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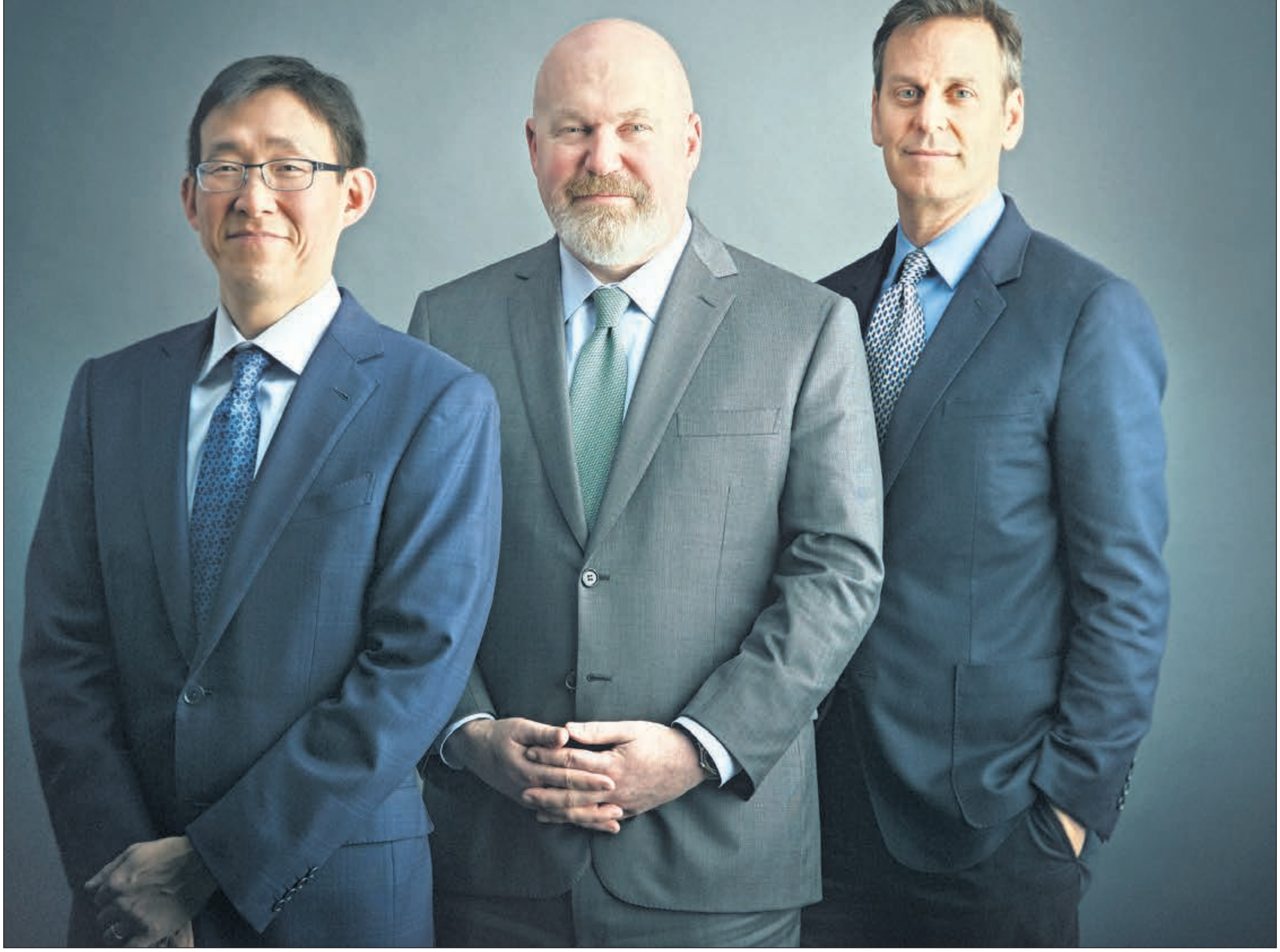
BRAINPOWER

John Liew, Cliff Asness, David Kabiller, and a team of high-powered Ph.Ds have built AQR into a $141 billion investment giant that gets impressive returns in good markets and bad.



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COVER STORY

AQR's academic research has led to some truly alternative funds.

