance, Choueifaty said alpha is actually the result of insights. He said if a portfolio manager is rightfully insightful then his alpha will be positive. 'If he is wrong in his views his alpha will be negative. A portfolio manager that has the conviction that a specific risk driver will reward the risk better than another risk driver, will build a portfolio biased towards the first one, in order to take advantage of this insight.'



Going beyond smart beta

Building on the third myth, Choueifaty said smart beta investors capitalise on the fact that, even without proper investment insight, you can still build a portfolio that makes more sense than market-cap weighted beta. However, he said this is still not a worthwhile pursuit.

'A beta portfolio needs to be un-insightful, so as agnostic as possible. Factor investing involves targeting a particular factor tilt or set of factors such as value, low

volatility, or growth stocks for example. It is about taking advantage of risk reward heterogeneity. It is about being insightful.

'Risk factor investing relies on an ability to determine mispricing in that it consists into a capability to assess what is cheap and will become expensive. Hence why we question its belonging to the 'smart beta' movement. In fact, it is not about beta at all. It is alpha.'