

# Riding Bubbles with Smart Beta

Stockholm (HedgeNordic) – During his recent visit to Stockholm, we spoke to Yves Choueifaty, founder and President of the French smart-beta manager TOBAM about a recent research the firm produced on the worrying concentrations in the current credit market.

TOBAM may sound to some people like an acronym resulting from a merger of a spin off, but far from it. It actually stands for “Think Out of the Box Asset Management”. Founded in 2005, TOBAM is an independent asset manager focused on enhancing risk-adjusted returns by maximizing diversification in their so-called “Anti-benchmark” strategy, in which they manage close to USD 9 billion. This base strategy is patented and as Choueifaty emphasizes, “we have been recognized as one of the pioneers of the smart beta trend”.

Choueifaty illustrates the general idea behind this strategy. “A market-cap weighted benchmark is not neutral,” he explains, “it is extremely biased. So, when they want to be neutral, investors tend to buy the benchmark, but the benchmark itself is not neutral.” He supports his argument by showing a graph, representing the US Equity market performance over the past 30 years. When did the tech sector weigh the most in the index? Just before the burst of the tech bubble of course. The same can be said for the oil crisis in the 80s for example. As Choueifaty puts it: “The more expensive a risk driver becomes, the more the index will allocate to that risk. By following the index, you will end up maximizing your allocation to any given factor on the worst day.”

“Smart beta,” says Choueifaty, “is an alternative to “dumb” beta. By definition, alpha comes from the insights investors have, from their ability to forecast. Smart beta beats the index without insights, by being more diversified than the market cap weighted index. To diversify, you don’t need to know how to forecast.”

How do we apply these principles to the credit market and why does it matter right now? In the global high yield corporate bond benchmarks, Choueifaty’s team has observed that concentrations on a risk-adjusted basis are very heavy in the Energy sector. As a consequence, the credit markets have become highly correlated with oil prices. Another worry TOBAM’s research highlights is that the dispersion of spreads is reaching historically low levels. In practice, investors have a harder time generating alpha from picking the right credits. They are therefore reaching out for yields by selecting credits with worse ratings for example. This comes to say that investors will decreasingly be compensated for increasing credit risk going forward. For TOBAM, the answer lies in the need for improving diversification within credit allocation. This does not mean that investors will avoid a declining market altogether, but they will avoid being over-exposed to the risk factors that will underperform the most, thereby beating their market benchmark.