Market Brainiacs

by Andrew Bary

Photography by Derek Dudek

Since U.S. stocks peaked in July, few investments have produced strong returns. Global stocks, junk bonds, and most commodities have declined—in many cases, sharply. And many so-called alternative investments have failed to provide hoped-for diversification benefits. Just look at the big losses suffered by some notable hedge funds.

The situation hasn't been much better among liquid alternatives, or mutual funds that use hedge fund strategies such as merger and convertible arbitrage, long/short equity, and trend-following in futures markets. Yet, against this tough backdrop, a bunch of academics are delivering. Their firm, AQR Capital Management (AQR stands for applied quantitative research), is a distinctive investment manager with $141 billion in assets that seeks to translate academic insights about finance and the markets—such as the appeal of value and momentum investing—into winning quantitative strategies for institutional and retail buyers.

Nearly all of AQR's liquid-alt mutual funds are in the black since late July, including the industry's largest fund, the $11 billion AQR Managed Futures Strategy (ticker: AQMIX), which is up 7% through mid-February, against an 11% drop in the Standard & Poor's 500 and a 16% decline in the MSCI World index over the same period. "This has been one of the periodic reminders of the benefits of diversification. There has been a view since the market bottom in 2009 that all you needed was the S&P 500 index," says David Kabiller, a founding principal of the 18-year-old firm,

From left: David Kabiller, Cliff Asness, and John Liew founded AQR 18 years ago to put their academic insights to the test. AQR's liquid alternative mutual funds are among the best available.

AQR and the Competition

AQR's liquid-alt funds, upper table, stack up well against six large rivals, lower table. During the past year, three AQR funds have double-digit gains, way ahead of the S&P 500.

Fund Name	Ticker	Assets (bil)	Returns* YTD	1-Year	3-Year	5-Year
AQR Managed Futures Strategy	AQMIX	$10.9	4.6%	3.5%	7.0%	4.2%
AQR Multi-Strategy Alternative	ASAIX	2.8	0.0	8.3	6.5	N/A
AQR Style Premia Alternative	QSPIX	2.6	0.9	15.5	N/A	N/A
AQR Long-Short Equity	QLEIX	0.7	-1.4	11.8	N/A	N/A
AQR Diversified Arbitrage	ADAIX	0.6	-1.5	-6.1	-3.5	-1.5
AQR Equity Market Neutral	QMNIX	0.5	1.7	17.5	N/A	N/A

Fund Name	Ticker	Assets (bil)	Returns* YTD	1-Year	3-Year	5-Year
JHancock Global Absolute Return Strategies	JHAIX	$9.1	-3.1%	-4.4%	2.1%	N/A
Gateway	GATEX	8.0	-3.0	-1.8	2.7	3.2%
Boston Partners Long/Short Research	BPIRX	6.8	-4.8	-4.5	5.4	6.4
Merger Investor	MERFX	4.4	-1.2	-3.2	1.1	1.4
Diamond Hill Long-Short	DIAMX	4.1	-4.8	-6.9	4.5	5.8
Blackstone Alternative Multi-Strategy	BXMIX	4.1	-4.4	-3.1	N/A	N/A

Note- Data as of 2/19/16. *3- and 5-year returns are annualized. N/A = Not Applicable. Source: Morningstar

based in Greenwich, Conn. The other two founding principals are Cliff Asness and John Liew.

Indeed, the stock market selloff since the start of this year has shaped up as a key test of whether liquid alts can deliver the promised diversification and protect investors during downturns. Liquid-alt funds have been rightly criticized for generally disappointing returns during the recent bull market—and high fees, to boot.

The performance of AQR's liquid-alt funds has been good so far this year, with most in the black and besting many big rival funds. "What has happened this year is a nice data point that we are doing what we say," says Asness. "I'm proud of what we've done, but I want to be intellectually honest. One data point doesn't prove a concept, and I look forward to proving it many more times."

AQR's staff of more than 600 boasts 52 Ph.Ds, including Asness, who was Eugene Fama's student and teaching assistant at the University of Chicago. Fama, a Nobel laureate and former student of Milton Friedman, is known as the father of efficient-markets theory. The AQR academics would stack up well against the finance faculty at major universities. This brainpower is harnessed to develop and execute quantitative strategies that can generate market-beating returns. "You would be surprised how much effort it takes to turn the academic into the practical. Making money for clients involves controlling costs, managing risk, and building real portfolios. Academic work is just the tip of the iceberg," says Liew.

