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**Commentary: Debunking some of the biggest investment myths**

BY YVES CHOUEIFATY · OCTOBER 4, 2017 12:00 PM

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The investment management industry relies on foundations and pillars that strongly influence beliefs and decision-making. While some are robust and strongly defined, others are either flawed or not well-defined, which leads to misunderstandings. This is particularly important at a time where the industry is flooded with buzzwords and unreliable terminology, such as smart beta, factor investing and passive investment.

Misunderstandings about these terms are often triggered by a lack of clear definitions and can directly lead to material consequences in portfolio allocations. We discuss here some of these myths and their consequences.

**If you can't forecast, go passive**

There is a commonly held view that passive management — the tracking of market-capitalization-weighted indexes — is "neutral," that it provides a "neutral" and well-diversified access to the risk premium.

That is not the case.

Investing in a cap-weighted benchmark means buying a portfolio that is hugely biased and speculative. They attribute greater index representation to stocks or factors as they have appreciated and less after they became cheaper. These benchmarks inherently forecast that the successes of the past will be successes of the future.

This takes us to a second confusion, that of the "cheapness" of passive as opposed to active investment. Investing through market-cap-weighted benchmarks ultimately destroys value for investors, while emphasizing the speculative aspect of market pricing. While cheap in relation to fees, perhaps, passive investing is quite expensive in terms of portfolio efficiency.

Passive is a cheap way to buy expensive stocks.

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**Low tracking error equals low risk**

A second myth has it that tracking error is an accurate measure of risk. In this view, a low tracking error equals low risk, a high tracking error signals higher risk.

This is wrong.

Tracking error does not measure anything in absolute terms; it is exclusively a relative measure. Its interpretation depends necessarily on the basis of comparison. Tracking error cannot be interpreted as a proxy measure of risk, it does not even correlate to absolute risk.

Tracking error does not measure: economic capital risk; drawdown risk or specific risks (concentrations). It does not even give an indication of risk.

**Look at your holdings**

One additional myth suggests a portfolio's exposure to a risk driver can be judged simply by its allocation in terms of weights to a stock or sector. "Looking at your holdings" is not the solution.

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

Let us consider a Japanese stock portfolio and try to answer two simple questions about this portfolio.

**Question 1:** How much is the portfolio exposed to oil price variations?

In order to answer this question, an investor should not run to his desk and count the barrels of oil in the portfolio, the scientific answer to this question consists of computing the portfolio's correlation to the variations of the price of oil.

**Question 2:** How much is the portfolio exposed to Toyota?

Never answer "the portfolio holds 2.5% of Toyota." If the remaining 97.5% stocks 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. Never forget to wear your correlation glasses!

What matters is not the weight of a stock or a sector in the portfolio, but the portfolio's correlation to a risk driver, whether this driver is the price of oil, Toyota or any other driver.

**Risk-factor investing belongs to smart beta**

In 2005 and 2006, a handful of pioneers started an initiative, later defined as the smart beta initiative. Over time, an increasing number of strategies have been introduced under the "smart beta" banner that vary in their ability to deliver pure beta. One of the most notable changes has been the proliferation of factor-based investment strategies.

A beta portfolio is not about being insightful. The good news that smart beta brings is that even when you cannot forecast, even if you're not insightful, you still can build a portfolio that makes plenty of sense, more sense than the market-cap-weighted beta.

You can build a smart beta portfolio. From that point of view a beta portfolio needs to be uninsightful, as agnostic as possible.

Factor investing involves targeting a particular factor tilt or set (such as value, low volatility, or growth stocks for example). It is about taking advantage of risk-reward heterogeneity. It relies on an ability to determine mispricing, which would represent 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 about being insightful. It is about alpha. It provides a very good complement to smart beta, but cannot be assimilated to smart beta.

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**The role of active management is to beat the benchmark**

There is a commonly held, but deeply misguided perception that the average active manager does not represent value for money because they cannot beat a market-cap-weighted benchmark.

By definition the average active manager cannot outperform the benchmark because it is determined by the sum of activity carried out by both active and passive managers. And because passive managers have no impact on the benchmark — they merely follow it — it is, in fact, the sum of all the bets taken by active managers that determines the benchmark.

It is obvious hence that it is impossible for the average active manager to outperform (or underperform) the average active manager. The benchmark is, after all, the output of all the activities carried out by active managers.

The role of active managers as a group is not to outperform the index, but to drive that index and, therefore, the economy.

In conclusion, myths and misunderstandings persist in the asset management industry, and more education needs to be made to help investors understand the real meaning of various investment terms that continue to confuse and potentially lead to unintended negative consequences for their investments.

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