AQR is the largest manager in the fragmented, growing, and controversial liquid-alt market. The firm had $17 billion in liquid-alt assets, plus a smattering of long-only strategies, with total fund assets of $23 billion at year-end 2015. It is the liquid-alt industry's biggest grower, with $7 billion of inflows since the start of 2015. The industry totals $170 billion, excluding go-anywhere, unconstrained bond funds.

"AQR is the clear leader in delivering alternative strategies to retail investors," says Morningstar analyst Jason Kephart. "It has developed strategies that move to their own beat and fulfill the promise of delivering uncorrelated returns that will diversify a traditional portfolio."

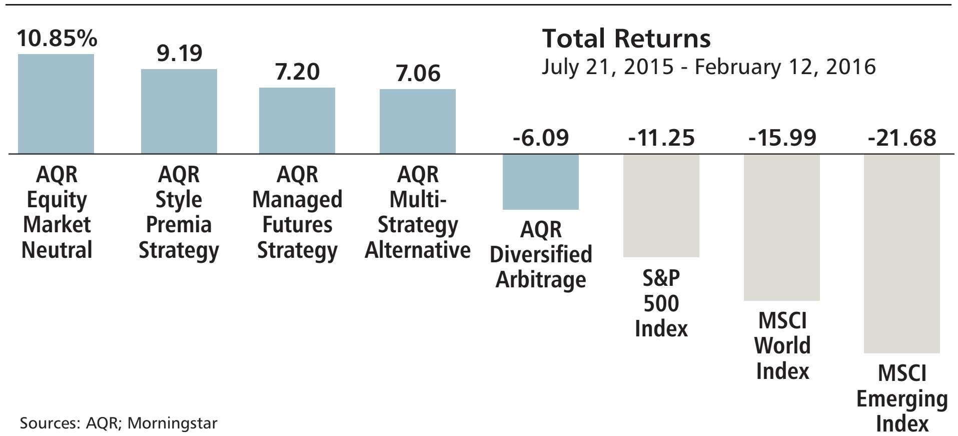
Affiliated Managers Group (AMG), which holds stakes in more than 30 investment managers, including Harding Loevner and Yacktman Asset Management, owns an undisclosed minority interest in AQR. The firm is among the largest and most successful managers in AMG's portfolio.

AQR manages a range of funds using different strategies across multiple asset classes—stocks, bonds, commodities, and currencies. It often uses futures, swaps, and other derivatives to implement its strategy. AQR has identified what it considers to be four winning investment styles—value, momentum, defensive, and what the firm calls carry. The last can involve currency-market trades, in particular shorting low-interest-rate currencies and buying currencies in countries with high inflation-adjusted yields. "Defensive" involves higher-quality investments. Momentum investing, or buying rising assets and shorting poor performers, is sometimes derided as a foolish mechanistic strategy, but AQR's research suggests that it's a winner. AQR's liquid-alt funds are similar to its institutional-investment strategies.

AQR's approach can be hard to understand. Because of this—and to deter hot money—the firm sells its liquid-alt funds almost entirely through financial advisors. Retail buyers can access the funds directly through fund supermarkets like Fidelity, but direct investments involve a minimum of $1 million. Investments through advisors and 401(k) plans have no minimum. AQR regularly brings groups of financial advisors to its headquarters for a daylong

Delivering Diversification

AQR's funds have done an admirable job of offering the diversification that buyers seek. All have been beating major world indexes since U.S. stocks peaked in July.



Sources: AQR; Morningstar

series of presentations that it calls AQR Symposium.

The extra education is useful given the complexity of its products. Among the wrinkles at AQR are what it calls high- and low-volatility versions of some funds, which use varying amounts of leverage. The liquid-alt pitch is that individuals can access the same types of investments as university endowments and other big institutions, to diversify equity-heavy portfolios, typically with a 10% to 20% allocation to liquid alts.

"AQR has replaced all-star guru managers with a systematic and consistent approach that we can deploy in client accounts with confidence," says Kevin Grimes, president of Grimes & Co., a Westborough, Mass., investment advisor. "It's almost an index fund of the alternatives space."

Grimes uses several AQR funds, including AQR Managed Futures Strategy, which seeks to ride trends in futures markets globally. "There are always trends, and having a piece of the portfolio in managed futures makes some sense," he says.

One problem with many futures funds is high fees. Grimes says some rivals, including expensive funds of funds, charge two or three times as much as AQR.

On the equity side, AQR constructs portfolios containing up to 1,700 global stocks selected by computer models, based on an array of financial measures. Among others, they include price/earnings ratio, price/book, balance-sheet strength, and stock-price momentum. The firm has no fundamental-research analysts, doesn't look at Wall Street research, and never talks to corporate management. It's an approach that differs markedly from most big-name hedge funds, such as David Einhorn's Greenlight Capital, Bill Ackman's Pershing Square Capital Management, and Third Point, managed by Dan Loeb. These funds are best known for large, "high conviction" stakes in a small number of companies.

"We have high conviction in the process, but not high conviction in any particular stock," says Jacques Friedman, the head of AQR's equity investment group.

The ideal AQR equity is a cheap, high-quality stock with strong price momentum, and a preferred short is an expensive, low-quality stock with a poor chart. The challenge, of course, is to find these securities and to do so in a systematic way.

Another differentiator is trading—and the patience behind it. AQR spends tens of millions of dollars a year on its technology, the centerpiece of which is a sophisticated electronic trading system designed to navigate stock markets dominated by high-frequency traders. The firm is willing to wait for its price to establish a position, rather than chase markets. With so many investments, AQR would rather pass on an individual security than get it at a bad price. It will buy another, instead, that matches its criteria at a better price.

Asness, Kabiller, Liew, and others founded AQR in 1998. A decade later, the firm launched a group of mutual funds using the same strategies it was employing for institutional clients. Asness calls AQR "a global institutional manager that happens to do liquid alts."

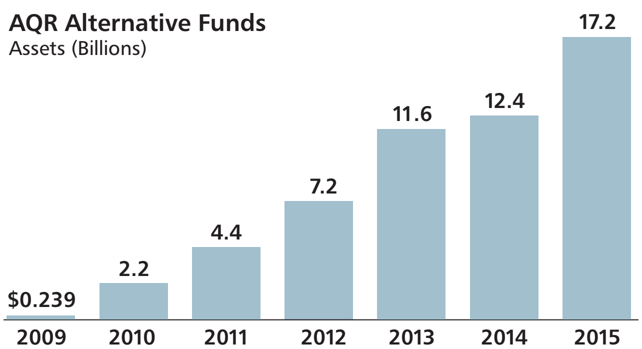
Outsiders say the firm is excellent at marketing and product development. It hired a finance professor from Harvard Business School, Gregor Andrade, more than a decade ago and rather than place him in portfolio management, where many finance academics end up, put him in sales. Asness and his team rightly thought an articulate finance professor would do better than a slick marketer, and strengthen the firm's international sales efforts.

The AQR Managed Futures Strategy seeks to latch on to trends—both up and down—in over 100 markets around the world, in four asset classes: stocks, bonds, commodities, and currencies. "Put simply, we're looking for markets going from good to great, or bad to worse," says Yao Hua Ooi, one of the fund managers.

The advantage of the strategy, he says, is that it is uncorrelated with other asset classes, and "has the most consistently strong performance in equity bear markets." That is when diversification matters most, as was the case in the third quarter of last year and the early part of this year.

Steady Asset Growth

AQR introduced its first liquid-alternative mutual funds in 2008. In seven years, the firm has grown into the largest player.



Source: AQR

In keeping with its academic tendencies, AQR published a paper in late 2014, "A Century of Evidence on Trend-Following Investing," which found that a trend-timing strategy had "strong positive returns and realized a low correlation to traditional asset classes" dating back to 1880. While noting the long-term appeal of trend-following, AQR acknowledged in the paper that the strategy hasn't had such strong returns since 2008, perhaps due to the large amount of money chasing the strategy, as well as choppier markets.

Reflecting what Asness would call intellectual honesty, AQR stated that these factors raise "questions regarding the future outlook of the strategy." Managed futures strategies work best when there are strong trends; volatile markets are tough. The five-year annualized return of AQR Managed Futures Strategyis OK, not great, at 4.2%. Last year, the fund was helped by the long downward trend in oil but hurt by choppy U.S. equity markets. The fund was up 4.6% in 2016 through Feb. 19, according to Morningstar.

The firm's next-largest funds, the $2.8 billion AQR Multi-Strategy Alternative (ASAIX) and the $2.6 billion AQR Style Premia Alternative (QSPIX) were flat and up 0.9%, respectively, in the same period, according to Morningstar.

The firm's smaller equity-only funds—AQR Equity Market Neutral (QMNIX) and AQR Long-Short Equity (QLEIX)—have had excellent performance in the past year, with gains of 17.5% and 11.8% respectively, versus a 9% drop for the S&P 500. It is hard to find many sizable equity-oriented hedge funds with similar performance.

Not everything is working. The AQR Diversified Arbitrage fund (ADAIX) is off 1.5% in 2016 and has negative annualized returns of 1.5% over the past five years. That fund uses several strategies, including merger arbitrage, convertible arbitrage, and so-called event-driven strategies such as corporate spinoffs.

Asness is a critic of the hedge fund industry, arguing that "they don't hedge enough and they charge too much." With its liquid-alternative mutual funds, AQR believes it has addressed the issue by constructing diversified portfolios, often with an equal number of longs and shorts that have low, zero, or negative correlations with the stock market. It also charges reasonable fees, at least relative to other liquid-alt managers and most hedge funds. There are no incentive fees or sales charges. The retail class of the AQR Managed Futures Strategy fund charges 1.5% annually, and the AQR Multi-Strategy fund, 2.2%, better than the 2-and-20 structure–2% fees and 20% of profits–of many hedge funds.

Asness also is active in politics. He is a supporter of Sen. Marco Rubio, and has a lively Twitter account (@Cimmerian999) in which he has taken on Republican presidential front-runner Donald Trump, calling out what he says are Trump's "fascist promises of greatness." He recently teased Trump, tweeting, "I wish I had Trump-level accomplishments. I'm still stuck on wife 1, bankruptcy 0, political philosophy 1, and hair God gave me."

AQR has garnered what amounts to high praise from Vanguard Group's founder and indexing champion Jack Bogle, who has said that when it comes to hedge funds, "AQR's strategy is the one I hate the least." Bogle, now 86, developed and championed Vanguard's low-fee equity index funds that have exploded in popularity and put pressure on traditional actively managed mutual funds.

AQR and other liquid-alt managers face a potential problem if the Securities and Exchange Commission decides to implement recently proposed rules that would limit leverage in mutual funds. Most of AQR's liquid-alternative funds have offsetting long and short positions. To enhance returns, the firm uses financial leverage that could be curbed by the SEC. "We absolutely can live with it, but it wouldn't be optimal," Asness says. "It would make it a little harder for us and a little worse for clients."

The risk level in some funds might have to be dialed back, damping potential returns.

Asness and other AQR executives stress that the proposal is merely that. Industry comments are due in about a month, and firms that run liquid-alt funds are apt to argue that the proposed rules would hinder funds designed to provide diversification benefits to investors. A new SEC rule could be a year or more away, and it's unclear what form it will take.

The AQR Multi-Strategy fund offers exposure to nine hedge fund strategies, including convertible-bond arbitrage, long/short equity, fixed-income relative value, managed futures, and global macro. The AQR Style Premia Alternative fund uses the four key investment characteristics–value, momentum, defensive, and carry–across stocks, bonds, commodities, and currencies.

Both funds have seen strong performance since the stock market peaked in July, and in the past 12 months. The Multi-Strategy fund and Style Premia funds are up an impressive 8.3% and 15.5%, respectively, in the past year, making them the top performers among the 20 largest liquid-alt funds.

Morningstar's Kephart says AQR funds have low correlations with financial markets, but higher correlations with one another since there often are overlapping strategies in various AQR funds. "You wouldn't want an alternatives portfolio of just AQR funds," he says. "They tend to do well or poorly at the same time."

The AQR Multi-Strategy Alternative fund has a "soft close," and the AQR Style Premia will move to a soft close on March 31, although new investors will be allowed into the funds as long as their advisor has been on the AQR platform.

Reflecting the quirky nature of AQR, the firm hosted a lunchtime lecture for employees earlier this year by Toby Moskowitz, a University of Chicago finance professor and author who "contributes to research on asset pricing and investment issues related to domestic and international strategies," AQR says.

The lecture topic: "How Luck Fools Investors, Baseball Umpires, Asylum Judges, and Even Dating." Among the perceptions that Moskowitz sought to debunk was the idea of a "hot hand" in basketball. The odds of a player making a basket in a game have more to do with his season-long shooting percentage than whether he has made or missed several shots in a row, he said. Likewise, he dismissed the idea that hot teams in the National Football League with strong late-season records do better in the playoffs. A better guide to playoff success is a team's full-season record, his research demonstrated.

The lecture touched on what AQR is good at–separating perception from reality via statistical analysis. That same approach is paying off with its investments.

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An investment in these Funds involves risk, including loss of principal. The Funds are not suitable for all investors.

The use of derivatives, forward and futures contracts, and commodities exposes the Funds to additional risks including increased volatility, lack of liquidity, and possible losses greater than the Fund's initial investment as well as increased transaction costs. Concentration generally will lead to greater price volatility. These Funds enters into a short sale by selling a security it has borrowed. If the market price of a security increases after the Fund borrows the security, the Fund will suffer a potentially unlimited loss when it replaces the borrowed security at the higher *price. Short sales also involve transaction and other costs that will reduce potential Fund gains and increase potential Fund losses. These Funds may not be a non-diversified fund. Because a fund may invest in securities of smaller numbers of issuers, a Fund may be more exposed to the risks associated with and developments affecting an individual issuer than a fund that invests more widely, which may, therefore, have a greater impact on the Fund's Performance.*

The AQR Diversified Arbitrage Fund seeks long-term absolute positive returns. The AQR Equity Market Neutral Fund seeks positive absolute returns. The AQR Long-Short Equity Fund seeks capital appreciation. The AQR Managed Futures Strategy Fund seeks positive absolute returns. The AQR Style Premia Alternative Fund seeks positive absolute returns. The AQR Multi-Strategy Alternative Fund seeks positive absolute returns.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please call +1.866.290.2688 or visit www.aqrfunds.com to view or download a prospectus online. Read the prospectus carefully before you invest. There are risks involved with investing including the possible loss of principal. Past performance does not guarantee future results. AQR Funds are distributed by ALPS Distributors, Inc. [AQR005124 Exp: 6/30/2017]

Performance Summary 6/30/2016	**Ticker**	**Quarter**	**YTD**	**1Yr**	**3Yr**	**5yr**	**Ann Since Inc**	**Inception Date**
AQR Diversified Arbitrage Fund	ADAIX	0.99%	0.11%	-4.67%	-3.16%	-1.01%	1.24%	1/16/2009
Merrill Lynch 3 Month T-Bill Index		0.07%	0.15%	0.19%	0.09%	0.09%	0.12%	
AQR Equity Market Neutral Fund	QMNIX	-1.71%	0.26%	12.94%			13.70%	10/7/2014
Merrill Lynch 3 Month T-Bill Index		0.07%	0.15%	0.19%			0.12%	
AQR Long-Short Equity Fund	QLEIX	-1.28%	1.73%	14.03%			15.22%	7/16/2013
(0.5 * MSCI WORLD) plus (0.5 * T Bills)		0.54%	0.51%	-1.04%			2.87%	
AQR Managed Futures Strategy Fund	AQMIX	1.76%	2.16%	4.69%	6.55%	4.62%	3.77%	1/5/2010
Merrill Lynch 3 Month T-Bill Index		0.07%	0.15%	0.19%	0.09%	0.09%	0.10%	
AQR Style Premia Alternative Fund	QSPIX	0.00%	-0.39%	9.89%			8.89%	10/31/2013
Merrill Lynch 3 Month T-Bill Index		0.07%	0.15%	0.19%			0.09%	
AQR Multi-Strategy Alternative Fund	ASAIX	-1.76%	-2.66%	6.02%	5.19%		3.55%	7/18/2011
Merrill Lynch 3 Month T-Bill Index		0.07%	0.15%	0.19%	0.09%		0.09%	

As of the latest Prospectus, the gross expense ratios for the Class I shares of ADAIX, QMNIX, QLEIX, AQMIX, QSPIX, and ASAIX, are expected to be 2.58%, 2.22%, 1.91%, 1.22%, 2.35%, and 2.46%, respectively. The performance data quoted represents past performance. Past performance does not guarantee future results. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Call 1-866-290-2688 or visit www.aqrfunds.com for current month-end performance. The Merrill Lynch 3-Month Treasury Bill Index consists of U.S. Treasury Bills maturing in 90 days

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